

MEMO# 11121

July 16, 1999

INSTITUTE COMMENTS ON PROPOSED RULE 17F-7 RELATING TO THE USE OF FOREIGN SECURITIES DEPOSITORIES

1 SEC Release No. IC-23815 (April 29, 1999). 2 Proposed rule 17f-7 requires funds to satisfy one of two risk-limiting conditions. The first would require the fund to obtain insurance or indemnification that would adequately protect the fund against losses attributable to custody risks. The second would require the fund's global custodian to prepare a risk analysis, among other things, relating to the depository. [11121] July 16, 1999 TO: INTERNATIONAL COMMITTEE No. 31-99 SEC RULES COMMITTEE No. 53-99 SECURITIES OPERATIONS COMMITTEE/CUSTODIANS ADVISORY GROUP RULE 17f-5 WORKING GROUP RE: INSTITUTE COMMENTS ON PROPOSED RULE 17f-7 RELATING TO THE USE OF FOREIGN SECURITIES DEPOSITORIES

The Institute submitted the attached comment letter to the Securities and Exchange Commission responding to the Commission's proposed amendments to rule 17f-5 under the Investment Company Act of 1940 and proposed new rule 17f-7 under the Act.¹ Together, the Commission's proposals would address the custody of investment company assets outside the US. More specifically, proposed rule 17f-7 would establish standards governing the maintenance of an investment company's assets with a foreign securities depository. In its letter, the Institute supported significant aspects of the Commission's proposal, such as the use of objective criteria to determine the eligibility of a depository and the elimination of the reasonable care standard with respect to securities depositories. However, the letter expressed the Institute's continued belief that the proposal jointly submitted by the Institute and the Association of Global Custodians in June, 1998 (and amended in February, 1999) is preferable to proposed rule 17f-7. The letter also expressed the general concern that the "risk-limiting conditions" included in proposed rule 17f-7 would inappropriately seek to regulate an investment company's investment decision-making process.² Because the Commission may adopt the risk-limiting conditions in proposed rule 17f-7 despite the Institute's concerns, the letter made certain specific recommendations for modifications and clarifications to the proposed rule. The Institute's principal comments in this regard are summarized below. Transfer Agents and the Definition of Eligible Securities Depository. The Institute commented that transfer agents should not be included in the definition of Eligible Securities Depository under proposed rule 17f-7(b)(1). The Institute expressed concern that inclusion of transfer agents in that definition could create confusion and may lead to an overly burdensome application of the rule. The letter suggested that it would be more appropriate to address those rare situations when a fund needs approval to use a transfer agent that performs custodial functions on a case-by-case basis. The Insurance or Indemnification Alternative. The Institute made several comments on the alternative

relating to insurance or indemnification. The Institute did not object to the concept of insurance as a safeguard, but expressed concern that this alternative could create an implication that a fund must insulate shareholders against losses in connection with the use of a foreign securities depository in all instances. In this regard, the letter urged the Commission to clarify that the proposed alternatives are separate and discrete from each other in all respects and, thus, the “guarantee” provided under the first alternative should not be read as creating a new standard of liability under the second alternative. The Institute also recommended that the proposal be modified so that it would not require a fund to obtain protection against “all” losses attributable to the custody risks of using a foreign securities depository, and recommended that the Commission provide guidance in the adopting release as to what would be deemed “adequate” insurance or indemnification coverage, as that term is used in proposed rule 17f-7(a)(1). The Risk Analysis Alternative. The Institute made two specific comments on the risk analysis alternative. First, the letter expressed the strong belief that the rule should not enumerate specific topics that the risk analysis would have to cover. The Institute cited the need for flexibility in preparing the analysis and the risk that enumerated factors could be misinterpreted as requiring a fund or its adviser to make a separate custody risk determination based on those factors. Second, the Institute asked for the Commission to concur in the view that proposed rule 17f-7 would not require a separate determination on depository risk as a prerequisite to making a decision to invest in a particular country. In other words, proposed rule 17f-7 should not prohibit a fund from investing in any foreign country with an Eligible Securities Depository, even if the fund's custodian reports that there may be significant risks associated with maintaining assets with that Eligible Securities Depository. Transition Period. The Institute urged the Commission to set a compliance date for rule 17f-7 that provides sufficient time for funds to comply with the new requirements in the proposed rule, and recommended that the compliance date be one year from the effective date of the rule. Robert C. Grohowski Assistant Counsel Attachment