

**MEMO# 14181**

November 26, 2001

## **SEC PROPOSES RULE AMENDMENTS RELATING TO SECURITIES DEPOSITORIES**

[14181] November 26, 2001 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 22-01 COMPLIANCE ADVISORY COMMITTEE No. 60-01 SEC RULES COMMITTEE No. 95-01 TRANSFER AGENT ADVISORY COMMITTEE No. 95-01 UNIT INVESTMENT TRUST COMMITTEE No. 27-01 RE: SEC PROPOSES RULE AMENDMENTS RELATING TO SECURITIES DEPOSITORIES

The Securities and Exchange Commission (the "Commission") recently proposed amendments to Rule 17f-4 of the Investment Company Act of 1940, the rule that governs investment companies' use of securities depositories.\* According to the Proposing Release, the amendments would update and simplify the rule to reflect the developments in securities depository practices and commercial law that have occurred over the years. Specifically, they would expand the types of investment companies that can maintain assets with a depository, expand the types of depositories they can use, and update the conditions they must follow to use a depository. The amendments also would eliminate unnecessary custodial compliance requirements, including the requirements that fund directors approve the fund's custody arrangements and fund approval of its custodian's depository arrangements. A copy of the Proposing Release is attached, and it is summarized below. Comments are due to the Commission by January 31, 2002. A conference call to discuss the proposal has been scheduled for December 11, 2001 at 2:00 p.m. (EST). If you would like to participate on the call, please notify Deborah Washington by sending an email to [deborah@ici.org](mailto:deborah@ici.org) that includes your name, firm, telephone number, and email address. If you are unable to participate on the call, please provide any comments you may have to Marguerite Bateman at 202/326-5813 (phone), 202/326-5827 (fax), or [bateman@ici.org](mailto:bateman@ici.org) (email), no later than December 10, 2001. Expansion of the Rule to Include Transfer Agents Currently, Rule 17f-4 permits funds to maintain assets with a depository established by a registered clearing agency, such as DTC, and the book-entry system of the Federal Reserve. The amendments would expand the scope of the rule to permit funds to maintain assets with a registered transfer agent for the purpose of holding shares of an open-end management \* Investment Company Act Release No. 25266 (Nov. 15, 2001) ("Proposing Release"). The Proposing Release also is available from the SEC's website at [www.sec.gov/rules/proposed/ic-25266.htm](http://www.sec.gov/rules/proposed/ic-25266.htm). 2 investment company. This change recognizes that transfer agents may serve as the functional equivalent of a depository, and responds to the growth in "fund of funds," the use of cash sweep accounts and other arrangements in which a registered investment company invests in mutual fund shares. The Commission requests comment on the expanded scope of the rule. Comment also is requested on whether the rule should be expanded to include other organizations that serve as depositories for funds. Expansion of the Rule to Include Non-Management Companies At present, only registered management investment companies, i.e., open-end funds and closed-end funds, may rely on Rule 17f-4. The proposed amendments would

expand the rule to permit unit investment trusts and face-amount certificate companies to use securities depositories. The SEC staff has previously granted no-action relief to non-management companies seeking to maintain assets in a depository to supplement custody arrangements with a trustee. Accordingly, the Commission's proposal would require the trustee of such non-management entities to approve these arrangements and establish an internal control system reasonably designed to prevent unauthorized officer's instructions. The Commission requests comment on the proposed use of depositories by non-management companies. The Commission also requests comment on the proposed conditions, and whether any additional conditions should apply.

**Proposed Amendments to the Compliance Requirements** The Proposing Release notes that recent revisions to Article 8 of the Uniform Commercial Code have rendered certain requirements of Rule 17f-4 unnecessary for the protection of fund assets. As a result, the proposed amendments would replace the segregation and earmarking, confirmation and successor custodian requirements with more general compliance requirements for custodians and depositories designed to provide reasonable protection for fund assets under modern commercial law. First, the fund's contract with its custodian would be required to provide that the custodian will take all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard assets held by the custodian, or assets maintained elsewhere for the benefit of the fund. If a fund deals directly with a depository, the contract or rules for participants must provide the depository will meet similar obligations. Second, the custody contract (or depository rules) must state that the custodian (or depository) will promptly provide the fund with periodic reports on its internal accounting controls and financial strength, and any available reports on the controls of any depository or intermediary custodian it uses. The Commission requests comment on these proposed contractual requirements. Specifically, the Commission requests comment on whether the rule should specify the duties applicable under particular circumstances, or whether it should clarify that custody contracts should not generally waive duties under commercial law. In addition, the Commission questions whether it is appropriate to require reports about the custodian's financial strength, whether reports on the subcustodian's internal controls are necessary and whether other requirements should apply to custodians or depositories. Finally, comment is sought on whether the amendments should provide a transition provision that would apply the current 3 requirements of the rule to any custody arrangement that remains subject to Article 8 before it was revised.

**Proposed Elimination of Board Approval Requirements** The Proposing Release notes that, since custody arrangements involving depositories have become largely routine, approval of such arrangements by directors appears unnecessary. The proposed amendments, therefore, would permit the fund itself (through an officer) to approve arrangements with depositories and with custodians that use depositories. The Proposing Release clarifies, however, that directors should continue to monitor the fund's dealings with its own custodian. The Commission requests comment on these proposals. Specifically, the Commission seeks comment on whether the fund or its directors should approve any arrangement in which the custodian maintains certificates in the fund's name with a centralized processing facility or maintains fund shares with a transfer agent that acts as a depository. The Commission also seeks comment on whether a fund's board should approve any direct dealings with a depository.

**Proposed Inclusion of Note on Applicability of Rule 17f-4 to Foreign Custodial Arrangements** The proposed amendments would add a note to Rule 17f-4 to clarify the rule's relationship to Rule 17f-5, which governs the maintenance of fund assets with a foreign custodian. The Proposing Release states that, if fund assets are held with a U.S. depository through a foreign custodian, this custody arrangement would be governed by both rules.

**General Request for Comment** In addition to comments on the rule amendments in the Proposing Release, the Commission requests suggestions for additional changes to existing rules or forms and

comments on other matters that may impact these proposals. The Commission specifically requests comment on whether the failure to apply Rules 17f-5 and 17f-7 to domestic depositories would create an unfair burden on competition between domestic depositories and global custodians of funds. Marguerite C. Bateman Associate Counsel Attachment (in .pdf format)

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