

MEMO# 14429

February 5, 2002

INSTITUTE COMMENT LETTER ON SEC RULE AMENDMENTS RELATING TO FUNDS' USE OF SECURITIES DEPOSITORIES

[14429] February 5, 2002 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 8-02 COMPLIANCE ADVISORY COMMITTEE No. 12-02 SEC RULES COMMITTEE No. 15-02 TRANSFER AGENT ADVISORY COMMITTEE No. 9-02 UNIT INVESTMENT TRUST COMMITTEE No. 6-02 RE: INSTITUTE COMMENT LETTER ON SEC RULE AMENDMENTS RELATING TO FUNDS' USE OF SECURITIES DEPOSITORIES As we previously informed you, the Securities and Exchange Commission recently proposed amendments to Rule 17f-4 under the Investment Company Act of 1940 that would update the conditions funds and their custodians must follow to use a depository, expand the types of depositories they can use, and expand the types of investment companies that can maintain assets with a depository.¹ The amendments also would eliminate unnecessary custodial compliance requirements. The Institute recently filed the attached comment letter on the proposed amendments with the Commission. In its letter, the Institute generally supports the goal of the proposals, which is to modernize and simplify the regulatory regime relating to funds' use of securities depositories. We also applaud efforts by the Commission to conform Rule 17f-4 to Revised Article 8 of the Uniform Commercial Code. Accordingly, the Institute's letter supports a number of the proposed amendments focused on these aspects of the rule. However, the Institute's letter questions the need for or the approach suggested by certain other of the proposed amendments. In summary, the Institute's letter made the following comments:

- The approach taken in proposed Rule 17f-4 does not fully accomplish its goal of reflecting the nature of the indirect holding system established under Revised Article 8. Therefore, the Institute recommends that the rule be revised further.
- The letter recommends that an amended Rule 17f-4 should recognize that, by reason of Revised Article 8, a custodian's use of securities depositories or other securities intermediaries is a means by which the custodian obtains and maintains its own

¹ See Memorandum 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, and Unit Investment Trust Committee No. 27-01, dated November 26, 2001.

² financial assets in order to perform its duty under the UCC to support the "security entitlements" that it establishes for its fund customers, not a means to re-deposit fund assets with a third party.

- Consequently, the letter recommends that Rule 17f-4 be amended to establish minimum standards of performance for the discharge by custodians of the duties that are imposed on them with respect to the maintenance of their own financial assets with securities depositories and other securities intermediaries.
- The letter

supports the elimination of the requirement for board approval of arrangements with securities depositories and the elimination of obsolete requirements currently included in the rule, such as the segregation and successor custodian requirements. • The letter supports revisions that would clarify the ability of funds to hold shares of other mutual funds through a custodian (i.e., indirectly) or directly (i.e., to self-custody those shares), but recommends that provisions relating to funds that hold directly be included in Rule 17f-2, rather than in Rule 17f-4. • The letter opposes the proposed characterization of transfer agents as securities depositories for purposes of Rule 17f-4. Revised Article 8 clarifies that when funds or their custodians hold shares of other funds by becoming the registered owner on the books of the issuer or its transfer agent, they hold “directly” rather than in an indirect holding arrangement such as exists when they hold through a securities depository. • The letter supports the requirement that funds be entitled to obtain such periodic reports concerning the internal accounting controls and financial strength of their own custodians as they may request, as well as available reports for any securities depositories with which funds directly maintain accounts. • The letter supports the expansion of Rule 17f-4 to permit the use of securities depositories by non-management investment companies. • The letter opposes the application of Rules 17f-5 and 17f-7 to domestic depositories as an unnecessary burden that would offer no discernible benefits to fund shareholders.

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