

MEMO# 11879

May 16, 2000

SEC ADOPTS NEW RULE 17F-7 AND AMENDMENTS TO RULE 17F-5 UNDER THE INVESTMENT COMPANY ACT

1 SEC Release No. IC-24424 (April 27, 2000) (the "Release"). A copy may also be obtained from the SEC's website at www.sec.gov. 2 SEC Release No. IC-23815 (April 29, 1999). The ICI/Bank Proposal recommended that Rule 17f-5 be amended to provide that the foreign custody manager's ("FCM") duty to make a reasonable care determination with respect to a securities depository would be deemed satisfied if the FCM determines that the depository meets eight objective criteria and the FCM has no actual knowledge of information that would indicate that the depository is not in compliance with the basic safekeeping standards applicable in the relevant market. 3 See SEC Release Nos. IC-23201 (May 21, 1998) (extending compliance date to February 1, 1999), IC-23670 (January (continued...)) [11879] May 16, 2000 TO: DIRECTOR SERVICES COMMITTEE No. 9-00 RE: SEC ADOPTS NEW RULE 17f-7 AND AMENDMENTS TO RULE 17f-5 UNDER THE INVESTMENT COMPANY ACT

The Securities and Exchange Commission has adopted new Rule 17f-7 and amendments to Rule 17f-5 under the Investment Company Act of 1940.¹ Together, these rules address the custody of investment company assets outside the United States. The Release, a copy of which is attached, is briefly summarized below. It includes a footnote specifically addressing boards' responsibility for the day-to-day decisions regarding foreign depository arrangements and their ability to delegate that responsibility. Background The adoption of new Rule 17f-7 and the amendments to Rule 17f-5 follows nearly three years of evaluating different approaches for a rule to govern the custody of fund assets with securities depositories outside the United States. Shortly after the Commission adopted amendments to Rule 17f-5 in 1997 (the "1997 Amendments"), it was determined that some of the new requirements may present problems when a foreign custody arrangement involves the selection of a foreign depository. To address these problems, the Institute and the Association of Global Custodians jointly submitted a proposal to the Commission in June 1998 (the "ICI/Bank Proposal"), which was later revised and resubmitted in response to specific concerns expressed by Commission staff. In April 1999 the Commission proposed further amendments to Rule 17f-5 and a new Rule 17f-7 under the Act (the "17f-5/17f-7 Rule Proposal"), which reflected an approach different than the one recommended in the ICI/Bank Proposal.² Throughout this period, the compliance date for the 1997 Amendments was repeatedly extended.³ (...continued) 28, 1999) (extending compliance date to May 1, 1999), and IC-23814 (April 29, 1999) (extending compliance date to May 1, 2000). 4 The rule defines a primary custodian (often referred to as a "global custodian") as a U.S. bank or qualified foreign bank (as defined in Rule 17f-5) that contracts directly with the fund to provide custodial services for foreign assets. 5 As proposed, Rule 17f-7 would have

permitted a fund to rely on indemnification or insurance that adequately protects the fund from all custody risks of using the depository, as an alternative to the risk analysis requirement. In (continued...) 2 New Rule 17f-7 New Rule 17f-7 under the Investment Company Act permits a fund to maintain assets with a foreign securities depository if certain conditions are met. First, the depository must be an "eligible securities depository," as defined in the rule and described below. Second, the fund's "primary custodian"⁴ must provide the fund or its adviser with an analysis of the custodial risks of using the depository, monitor the depository on a continuing basis and notify the fund of any material changes in risks associated with using the depository. Each of these requirements is described below.

Eligible Securities Depository. Under Rule 17f-7, an eligible securities depository must:

- Act as or operate a system for the central handling of securities that is regulated by a foreign financial regulatory authority;
- Hold assets on behalf of the fund under safekeeping conditions no less favorable than those that apply to other participants;
- Maintain records that identify the assets of participants, and keep its own assets separated from the assets of participants;
- Provide periodic reports to participants; and
- Undergo periodic examination by regulatory authorities or independent accountants.

As recommended by the Institute and others, the definition of eligible securities depository does not include certain foreign transfer agents, as proposed. Consistent with our recommendation, the Commission has determined that it would be more appropriate to address on a case-by-case basis those rare situations when a fund needs approval to use a transfer agent that performs custodial functions.

Risk Analysis, Monitoring and Notification. The risk analysis requirement is broadly written to provide custodians with flexibility to tailor the risk analysis to the specific risks involved in the use of each depository. As recommended by the Institute, the rule does not specify factors that should be included in a depository risk assessment. The Release states that the Commission would expect an analysis to cover a depository's expertise and market reputation, the quality of its services, its financial strength, any insurance or indemnification arrangements,⁵ the extent and quality of regulation and independent examination of the (...continued) light of the issues relating to this proposal raised by the Institute and other commenters and the likelihood that funds would not use it, the Commission decided not to adopt it. ⁶ Release at p.11. A footnote accompanying the text states that, "These standards generally require the exercise of care, but do not set limits on the risks that a fund or its adviser may find acceptable for the fund's depository arrangements." Release at n.28. ⁷ Release at n.27. ⁸

The Release states that compliance with the 1997 Amendments will become moot when amended Rule 17f-5 and new Rule 17f-7 take effect. Therefore, the SEC has extended the compliance date of the 1997 Amendments to the June 12, 2000 effective date for the Rule 17f-5 amendments and new Rule 17f-7. ³

depository, its standing in published ratings, its internal controls and other procedures for safeguarding investments, and any related legal proceedings. As requested by the Institute, the Commission clarified in the Release that Rule 17f-7 does not require a separate determination on depository risk as a prerequisite to making a decision to invest in a particular country, rather the determination may be made in the overall context of that investment decision. The Release further states that, "The decision whether to place fund assets with a depository should be made by the adviser (subject to oversight of the fund's board) or the fund, after consideration of the information provided by the primary custodian or its agent, and based on standards of care that are generally applicable to fund advisers and directors."⁶ The Commission acknowledges in the Release that fund boards do not typically have the expertise to make day-to-day decisions regarding foreign depository arrangements.⁷ The Commission assumes that a fund board would delegate these responsibilities to the fund's adviser, subject to the board's general oversight, even though the rule does not require delegation. When custodial risks are a material factor in the decision to enter or exit a market, the Commission would expect the

adviser to inform the board of the risks based on information provided by the primary custodian or its agent. Exercise of Care. Rule 17f-7 requires the fund's contract with its primary custodian to provide that the primary custodian will agree to exercise reasonable care, prudence and diligence in performing its duties under the rule, or adhere to a higher standard. Rule 17f-5 Amendments Rule 17f-5 will continue to govern a fund's use of a foreign bank custodian. As amended, the rule excludes arrangements with foreign securities depositories from its scope because they are addressed by Rule 17f-7. Effective Date; Compliance Date The amendments to Rule 17f-5 and new Rule 17f-7 will be effective on June 12, 2000. Compliance with the new rule and rule amendments will not be required until July 2, 2001. In the interim, a fund may operate its foreign custody arrangements in accordance with the new rule and amendments or with the 1997 Amendments to Rule 17f-5,⁸ or it may comply with "old" Rule 17f-5 as it existed prior to the 1997 Amendments (but subject to the definition of an eligible foreign custodian under the 1997 Amendments).

4Marguerite C. Bateman Associate Counsel Attachment

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