

MEMO# 10946

April 30, 1999

COMMISSION PROPOSES NEW RULE ON SECURITIES DEPOSITORIES AND AMENDMENTS TO RULE 17F-5

1 SEC Release No. IC-23815 (April 29, 1999). [10946] April 30, 1999 TO: INTERNATIONAL COMMITTEE No. 19-99 SEC RULES COMMITTEE No. 32-99 SECURITIES OPERATIONS COMMITTEE/CUSTODIANS ADVISORY GROUP RULE 17f-5 WORKING GROUP RE: COMMISSION PROPOSES NEW RULE ON SECURITIES DEPOSITORIES AND AMENDMENTS TO RULE 17f-5

The Securities and Exchange Commission yesterday proposed amendments to rule 17f-5 under the Investment Company Act of 1940 and a new rule 17f-7 under the Act to address the custody of investment company assets outside the US.¹ The proposals would establish standards governing the maintenance of an investment company's assets with a foreign securities depository. A copy of the Commission's release is attached. The comment period on this proposal ends on Thursday, July 15, 1999. If there are comments that you would like the Institute to consider including in its comment letter, please contact Robert C. Grohowski by phone at (202) 371-5430, by fax at (202) 326-5841 or by e-mail at rcg@ici.org by Friday, June 25, 1999. Background To address problems with the application of amended Rule 17f-5 to securities depositories, the Institute and the Association of Global Custodians ("Association") jointly submitted a proposal to the Commission in June, 1998. The proposal was revised and resubmitted in February, 1999 in response to specific concerns expressed by the Commission. The revised joint submission recommended that the Commission amend rule 17f-5 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. Commission Proposals Instead of following the approach recommended by the Institute and the Association, the Commission has proposed amendments to rule 17f-5 and a new rule 17f-7 that, together, would govern ² See, e.g., SEC Release No. IC-23670 (January 28, 1999). the maintenance of fund assets outside the US. Generally speaking, rule 17f-5 would continue to govern the use of foreign bank custodians and subcustodians and proposed rule 17f-7 would govern the use of foreign securities depositories. Proposed rule 17f-7 would establish four basic standards for foreign depositories to be deemed eligible to be used by funds, based upon the criteria suggested by the Institute and the Association in the joint proposal. In addition, the proposed rule would require that one of two "risk-limiting conditions" be met. A fund could obtain indemnification or insurance that adequately protects it against all custody risks of using the depository. Alternatively, the fund's contract with its global custodian could include provisions that would obligate the custodian

to provide the fund or its adviser with an initial risk analysis of the depository, continuously monitor risks associated with the use of the depository, and notify the fund or its adviser of material changes in these risks. The global custodian generally also would have to agree to exercise reasonable care with respect to these and other duties. Proposed rule 17f-7 would not contain any provisions regarding the delegation of authority under the rule, under the theory that decisions to maintain assets with the depository should be made by the adviser, subject to oversight by the fund board, based upon information provided by the global custodian. Proposed rule 17f-7 would not assign a particular role to the investment adviser or the fund board in this regard, although the Commission assumes that the adviser generally would determine whether to place fund assets in a depository under the general oversight of the board. Compliance with the 1997 amendments to Rule 17f-5, except for the amended definition of “eligible foreign custodian,” will continue to be suspended until the Commission has completed consideration of proposed rule 17f-7. As you know, this compliance date had previously been extended several times, most recently to May 1, 1999.² Robert C. Grohowski Assistant Counsel Attachment

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