COMMENT LETTER

July 15, 1999

Comment Letter on SEC Proposal Re Foreign Custody of Fund Assets, July 1999

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Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Custody of Investment Company Assets Outside the United States (File No. S7-15-99)

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to rule 17f-5 and proposed new rule under the Investment Company Act of 1940, rule 17f-7, to address the custody of investment company assets outside the United States.[2] These proposals, in particular proposed rule 17f-7, are designed to provide a framework under which an investment company can protect its assets while maintaining them with a foreign securities depository.

The Commission's proposals follow two years of evaluating different approaches for a rule to govern the custody of fund assets with securities depositories outside the U.S. Shortly after the Commission adopted amendments to rule 17f-5 in 1997, it became apparent that it was not possible for U.S. banks, qualified foreign banks, fund boards or their investment advisers meaningfully to evaluate depositories under the new criteria set forth in paragraph (c) of the rule. In June 1998, the Institute and the Association of Global Custodians jointly submitted a package of amendments to rule 17f-5 to establish a workable framework for the evaluation of foreign securities depositories under the rule (the "ICI/Bank Proposal").[3] The ICI/Bank Proposal proposed an objective test, which consisted of eight factors, that a Foreign Custody Manager ("FCM"), as defined in the rule, could apply in determining whether a foreign securities depository provides reasonable care to deposited assets. Last February, the Institute and the Global Custodians modified the ICI/Bank Proposal to respond to concerns about it raised in meetings with Commission staff.[4]

The Commission has proposed taking a different approach. While we continue to believe that the ICI/Bank Proposal is preferable to proposed rule 17f-7, we support 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. We are seriously troubled, however, by the specific regulatory requirements (styled as "risk-limiting conditions") relating to an investment company's investment decision-making process included in proposed rule 17f-7. If the Commission nevertheless determines to include these types of conditions in the rule, we recommend that certain modifications and clarifications be made and that firms be given a transition period of one year to comply with the terms of the new rule. Our specific comments on proposed rule 17f-7 are set forth below.5

Proposed Rule 17f-7

Proposed rule 17f-7 has two separate components. First, the rule would permit funds to maintain assets with a securities depository only if it is an "Eligible Securities Depository," as defined in the rule. Second, the rule would require a fund to comply with one of two alternative risk-limiting safeguards, either (1) obtaining indemnification or insurance that would protect the fund against all custody risks or (2) having its custody contract require the global custodian to provide the fund or its adviser with a risk analysis of the depository, to monitor those risks and to notify the fund or its adviser of any material change. The reasonable care determination required under rule 17f-5 would not be required under proposed rule 17f-7 with respect to securities depositories.

Definition of Eligible Securities Depository

The Institute supports the use of objective criteria to determine whether a depository may be eligible under proposed rule 17f-7.6 In this regard, we are pleased that the Commission proposes to eliminate the reasonable care standard with respect to securities depositories. Objective criteria, rather than the more subjective standards applicable to subcustodian banks, are more appropriate for the evaluation of securities depositories.7

We are opposed, however, to the inclusion of certain transfer agents in the definition of Eligible Securities Depository. Proposed rule 17f-7(b)(1) would include "a transfer agent that transfers and holds uncertificated securities on the books of an issuer for market participants" as a depository that may be eligible based on the other criteria listed in the rule. The functions performed by transfer agents vary greatly from one country to another. While some transfer agents may be analogous to securities depositories, others clearly are not, and for still others it is not clear because they may perform some but not all of the functions of a depository. We are therefore concerned that the definition in proposed rule 17f-7(b)(1) could create confusion and may lead to an overly burdensome application of the rule.8 We believe 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. We therefore recommend that the phrase ",or a transfer agent that transfers and holds uncertificated securities on the books of an issuer for market participants," in proposed rule 17f-7(b)(1) be narrowed or deleted.

Risk-Limiting Conditions

As noted above, the proposed rule would go beyond setting minimum objective standards for eligibility and would require funds to adopt one of two alternative approaches designed to limit the risks that funds may face when maintaining assets with a foreign securities depository. The Institute continues to believe that it is neither necessary nor appropriate to

include these alternatives in the rule. The Commission appears to consider the second alternative in particular as part of a fund's investment decision.9 The Commission has never sought to regulate in any way a fund's investment decision-making process and should not do so now. Therefore, we recommend that the Commission not include these standards in the final rule. Nevertheless, if the Commission decides to go forward with the proposed risk-limiting conditions, we recommend that they be modified in the manner discussed below. We also recommend that the Commission confirm in the adopting release that it does not intend to regulate investment decision-making generally.

Indemnification or Insurance. Under the first alternative, a fund could obtain indemnification and/or insurance that would "adequately protect the fund against all losses attributable to the custody risks associated with maintaining assets with the Eligible Securities Depository." 10 The Institute does not object to the concept of insurance as a safeguard. We are concerned, however, 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, including under the second alternative. We urge 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.

In addition, the Institute recommends 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. It is our understanding that it would be virtually impossible for a fund to obtain such broad protection. Insurers commonly include exclusions covering, for instance, nuclear incidents, war, insurrection, civil disobedience, natural disasters and Y2K. While most losses that would be excluded under these provisions would likely be characterized as investment losses, we are concerned that an argument could be made that they are at least partially attributable to custody risk. If such an argument were successful, the fund would be deemed not to have fulfilled its obligation under this alternative safeguard to insure against all losses attributable to custody risks. Therefore, we recommend that the word "all" be deleted from proposed rule 17f- -7(a)(1) or, at the very least, that the Commission clarify that those types of exclusions would not exclude coverage for the risks that this provision is intended to protect against.

We also recommend 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). More specifically, we recommend that guidance be provided both as to the scope and amount of coverage that would be required for protection to be deemed "adequate."11 In this regard, we urge the Commission to carefully consider the reasonable likelihood that such coverage will be commercially available, as well as the anticipated cost of obtaining it. This guidance is necessary to avoid any uncertainty that could otherwise exist as to whether a fund has satisfied this alternative.

Risk Analysis. Under the second alternative, a fund's contract with its primary custodian would have to require the custodian to provide the fund or its investment adviser with an initial risk analysis, continuously monitor custody risks, and promptly notify the fund or its adviser of any material change. We have two specific comments on this alternative safeguard.

First, the Release lists eight topics that the Commission would expect the risk analysis to cover, as a general matter, and requests comment on whether the rule should specifically

require the analysis to cover these or other areas.12 We strongly believe that it should not. A requirement that the risk analysis include specific, enumerated factors relating to custody risk could be misinterpreted as requiring a fund or its adviser to make a separate custody risk determination based on these factors. This result would clearly be inconsistent with the Commission's position expressed in the Release that the determination to maintain assets with a foreign depository is part of a fund's broader decision to invest in a particular country. In addition, it is important that the custodian have flexibility in preparing its analysis, particularly in view of the varying degrees of risk that exist among different depositories. For example, there would be no need for a fund or its adviser to receive as detailed an analysis of a long-standing depository in a developed country as it would for a newly-formed depository in an emerging market country.

Second, the Release indicates that the risk associated with the use of a particular depository (that meets the objective criteria set forth in the proposed rule) is just one of many factors considered in deciding whether to invest or continue to invest in a country, and that the determination to invest in a country and to place assets with an Eligible Securities Depository would be subject to the same standards of care that are generally applicable to all investment decisions.13 In our view, this means 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. Instead, consistent with the standards of care generally applicable to the investment decision-making process, a fund may evaluate the risks associated with the use of a particular depository as part of its overall evaluation of all relevant risk factors associated with a decision to invest in a particular market. 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. We recommend that the Commission expressly concur with this view in the adopting release.

Transition Period

If adopted, the requirements in proposed rule 17f-7 would have to be met before assets could be placed with an Eligible Securities Depository. The Institute urges 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 recommends that the compliance date be one year from the effective date of the rule. A one-year period would allow funds and their advisers and custodians sufficient time to make the necessary eligibility determinations for securities depositories and take the steps required under one of the alternative safeguards, either obtaining the necessary insurance or indemnification or preparing the required risk analysis and amending their custody contract. We note that a one-year compliance period was used for the rule 17f-5 amendments in 1997.14

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The Institute appreciates the opportunity to comment on this important rule proposal. If you have any questions about the matters discussed herein, please contact me at (202) 326-5824 or Bob Grohowski at (202) 371-5430.

Very truly yours,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Division of Investment Management

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ENDNOTES

1 The Investment Company Institute is the national association of the U.S. investment company industry. Its membership includes 7,546 open-end investment companies ("mutual funds"), 457 closed-end investment companies, and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.730 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

2 Investment Company Act Release No. 23815 (April 29, 1999) (the "Release").

3 See Letter from Amy B.R. Lancellotta, Senior Counsel, ICI, and Daniel L. Goelzer, Baker & McKenzie, to Barry P. Barbash, Director, Division of Investment Management, dated June 30, 1998.

4 In particular, the staff expressed concern that a depository might be deemed to provide reasonable care under the eight factors, notwithstanding the fact that the FCM had actual knowledge that the depository was materially unsafe or out of compliance with local regulatory requirements. To address that concern, the ICI/Bank Proposal was revised to include a proviso following the eight objective factors to make clear that a reasonable care determination could not be made if the FCM had "actual knowledge" of information that indicates that the depository was not in compliance with basic safe-keeping standards applicable in the relevant market. See Letter from Amy B.R. Lancellotta, Senior Counsel, ICI, and Daniel L. Goelzer, Baker & McKenzie, to Paul F. Roye, Director, Division of Investment Management, dated February 26, 1999.

5 The Institute does not have any specific comments on the proposed amendments to rule 17f-5 and supports adoption of those amendments as proposed.

6 While the proposal does not explicitly assign the responsibility for determining whether a depository meets the criteria to be an Eligible Securities Depository, we assume that a fund’s primary custodian would fulfill this responsibility. See, e.g., Letter to Paul F. Roye, supra note 4 (noting that the ICI/Bank Proposal would allow fund boards to delegate FCM responsibilities, including the determination of whether a depository in question meets the eight objective criteria, to the fund’s primary custodian).

7 See, e.g., ICI/Bank Proposal at 2-3.

8 For example, Russian companies do not issue share certificates. Instead, equity securities of Russian issuers are maintained in book-entry form by registrars. A 1995 no-action letter estimated that 3,000 registrars located throughout Russia carried out share registration

services at that time for Russia’s 15,000 privatized companies. See Templeton Russia Fund, Inc. (pub. avail. April 18, 1995). Although many of these registrars may be deemed to be transfer agents within proposed rule 17f-7(b)(1), it is impractical to believe that funds would obtain a risk analysis report for each of these 3,000 registrars.

9 See Release at 10.

10 Proposed rule 17f-7(a)(1).

11 With respect to the scope of coverage, it is unclear whether a fund could obtain "adequate protection" by insuring against the types of losses typically covered by fidelity bonds (e.g., larceny and embezzlement), or whether a fund would also be required to be insured and/or indemnified against losses due to negligent acts or omissions of the depository. It is our understanding that insurance covering a fund for losses resulting from a depository’s or other third party’s negligence would not likely be commercially available, as this type of negligence-based insurance generally covers only activities controllable by the insured party.

With respect to the amount of coverage, it is unclear whether a fund only could obtain "adequate protection" by securing "each and every occurrence" coverage, or whether it would be satisfactory for a fund to secure "aggregate limit" coverage. In either case, there is also a question as to whether the limit would have to be equal to the value of the fund’s deposited assets or could be in some lesser amount.

12 See Release at 20.

13 See Release at 20 ("Decisions regarding whether to place fund assets with a depository would be made by the adviser or board based on standards of care that are generally applicable to fund advisers and directors.").

14 See Investment Company Act Release No. 22658 (May 12, 1997).
