The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

September 3, 2002

Comment Letter on Performance Standards for Custodians, September 2002

September 3, 2002

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Custody of Investment Company Assets with a Securities Depository (File No. S7-22-01)

Dear Mr. Katz:

The Investment Company Institute1 is submitting this letter with respect to the Securities and Exchange Commission's proposed amendments to Rule 17f-4 under the Investment Company Act of 19402 as a supplement to our initial letter3 to clarify certain issues that have been raised by The Association of Global Custodians on the Commission's proposal.4 Of greatest importance is the issue of whether Rule 17f-4 should be amended to subject fund custodians to minimum performance standards, such as a standard of "due care," in discharging their duties under UCC Article 8 with respect to custodied fund securities that are held indirectly through securities depositories. For the reasons set forth here and in our initial comment letter, we continue to believe that it is necessary and appropriate for the Commission to make fund custodians subject to such standards.

The custodian's Article 8 duties include the obligation to "obtain and thereafter maintain … financial asset[s] in a quantity corresponding to the aggregate of all security entitlements [that the custodian] has established in favor of its entitlement holders…."5 Article 8 provides that a minimum standard of "due care in accordance with reasonable commercial standards" will apply to the performance of those duties "in the absence of [an] agreement" of the parties specifying their own standards of performance, or unless "specified standards" are imposed by other law or regulation.6 The "due care" performance standard recommended by the Institute is the same as the standard that automatically applies to custodians under Article 8 unless contrary or more specific standards are imposed on them under contract or by other law or regulation. We are not aware of (and the AGC letter does not reference) any other law or regulation that imposes contrary or

more specific standards on custodians. Therefore, the effect of our recommended standard would simply be to preclude funds from establishing contractual performance standards for their custodians that are less stringent than the "due care" standard called for under Article 8.7

The Institute continues to believe that such minimum and general requirements are necessary and appropriate. Moreover, we continue to believe that our recommended rule language is simply a reformulation, in terms that are more fully consistent with Article 8, of the requirements proposed by the Commission.8 For the reasons set forth in our initial comment letter, we do not believe that the Commission's proposed language would technically achieve its intended purpose. Nevertheless, it seems clear that the purpose was to establish a minimum performance standard for custodians using securities depositories for the custody of fund assets.

The AGC Letter expresses concern that a Commission rule stating that a custodian "may maintain financial assets corresponding to the security entitlements that a Custodian establishes for the Fund"9 somehow "reflects the fiction" that fund custodians have discretion about whether or not to hold fund assets in domestic securities depositories.10 We agree with the AGC that, for all practical purposes, neither the fund nor the custodian have any discretion in this matter once the decision to invest in a particular security is made.11 However, the absence of discretion does not change the fact that, under Article 8, when custodians establish security entitlements for their fund customers, they (not the funds who are their customers) are subject to a duty to obtain and maintain financial assets—in the form of their own security entitlements with securities depositories or otherwise—corresponding to the funds' security entitlements.12

We believe that this duty can be set forth in amended Rule 17f-4 either by the proposed rule language in our initial comment letter or by revising that language to state, in part, as follows (deleted language is struck through; new language is underlined):

A Fund's Custodian may maintain financial assets corresponding to the security entitlements that the Custodian establishes for the Fund by acquiring and maintaining its own security entitlements with one or more Securities Depositories or Intermediary Custodians, provided that the Fund's contract with the Custodian requires that the Custodian: (1) is at a minimum obligated to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain such financial assets. 13

The Institute appreciates the opportunity to provide these supplementary comments. We would be glad to discuss this issue and others related to the proposed amendments to Rule 17f-4 at any time. If you have any questions or would like to meet with us regarding our comments, please contact the undersigned at (202) 326-5824 or Dorothy Donohue at (202) 218-3563.

Sincerely yours,

Amy B.R. Lancellotta
Senior Counsel

cc: Paul F. Roye, Director
Robert E. Plaze, Associate Director
C. Hunter Jones, Assistant Director

Division of Investment Management
U.S. Securities and Exchange Commission

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,973 open-end investment companies ("mutual funds"), 514 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.363 trillion, accounting for approximately 95 percent of total industry assets, and over 87.8 million individual shareholders.

2 SEC Release No. IC-25266 (November 15, 2001).

3 See Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission, dated January 31, 2002.

4 See Letter from Daniel L. Goelzer, Counsel to the Association of Global Custodians, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated May 24, 2002 ("AGC Letter").

5 UCC §8-504(a). See January ICI Comment Letter at 4.

6 See January ICI Comment Letter at 5; UCC §§8-504(c)(2) and 8-509(a) and (b).

7 The AGC Letter states that UCC §8-509 "recognizes that the duties imposed by Article 8 may be varied by other laws or regulations and that compliance with those laws and regulations satisfies the UCC." AGC Letter at 7, 8. We do not believe that this accurately describes the meaning of Article 8. UCC §8-509(a) provides a means for satisfying Article 8 duties by complying with performance standards specified under other law, not for varying or waiving the underlying duties themselves.

8 Proposed Rule 17f-4(a)(1)(i) ("the Custodian will: [t]ake all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard Assets maintained by the Custodian with a Securities Depository or Intermediary Custodian for the benefit of the Fund ….").

9 ICI Attachment, suggested §17f-4(a), cited in AGC Letter at 8.

10 AGC Letter at 8.

11 This is because, in the modern securities holding system, both investors and their securities intermediaries normally do not "deposit" securities with anyone. Rather, investing funds and intermediary custodians largely take acquired securities as they find them. If the securities have been immobilized with a securities depository, the custodian will acquire security entitlements in those securities to support the entitlements it has established for the fund.

12 Despite the AGC's assertion to the contrary, we did not suggest in our initial comment letter and we do not suggest here that funds do not actually own their portfolio securities (or that ownership is shifted to the fund's custodian). The fund owns its portfolio securities indirectly through its security entitlements with its custodian. Those security entitlements

are the fund’s financial assets and are distinct from the financial assets that the custodian maintains with securities depositories to support the security entitlements of all of its customers, as well as its own proprietary holdings. Our point was, and continues to be, simply that amended Rule 17f-4 should neither confuse nor effectively merge these two, separate interests by characterizing the custodian’s financial assets as fund assets. Indeed, our specific recommendation was and is that amended Rule 17f-4 not define the term, “Assets,” thus avoiding any characterization of who owns which of the layered financial assets involved when funds hold securities indirectly.

13 This revision is intended to provide a practical solution for the AGC’s concern that custodians cannot be direct violators of Commission rules. Such a change also should address the AGC’s concern that funds not be “absolve[d]” … from responsibility for the custody of fund assets.” AGC Letter at 6.
