

PUBLIC

APR 26 1993

Our Ref. No. 92-511-CC
Custody of B Shares
Trading on the
Shenzhen and Shanghai
Securities Exchanges
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letters of August 31, 1992 and March 10, 1993, request our assurance that we would not recommend enforcement action to the Commission under Section 17(f) of the Investment Company Act of 1940 ("1940 Act") and Rule 17f-5 thereunder if registered investment companies maintain custody of "B" shares listed on the Shenzhen Stock Exchange ("Shenzhen Exchange") and the Shanghai Securities Exchange ("Shanghai Exchange") through the facilities of one or more of ten financial institutions 1/ that act as custodians or subcustodians for the assets of registered investment companies. 2/

In Jardine Fleming China Region Fund, Inc. ("Fund") (pub. avail. Apr. 26, 1993), the staff assured the Fund that it would

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- 1/ Bankers Trust Company, The Bank of New York, Boston Safe Deposit and Trust Company, Chase Manhattan Bank NA, Chemical Bank, Citibank NA, Hongkong and Shanghai Banking Corporation Limited, Morgan Guaranty Trust Company of New York, Standard Chartered Bank, and State Street Bank and Trust Company.
- 2/ Section 17(f) of the 1940 Act provides that every registered management investment company shall maintain its securities and similar investments in the custody of (1) a bank meeting certain requirements, (2) a member of a national securities exchange, (3) the company itself, in accordance with Commission rules, or (4) a system for the central handling of securities pursuant to which all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of such securities, in accordance with Commission rules. Rule 17f-5 provides an exemption from Section 17(f) to allow a registered management investment company to deposit foreign securities in the custody of an "eligible foreign custodian." Rule 17f-5(c)(2)(i) defines the term "eligible foreign custodian" to include "a banking institution or trust company, incorporated or organized under the laws of a country other than the United States, that is regulated as such by that country's government or an agency thereof and that has shareholders' equity in excess of \$200,000,000." Rule 17f-5(c)(2)(iii) defines the term "eligible foreign custodian" to include "a securities depository or clearing agency, incorporated or organized under the laws of a country other than the United States, which operates the central system for handling of securities or equivalent book-entries in that country."

not recommend enforcement action to the Commission under Section 17(f) or Rule 17f-5(c)(2)(i) if the Fund, through its global custodian, held "B" shares listed on the Shenzhen Exchange on the books of a Shenzhen branch of a U.S. bank and on the books of Shenzhen branches of foreign banks (together, "Agent Banks"). Our position was based, in part, on the Fund's representations that 1) each of the Agent Banks is either a foreign branch of a U.S. bank that has shareholders' equity in excess of \$100,000,000, or a branch of a foreign bank that has shareholders' equity in excess of \$200 million; and 2) each of the Agent Banks acts as the sole registration institution for a particular issue of "B" shares, maintains a computerized book-entry system, and issues a share registration receipt in connection with each trade.

The staff also assured the Fund that it would not recommend enforcement action to the Commission under Rule 17f-5(c)(2)(iii) if the Fund, through its global custodian, held "B" shares listed on the Shanghai Exchange in an account in the book-entry system of the Shanghai Exchange. Our position was based, in part, on the Fund's representations that the Shanghai Exchange is the central book-entry depository and sole clearing agent, transfer agent, and registrar of all "B" shares traded on that Exchange. 3/

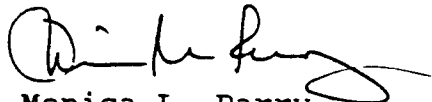
Accordingly, on the basis of our response to the Fund and on the facts and representations in your letters, but without necessarily agreeing with your legal arguments, we would not recommend enforcement action to the Commission if registered investment companies maintain custody of "B" shares listed on the Shenzhen Exchange and the Shanghai Exchange through the facilities of one or more of the ten financial institutions named in your letter that act as custodians or subcustodians for the assets of registered investment companies, in the manner described in the staff's letter to the Fund.

This enforcement position is further based on your representation that each of the ten financial institutions agrees that if it is the custodian for a registered investment company, it will forward a "B" shares confirmation request received from that company to the appropriate subcustodian, and if it is a subcustodian for a registered investment company, it will forward such a request received from the primary custodian (or from a higher-tier subcustodian) to either the appropriate next-tier

3/ In Hong Kong Securities Clearing Co. Ltd. (pub. avail. Sept. 8, 1992), the staff granted no-action relief under Rule 17f-5(c)(2)(iii) to an entity that operated the only central system for the handling of book-entry securities traded on the Hong Kong Stock Exchange.

subcustodian or to the appropriate "B" shares book-entry system.

This position is based on the facts and representations in your letter; any different facts or representations may require a different conclusion. This letter expresses the Division's position on enforcement action only and does not purport to express any legal conclusions on the issues presented.



Monica L. Parry
Senior Counsel

BAKER & MCKENZIE

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March 10, 1993

VIA MESSENGER

Gene A. Gohlke
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Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
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Robert B. Carroll
Senior Special Counsel
Division of Investment Management
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Re: Custody Pursuant to Investment Company Act
Rule 17f-5 of B Shares Trading on the Shenzhen
and Shanghai Stock Exchanges/Supplement to
No-Action Request dated August 31, 1992

Dear Messrs. Gohlke and Carroll:

This is in response to our recent telephone conversations concerning Baker & McKenzie's pending no-action letter request regarding the application of Investment Company Act Rule 17f-5 to custody of B shares trading on the Shenzhen and Shanghai stock exchanges in the People's Republic of China. In those conversations, you have indicated that, in the context of a Commission inspection of a registered fund which held B shares, the staff might wish to review documents confirming the fund's B shares position. Accordingly, you asked that I supplement the no-action request with information concerning this issue.

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RULE 17f-5
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As you are aware, Rule 17f-5 provides that investment company assets may be held in custody pursuant to the rule only if a majority of the investment company's directors have approved a written contract which requires, among other things, that --

"(D) Adequate records will be maintained identifying the assets as belonging to the company;

"(E) The company's independent public accountants will be given access to those records or confirmation of the contents of those records; and

"(F) The company will receive periodic reports with respect to the safekeeping of the company's assets, including, but not limited to, notification of any transfer to or from the company's account." Rule 17f-5(a)(1)(iii)(D)-(F).

Our no-action request does not seek relief from, or modification of, these requirements. Accordingly, if our request is granted, these requirements will remain fully applicable to any custody agreement under which our clients hold B shares for the account of a registered investment company.

We believe that these provisions should largely satisfy the staff's concerns regarding its ability to obtain confirmation, in the context of an inspection, of a fund's B shares position. The staff would routinely have access to the periodic reports which such a fund had received from its custodian regarding the fund's B shares. Moreover, if the staff wished to obtain and review a specific confirmation of a fund's B shares position as of a given date, it could request that the fund instruct its accountants to obtain such a confirmation, as contemplated by Rule 17f-5(a)(1)(iii)(E). B shares custodians and subcustodians will necessarily base their records, confirmations, and periodic reports on the data supplied to them by the B shares clearing banks which, as set forth in our no-action request, reconcile their records to those of the Registrars Co. (in Shenzhen) or of the exchange itself (in Shanghai).

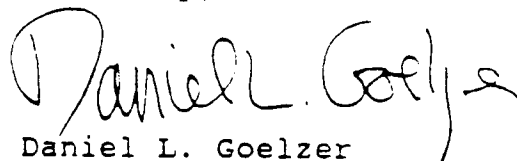
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You have, however, also asked that, as an element of their no-action request, our clients represent to the staff that, if so instructed by a U.S.-registered investment company for which they act as custodian or subcustodian, they would apply to the relevant B shares book entry system for confirmation of that fund's B shares position. As explained in our August 31 letter, in Shenzhen this system consists of the three registration banks and the Registrars Company; in Shanghai, the exchange itself maintains the book entry system. Our clients have each individually authorized us to respond to the staff's concern by representing that, where one of them is the U.S. custodian for a fund, it will forward a B shares confirmation request received from that fund to the appropriate subcustodian; where one of them is a subcustodian, it will forward such a request received from the primary custodian (or from a higher-tier subcustodian) to either the appropriate next-tier subcustodian or to the appropriate B shares book entry system.

Please contact Daniel L. Goelzer or Simon Zornoza of Baker & McKenzie (Washington) at 202/452-7013 if you have further questions concerning this matter. As I know you are aware, there is great interest in B shares investment among registered funds, and we look forward to final action on our no-action request as soon as possible.

Sincerely,



Daniel L. Goelzer

¹ Our August 31, 1992 no-action request was submitted on behalf of the ten financial institutions listed therein. In a given case, one or more of these institutions may act as custodian or subcustodian for a particular registered investment company. Our clients make no representation concerning the procedures and practices of the Shenzhen or Shanghai book entry systems for responding to confirmation requests.

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August 31, 1992

ICA Section 17(f)
ICA Rule 17f-5

DELIVERED BY HAND

Office of the Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

**Re: Custody of B Shares Trading on the
Shenzhen and Shanghai Securities Exchanges**

Ladies and Gentlemen:

We are counsel to the following ten financial institutions that act as custodians or subcustodians for the assets of registered investment companies:

Bankers Trust Company
The Bank of New York
Boston Safe Deposit and Trust Company
Chase Manhattan Bank NA
Chemical Bank
Citibank NA
Hongkong and Shanghai Banking Corporation Limited
Morgan Guaranty Trust Company of New York
Standard Chartered Bank
State Street Bank and Trust Company

On behalf of these institutions, we request the assurance of the Staff of the Division of Investment Management that it will not recommend enforcement action under Section 17(f) of the Investment Company Act of 1940 against any registered investment company that maintains custody of B shares traded on the Shenzhen or Shanghai securities exchanges through the facilities of one or more of our clients. As set forth below, we believe that the book-entry systems established for each of these exchanges as the exclusive

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method of share ownership are consistent with the requirements of Rule 17f-5. We ask that the Staff concur in this conclusion.

As you are aware, trading commenced earlier this year in so-called "B shares" on the Shenzhen Securities Exchange and the Shanghai Securities Exchange in the People's Republic of China ("PRC"). B shares are available for purchase by non-Chinese investors, and there is considerable interest on the part of certain U.S. investment companies in acquiring these securities. Currently, however, most registered funds have refrained from making such purchases because of uncertainty concerning the custody requirements applicable to B shares. We do not believe that the Commission's custody rules were intended to operate as a prohibition against investment company purchases of particular securities, much less to prohibit the purchase of all securities publicly traded in a particular country. Yet, in the case of the PRC, there is a risk that U.S. custody requirements could be interpreted to have this effect. Unlike the situation in which an investment company has the theoretical ability to opt out of a depository or book-entry system and cause its custodian to take possession of the fund's securities, participation in the Shenzhen and Shanghai book-entry systems is the only means of ownership available to foreign investors acquiring B shares.

We believe that U.S. investment companies that purchase B shares through the facilities of our clients will be fully protected against the risks with which Section 17(f) and Rule 17f-5 are concerned, and that the custody requirements should not, therefore, pose an obstacle to investment company B share purchases. Our analysis is set out below.

I. Operation of the PRC Securities Markets¹

In December, 1991, companies in the PRC were authorized to issue B shares, a special class of securities that can only be purchased by and traded among foreign investors. The Shenzhen Securities Exchange and the Shanghai Securities Exchange, which

¹ The factual material set forth in this letter is based on published information concerning the operations of the Shenzhen and Shanghai markets, descriptions received from certain of our clients, and the experience of knowledgeable persons in our Hong Kong and Shanghai offices. However, practices in the Shenzhen and the Shanghai markets are evolving. In the event that we learn additional information during the pendency of this request, we will of course inform the Staff.

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handle primarily non-B share transactions involving domestic investors, also provide a trading market for B shares. Each issuer's shares may trade on only one of these two exchanges. B shares are denominated in Renminbi² and are uncertificated; that is, ownership of B shares is reflected by book-entry in a system maintained, in Shenzhen, by three "registration banks" on behalf of the Shenzhen Securities Registrars Co., Ltd. (the "Registrars Co.") and, in Shanghai, by the exchange itself.³

A. Legal Framework⁴

The People's Bank of China (the "PBOC"), the central bank of the PRC, is the government agency charged with overall regulation of the securities markets. The PBOC has delegated day-to-day supervision and management of share issuance and trading to its local branches. In addition to national supervision, the Shenzhen and Shanghai markets operate under an array of measures promulgated by the municipal authorities in their respective cities. These measures were adopted either jointly with, or with the approval of, the PBOC. The PBOC branches have, in turn, issued rules to implement the municipal measures, and the securities exchanges have adopted corresponding operating rules. In Shenzhen, the Registrars Co. also has adopted rules of operation (with the approval of the PBOC-Shenzhen).

The municipal ordinances in question provide, among other things, for the establishment of an exchange in each of the two cities for the trading of B shares, subject to the approval of the

² Although shares are priced in Renminbi on both exchanges, B share settlement occurs in Hong Kong dollars in Shenzhen and in U.S. dollars in Shanghai. The Securities Trading Automated Quotation system (STAQ), operated by Reuters, displays B shares quotations. STAQ converts Renminbi prices to Hong Kong dollars before disseminating quotations.

³ The Registrars Co. (in Shenzhen) and the exchange (in Shanghai) perform functions comparable to those of a transfer agent.

⁴ English versions of the key measures and rules applicable to the Shenzhen and Shanghai markets have been published by Baker & McKenzie in a booklet entitled Selected Securities Regulations of the People's Republic of China (hereinafter "SSR"). A copy of this booklet is attached. Relevant provisions of these measures and rules are cited herein.

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PBOC. The measures designate the PBOC branches as being the "Authority in Charge" and regulate:

- organization of the exchanges, including their management and membership;
- types of entities that may issue B shares and the approval process for such issuances;
- conditions required for listing B shares on the exchanges and the approval process for listing;
- qualifications of local brokers eligible to execute transactions in B shares;
- qualifications of foreign brokers to place trades with local brokers;
- clearing and settlement procedures and the appointment of clearing banks;
- share transfer and registration procedures.

The local measures also deal with such matters as dispute resolution, foreign exchange, tax liability, and penalties for violations.

Of significance to this request, the legal framework established jointly by the PBOC and municipal authorities requires that B share custody strictly conform to the rules of each exchange. In particular, there is no opportunity to take physical custody of shares or to otherwise opt out of the mandatory book entry system.⁵ B shares listed on a given exchange must trade solely on that exchange.⁶ The application of these laws to B share ownership and trading is discussed in detail below.

⁵ See Articles 3 and 7, Provisional Rules of Shenzhen Municipality for Registration of Special Renminbi-Denominated Shares (SSR at 55). Article 30, Detailed Implementing Rules for the Measure of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 22).

⁶ Article 16, Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 47). Article 18, Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 17).

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B. The Shenzhen Securities Exchange

In order to execute B share transactions on the Shenzhen Securities Exchange, investors must route their orders through one of a limited number of international brokers approved by the PBOC-Shenzhen.⁷ These international brokers, which are primarily located in Hong Kong, are not members of the Exchange and must, in turn, place client orders through local brokers. Each foreign broker must have executed detailed agency agreements with the various local brokers, and these agreements must be approved by the PBOC-Shenzhen.⁸

Clearing, settlement, and share ownership registration are accomplished through one of three banks (referred to herein as the "registration banks"). The registration banks, which were selected by the Exchange subject to the approval of the PBOC-Shenzhen,⁹ are: (i) Standard Chartered Bank (Shenzhen Branch); (ii) Hongkong and Shanghai Banking Corporation Ltd. (Shenzhen Branch); and (iii) Citibank NA (Shenzhen Branch). All trades for a given issuer are cleared through one, and only one, of the three registration banks.¹⁰ The relevant bank opens a share registration account in the name of each investor, and this account is assigned a unique

⁷ See Article 15, Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 47); Articles 4 and 13, Detailed Implementing Rules for the Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 50, 52). There are currently 13 approved foreign brokers.

⁸ See Article 47, Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares (SSR at 37); Article 9, Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 47); Articles 2 and 14, Detailed Implementing Rules for the Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 50, 52); and Article 11, Operating Rules of the Shenzhen Securities Exchange for Trading and Clearing of B Shares (SSR at 60).

⁹ See Article 20, Detailed Implementing Rules for the Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 53).

¹⁰ Article 5(5), Operating Rules of the Shenzhen Securities Exchange for Trading and Clearing of B Shares (SSR at 59).

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number. Where the investor acts through an intermediary, such as its custodian or subcustodian, the account will include the name of the intermediary.¹¹

The registration banks maintain the computerized book-entry system reflecting the ownership of B shares.¹² The registration banks process securities transactions by effecting debit and credit entries to participants' stock accounts held at the banks, and by corresponding entries in the share registration account. The registration bank responsible for a given transaction also issues a share registration receipt in connection with the trade.¹³ This document is a statement of account which evidences the fact that specific B shares have been registered in the name of the investor, but is not itself negotiable and does not confer rights in the underlying security.¹⁴

All trades are reported daily by the registration banks to the Registrars Co., the official share registrar for B shares traded on the Shenzhen Securities Exchange.¹⁵ However, the Registrars Co., a state-owned corporation, has largely delegated its registry functions to the registration banks.¹⁶ The Registrars Co., like the registration banks, maintains its own computerized share ownership records for B shares traded on the Exchange. The

¹¹ See Articles 6 and 8, Provisional Rules of the Shenzhen Municipality for Registration of Special Renminbi-Denominated Shares (SSR at 55).

¹² Id. at Article 3, (SSR at 55).

¹³ Id. at Articles 3 and 4, (SSR at 55).

¹⁴ Id. at Article 5, (SSR at 55).

¹⁵ See Article 67, Provisional Measures of Shenzhen Municipality for Administration of the Issue and Trading of Shares (SSR at 39); Article 18, Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 47); and Article 2, Provisional Rules of the Shenzhen Municipality for Registration of Special Renminbi-Denominated Shares (SSR at 55).

¹⁶ The Registrars Co.'s authority to delegate its functions appears in Article 21, Detailed Implementing Rules for the Provisional Measures of Shenzhen Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 53).

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function of the Registrars Co. is limited, however, to providing a back-up for the records of the registration banks. After the registration banks electronically report share transfers to the Registrars Co., it cross-checks the information against trade reports received from the Exchange.¹⁷ If discrepancies are discovered, the Registrars Co. contacts the relevant registration bank to resolve the problem. Once the accounts tally, the Registrars Co. and the registration bank sign the cross-checked accounts which then become the official record of ownership. The Registrars Co., through the registration banks, also performs the functions of a dividend paying agent for the issuer companies, withholds the appropriate taxes, and forwards shareholder communications.¹⁸

C. The Shanghai Securities Exchange

Each investor in B shares on the Shanghai Securities Exchange has an account with the Exchange.¹⁹ An intermediary, such as an investment company's custodian or subcustodian, may open such an account in its own name for the account of its investor client, e.g. XYZ Bank a/c ABC Fund. The investor's (or its intermediary's) account with the Exchange must be opened through a PBOC-Shanghai approved foreign broker.²⁰ Trades are initiated through one of the foreign brokers, which in turn effects the trade through a PBOC-approved local broker.²¹

¹⁷ Article 17, Provisional Rules of Shenzhen Municipality for Registration of Special Renminbi-Denominated Shares (SSR at 57).

¹⁸ Id. at Articles 19-21 (SSR at 57).

¹⁹ See Articles 25 and 26, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 22).

²⁰ See id. Articles 12-15 (SSR at 21).

²¹ See Article 41, Measures of Shanghai Municipality for Administration of the Trading of Securities (SSR at 9); Article 21, Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 18); Article 8, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 20); and Article 7, Supplementary Operating Rules for the Trading Market (Special Renminbi-Denominated Shares) of the Shanghai Securities

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Both the local and foreign brokers send clearing and settlement instructions to an entity authorized to act as a clearing bank.²² The only authorized clearing bank is Citibank N.A.'s Shanghai Branch ("Citibank Shanghai"). Citibank Shanghai matches trades, and debits and credits the accounts which the local and foreign brokers maintain with it. On the settlement date, Citibank Shanghai confirms the net settlement amount of each local broker to the Bank of Communications of China ("BCC"), a state-owned institution. Citibank Shanghai will then debit and credit the account maintained by the BCC and the local brokers. BCC reports to the Exchange the primary settlement between the local broker and the Exchange. Specifically, settlement occurs in the following manner:

Cash. Cash clearing for B share transactions takes place at two levels -- (1) between the buying and selling local brokers and (2) between these local brokers and the foreign brokers representing the buyer and the seller.²³ Citibank Shanghai handles the clearance of cash accounts between the foreign and local brokers. BCC handles clearance as between the local brokers. The purchaser transfers funds to its foreign broker's clearing account at Citibank Shanghai via Citibank's New York Branch. Both the foreign and local brokers send cash clearing and settlement instructions to Citibank Shanghai. Citibank Shanghai matches the instructions, debits and credits the cash accounts which the foreign and local brokers maintain with it, and transfers the sale proceeds to the local broker's account at the BCC. On the settlement date, the BCC clears accounts between the buying and selling local brokers and transfers payment to Citibank Shanghai, for the account of the seller's foreign broker.

Securities. BCC reports the settlement to the Exchange. The Exchange makes the appropriate securities account

Exchange (SSR at 26).

²² Article 40, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 24).

²³ The first-level and second-level clearance procedures are set forth in Articles 34-39, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 23).

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transfers and credits the securities to the purchaser's account. Shares are registered either in the name of the investor or its intermediary, as described above, by the Exchange's computer at the close of business on the settlement date. The Exchange also generates a confirmation which is sent to the foreign broker for delivery to the investor or its intermediary.

As noted above, the Shanghai Securities Exchange acts as its own registrar for B shares.²⁴ The Exchange also handles all dividends and shareholder communications.²⁵ To assist investors' intermediaries (i.e. custodians) in performing their tasks, the Shanghai Securities Exchange recently commenced issuing "B Share Custodian Services Confirmation Letters" to banks acting in a custodian capacity.²⁶ The letter entitles the custodian to receive a copy of the Exchange's transaction report on the trade date and the confirmation of registration following settlement. It also permits the custodian to access the Exchange's computer (strictly for informational purposes only) to monitor the flow of securities in and out of the investor's account.

II. Custody Requirements Under the Investment Company Act

A. Section 17(f)

Section 17(f) of the Investment Company Act of 1940 requires that registered investment companies maintain their portfolio securities in the custody of either a U.S. bank (with aggregate capital in excess of \$500,000), a member of a national securities exchange, or in self-custody. The Commission has, by rule,

²⁴ The Exchange's registrar functions are referred to id. at Article 47, (SSR at 24); and Articles 16 and 17 of the Supplementary Operating Rules for the Trading Market (Special Renminbi-Denominated Shares) of the Shanghai Securities Exchange (SSR at 27).

²⁵ Dividend payments are made by an issuing company to the Exchange, which channels payment via the local and foreign brokers' accounts to the investor or its intermediary. The Exchange similarly transmits corporate communications via the brokers.

²⁶ See Article 47, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 24). Article 47 refers to these documents as "B share deposit certificates."

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expanded the category of custodians in various respects. In particular, Rule 17f-5 creates an exemption from Section 17(f) to permit investment companies to maintain their foreign securities and related cash and cash equivalents in the custody of an eligible foreign custodian, as defined in the rule, subject to various conditions. As relevant here, Rule 17f-5 defines an eligible foreign custodian to include --

- (1) a foreign bank that is regulated as such in the foreign country and which has in excess of \$200 million in shareholders' equity; or
- (2) a foreign securities depository or clearing agency which operates the central system for handling of securities or equivalent book-entries in that country.

B. Custodians in Certificateless Environments

Section 17(f) and Rule 17f-5 generally contemplate that investment company portfolio securities will exist in the form of physical certificates, and that the holder of such a certificate is a custodian. However, with the increasing use of pure book-entry systems and the corresponding dematerialization of securities in the United States and other parts of the world, the question arises as to who must be viewed as the custodian of a certificateless security, and who must therefore comply with Section 17(f) or one of the exemptive rules thereunder. The Commission has not squarely considered this question, and the Staff has touched upon it only in the domestic context, through various no-action requests under Rule 17f-4.²⁷

²⁷ Investment Company Act Rule 17f-4 authorizes an investment company or its custodian, in accordance with certain procedures set forth therein, to deposit securities owned by the fund in a clearing agency which is registered under Section 17A of the Securities Exchange Act of 1934 and which acts as a securities depository. Rule 17f-4(a) defines a securities depository as a system for the central handling of securities where all deposited securities of any particular class are treated as fungible and may be transferred or pledged by bookkeeping entry. In proposing Rule 17f-4, the Commission distinguished investment company participation in such a depository from investment company ownership of securities issued only in book-entry form, and indicated that such ownership was outside of the scope of proposed Rule 17f-4. See Use of Depository Systems by Registered Management

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Thus, in Institutional Equity Fund (Feb. 27, 1984), an investment company's bank custodian wished to maintain stock index options owned by the fund at the Options Clearing Corporation ("OCC"). The stock index options were uncertificated and ownership was reflected in the records of the OCC, a registered clearing agency. The fund argued that the OCC should be treated as a securities depository for the purposes of Rule 17f-4 to permit it to act as custodian. The Staff granted the no-action relief, without expressing any views as to the fund's legal conclusions. Similarly, in American Pension Investors Trust (Feb. 1, 1991) and FundVest (Nov. 21, 1984), the Staff also granted no-action relief in situations where the investment company's custodian maintained shares in the book-entry systems maintained by the issuer's transfer agents. The applicants argued that the transfer agents were the functional equivalent of a depository under Rule 17f-4.

It might be concluded from these letters that book-entry systems, whether maintained by a clearing agency or a transfer agent, are the "custodians" of the uncertificated securities reflected on their records for Section 17(f) purposes. As far as we are aware, however, the Staff has not considered this issue in the context of any non-U.S., government-mandated, certificateless system, such as the one established in the PRC. Similarly, neither the Commission nor the Staff appear to have addressed the application of Rule 17f-5 to such a system.²⁸ The issue is

Companies, Investment Company Act Release No. 10053 at note 2 (Dec. 8, 1977), 42 Fed. Reg. 63272, 63273 (1977).

Rule 17f-5 contains no definition of the phrase "securities depository." Thus, it is unclear whether the reference in Rule 17f-5(c)(2)(iii) to a "securities depository" includes a book-entry issuance system of the sort described in Release No. 10053.

²⁸ In proposing Rule 17f-5, the Commission stated that the type of securities depository intended to be covered by the rule included the Canadian Depository for Securities, Ltd., the Frankfurter Kassenverein, and SICOVAM. See Exemption for Custody of Securities by Foreign Banks and Foreign Securities Depositories, Investment Company Act Release No. 12354 at note 51 (Apr. 5, 1982), 47 Fed. Reg. 16341, 16346 (1982). Of these three depositories, only SICOVAM operates a fully scripless system. However, in 1984, the reference to these depositories was omitted from the amended proposing release and from the adopting release. Although it is therefore not clear whether the Commission regarded SICOVAM as a

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particularly troublesome because, as the no-action letters discussed above demonstrate, domestic book-entry systems can bring themselves within the ambit of Rule 17f-4, as long as they constitute the central system for the particular security involved. An identical book-entry system, when transplanted to a foreign jurisdiction, however, would not qualify as an eligible foreign custodian under Rule 17f-5 unless it satisfied the standards for the central system for the country involved.

C. Foreign "Central Systems" as Custodians

As noted above, under Rule 17f-5, the term "eligible foreign custodian" includes a depository or clearing agency which operates "the central system for handling securities or equivalent book-entries in that country." In order to qualify as the central system, it is not necessary that the system handle all or even most of the securities traded in the country in question,²⁹ nor is it necessary that the system be the only depository in that country. However, where more than one depository handles the same securities, the Commission has required that the various depositories be sufficiently integrated so as to constitute a single central system. In making this "integration" determination, the Staff has looked for common operating procedures, compatible computer systems, the capacity of component entities to hold securities for each other, and even common ownership where appropriate.³⁰

custodian when it adopted Rule 17f-5, SICOVAM would in any event presumably be an "eligible foreign custodian" under the rule because it operates the central system in France. However, in 1985, one of the other two depositories named in Release No. 12354, the Frankfurter Kassenverein, was the subject of an exemptive application filed by State Street Bank and Trust Company. In granting the exemptive order, the Commission made no reference to its original characterization of the Kassenverein as an eligible foreign custodian. See infra note 30.

²⁹ See, e.g., The Central Depository (PTE) Ltd. SEC No-Action Letter (Mar. 27, 1990) (the central depository in Singapore handled only securities traded on the Stock Exchange of Singapore Dealing and Automated Quotations system).

³⁰ In 1985, the Commission issued an order permitting the Frankfurter Kassenverein, one of seven regional depositories in Germany, to act as a securities depository under Rule 17f-5. State Street Bank and Trust Company, Investment Company Act Release No.

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In contrast, where there is more than one facility in a particular country, but the various facilities do not handle the same securities, the Staff has not required integration as a condition to qualification of the facility as "the central system." Thus, in S.D. Indeval, S.A. de C.V. (Oct. 19, 1990), the Staff accepted that Indeval operates the central system for handling securities traded on the Mexican Stock Exchange, while also recognizing that the Mexican Central Bank handles certain Mexican Government securities not cleared by Indeval. Obviously, where a number of depositories exist in a country, each handling the same or partially the same securities,³¹ the integration requirement is an appropriate safeguard. However, where two facilities handle wholly different securities, integration in the sense employed in Investment Company Institute³² would be meaningless.

III. Discussion

A. Overview of Issues

The application of Section 17(f) and Rule 17f-5 to the book-entry systems operated in the Shenzhen and Shanghai markets raises

14698 (Aug. 28, 1985). Based on this order, the Staff subsequently articulated standards by which to determine whether multiple depositories in the same country are sufficiently integrated to be considered as operating the central system in that country. Investment Company Institute, SEC No-Action Letter (Nov. 4, 1987). In particular, the Staff noted that the seven German depositories, although independent, operated under the same procedural guidelines, held securities for each other to reduce the need for physical transfers, and were closely linked by computer. The integration test was later also applied to the various Dutch depositories, where the several entities comprising the central system shared computer systems, operating procedures, and common ownership. KAS-Associatie, N.V., SEC No-Action Letter (May 15, 1989).

³¹ See, e.g., Reserve Bank of Australia, SEC No-Action Letter (request denied) (May 8, 1991), in which the Staff appeared to be concerned that the Reserve Bank might be independently performing overlapping depository functions with Austraclear without the requisite level of integration. Austraclear had previously been the recipient of no-action relief (SEC No-Action Letter (Jan. 17, 1990).

³² Supra note 30.

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several issues. We believe, however, that an investment company which holds B shares through the facilities of its U.S. custodian, or through an institution which is an eligible foreign custodian as defined in Rule 17f-5, satisfies the requirements of the Section and the Rule. In particular --

1. Given that B shares have no physical existence and that ownership is reflected solely through book-entries, the book-entry system need not itself be regarded as a custodian. While we recognize that, in the domestic context, the Staff has implicitly treated book-entry systems for dematerialized securities as depositories and therefore custodians, the Shenzhen and Shanghai systems can be distinguished from those situations and need not be viewed as custodians.
2. Alternatively, the Shenzhen and Shanghai book-entry systems may act as investment company custodians by virtue of the fact that both systems are operated in fact by branches of banks which each individually qualify either as a U.S. bank under Section 17(f) or as an eligible foreign custodian under Rule 17f-5(c)(2)(i). Since the book-entry function in Shenzhen is operated by banks which individually are eligible to serve as investment company custodians, we believe that the shares handled through this system are, as a practical matter, in the custody of an entity which satisfies the Commission's custody requirements. Similarly, in Shanghai, Citibank is the sole nexus between foreign investors and the share registrar.
3. If the book-entry system in each market must be deemed a custodian and if it is not an eligible foreign custodian notwithstanding the eligibility of the banks which perform the essential functions, the Shenzhen and Shanghai systems nonetheless qualify as eligible foreign custodians under the "central system" element of Rule 17f-5. The key fact is that each is the sole book-entry system for the securities it handles.

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Each of these alternative approaches to no-action relief is outlined in more detail below.

B. Analysis

1. The Nominal Owners as Custodians

In the type of book-entry system employed in the PRC, an argument can be made that the first-tier custodian of the B shares is the entity whose name appears as share owner in the book-entry system, not the system itself. Provided this entity is the fund's U.S. custodian or one of its foreign subcustodians,³³ and the entity is a qualified U.S. bank or an eligible foreign custodian, the requirements of Section 17(f) or Rule 17f-5 would be met. Thus, the book-entry systems in Shenzhen and Shanghai would not need to be analyzed as custodians under Section 17(f) and Rule 17f-5.

First, the book-entry systems established in Shenzhen and Shanghai are not "custodians" in the literal sense of the word. No share certificates are physically deposited, since none exist. The systems are therefore unlike depositories in which share certificates are immobilized and subsequent share transactions are reflected only as book-entries on the depository's records.³⁴ While we recognize that the Staff has implicitly treated the transfer agents of certain domestic uncertificated securities as custodians for Rule 17f-4 purposes,³⁵ neither the Commission nor the Staff has had occasion to consider whether the same interpretation should apply to a government-mandated foreign book-entry system for uncertificated securities. Where the investment

³³ Of course, a security held by a U.S. investment company may have several custodians. For example, a depository's records may reflect that the security is owned by a depository participant; the participant's records, in turn, may show that it is held for the account of a local bank; and the bank's records may indicate that it is held for the customers of the mutual fund's prime U.S. custodian. Each of these entities would be viewed as in custody of the security in question and would be required to satisfy Section 17(f) or one of the rules thereunder.

³⁴ Such a depository is, of course, a custodian of the securities it holds.

³⁵ See American Pension Investors Trust and FundVest, supra page 11.

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company enjoys the protection resulting from the fact that the nominal owner of its securities is an eligible foreign custodian acting in compliance with Rule 17f-5, we believe that no added purpose is served by concluding that the foreign book-entry system is also a custodian.

Second, the objectives of the custody requirements are satisfied by treating the nominal owner as the first-tier custodian. The purpose of Section 17(f) is to protect investment company assets from loss or defalcation.³⁶ In the case of physical share certificates, these assets are at the risk of the entity which holds or has access to the certificates. In a book-entry system in which no such certificates exist, there is no risk of physical loss. Rather, the primary risk is that the entity in whose name the security is held may, by virtue of its nominal ownership, expose the security to loss, such as by subjecting it to the claims of the nominal owner's creditors. This suggests that the nominal owner should be treated as the first-tier custodian subject to the requirements of Section 17(f) or Rule 17f-5, and that the entity which maintains the share ownership records need not be so treated.

Finally, in determining what entity is a custodian of B shares, we believe that it is significant that the nominal owner will be issued an instrument which can be viewed as a partial surrogate for a physical certificate. In Shenzhen, the "share registration receipt" issued by the registration bank, while not itself negotiable, constitutes a statement of account and serves as evidence of the fact that the holder has B shares registered in its name.³⁷ In the event that any dispute might arise between the investment company's custodian and registration bank (or the Registrars Co.) concerning whether the custodian owns shares on

³⁶ It is relevant to note that the Commission historically has viewed Section 17(f) as designed to protect the assets of investment companies against theft and misappropriation by the fund or its affiliated persons, not by third parties appointed to handle certain fund activities. 7 SEC Annual Report 15 (1940); 10 SEC Annual Report 169 (1944). The legislative history of the Act is to the same effect. See Hearings on S. 3580 before the Senate Committee on Banking and Currency, 76th Cong., 2d Sess., Part I at 57-70, 264 (1940); Senate Report on S. 4108 at 6.

³⁷ See Articles 3-5, Provisional Rules of Shenzhen Municipality for Registration of Special Renminbi-Denominated Shares (SSR at 55).

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behalf of its client, the custodian's possession of the share receipt could be used to establish such ownership. Accordingly, it is the holder of that receipt, not the issuer thereof, that is most logically viewed as a custodian. Similarly, in Shanghai, the Confirmation Letter issued by the Exchange performs a comparable function.³⁸

2. The Registration Banks as Custodians

An alternative approach to analyzing B share custody issues would be to focus on the role of the registration banks in Shenzhen and the clearing bank -- Citibank -- in Shanghai. Since the book-entry system for each exchange is comprised of, or is dependent upon, banks which are qualified to serve as investment company custodians under either Section 17(f) or Rule 17f-5, the B shares maintained on the books of these facilities are necessarily in the hands of a qualifying custodian. It would be anomalous to conclude that the book-entry system is ineligible, even though its key component banks are eligible; the whole cannot be less than the sum of its parts.³⁹

a. Shenzhen

As explained in detail above, in Shenzhen, transactions in B shares may only occur through a specified registration bank. That

³⁸ See supra note 26 and accompanying text.

By way of comparison, the Canadian securities authorities have determined that domestic, foreign, and transnational "book-based" (or book-entry) systems are not "custodians" or "sub-custodians" subject to the custody provisions of Canadian National Policy No. 39 applicable to Canadian mutual funds. The Policy expressly cites as examples of such systems the Canadian Depository for Securities Ltd. and the Depository Trust Company. See Section 7.01(9), Canadian National Policy No. 39, issued by the Canadian Securities Administrators, effective Jan. 1, 1988.

³⁹ We recognize, of course, that it is conceivable that, in the future, additional registration banks (in Shenzhen) or clearing banks (in Shanghai) could be appointed which are not qualified to act as custodians for U.S. mutual funds under Section 17(f) or Rule 17f-5. Given the stringent criteria for such banks, this is, as a practical matter, unlikely. Should it occur, however, the consequence would merely be that U.S. mutual funds could not utilize the facilities of the ineligible banks.

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bank issues a statement or "receipt" with respect to the transaction, which evidences the share holding. The registration bank also maintains share ownership records. The role of the Registrars Co. is limited and primarily formal; as is authorized in its governing ordinance, the Registrars Co. has largely delegated its functions to the registration banks. Given that these banks qualify as custodians, we believe that the Shenzhen book-entry system which they operate likewise qualifies.

The Staff took an analogous approach in KAS⁴⁰ and in Reserve Bank of New Zealand.⁴¹ In those letters, the Staff considered the eligibility of depository facilities both under the foreign bank definition of eligible foreign custodian and under the central system definition. In both cases, it was determined that the entities qualified as "central systems" even though they did not have the requisite level of shareholders' equity to qualify as foreign banks. We believe that, in the reverse situation, where the component banks of the book-entry system qualify as custodians under either Section 17(f) or Rule 17f-5, the Staff's approach should be identical. That is, each registration bank might be viewed as a depository for the B shares it handles. Since these banks are eligible to act as custodians, the Commission's custody requirements are satisfied.

b. Shanghai

Similar reasoning also supports the conclusion that the Shanghai book entry system constitutes an eligible custodian because of Citibank Shanghai's role in the administration of that system. Admittedly, Citibank Shanghai does not play the predominant role in the Shanghai system that the registration banks play in Shenzhen. In particular, unlike the situation in Shenzhen, the share registrar -- the Shanghai Exchange itself -- has not delegated its functions to Citibank Shanghai. Moreover, in Shanghai, the Bank of Communications of China -- which does not appear to be an eligible foreign custodian as defined in Rule 17f-5 -- is also a participant in the cash clearing system and in communicating information concerning transactions to the Shanghai Securities Exchange. We believe, however, that these distinctions are not fatal to concluding that, as in Shenzhen, the essential component of the book entry system is an eligible foreign custodian.

⁴⁰ Supra note 30.

⁴¹ SEC No-Action Letters (May 25 and Nov. 15, 1990).

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As described above, the Shanghai B share registration records are derived solely and automatically from the clearing information furnished to the Exchange by BCC. BCC, in turn, derives its information concerning B share transactions from Citibank Shanghai. As a practical matter, Citibank Shanghai controls the input to the registration records; the share registrar merely records information it receives from Citibank Shanghai through BCC. Since there are no physical certificates in the custody of any of the participants, the relevant issue from the stand-point of safeguarding an investment company investor's shares is the reliability of this information. Section 17(f) reflects a determination that investment companies may rely on U.S. banks, such as Citibank Shanghai, to safe-guard their assets. Citibank Shanghai's eligibility as a custodian should suffice to establish the eligibility of the Shanghai system.

3. The Share Registry Systems as Custodians

Third, we believe that each exchange and its book-entry system is "central" for the securities it handles within the meaning of Rule 17f-5. The PRC securities markets are different from many others in that a particular securities issue trades only on one exchange.⁴² Accordingly, the book-entry systems for Shenzhen and Shanghai operate independently of each other without the need for any inter-system transfers of securities. Each book-entry system can, therefore, be characterized as operating the central -- indeed, the sole -- system for its exchange; for all B shares traded on that exchange; and for all trading in those B shares throughout the PRC. Under these circumstances, we believe that each book-entry system satisfies the central system definition in Rule 17f-5(c)(2)(iii).

As discussed above, this approach is consistent with the Staff's position in S.D. Indeval, S.A. de C.V.⁴³ Indeval did not operate the only central system in Mexico, since the Mexican central bank also operated a system for certain Mexican Government securities. Nonetheless, the Staff agreed that Indeval satisfied the Rule 17f-5 central system requirement because it was the central system for the securities it handled, which were different from the securities handled by the Mexican central bank. Similarly, in the PRC, Shenzhen and Shanghai are each the sole and exclusive share registry systems for their markets and the B shares

⁴² See supra note 6 and accompanying text.

⁴³ Supra page 13.

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traded therein. Unlike the situation in Reserve Bank of Australia,⁴⁴ there is no overlap in the securities handled between Shenzhen and Shanghai. For these reasons, both Shenzhen and Shanghai are the central system in the sense relevant to their respective markets,⁴⁵ since a book-entry system need not handle all securities traded in a particular country, but need only be the exclusive system that handles particular securities.

For these reasons, we believe it is unnecessary to establish that Shenzhen and Shanghai constitute an integrated system. Since there is no possibility of any transfer of funds or securities between the two systems, integration would serve no function. Indeed, we are hard-pressed to understand how two self-contained systems of this nature could be integrated. Both systems are, as described above, subject to the oversight and control of the PRC Government through the PBOC. The PBOC has already established certain common policies and procedures for both systems, such as T+3 settlement,⁴⁶ and continuously monitors their activities. Under the circumstances, further "integration" is unnecessary.

IV. Conclusion

For the reasons stated above, we request that the Staff confirm that it will not recommend enforcement action under Section 17(f) of the Investment Company Act of 1940 against any registered investment company that, in reliance upon Section 17(f) and Rule 17f-5 thereunder, maintains assets through the custody facilities

⁴⁴ Supra note 32.

⁴⁵ This approach is consistent with the analogous domestic requirements under Rule 17f-4. We note that, prior to the adoption of Rule 17f-5, Rule 17f-4 was used as a bench mark for determining the acceptability of a foreign depository and the proposed custody arrangements. See, e.g., State Street Bank and Trust Company SEC No-Action Letter (Jan. 12, 1984). We note that this is also the test established in Section 17A of the Securities Exchange Act of 1934, which is incorporated by reference into Rule 17f-4, and the test established for qualifying pension plans which maintain assets overseas under ERISA Regulation 404b-1.

⁴⁶ See Article 24, Detailed Implementing Rules for the Measures of Shanghai Municipality for Administration of Special Renminbi-Denominated Shares (SSR at 23); Article 60, Operating Rules of the Shenzhen Securities Exchange for Trading and Clearing of B Shares (SSR at 66).

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of one or more of our clients in the book-entry systems of the Shenzhen and Shanghai securities markets. In the event that the Staff is not inclined to grant the relief requested herein, I would respectfully request the opportunity to meet with you prior to any final determination.

For the convenience of the Staff, seven copies of this letter are enclosed. If you require further information, or wish to discuss this request, please feel free to contact me, or Simon Zornoza of this office, at (202) 452-7000.

Sincerely,



Daniel L. Goelzer

Enclosure:

Selected Securities Regulations of the Peoples Republic of China