



DIVISION OF
INVESTMENT MANAGEMENT

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ACT JCA
SECTION 17f
RULE 17f-5
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Re: Compulsory Depositories under Rule 17f-5

Dear Ms. Donohue and Mr. Goelzer:

This is in response to your letters of November 24 (on behalf of the Investment Company Institute ("ICI")) and December 11 (on behalf of the Association of Global Custodians ("Global Custodians")) to the Division seeking our guidance in the interpretation of recent amendments to rule 17f-5 under the Investment Company Act of 1940 (the "Act"). Because your letters raise the same issues, we are providing a single response.

In your letters, you ask whether the selection of a compulsory depository may be delegated to the "Foreign Custody Manager" of an investment company under rule 17f-5 under the Act. As explained in more detail below, rule 17f-5 draws no distinction between compulsory and other securities depositories that are "eligible foreign custodians" under the rule. As a result, the selection of a compulsory depository may be delegated to a fund's Foreign Custody Manager.

Discussion

Rule 17f-5 permits investment companies registered under the Act to maintain assets in foreign countries with foreign custodians under certain conditions. In 1997, the Commission amended the rule to permit the delegation of certain fund board responsibilities under the rule and to expand the types of foreign banks and securities depositories that may

serve as investment company custodians.¹ The Commission also revised the rule to eliminate the requirement that certain findings be made regarding "prevailing country risks"-- systemic risks that affect the ability of any custodian to safeguard assets in a particular country.² The amended rule "focuses exclusively on the selection and monitoring of an eligible foreign custodian."³

The Global Custodians contend that the Commission's determination to exclude prevailing country risks from the rule logically results in the interpretation of rule 17f-5 as excluding compulsory depositories from the "selection process" under rule 17f-5. They believe that is so because a fund whose board has decided to invest in a country with a compulsory depository "as a practical matter" must use that depository. Thus, according to the Global Custodians, the decision to invest in such a country is inevitably a decision to use that country's compulsory depository, and should be made by the fund's board rather than its Foreign Custody Manager. As a result, the Global Custodians argue, rule 17f-5 should be interpreted as not permitting a fund's board to delegate the selection of a compulsory foreign depository.

We do not believe that rule 17f-5 can be interpreted to exclude compulsory depositories from the rule's selection process, nor do we believe that rule 17f-5 can be interpreted to preclude fund boards from delegating to a Foreign Custody Manager the selection of a compulsory depository. Rule 17f-5, by its terms, includes compulsory securities depositories as eligible foreign custodians.⁴ Under the rule, a fund's board of directors may delegate to its Foreign Custody Manager the selection of any type of eligible foreign custodian, subject to the conditions included in the rule.⁵

The Global Custodians assert that the practical effect of the rule amendments may be to require a Foreign Custody Manager to determine that a fund may not invest in a particular

¹ Custody of Investment Company Assets Outside the United States, Investment Company Act Rel. No. 22658 (May 12, 1997) [62 FR 26923 (May 16, 1997)] ("Adopting Release").

² Adopting Release at Section III.A.2.

³ *Id.*

⁴ Rule 17f-5(a)(1)(ii) (defining an eligible foreign custodian to include, among others, a "securities depository. . . that acts as a system for the central handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority. . .").

⁵ Rule 17f-5(b).

foreign country because a compulsory depository does not meet the standards of the rule.⁶ This effect, however, is not inconsistent with eliminating consideration of prevailing country risks from the rule. The duties of the Foreign Custody Manager when assessing a compulsory depository are to evaluate whether the depository will exercise reasonable care and diligence in safeguarding fund assets.⁷ Such duties involve evaluation of the risks associated with the particular custodian and not prevailing country risks.⁸

We acknowledge that the rule amendments *could have* treated the custodial risks associated with the use of a compulsory depository as prevailing country risks because the use of such a depository may be necessary to invest in a particular country. This approach, however, would have eliminated an important protection of rule 17f-5—that the board or its delegate determine whether the *particular* custodian will provide reasonable care for fund assets.⁹ In addition, it would likely have involved the Commission and the Division in the determination of which foreign depositories are "compulsory" under the rule.¹⁰

⁶ We note that in determining whether a fund's assets will be subject to reasonable care if maintained with a particular custodian, the Foreign Custody Manager may base its decision on the standards applicable to custodians in the relevant market. Rule 17f-5(c)(1).

⁷ Rule 17f-5(c)(1)(i)-(iv).

⁸ Throughout the rulemaking process that resulted in the 1997 amendments, the Commission consistently indicated that it regarded selection of compulsory depositories to be "conceptually" within the selection of a particular foreign custodian rather than the evaluation of prevailing country risk. See Adopting Release, *supra* note 1, at n.29 and Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 21259 (July 27, 1995) [60 FR 39592 (Aug. 2, 1995)] n.71 (proposing amendments to rule 17f-5).

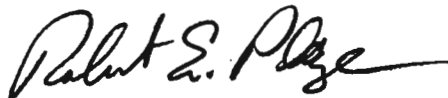
⁹ Rule 17f-5(c)(1)(i)-(iv).

¹⁰ Under rule 17f-5, before it was amended in 1997, the Division was asked on numerous occasions to determine whether a particular depository or clearing agency operated the central system for handling securities in its respective country. See, e.g., Securities and Exchange Board of India (pub. avail. Feb. 25, 1997); Interbolsa (pub. avail. Aug. 5, 1996); Financial Services Board (pub. avail. April 24, 1996); Hongkong Securities Clearing Company Limited (pub. avail. July 13, 1995); Warsaw Stock Exchange (pub. avail. Oct. 20, 1994); Japan Securities Depository Center (pub. avail. Aug. 31, 1993).

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We understand that the application of rule 17f-5's selection criteria to compulsory depositories raises several issues for funds, their advisers and foreign custody managers. We look forward to working with you and other interested members of the public to assist in resolving these issues.

Sincerely,



Robert E. Plaze
Associate Director