Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC–25266; File No. S7–22–01]

RIN 3235–AG71

Custody of Investment Company Assets With a Securities Depository

AGENCY: Securities and Exchange Commission (''Commission'').

ACTION: Proposed rule.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Company Act that governs investment companies' use of securities depositories. The amendments would expand the types of investment companies that can maintain assets with a depository, expand the types of depositories they can use, and update the conditions they must follow to use a depository. The amendments are designed to respond to developments in securities depository practices and commercial law since the rule was adopted.

DATES: Comments must be received on or before January 31, 2002.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–0609. Comments also may be submitted electronically to the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7–22–01; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW., Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet web site (http://www.sec.gov).[1]

[1] We do not edit personal, identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

FOR FURTHER INFORMATION CONTACT: Hugh P. Lutz, Attorney, or C. Hunter Jones, Assistant Director, Office of Regulatory Policy, at (202) 942–0690, in the Division of Investment Management, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549–0506.

SUPPLEMENTARY INFORMATION: The Commission today is proposing for public comment amendments to rule 17f–4 (17 CFR 270.17f–4) under the Investment Company Act of 1940 (15 U.S.C. 80a) (the ''Investment Company Act'' or the ''Act'').[2]

Table of Contents

Executive Summary

Rule 17f–4 under the Investment Company Act permits a registered management investment company (''fund'') to deposit the securities it owns in a system for the central handling of securities (''securities depository''). The Commission adopted the rule in 1978. Since then, the custody practices and commercial law that relate to custody arrangements with securities depositories have changed substantially.

Today we are proposing amendments to update and simplify rule 17f–4 to reflect these business and legal developments. The proposed amendments would permit additional types of custodians to operate depositories and allow depositories to perform additional functions under the rule, and would expand the types of investment companies that can rely on the rule. The amendments also would eliminate certain custodial compliance requirements of rule 17f–4 that are no longer necessary. Instead, the fund's contract with its custodian would be required to provide that the custodian will take appropriate action to safeguard assets held for the fund, and furnish the fund with periodic reports on its internal accounting controls and financial strength. Finally, the amendments would eliminate requirements that fund directors approve the fund's own custody arrangements and that the fund approve its custodian's arrangements with depositories.

I. Background

Section 17(f) of the Investment Company Act governs the custody of a fund's assets, including its portfolio securities.[3] This section requires a fund to maintain its securities and other investments with certain types of custodians under conditions designed to assure the safety of the fund's assets. After the ''paperwork crisis'' of the late 1960s demonstrated the inefficiency of transferring securities in paper certificate form,[4] Congress amended section 17(f) to permit a fund to deposit its securities in a system for the central handling of securities (also referred to as a ''securities depository''), subject to rules adopted by the Commission.[5] A securities depository handles the custody and transfer of securities through electronic bookkeeping rather than physical delivery of certificates.[6] Today, the widespread use of depositories permits the efficient

[2] Unless otherwise noted, all references to ''rule 17f–4'' or any paragraph of the rule will be to 17 CFR 270.17f–4.

[3] 15 U.S.C. 80a–17(f).

[4] *See* James S. Rogers, *Policy Perspectives on Revised UCC Article 8*, 43 UCLA L. Rev. 1431, 1442 (1996) [''Policy Perspectives''].

[5] *See* section 17(f) (authorizing use of ''system for the central handling of securities''); H.R. Rep. No. 1382, 91st Cong., 2d Sess. at 27 (1970) (amendment was intended to permit the use of a ''central certificate depository''); Policy Perspectives, *supra* note 4, at 1442–45 (the primary response to problems with paper settlement was immobilization of securities certificates through depositories; some securities were also dematerialized); Group of Thirty, Clearance and Settlement Systems in the World's Securities Markets 55–56 (Mar. 1989) (securities are immobilized by storing certificates with a depository that can transfer them by changing electronic records; securities are dematerialized by dispensing with any physical evidence of ownership and relying entirely on electronic records).

[6] *See* section 17(f).

electronic processing of high volumes of securities transactions.[7]

In 1978, the Commission adopted rule 17f–4 to establish conditions for use of securities depositories by funds.[8] The conditions were designed to limit potential risks to funds using the new depository systems. The conditions were drafted to be compatible with the 1978 revisions to Article 8 of the Uniform Commercial Code, which governs the ownership and transfer of investment securities under state law.[9]

Custody practices evolved after 1978, leading to significant revisions to Article 8 in 1994 (''Revised Article 8'').[10] Prior Article 8 assumed that issuers would record investors' interests on their own books. Today, investors typically maintain a security through an account with a broker-dealer, bank or other financial institution (''securities intermediary''),[11] which in turn will maintain an account for its customers with a securities depository.[12] The depository generally does not record each investor's interest, but records the interest of the intermediary on behalf of all of its customers.[13] Thus, the individual investor's interest (or ''security entitlement'') [14] appears only on the books of the intermediary with which the investor maintains an account.[15] Revised Article 8 refers to this type of securities ownership arrangement as an ''indirect holding'' arrangement,[16] as distinguished from a ''direct holding'' arrangement in which the investor's ownership interest appears on the issuer's books.[17] Revised Article 8 has significantly clarified the legal rights and duties that apply in indirect holding arrangements,[18] and every state has enacted Revised Article 8 into law.[19]

Last year, we adopted a new rule concerning the use of *foreign* securities depositories that focused on the risk of these arrangements.[20] In the *domestic* context, the important changes in custody practice and commercial law that have occurred since 1978 have reduced the risks of these arrangements, and made some requirements of rule 17f–4 unnecessary for the protection of fund assets. Today we are proposing to revise rule 17f–4 to reflect these and other developments. The amendments would (i) expand the types of custodial entities that may operate depositories under the rule and the functions they may perform, as well as the types of investment companies that may rely on the rule, (ii) update the conditions of the rule, and (c) revise certain fund approval requirements for custody arrangements involving depositories.

II. Discussion

A. Functions of a Securities Depository

We propose to update the terms we use in the rule to reflect the broader range of functions today performed by securities depositories for funds. The rule currently permits a securities depository to hold fund securities that are *transferred* (or pledged) by bookkeeping entry.[21] The proposed amendments would permit a depository to hold fungible assets that are transferred, pledged, or ''otherwise acquired or disposed of'' by bookkeeping entry.[22] Permitting a depository to hold assets that may be ''acquired or disposed of'' without being ''transferred'' would accommodate the use of depositories that hold open-end fund shares or ''Treasury Direct'' securities, both of which securities typically are conveyed through redemption by the issuer.[23] Other

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[7] The use of depositories also may enhance the efficiency of clearance and settlement by permitting the netting of offsetting transactions of depository participants before account balances are adjusted, and may eliminate some risks of holding paper certificates. *See* Policy Perspectives, *supra note*, at 1442; Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 23815 (Apr. 29, 1999) [64 FR 24489 (May 6, 1999)] at n.20 and accompanying text. The immobilization of certificates in depositories has steadily increased since 1975 when Congress amended the Securities Exchange Act of 1934 (''Exchange Act'') to authorize the Commission to develop a national system for clearance and settlement. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 4–6, 55–56 (1975); sections 3(a)(23)(A) and 17A of the Exchange Act [15 U.S.C. 78c(a)(23)(A), 78q–1].

[8] *See* Deposits of Securities in Securities Depositories, Investment Company Act Release No. 10453 (Oct. 26, 1978) [43 FR 50869 (Nov. 1, 1978)] [''1978 Adopting Release'']. We estimate that more than 97 percent of all funds now use depository custody arrangements. Our estimate is based on responses to Item 18 of Form N–SAR [17 CFR 274.101].

[9] *See* Uniform Commercial Code, 1978 Official Text with Comments, Article 8, Investment Securities (West 1978) (''Prior Article 8''); Use of Depository Systems by Registered Management Companies, Investment Company Act Release No. 10053 (Dec. 8, 1977) [42 FR 63722 (Dec. 19, 1977)] (''1977 Reproposing Release'') at nn. 4–7, 9, 12 and accompanying text (citing provisions of Prior Article 8); 1978 Adopting Release, *supra* note 8, at nn. 4 and 6.

[10] *See* Uniform Commercial Code, Revised Article 8—Investment Securities (With Conforming and Miscellaneous Amendments to Articles 1, 4, 5, 9, and 10) (1994 Official Text with Comments) (''Revised Article 8''), Prefatory Note at I.B., C., and D.; Warren F. Cooke, *United States Legal Report, in Banking Yearbook 1998* 157–62 (Richard Forster ed., Euromoney Publications 1998) (referring to Revised Article 8 as ''[o]ne of the most significant legal shifts in the U.S. legal landscape affecting banking'').

[11] Revised Article 8, *supra* note 10, Prefatory Note to Art. 8, Part III.A. and § 8–102(a)(14) (defining a ''securities intermediary'').

[12] The Depository Trust Company (''DTC'') is a registered clearing agency that acts as the securities depository for most publicly traded equity securities and many fixed-income securities (other than government securities) in U.S. markets.

[13] Intermediaries deposit their securities with a depository, and the depository's records reflect the ownership interests of the various intermediaries in those securities. *See* Revised Article 8, *supra* note 10, Prefatory Note to Art. 8, Parts I.B., C., and D.

[14] *See* Revised Article 8, supra note , § 8–102(a)(17) and cmt. 17 (''security entitlement'' means ''the rights and property interest of an entitlement holder with respect to a financial asset'' in an ''indirect holding'' arrangement).

[15] A security entitlement gives the investor a limited pro rata property interest in comparable entitlements (or other interests in securities) maintained by the investor's intermediary with a depository or other intermediary. *See* Revised Article 8, *supra* note 10, §§ 8–503(b) and cmt. 1, and 8–504 and cmt. 1 (all customers of the securities intermediary share a pro rata property interest in all interests in the same financial asset held by the intermediary).

[16] An indirect holding arrangement can be compared to a chain of persons who hold interests in a particular security. The investor stands at one end of the chain and the issuer at the other end. They are linked by one or more securities intermediaries (such as a bank and a depository). The investor has certain rights against the intermediary linked to it, which in turn has rights against the next intermediary. The issuer owes certain duties to the depository, which owes duties to the next intermediary, which owes duties to the investor. *See generally* Revised Article 8, *supra* note 10, Prefatory Note to Art. 8, Parts I.B., C., D., and II.C., and § 8–109.

[17] In a direct holding arrangement, the investor or its custodian may hold either certificates or uncertificated securities that have been registered in the investor's own name.

[18] *See infra* note and accompanying text.

[19] Revised Article 8 has been adopted by all 50 states, the District of Columbia, and Puerto Rico. The National Conference of Commissioners on Uniform State Laws, *Introductions & Adoptions of Uniform Acts: A Few Facts About'Revised UCC Article 8* (1994) (visited Aug. 14, 2001) <http://www.nccusl.org/nccusl/uniformact—factsheets/uniformacts-fs-ucca8.asp>. The U.S. Department of the Treasury relied on Revised Article 8 in drafting its Treasury/Reserve Automated Debt Entry System (''TRADES'') regulations for government securities. *See* Regulations Governing Book-Entry Treasury Bonds, Notes and Bills, Department of the Treasury Circular, Public Debt Series, No. 2–86 [61 FR 43626 (Aug. 23, 1996)] (''1996 Treasury Circular'') (adopting TRADES regulations codified at 31 CFR 357, Subpart B). The Commission staff has stated that it would not recommend enforcement action if certain funds used the federal book-entry system under the revised regulations. Investment Company Institute, SEC No-Action Letter (Oct. 3, 1997).

[20] *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 24424 (Apr. 27, 2000) [65 FR 25630 (May 3, 2000)] (''Rule 17f–7 Adopting Release'').

[21] *See* rule 17f–4(a).

[22] Proposed rule 17f–4(b)(9). Rule 17f–4 also requires that the securities be fungible. Under the proposed amendments, the securities would be considered fungible even if a depository transfers some shares of the same class in different forms (*e.g.*, it transfers most shares in electronic form, but periodically transfers some shares in certificate form).

[23] *See* Revised Article 8, supra note 10, at § 8–102(a)(18) (''uncertificated security'' means a security that is not represented by a certificate); § 8–103 cmt. 3 (''the typical transaction in shares of open-end investment companies is an issuance or redemption, rather than a transfer of shares''); 1996 Treasury Circular, *supra* note 19, Appendix B to

Continued

amendments to rule 17f–4 also would permit a depository to hold assets that are conveyed ''by physical delivery.'' [24] This change is designed to facilitate the use of centralized custody arrangements for investments that are commonly held in certificate form.[25]

The proposed amendments also would update the terminology of rule 17f–4 that describes how funds and their custodians use depositories. The rule currently permits a fund or its custodian (or an agent of the custodian) to ''deposit * * * securities owned by'' the fund in a depository.[26] The proposed amendments would permit a fund or its custodian to ''place and maintain assets'' in a depository,[27] and permit a custodian to use an ''intermediary custodian.''[28]

B. Scope of the Rule

Rule 17f–4 permits funds to maintain assets with a depository established by a registered clearing agency, such as DTC, and the book-entry system of the Federal Reserve.[29] We now propose to revise the scope of rule 17f–4 by permitting funds to maintain assets with a registered transfer agent for the purpose of holding shares of an open-end registered management investment company (mutual fund).[30] This amendment would acknowledge that a mutual fund's transfer agent may serve as the functional equivalent of a depository.[31] This amendment responds to the growth in ''fund of funds,'' cash sweep and other arrangements in which a registered investment company invests in shares of a mutual fund.

We request comment on the scope of rule 17f–4 and our proposed amendments. Are there other organizations that act as depositories for funds? Should they be included in the rule?

C. Reliance on Rule by Non-Management Companies

Rule 17f–4 currently permits only registered *management* investment companies, *i.e.,* open-end funds (or mutual funds) and closed-end funds, to rely on the rule.[32] The proposed amendments would broaden the rule to permit any registered investment company, including a unit investment trust (''UIT'') or a face-amount certificate company, to use a securities depository.[33] The staff has stated that it would not recommend enforcement action in similar circumstances when non-management companies maintained assets in a depository[34] to supplement custody arrangements with a trustee.[35] Because a non-management company has no directors, officers, or investment adviser, the proposed amendments would authorize a trustee to approve these arrangements.[36] The trustee also would have to establish an internal control system reasonably designed to prevent unauthorized officer's instructions.[37] The Commission requests comment on these proposals for the use of depositories by non-management companies. Should other conditions apply to these arrangements? [38]

D. Compliance Requirements for the Custodian or Securities Depository

Rule 17f–4 requires that, if a fund holds securities in a depository through a custodian or its agents, the custodian must maintain the fund's securities in a depository account for the custodian's

Part 357 at n.1 and accompanying text (describing ''Treasury Direct'' system through which investors may hold non-transferable Treasury securities issued directly to them).

[24] A centralized processing facility that transfers certificates by physical delivery appears to offer benefits comparable to those of a depository, including centralized custody, recordkeeping, and transfer capabilities, and reduction of the expenses, delays, and risks of decentralized holding of certificates.

[25] These types of investments include some equity securities, bankers acceptances, certificates of deposit, municipal securities, and non-depository eligible mortgage-backed securities.

[26] Rule 17f–4(b).

[27] Proposed rule 17f–4(a). ''Place and maintain'' would be substituted for ''deposit'' in order to make the language of the rule more consistent with Revised Article 8 and with rules 17f–5 and 17f–7. *See* Revised Article 8, *supra* note 10, § 8–504 (duty of securities intermediary to ''maintain'' financial asset); rule 17f–5 Note; rule 17f–7 Note. ''Assets'' would be substituted for ''securities owned by the fund'' to clarify that assets are not always held in the fund's name and may not be its exclusive property. *See supra* note 15. ''Assets'' would include cash, securities, and similar investments owned by the fund or held by another person for the fund's benefit. Proposed rule 17f–4(b)(1). The staff has stated that it would not recommend enforcement action if a fund that participated directly in a depository maintained a cash account to facilitate settlement or to secure obligations to a reserve fund. Midwest Securities Trust Co., SEC No-Action Letter (Mar. 14, 1990).

[28] Proposed rule 17f–4(b)(5) (an intermediary custodian would mean any subcustodian through which the fund's custodian maintains assets with a depository, if the subcustodian is qualified to act as a custodian).

[29] *See* rule 17f–4(b)(1), (2), (c), and (d). The proposed amendments would update references to Treasury regulations to reflect revisions and to add a reference to the Treasury Direct regulations. *See supra* note 19; proposed rule 17f–4(a)(4)(i).

[30] Proposed rule 17f–4(a)(4)(iii). A conventional depository rarely holds shares issued by a fund. *See* Transfer Agents Operating Direct Registration System, Securities Exchange Act Release No. 35038 (Dec. 1, 1994) [59 FR 63662 (Dec. 8, 1994)] at n.6 and accompanying text. The staff has stated that it would not recommend enforcement action when a fund acts as a transfer agent for its own shares. *See* Capital Supervisors Helios Fund, Inc., SEC No-Action Letter (June 18, 1984). *See also* American Pension Investors Trust, SEC No-Action Letter (Feb. 1, 1991) (staff stated it would not recommend enforcement action if the custodian for fund of funds maintained shares of underlying funds with its transfer agent based on rule 17f–4 if underlying funds did not disclaim liability for acting on instructions believed to be genuine); Gardner Fund, SEC No-Action Letter (Mar. 7, 1988) (staff stated that it would not recommend enforcement action if fund of funds maintained its investments directly with transfer agents of unaffiliated funds, subject to conditions based on rules 17f–2 and 17f–4).

[31] A registered transfer agent, like a clearing agency, is subject to significant regulatory oversight. A transfer agent must register with the Commission or a bank regulatory agency, section 17A(c) of the Exchange Act [15 U.S.C. 78q–1(c)], and must comply with Commission regulations that govern its primary functions. *See* sections 17A(d)(1) and (2) of the Exchange Act [15 U.S.C. 78q–1(d)(1)–(2)] (Commission may prescribe regulations for any registered transfer agent, which may be enforced by Commission or transfer agent's appropriate regulatory agency); rules 17Ad–1 to 17Ad–13 [17 CFR 240.17Ad–1—240.17Ad–13] (Commission rules apply to all registered transfer agents, including banks, with limited exceptions for ''exempt transfer agents'' that handle few transactions under 17 CFR 240.17Ad–4(b)); Securities Exchange Act Release No. 35038, *supra* note 30 (Commission rules address matters including the timely issuance and cancellation of certificates, recordkeeping practices, and the safeguarding of securities and cash); sections 17A(d)(3), (d)(4), and (f) of the Exchange Act [15 U.S.C. 78q–1(d)(3), (d)(4), and (f)] (rules adopted by other regulatory bodies must be consistent with Commission rules).

[32] Rule 17f–4(b). Section 17(f) of the Investment Company Act likewise applies to registered management companies.

[33] Proposed rule 17f–4(b)(4) (''fund'' means a registered investment company).

[34] *E.g.,* Bradford Trust Co., SEC No-Action Letter (Nov. 29, 1982) (staff stated it would not recommend enforcement action if trustee maintained UIT's holdings of corporate and municipal bonds with DTC); United States Trust Co. of New York, SEC No-Action Letter (Apr. 16, 1992) (staff stated it would not recommend enforcement action if trustee maintained UIT's investments in open-end funds with transfer agents of portfolio funds under conditions based on rule 17f–4, if portfolio funds did not disclaim liability for acting on instructions believed to be genuine). Insurance company separate accounts registered as UITs also may use depository-like arrangements. *See* rule 26a–2(b) under the Act [17 CFR 270.26a–2(b)] (separate account registered as UIT may hold securities of underlying portfolio funds in uncertificated form with transfer agent); rules 6e–2(b)(9)(iv) and 6e–3(T)(b)(9)(iv) under the Act [17 CFR 270.6e–2(b)(9)(iv), and 270.6e–3(T)(b)(9)(iv)].

[35] Section 26(a)(2)(D) of the Act [15 U.S.C. 80a–26(a)(2)(D)] requires the assets of a UIT to be held by a trustee. Section 28(c) of the Act [15 U.S.C. 80a–28(c)] imposes similar requirements on a face-amount certificate company, but authorizes the Commission to adopt custody rules.

[36] Proposed rule 17f–4(a)(3).

[37] Proposed rule 17f–4(a)(2)(ii) and (b)(6). The staff has stated that it would not recommend enforcement action if, among other things, a trustee maintained a system designed to prevent unauthorized officer's instructions. United States Trust Co. of New York, *supra* note 34. Under the proposed amendments, the trustee as the fund's custodian also would have to enter into an appropriate custody agreement with the company's sponsor. *See* proposed rule 17f–4(a)(1).

[38] *See, e.g.,* United States Trust Co. of New York, *supra* note 34 (staff stated that it would not recommend enforcement action if, among other things, the shares of a portfolio fund were registered with transfer agent in the name of trust company as trustee of UIT).

customers that is separate (or ''segregated'') from the depository account for the custodian's own securities, and must identify (or ''earmark'') on the custodian's records a portion of the total customer securities as belonging to the fund (the ''segregation and earmarking requirements''). The custodian also must send to the fund confirmations of transfers to or from the fund's account with the custodian (the ''confirmation requirement'').[39] In addition, a depository that deals directly with a fund must deliver the fund's securities to an appropriate successor if the depository no longer acts for the fund (the ''successor custodian requirement'').[40] Each of these requirements appears unnecessary for the protection of fund assets in light of the revisions to commercial law adopted in Revised Article 8. The proposed amendments would eliminate these requirements and substitute requirements designed to provide reasonable protection for fund assets under modern commercial law.

With respect to the segregation and earmarking requirements, Revised Article 8 provides that a fund and other customers of a custodian have proportionate interests in all securities of the custodian, even if the custodian does not segregate particular securities as the property of customers.[41] In addition, the earmarking of some securities for the fund rather than other customers appears inconsistent with the guiding principle of Revised Article 8 to treat entitlement holders alike.[42] The confirmation requirement of rule 17f–4 seems unnecessary to establish the fund's ownership of security entitlements under commercial law,[43] and may in effect limit the methods the custodian uses to inform the fund about the status of its securities account.[44] Finally, the rule's successor custodian requirement seems unnecessary[45] and concerns matters that should reasonably be the responsibility of the fund.[46]

The proposed amendments to rule 17f–4 would substitute more general compliance requirements for custodians and depositories in place of these existing requirements.[47] First, the fund's contract with its custodian would be required to provide that the custodian will take all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard assets held by the custodian, or assets maintained elsewhere for the benefit of the fund.[48] If the fund deals directly with a depository, the depository's contract or rules for participants would be required to provide that the depository will meet similar obligations.[49] These undertakings would assure that the fund's own custodian or depository must comply with the specified duties of a securities intermediary or issuer under Revised Article 8.[50] This assurance is important because Revised Article 8 sharply limits the ability of a fund to seek recourse from any party other than its own custodian for assets mishandled by the custodian.[51]

Second, the custody contract (or depository rules) would have to state that the custodian (or depository) will promptly provide periodic reports on its internal accounting controls and financial strength, and available reports on the controls of any depository or intermediary custodian it uses.[52] Rule 17f–4 currently requires a custodian to provide similar reports about internal controls.[53] Periodic review of a custodian's controls by fund auditors is a significant safeguard for fund assets.[54] The fund also should consider the financial strength of its own custodian or of any depository with which it deals directly.[55]

The Commission requests comment on the proposed contractual requirement to take actions necessary or appropriate under applicable commercial and regulatory law to safeguard assets. Should the rule specify duties applicable in particular

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[39] *See* rule 17f–4(d)(2)–(3).

[40] *See* rule 17f–4(c)(2).

[41] *See supra* note 15 and accompanying text; *cf.* Revised Article 8, *supra* note 10, § 8–511 (entitlement holders have priority over creditors' claims to all assets of their securities intermediary, unless a creditor has perfected a security interest in some assets by obtaining ''control''). In direct holding arrangements, segregation of customer assets seems unnecessary to protect fund shares or securities certificates that are maintained in the fund's own name with a depository such as a transfer agent or a centralized processing facility.

[42] *See* Revised Article 8, *supra* note 10, § 8–503 and cmts. 1–2 (one entitlement holder generally cannot assert that its rights to the assets held by a securities intermediary are superior to the rights of another entitlement holder; a security entitlement is not a claim to a specific identifiable thing).

[43] *See* Revised Article 8, *supra* note 10, § 8–501(b) and cmt. 2 (securities intermediary creates a security entitlement when it indicates by book entry that a financial asset has been credited to the customer's account, accepts an asset for credit to the account, or becomes obligated under law to credit an asset); cmt. 3 (the existence of a security entitlement does not depend on when the custodian acquires financial assets to support it); *cf.* 1977 Reproposing Release, *supra* note 9, at nn. 4–7 and accompanying text (confirmation may help to establish fund's ownership of securities). Confirmation also seems unnecessary to protect assets that are maintained directly with a depository in the fund's own name. *See supra* note 41.

[44] The custodian and fund may prefer timed updates, daily balance reports, or other methods of indicating that the custodian has credited an account. *See* Revised Article 8, *supra* note 10, § 8–501(b) cmt. 2 (''Paragraph (1) does not attempt to specify exactly what accounting, record-keeping, or information transmission steps suffice to indicate that the intermediary has credited the account. That is left to agreement, trade practice, or rule in order to provide the flexibility necessary to accommodate varying or changing accounting and information processing systems.'').

[45] Rule 17f–4(c)(2) requires that, if a fund deals with a depository directly (rather than through a custodian), the arrangement with the depository must provide that, if the depository ceases to act for the fund, it will deliver the fund's assets to an appropriate successor custodian. The provision appears unnecessary because failure by a fund to maintain assets in a permissible manner would violate section 17(f) of the Act.

[46] *See infra* Section II.E.

[47] Proposed rule 17f–4(a)(1) and (2)(i).

[48] Proposed rule 17f–4(a)(1)(i) (obligation of custodian or trustee of unit investment trust). The applicable commercial law normally would be the local law of the jurisdiction of the custodian, *see* Revised Article 8, *supra* note 10, § 8–110, which would usually be Revised Article 8 or similar regulations that govern the federal book-entry system.

[49] Proposed rule 17f–4(a)(2)(i). A depository that deals only with the fund's custodian would not have to enter into an agreement with the fund.

[50] The securities intermediary's duties under commercial law include: (i) maintaining sufficient unencumbered financial assets to cover all security entitlements of all entitlement holders, *see* Revised Article 8, *supra* note 10, § 8–504; (ii) obtaining for the entitlement holder payments made by the issuer of a financial asset, *id.*, § 8–505; (iii) exercising rights with respect to a financial asset (such as the right to vote proxy materials) as directed by the holder, *id.*, § 8–506; (iv) complying with orders given by the holder concerning financial assets (such as to dispose of entitlements), *id.*, § 8–507; and (v) changing the holder's entitlement into another available form of holding upon request (such as converting it into a security certificate in a direct holding arrangement), *id.*, § 8–508. A transfer agent may be subject to the duties of an issuer under commercial law. *See, e.g.,* Revised Article 8, § 8–207 (duties of issuer concerning registered owner); § 8–401 (duty of issuer to register transfer).

[51] *See* Revised Article 8, *supra* note 10, §§ 8–116, 8–502, 8–503 and cmts. 2–3, 8–510 (adverse claims may not be asserted against a purchaser who acquires a security entitlement for value and without notice of the adverse claims; entitlement holders may assert a claim against a purchaser other than their securities intermediary only if their own intermediary is insolvent and lacks sufficient assets to satisfy their claims, and the purchaser knowingly colluded with the intermediary to violate duties to holders); Policy Perspectives, *supra* note 4, at 1508.

[52] Proposed rule 17f–4(a)(1)(ii) (obligation of custodian); *see* proposed rule 17f–4(a)(2)(i) (similar obligation for depository that deals directly with the fund).

[53] *See* rule 17f–4(d)(4).

[54] Fund auditors review a custodian's internal controls when evaluating factors that could affect the fair presentation of information in financial statements. *See* AICPA Audit and Accounting Guide, Audits of Investment Companies, ¶¶ 2.132 to 2.136 (May 1, 1998) (auditor reviews fund's internal control structure and considers custodian's controls; should test interaction of these controls); Sub-Item 77B of Form N-SAR [17 CFR 274.101] (auditor's report on internal controls must be attached to the fund's Form N-SAR report).

[55] Revised Article 8 severely limits the circumstances in which the fund could assert a claim against anyone other than its own custodian. *See supra* note and accompanying text.

circumstances?[56] Should the rule clarify that custody contracts should not generally waive duties under commercial law? [57] We also request comment on the proposed contractual requirement to provide reports on the custodian's internal accounting controls and financial strength, and reports on the internal controls of subcustodians. Is it appropriate to require reports about the custodian's financial strength? Are reports on subcustodians' internal controls unnecessary because subcustodians do not deal directly with the fund? [58] Should other requirements apply to a custodian or depository? Should the amendments include a transition provision that would apply the current requirements of the rule to any custody arrangement that remains subject to Prior Article 8?[59]

E. Approval of Custody Arrangements

We are proposing to eliminate the requirements of rule 17f–4 that fund directors approve (i) the fund's direct arrangements with depositories, and (ii) arrangements by custodians with depositories.[60] Custody arrangements involving depositories have become routine.[61] Although directors, in exercising their general responsibility to oversee fund operations, should monitor the fund's dealings with its own custodian, close involvement in approving arrangements with domestic depositories appears unnecessary. The amendments would permit the fund itself (through an officer) to approve arrangements with depositories and with custodians that use depositories.[62]

The Commission requests comment on these proposals. Should the fund or its directors have to approve any arrangement in which the custodian maintains certificates in the fund's name with a centralized processing facility,[63] or maintains fund shares with a transfer agent that acts as a depository? Should the fund board have to approve any direct dealings with a depository?

F. Note Clarifying Application of Rule 17f–4

We propose to add a note to rule 17f–4 clarifying the relationship between that rule and rule 17f–5 under the Act, which governs the maintenance of fund assets with a foreign custodian.[64] The note would state that a custody arrangement in which fund assets are held with a U.S. depository through a foreign custodian, would be governed by rule 17f–5 as well as by rule 17f–4.[65]

III. General Request for Comment

The Commission requests comment on the rule amendments proposed in this Release, suggestions for additional changes to existing rules or forms, and comment on other matters that might have an effect on the proposals contained in this Release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,[66] the Commission also requests information regarding the potential impact of the proposals on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

IV. Effects on Efficiency, Competition, and Capital Formation

Section 2(c) of the Investment Company Act requires the Commission, when it engages in rulemaking and is required to determine whether an action is consistent with the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[67] The Commission therefore requests comment whether the proposals, if adopted, would promote efficiency, competition, and capital formation. Does rule 17f–4 currently create inefficiencies? Would the proposed amendments reduce or compound those inefficiencies? Would other regulatory approaches be more efficient? Does rule 17f–4 currently hinder competition or capital formation? Would the proposed amendments, or any alternative amendments, result in improvements in competition or capital formation? Commenters are requested to provide empirical data to support their views.

We have received correspondence from an association of global bank custodians (''Bank Custodians'') that raises issues of regulatory fairness under the Commission's rules. The Bank Custodians recommend that the Commission treat domestic and transnational depositories similarly under the Commission's custody rules under section 17(f).[68] The Bank

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[56] Special duties might be appropriate when a fund or its custodian maintains securities certificates with a centralized processing facility. If the certificates are not endorsed to the facility, and the facility does not act as a representative for the issuer, the facility may not have to comply with either the duties of a securities intermediary or the duties of an issuer under Revised Article 8.

[57] *See* Revised Article 8, *supra* note 10, §§ 8–111, 8–504(c)(1), 8–505(a)(1), 8–506(1), 8–507(a)(1), 8–508(1), 8–509(b) (securities intermediary must perform its duties under Revised Article 8 with ''due care in accordance with reasonable commercial standards,'' unless modified by regulatory requirements or contractual provisions that meet ''good faith'' standard).

[58] A fund could rarely assert a claim against an intermediary with which it does not deal directly. *See supra* note 51.

[59] A few U.S. jurisdictions may require additional time to enact Revised Article 8 into law. *See supra* note. In jurisdictions where Revised Article 8 is in effect, a fund would need to update its custody contracts to incorporate the revised protections and remove any inconsistent provisions. *See* proposed rule 17f–4(a)(3) (discussed below).

[60] *See* rule 17f–4(c)(3), (d)(5); proposed rule 17f–4(a)(3).

[61] *See* Revision of Certain Annual Review Requirements of Investment Company Boards of Directors, Investment Company Act Release No. 19719 (Sept. 17, 1993) [58 FR 49919, 49920 (Sept. 24, 1993)] (commenters suggested that depository arrangements are commonplace, generally do not involve conflicts of interest, and involve a degree of technical expertise that is more appropriately exercised by fund management); *cf. id.* at n.15 (consent requirement in section 17(f) may favor director approval); *see* SEC Division of Investment Management, Protecting Investors: A Half-Century of Investment Company Regulation at 255 (May 1992) (directors should primarily address conflicts of interest).

[62] *See* proposed rule 17f–4(a)(3). This approval would satisfy the statutory requirement that a custodian use a system for the central handling of securities only ''with the consent of the registered management company for which it acts as custodian.'' *See* section 17(f). If the fund is a unit investment trust or other non-management company, a trustee would be required to approve those arrangements. *See* proposed rule 17f–4(a)(3).

[63] *See supra* note and accompanying text.

[64] The note would not add any new requirements, but instead would clarify the operation of rules 17f–4 and 17f–5 in cases where fund assets are held with a U.S. depository through a foreign custodian.

[65] In some circumstances, rule 17f–2 (governing fund ''self-custody'') may apply to a depository arrangement as well. The staff has taken the position that a ''self-custody'' arrangement may arise when the fund's investment adviser controls or is controlled by (or is under common control with) the fund's custodian, intermediary custodian, or depository, and that these arrangements may be subject to rule 17f–2 under the Investment Company Act (governing self-custody arrangements), as well as rule 17f–4. *See, e.g.,* Rodney Square Fund, SEC No-Action Letter (June 15, 1987) (staff refused to provide assurance concerning enforcement action in case where a fund's custodian was adviser to one fund and controlled adviser to other funds, and custodian/adviser retained effective control over assets even though it maintained assets with unaffiliated depository). *See also* Mutual Fund Group, SEC No-Action Letter (Dec. 12, 1989) (staff refused to provide assurance concerning enforcement action in case where a fund's adviser also acted as subcustodian, despite fund's use of unaffiliated custodian); In the Matter of Gofen and Glossberg, Inc., Investment Advisers Act Release No. 1400 (Jan. 11, 1994) (the Commission imposed sanctions for adviser's failure to protect client trust assets held by unaffiliated custodian but transferable by adviser's employees as trustees). The existence of common personnel also may raise self-custody concerns. *See, e.g.*, Dean Witter World Wide Investment Trust, SEC No-Action Letter (Mar. 14, 1988) (staff stated that it would not recommend enforcement action if, among other things, foreign adviser's personnel did not have access to assets held by affiliated domestic custodian).

[66] Pub. L. 104–121, Title II, 110 Stat. 857 (1996).

[67] 15 U.S.C. 80a–2(c).

[68] *See* Letter from Daniel L. Goelzer, Baker & McKenzie, to Robert E. Plaze, Associate Director, Division of Investment Management (Dec. 7, 2000). *See also* Letter from Daniel L. Goelzer, Baker & McKenzie, to C. Hunter Jones, Assistant Director, Division of Investment Management (Oct. 17, 2001). These letters are available in File No. S7–19–00 (comments on Commission's Regulatory Flexibility

Custodians stated that the treatment of depositories under rule 17f–4, rule 17f–5 (governing eligibility of foreign custodians to hold fund assets), and rule 17f–7 (governing eligibility of foreign depositories to hold fund assets) is premised on two assumptions—that U.S. depositories will handle and hold securities that are traded in the United States, and that foreign banks and depositories will handle and hold securities that trade outside the United States, in the jurisdiction in which the securities' markets are located. In the Bank Custodians' view, these assumptions are becoming increasingly obsolete, because local depositories often do not serve a single market but instead are portals to custody in other markets. Given this development, the Bank Custodians suggest that rule 17f–4 should include requirements that are similar to those contained in rules 17f–5 [69] and 17f–7 [70] or, alternatively, that the requirements of the latter rules should apply if a domestic depository holds custody of its assets with foreign custodians or depositories.[71]

We have decided not to propose the amendments to rule 17f–4 suggested by the Bank Custodians at this time, because they may impose unnecessary burdens on funds using U.S. depositories. We regulate the U.S. depositories discussed by the Bank Custodians as clearing agencies under the Securities Exchange Act of 1934.[72] As such, they are subject to rigorous standards for their operations, which are designed to safeguard the interests of investors, including investment companies.[73] Before a clearing agency may establish a link with a foreign custodian or depository, it must obtain an order from us after demonstrating that its arrangement with the custodian or depository will adequately safeguard customer securities.[74] We believe our approval and ongoing monitoring of a clearing agency's link with a foreign custodian or depository provide at least the same degree of protection of fund assets as the standards that apply to a foreign custodian or depository that holds assets on behalf of a fund under rules 17f–5 and 17f–7.[75] Thus it initially appears unnecessary to require U.S. depositories that link to foreign custodians and depositories to also satisfy the eligibility requirements of rules 17f–5 and 17f–7.

While we are not proposing the amendments to rule 17f–4 recommended by the Bank Custodians, we are concerned about the issues of regulatory fairness raised in their letter. Would our failure to apply rules 17f–5 and 17f–7 (or their requirements) to domestic depositories create an unfair burden on competition between domestic depositories and global custodians of funds? If it would, should we therefore apply those rules to U.S. depositories that hold fund assets through foreign linkages? Alternatively, should we amend rules 17f–5 and 17f–7 to provide an exception from some or all of their requirements if a fund maintains assets with a foreign custodian with which a U.S. depository has established a linkage? Would such a change impede the establishment of linkages that a U.S. depository might otherwise choose to establish?

We specifically request analyses of the costs and benefits of any such regulatory approaches. Is there any difference in costs to funds and risks to investors, either because of differences in disclosure to funds or otherwise, between arrangements in which a fund uses a clearing agency's linkage with a foreign depository to hold custody of foreign assets, versus arrangements in which a fund holds assets in a foreign depository through a global custodian? Would any of the alternatives impose unnecessary regulatory burdens, or impose overlapping or duplicative requirements? What would be the effect of each alternative on efficiency, competition, and capital formation? We request that commenters provide us with data that we might use in evaluating the costs and benefits of the alternative approaches.[76]

V. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits that result from its rules. The proposed amendments to rule 17f–4 respond to developments in securities custody practices and commercial law that have occurred since the rule was adopted. The proposed amendments would expand the types of funds and custodial entities that may rely on the rule, update the rule's compliance requirements, and reduce burdens on fund directors. Discussed below are certain costs and benefits that the Commission has identified with respect to the proposed rule amendments.

The Commission requests comment on the costs and benefits of the

Agenda issued Oct. 17, 2000) and in File No. S7–22–01.

[69] Rule 17f–5 generally requires that a delegate of the fund's board of directors (i) determine that the assets will be subject to reasonable care, (ii) determine that the arrangement with the foreign custodian is governed by a written contract that meets specified standards, and (iii) monitor the appropriateness of maintaining the fund's foreign assets with the custodian. Rule 17f–4 does not include these requirements.

[70] Rule 17f–7 generally requires a foreign depository to meet minimum requirements in order to be an ''eligible securities depository'' and requires that each fund's primary custodian provide the fund (or its adviser) with a continually updated risk analysis of the foreign depository. Rule 17f–4 does not include these requirements.

[71] We encountered a similar issue during the adoption of rule 17f–7. We noted at that time that the risk analyses performed under that rule with respect to a transnational depository should include information reasonably available about the depository's global custodial network. *See* Rule 17f–7 Adopting Release, *supra* note , at n.24.

[72] *See* section 17A of the Exchange Act [15 U.S.C. 78q–1]. The Fedwire system and mutual fund transfer agents do not register as clearing agencies, but are very unlikely to hold securities through a foreign custodian or depository.

[73] In 1980 the Commission specified the standards that would apply to the registration and oversight of clearing agencies under the Exchange Act. Those standards relate to the provisions of section 17A that require clearing agencies to have the capacity to facilitate the prompt and accurate settlement of securities transactions, and safeguard securities and assets in their control. *See* 15 U.S.C. 78q–1(b)(3)(A), (F). The standards require the clearing agency, among other things, to: (i) perform periodic risk assessments of its operations; (ii) have a board audit committee composed of non-management directors who select (or participate in selecting) the agency's independent public accountant and review its work; (iii) have a competent internal audit department that reviews the clearing agency's system of internal accounting controls; (iv) annually furnish to participants audited financial statements, and furnish on request unaudited quarterly financial statements; (v) annually furnish to participants an opinion report prepared by the independent public accountant based on a study and evaluation of the clearing agency's system of internal accounting control; and (vi) have detailed plans to assure the physical safeguarding of securities and funds, the integrity of the automatic data processing systems, and the recovery from loss or destruction of securities, funds or data. *See* Securities Exchange Act Release No. 16900 (June 17, 1980) [45 FR 41920 (June 23, 1980)].

[74] *See, e.g.,* Self-Regulatory Organizations; The Depository Trust Company, Securities Exchange Act Release No. 39657 (Feb. 12, 1998) [63 FR 8725 (Feb. 20, 1998)] (notice of proposed link between DTC and Canadian securities depository); Self-Regulatory Organizations; The Depository Trust Company, Securities Exchange Act Release No. 40523 (Oct. 13, 1998) [63 FR 54739 (Oct. 13, 1998)] (order approving proposed link).

[75] When approving links between a U.S. clearing agency and a foreign custodian or depository, the Commission applies the same standards for the safeguarding of securities as it does for securities held with a U.S. clearing agency. *See supra* note 73. Thus, a U.S. clearing agency's custodial arrangements with a foreign custodian or depository are held to U.S. standards. In contrast, rule 17f–5 permits a fund's foreign custody manager to determine that assets maintained on behalf of the fund are subject to reasonable care based on the standards applicable to custodians in the relevant foreign market, even if those standards are lower than those that would be acceptable for a U.S. custodian. *See* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 22658 (May 12, 1997) [62 FR 26923 (May 16, 1997)], at n.39 and accompanying text.

[76] The Bank Custodians have estimated, for example, that the average costs of complying with the risk monitoring provisions of rule 17f–7 for its nine member banks are $300,000 per bank. *See* Letter from Daniel L. Goelzer, Baker & McKenzie, to C. Hunter Jones, Assistant Director, Division of Investment Management (Oct. 17, 2001).

proposed rule amendments. We encourage commenters to identify, discuss, analyze, and supply relevant data regarding any additional costs and benefits.

A. Benefits

The Commission staff estimates that approximately 5,255 entities (including 4,900 registered investment companies,[77] 130 custodians, and 225 possible securities depositories[78]) would benefit from the proposed amendments.

Updates the rule to reflect current custody practice and commercial law. The proposed amendments to rule 17f–4 would benefit funds, advisers, and custodians because the amendments update the rule to conform to current custody practices and commercial law. As discussed above, rule 17f–4 was adopted in 1978 and was designed to operate in the context of commercial law applicable at that time. Custody practices and commercial law have changed significantly since 1978, and the proposed amendments would bring the rule up to date in those respects.

The Commission staff has issued numerous no-action letters in an attempt to keep the rule current with custody practice and commercial law.[79] Investment companies, custodians, subcustodians, transfer agents, and securities depositories would benefit from these amendments because the amendments would reflect changes in custody practices and applicable commercial law.

Removes unnecessary regulatory requirements. The proposed amendments to rule 17f–4 would remove three custodial compliance requirements[80] that have accounted for a significant amount of custodians' time and resources. The Commission staff estimates that custodians could spend approximately 66,300 hours[81] and $3,673,852[82] annually to comply with these three requirements. The proposed amendments would eliminate the burden of complying with these requirements, which could benefit fund investors through reduced costs.

Provides general compliance requirements. In place of the three custodial compliance requirements, the proposed amendments to rule 17f–4 would include more general compliance requirements. Most importantly, the proposed amendments would require that the fund's contract with its custodian must provide that the custodian take all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard assets held by the custodian. This safeguarding of assets requirement is more flexible and less prescriptive than the current requirements in rule 17f–4. This reduces costs by creating a more efficient safeguarding process.

Allows more entities to operate securities depositories. Under the proposed amendments, more entities would be able to operate securities depositories. This would benefit the additional entities that are allowed to operate securities depositories such as registered transfer agents. These entities already perform depository-like functions[83] and the proposed amendments would codify this practice. Current rules only allow registered clearing agencies, of which there are 13, and those using the federal book-entry system, of which there are 12, to be securities depositories. The effect of the proposed amendments would be to allow approximately 200 registered transfer agents to operate depositories under the rule. This would increase competition for services, lowering costs and bettering services to investment companies.

Expands the functions of securities depositories. The proposed amendments to rule 17f–4 would enlarge the functions that a securities depository may perform on behalf of a fund. The amendments would clarify that securities depositories can hold assets, such as open-end fund shares or ''Treasury Direct'' securities, that are typically conveyed only through redemption by the issuer. Securities depositories also would be permitted to hold assets that are conveyed by physical delivery. These amendments would facilitate the use of centralized custody arrangements for investments. Costs would be reduced in the clearing and settlement process, because it is easier to clear and settle transactions with an entity that can hold almost all the assets of the fund than with several entities that hold separate portions of fund assets. Reducing the costs and fees associated with securities depositories and custodians should benefit each industry.

Makes more entities eligible to rely on rule 17f–4. The proposed amendments would benefit all of the approximately 800 registered non-management companies because they could rely on rule 17f–4 and maintain assets in a securities depository under the clear standards of the rule. Investors would benefit from this amendment because the non-management company assets would be maintained with a securities depository under the standards of rule 17f–4.

Reduces burdens on fund directors. The proposed amendments to rule 17f–4 would remove the burdens on fund directors to approve all custody arrangements and changes to those arrangements. Instead, a fund's officers would approve the fund's own arrangement with a custodian that uses a depository and its own arrangement directly with a depository.[84] The proposed amendments should benefit fund directors and fund shareholders by eliminating the need for fund directors to approve arrangements that have become increasingly routine.

B. Costs

The proposed amendments to rule 17f–4 would impose one-time costs on funds, custodians, and securities depositories. As discussed above, contracts between funds and custodians (or securities depositories) would need to be modified to include language that the custodian will take all actions reasonably necessary to safeguard the assets held by the custodian and that the custodian will provide periodic reporting on its internal accounting controls and financial strength to the fund. The modification of these contracts will impose some costs. During the first year, the Commission

[77] The number of registered investment companies is based on approximately 4,100 management investment companies, 795 unit investment trusts, and 5 face amount certificate companies.

[78] The proposed amendments would allow more entities to operate as a securities depository. This number is approximated by adding the following entities: 12 Federal Reserve Banks; 13 clearing agencies; and approximately 200 registered transfer agents.

[79] *See, e.g., supra* notes 27 and 34.

[80] The three custodial compliance requirements (the segregation, earmarking, and confirmation requirements) are discussed above. *See supra* note and accompanying text.

[81] The staff estimates that, to comply with the rule, each custodian spends about 10 hours segregating, 250 hours earmarking, and 250 hours on daily confirmations to funds. (510 hours × 130 custodians = 66,300 total hours by all custodians).

[82] The following is an estimated breakdown of the annual cost for custodians to comply with the three compliance requirements:

Segregation—10 total hours: 5 hours of support staff and 5 hours by professional staff.

Earmarking—250 hours: 125 hours of support staff and 125 hours of professional staff.

Daily Confirmations—250 hours: 250 hours of support staff.

Total: 380 hours of support staff ($30.58 per hour) and 130 hours of professional staff ($128 per hour). (380 × $30.58) + (130 × $128) = $28,260.40x 130 custodians = $3,673,852.

[83] *See supra* note and accompanying text.

[84] As noted above, however, a fund's directors should review the fund's custody arrangements as an exercise of their general oversight responsibilities.

staff estimates that it could take a total of approximately 10 hours and $1,555 [85] per fund to comply with the proposed amendments. It is estimated that all the funds together would spend approximately 45,160 hours [86] and $7,020,483 [87] to comply with the proposed amendments. This would be a one-time event, and the future contracts between funds and custodians (or securities depositories) would include this language. After the first year, the staff estimates that funds change custodians (or securities depositories) on average every 10 years, *i.e.,* each year only 10 percent of funds change custodians (or securities depositories). The Commission staff estimates each fund will spend approximately 2 hours and $393 [88] each year to ensure compliance with the contracts between funds and custodians or about 980 hours and $192,712 annually for all funds to ensure contract compliance after the first year.[89]

We request comment on the costs and benefits of the proposed rule amendments and invite commenters to submit their own estimates of costs and benefits that would result from the proposal. In order to fully evaluate the costs and benefits associated with the proposed amendments, we request that commenters' estimates of the costs and benefits of the proposed amendments be accompanied by specific empirical data supporting their estimates.

VI. Summary of Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis (''IRFA'') in accordance with 5 U.S.C. 603 regarding the amendments to rule 17f–4 under the Investment Company Act. The following summarizes the IRFA.

The IRFA summarizes the background of the proposed amendments. The IRFA also discusses the reasons for the proposed amendments and the objectives of, and legal basis for, the amendments. Those items are discussed above in this release.

The IRFA discusses the effect of the proposed amendments on small entities. Rule 17f–4 specifies conditions under which funds maintain assets with securities depositories either directly, or through custodians that maintain assets with depositories. As a result, the proposed amendments to rule 17f–4 have the potential to affect (i) any fund that directly or indirectly uses securities depositories, (ii) its custodian, and (iii) any securities depository.

Approximately 4,900 registered investment companies, including approximately 230 registered investment companies that are small entities, would be affected by amended rule 17f–4.[90] Approximately 130 custodians, most of which are banks or registered broker-dealers, would be affected by rule 17f–4. Few if any of these custodians are small entities.[91] Approximately 225 entities would be permitted by the rule amendments to serve as fund securities depositories; few if any of these entities are small entities. The IRFA states that Commission staff expects the proposed amendments to have little impact on small entities. The rule amendments obligate fund custodians and depositories that deal directly with funds to undertake to take all actions reasonably necessary or appropriate to safeguard the fund's assets. These undertakings would not add to the existing obligations of funds, custodians, and depositories. Rather, they would assure that the fund's custodian or depository complies with the specified duties of a securities intermediary or issuer under Revised Article 8. In addition, the aggregate burden on small entities would be minimal because few of the affected entities (*i.e.,* funds, custodians, and depositories) are small entities.

The IRFA explains that the proposed amendments would significantly ease reporting, recordkeeping, and other compliance requirements of rule 17f–4. The rule currently provides that, if a fund holds securities in a depository through a custodian or its agents, the custodian must maintain the fund's securities in a depository account for the custodian's customers that is separate from the depository account for the custodian's own securities, and must identify on the custodian's records the portion of the total customer securities that belong to the fund. The custodian also must send the fund confirmations of transfers to or from the fund's account with the custodian.[92] In addition, a depository that deals directly with a fund must deliver the fund's securities to an appropriate successor if the depository no longer acts for the fund.[93] The proposed amendments would eliminate these requirements and substitute more general compliance requirements for custodians and depositories.[94]

The IRFA states that the Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any significant economic impact on small entities. As discussed above, few of the entities that would be affected by the proposed amendments to rule 17f–4 would be considered to be small entities for purposes of the Regulatory Flexibility Act. Moreover, the overall impact of the amendments would be to decrease the burdens on all entities, including small entities, because the burdens under the proposed amendments should be more than offset by the elimination of existing requirements. Therefore, the potential

[85] This number is calculated by adding the following:

Fund Directors—1 hour × $500 per hour = $500

In House Counsel—8 hours × $128 per hour = $1,024

Support Staff—1 hour x $30.58 per hour = $30.58

Total = 10 hours and $1,554.58

[86] This number is calculated by:

Renegotiation of contracts—multiply 97 percent of the 4,100 funds that already have contracts with custodians by 10 hours (3,977 × 10 hours = 39,770 hours).

New contracts—multiply 539 (490 non-management companies that use custodians + 49 funds that deal directly with securities depositories) by 10 hours (539 × 10 hours = 5,390 hours).

Total = 39,770 hours + 5,390 hours = 45,160 hours

[87] This number is calculated by:

Renegotiation of contracts—multiply 97 percent of the 4,100 funds that already have contracts with custodians by $1,554.58 (3,977 × $1,554.58 = $6,182,564.70).

New contracts—multiply 539 (490 non-management companies that use custodians + 49 funds that deal directly with securities depositories) by $1,554.58 (539 × $1,554.58 = $837,918.62).

Total = $6,182,564.70 + $837,918.62 = $7,020,483.32

[88] This number is calculated by adding the following:

Fund Director—.5 hours × $500 per hour = $250

In House Counsel—1 hour × $128 per hour = $128

Support Staff—.5 hours × $15 per hour = $15.29

Total = 2 hours and $393.29

[89] The annual hours and cost is calculated by multiplying the hours and cost per fund by 490 funds (10 percent of 4900 funds).
securities depositories) would likely incur minimal costs in providing copies of existing reports on internal accounting controls to funds. The rule amendments would not require the preparation of new reports.

[90] A fund is considered a small entity for purposes of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.*, if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less. 17 CFR 270.0–10. There are approximately 4,900 registered investment companies, including 240 small entities. Approximately 97 percent of registered investment companies (4,750) report that they maintain assets in securities depositories. Assuming that a proportionate number of small entities use securities depositories, then approximately 230 registered investment companies that are small entities will be affected by the rule amendments.

[91] A bank is considered by the Small Business Administration to be a small entity if it has less than $100 million in assets. *See* 13 CFR 121.201 (1999). *See also* 5 USC 601(3). A bank's assets are determined by averaging its total assets reported for each of the last four quarters. *See* 13 CFR 121.201 n.8.

[92] *See* rule 17f–4(d)(2)–(3).

[93] *See* rule 17f–4(c)(2).

[94] Proposed rule 17f–4(a)(1) and (2)(i).

impact of the amendments on small entities should not be significant. For these reasons, alternatives to the proposed amendments and proposed new rule are unlikely to minimize any impact that the proposed amendments may have on small entities.[95]

The Commission encourages the submission of comments with respect to any aspect of the IRFA. Comment specifically is requested on the number of small entities that would be affected by the proposed amendments, and the likely impact of the proposed amendments on small entities. Commenters are requested to describe the nature of any impact and to provide empirical data supporting the extent of the impact. These comments will be considered in connection with the adoption of the rule amendments, and will be placed in the same public file as comments on the proposed rules themselves. A copy of the IRFA may be obtained by contacting Hugh P. Lutz, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549–0506.

VII. Paperwork Reduction Act

Certain provisions of the proposed amendments to rule 17f–4 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act of 1995 [(44 U.S.C. 3501–3520)] (''PRA''), and the Commission is submitting the proposed amendments to the Office of Management and Budget in accordance with 44 U.S.C. 3507(d). The title for the collection of information is ''Custody of Investment Company Assets with a Securities Depository.'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

The proposed amendments to rule 17f–4 would eliminate several collection of information requirements (specifically, the segregation, earmarking and confirmation requirements)[96] and replace them with more general requirements. The proposed amendments would require a modification of contracts between funds and custodians (or securities depositories) to provide that the custodian will take all actions reasonably necessary or appropriate under applicable commercial and regulatory law to safeguard fund assets.[97] In addition, the custody contract (or depository rules) would have to state that the custodian (or depository) will promptly provide periodic reports on its internal controls and financial strength, and available reports on the controls of any depository or intermediary custodian it uses.[98]

The Commission staff estimates that 5,255 respondents (including 4,900 registered investment companies,[99] 130 custodians, and 225 possible securities depositories[100]) would be subject to the proposed amendments to rule 17f–4. The rule is elective, but most, if not all, funds use depository custody arrangements.[101] The proposed amendments to the rule would increase the information collection burden by approximately 8,138 hours during the first year because of the required one-time contract modifications detailed above. After the first year, the information collection burden would decrease by approximately 36,042 hours annually. These changes are reflected in the summaries below:

First year burden	Paperwork burden hours
Current Rule 17f–4	42,600
Rule 17f–4 as proposed to be amended	50,738
Net Change	8,138
Annual Burden after First Year	
Current Rule 17f–4	42,600
Rule 17f–4 as proposed to be amended	6,558
Net Change	(36,042)

Arrangements between funds, custodians, subcustodians, and securities depositories are written arrangements according to business practice. The Commission believes that requiring investment companies to modify their existing contracts with custodians and depositories to incorporate the new compliance requirements would create an initial one-time burden of 10 hours per fund, or about 45,160 burden hours for all funds.[102]

The Commission estimates that after the first year, 490 investment companies[103] would spend on average 2 hours annually complying with the contract requirements of the rule (*i.e.,* signing contracts with additional custodians or securities depositories) for a total of 980 burden hours.

Currently rule 17f–4 requires custodians or their agents to send periodic reports to funds concerning internal accounting controls of the depository, the custodian, and its agents. The proposed amendments would require that this report include any reports on the financial strength of the custodian and any other available reports on the internal accounting controls of securities depositories or their operators and of any intermediary custodian. The Commission staff estimates that 130 custodians or their agents and 49 securities depositories[104] would spend 12 hours[105] annually in transmitting such reports to funds. The total annual burden hours for compliance with proposed rule 17f–4's reporting requirement is estimated to be 2,148 hours annually.

Under rule 17f–4, funds are required to approve any new depository arrangements or changes to existing

[95] Alternatives in this category would include: (i) establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating or simplifying the compliance requirements for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of all or part of the rule.

[96] *See supra* note 39 and accompanying text.

[97] If the fund deals directly with a depository, the depository's contract or rules for participants would be required to provide that the depository would meet similar obligations.

[98] This provision is designed to assure that the fund (or its adviser) receives any reports that are already available about the financial soundness of the custodian and depository. The provision would not require the special preparation of additional reports.

[99] The number of registered investment companies comprises approximately 4,100 management investment companies, 795 unit investment trusts, and 5 face amount certificate companies.

[100] The proposed amendments would increase the types of entities eligible to serve as depositories. The estimate of 225 possible entities is reached by adding the following: 12 Federal Reserve Banks, 13 clearing agencies, and approximately 200 registered transfer agents.

[101] The Commission staff estimates that more than 97 percent of all funds now use depository custody arrangements. This estimate is based on responses to Item 18 of Form N–SAR [17 CFR 274.101].

[102] The Commission staff estimates that 97 percent of the 4,100 registered management companies (3,977 funds) would have to renegotiate their custodial contracts to comply with the proposed amendments. In addition, the staff estimates that 490 of the 800 non-management companies would enter into new custodial contracts consistent with the proposed amendments. The staff estimates that 49 investment companies deal directly with securities depositories and would enter into contracts with securities depositories consistent with the proposed amendments. The staff estimates that it would take 10 hours per fund to comply with the two contract provisions required by the proposed amendments. The total number of burden hours for the first year would be 45,160 hours (4,516 funds × 10 hours).

[103] The staff estimates that approximately 10 percent of all funds, or 490 funds, approve new depository custody arrangements yearly, *i.e.*, a fund changes custodians (or securities depositories) every 10 years.

[104] The proposed amendment also would extend this requirement to securities depositories with which a fund deals directly. Commission staff estimates that 49 funds, or about one percent of funds, deal directly with securities depositories.

[105] Custodians or their agents usually send out periodic reports twice a year. Currently, it is estimated that custodians or their agents spend 6 burden hours per report to fulfill the requirement of rule 17f–4.

depository arrangements. The staff estimates that 490 funds per year currently spend 8 hours annually reviewing these arrangements and the modifications to them. The proposed amendments to the rule would require a fund to approve only its own custody arrangements with a custodian or securities depository; the staff estimates that on average 490 funds per year will spend 6 hours in approving custody arrangements. The total burden hours for this requirement are 2,940 annual burden hours.

If a fund deals directly with a securities depository, the proposed amendments to rule 17f–4 would require that the fund implement internal control systems reasonably designed to prevent unauthorized officer's instructions (by providing at least for the form, content, and means of giving, recording, and reviewing all officer's instructions). Currently rule 17f–4 requires funds to have internal control systems designed to prevent unauthorized instructions. The Commission staff estimates that 49 funds, or one percent of all funds, will spend 10 hours annually implementing systems to prevent unauthorized officer's instructions, resulting in 490 burden hours for this requirement under the proposed amendments to rule 17f–4.

We request your comments on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(b), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimates of the burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609 with reference to File No. S7–22–01. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, refer to File No. S7–22–01, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 5th Street, NW., Washington, DC 20549.

VIII. Statutory Authority

The Commission is proposing to amend rule 17f–4 pursuant to the authority set forth in sections 6(c), 17(f), 26, 28, 30, 31, and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a–6(c), 80a–17(f), 80a–26, 80a–28, 80a–29, 80a–30, and 80a–37(a)].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, 80a–39, unless otherwise noted;

2. Section 270.17f–4 is revised to read as follows:

§ 270.17f–4. Custody of investment company assets with a securities depository.

(a) *Custody arrangement with a securities depository.* A Fund or its Custodian may place and maintain Assets with a Securities Depository, *provided that:*

(1) *Contract with custodian.* If the Fund uses a Securities Depository through its Custodian (or through the Fund's trustee, if the Fund is a Non-Management Company), the Fund's contract with the Custodian (or trustee) provides that the Custodian will:

(i) Take 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; and

(ii) Promptly provide periodic reports concerning the internal accounting controls and financial strength of the Custodian, and available reports concerning the internal accounting controls of any Securities Depository or its operator and of any Intermediary Custodian.

(2) *Direct dealings with securities depository or non-management company arrangements.* If the Fund maintains Assets directly with a Securities Depository, or is a Non-Management Company:

(i) The Fund's contracts with the Securities Depository or its operator, or the Securities Depository's written rules for its participants, provide that the Securities Depository will, in performing its duties, comply with obligations comparable to those of a Custodian under paragraphs (a)(1)(i) and (ii) of this section; and

(ii) The Fund (or the Fund's trustee, if the Fund is a Non-Management Company) has implemented internal control systems reasonably designed to prevent unauthorized Officer's Instructions (by providing at least for the form, content, and means of giving, recording, and reviewing all Officer's Instructions).

(3) *Fund's approval.* An officer of the Fund (or a trustee of a Fund that is a Non-Management Company) has approved each of the Fund's own custody arrangements with its Custodian or with a Securities Depository under this paragraph (a).

(4) *Operators of a securities depository.* The Securities Depository is operated by:

(i) A Federal Reserve Bank or other person authorized to hold custody of securities in the federal book-entry system described in regulations of the United States Department of the Treasury codified at 31 CFR Part 357, Subparts B and C, or comparable regulations of other federal agencies affecting the book-entry system;

(ii) A clearing agency registered with the Commission under section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1); or

(iii) A transfer agent registered with the Commission or other appropriate regulatory agency as provided in section 17A of the Securities Exchange Act of 1934 (15 U.S.C 78q–1), when acting as agent for an open-end registered investment company whose securities it holds.

(b) *Definitions.* For purposes of this section:

(1) *Assets* means cash and securities and similar investments that are owned by the Fund or held by another person for the benefit of the Fund.

(2) *Custodian* means a bank or other person authorized to hold Assets for the Fund under section 17(f) of the Act (15 U.S.C. 80a–17(f)) or Commission rules in this chapter, but does not include a Fund itself, a Safekeeping Facility, or a Foreign Custodian.

(3) *Foreign Custodian* means a custodian whose use is governed by § 270.17f–5 or § 270.17f–7.

(4) *Fund* means an investment company registered under the Act.

(5) *Intermediary Custodian* means any subcustodian through which a Custodian maintains any Assets with a Securities Depository, if the subcustodian is qualified to act as a Custodian.

(6) *Officer's Instruction* means a request or direction to a Securities Depository or its operator in the name of the Fund by one or more persons authorized by the Fund's board of directors (or by the Fund's trustee, if the Fund is a Non-Management Company) to give it.

(7) *Non-Management Company* means a Fund that is a unit investment trust or a face-amount certificate company.

(8) *Safekeeping Facility* means any vault, safe deposit box, or other repository for safekeeping maintained by a bank or other company whose functions and physical facilities are supervised by a federal or state authority, if the Fund maintains its own Assets there in accordance with § 270.17f–2.

(9) *Securities Depository* means a system for the central handling of Assets in which Assets are treated as fungible and are transferred, pledged, or otherwise acquired or disposed of by bookkeeping entry without physical delivery, or by physical delivery within or through the system.

Note to § 270.17f–4: If a Fund's (or its custodian's) custody arrangement with a Securities Depository involves one or more Eligible Foreign Custodians (as defined in § 270.17f–5) through which assets are maintained with the Securities Depository, § 270.17f–5 will govern the Fund's (or its custodian's) use of each Eligible Foreign Custodian.

Dated: November 15, 2001.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01–29021 Filed 11–20–01; 8:45 am]

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DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 3

Transactions Other Than Contracts, Grants, or Cooperative Agreements for Prototype Projects

AGENCY: Office of the Secretary, DoD.

ACTION: Proposed rule.

SUMMARY: This proposed rule outlines the conditions for appropriate use enacted by law, defines a nontraditional Defense contractor, and provides audit policy application to transactions other than contracts, grants or cooperative agreements for prototype projects. It directly impacts the public by prescribing conduct that must be followed by a party to, or entity that participates in the performance of any such transaction.

DATES: Comments on the proposed rule must be received in writing to the address specified below on or before January 22, 2002, to be considered in the formation of the final rule.

ADDRESSES: Interested parties should submit written comments on the proposed rule to: Office of the Director, Defense Procurement, Attn: Ms. Teresa Brooks, PDUSD(A&T)/DP(CPA), 3060 Defense Pentagon, Washington, DC 20301–3060. Telefax (703) 614–1254.

FOR FURTHER INFORMATION CONTACT: Teresa Brooks, (703) 695–8567.

SUPPLEMENTARY INFORMATION:

Background and Purpose

Section 845 of the National Defense Authorization Act for Fiscal Year 1994, Pub.L. 103–160, as amended, authorizes the Secretary of a Military Department, the Director of Defense Advanced Research Projects Agency and any other official designated by the Secretary of Defense, to enter into transactions other than contracts, grants or cooperative agreements for prototype projects that are directly relevant to weapons or weapon systems proposed to be acquired or developed by the Department of Defense. Such transactions are commonly referred to as ''other transaction'' agreements for prototype projects. To the extent that a particular statute or regulation is limited in its applicability to the use of a procurement contract, it would generally not apply to ''other transactions'' for prototype projects.

Part 3 to 32 CFR was initially established to implement the section 801 of the National Defense Authorization Act for Fiscal Year 2000 requirement that an ''other transaction'' agreement for a prototype project that provides for payments in a total amount in excess of $5,000,000 include a clause that provides Comptroller General access to records. However, there are additional requirements that now warrant public comment and expansion of part 3 to 32 CFR. Specifically, section 803 of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001 (Pub.L. 106–398) identified conditions for appropriate use of the authority and defined a nontraditional Defense contractor. In addition, the Department has developed audit policy applicable to transactions for prototype projects. These additional requirements are addressed in this proposed rule.

Regulatory Evaluation

Executive Order 12866, ''Regulatory Planning and Review.''

It has been determined that this rule is not a significant rule as defined under section 3(f)(1) through 3(f)(4) of Executive Order 12866.

Unfunded Mandates Reform Act (Sec. 202, Pub.L. 104–4).

It has been certified that this rule does not contain a Federal mandate that may result in the expenditure by State, local and tribal governments, in aggregate, or by the private sector, of $100 million or more in any one year.

Pub.L. 96–354, ''Regulatory Flexibility Act'' (5 U.S.C. 601).

It has been certified that this part is not subject to the Regulatory Flexibility Act (5 U.S.C. 601 et seq.) because it would not, if promulgated, have a significant economic impact on a substantial number of small entities. The rule does not require additional record keeping or other significant expense by project participants.

Pub.L. 96–511, ''Paperwork Reduction Act of 1995'' (44 U.S.C. 3501 et seq.)

It has been certified that this rule does not impose any reporting or record keeping requirements under the Paperwork Reduction Act of 1995.

Federalism (Executive Order 13132).

It has been certified that this rule does not have federalism implications, as set forth in Executive Order 13132.

List of Subjects in 32 CFR Part 3

Grants program.

Accordingly, part 3 to 32 CFR proposed to be amended as follows: