

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release No. IC-25934; File No. S7-22-01]

RIN 3235-AG71

Custody of Investment Company Assets With a Securities Depository

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

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to the rule under the Investment Company Act of 1940 that governs investment companies' use of securities depositories. The amendments expand the types of investment companies that may maintain assets with a depository, and update the conditions they must follow to use a depository. The amendments respond to developments in securities depository practices and commercial law since the rule was adopted.

EFFECTIVE DATES: The amendments are effective on March 28, 2003. The incorporation by reference of certain definitions listed in the rule is approved by the Director of the Federal Register as of March 28, 2003.

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 adopting 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").¹

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Executive Summary

The Commission today is adopting amendments to rule 17f-4 under the Investment Company Act, the rule that 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 custody practices and commercial law that relate to custody arrangements have changed substantially since we adopted the rule in 1978, and the amendments update and simplify rule 17f-4 to reflect these business and legal developments. The amendments permit additional types of investment companies to rely on the rule, and allow depositories to perform additional functions under the rule. The amendments also eliminate a number of specific custodial compliance requirements of rule 17f-4, and require instead that a fund's custodian, when using a depository, exercise due care in accordance with reasonable commercial standards.

I. Background

Section 17(f) of the Investment Company Act governs the custody of a fund's assets, including its portfolio securities.² 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. It permits a fund to maintain its securities in a system for the central handling of securities (commonly referred to as a "securities depository"), subject to rules adopted by the Commission.³

The Commission adopted rule 17f-4 in 1978 to establish conditions for the use of securities depositories by funds.⁴ The conditions were designed to limit

potential risks to funds using securities depositories, and were drafted to be compatible with the 1978 revisions to Article 8 of the Uniform Commercial Code ("UCC"), which covers the ownership and transfer of investment securities under state law.⁵ Since 1978, securities custody practices have changed substantially, as more investors (including funds) have come to hold their securities with depositories such as the Depository Trust Company, either directly or through an intermediary. In 1994, Article 8 was substantially revised to clarify the legal rights of funds and other investors that use securities depositories.⁶ In addition, experience with depositories during this period has shown that the use of depositories raises substantially fewer risks than had been apparent in 1978.

In November 2001, we proposed amendments to rule 17f-4 to reflect these significant developments.⁷ We received six comment letters on the proposal.⁸ Commenters generally favored the amendments, but also recommended several changes that they believed would improve the interaction

⁵ See UCC, 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 4, at nn.4 and 6.

⁶ 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"), which in turn will maintain an account for its customers with a securities depository. The depository generally does not record each investor's interest, but records the interest of the intermediary on behalf of all of its customers. Thus, the individual investor's interest (or "security entitlement") appears only on the books of the intermediary with which the investor maintains an account. Revised Article 8 refers to this type of securities ownership arrangement as an "indirect holding" arrangement, as distinguished from a "direct holding" arrangement in which the investor's ownership interest appears on the issuer's books. 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"). Revised Article 8 has been adopted by all 50 states, the District of Columbia, and Puerto Rico.

⁷ See Custody of Investment Company Assets With a Securities Depository, Investment Company Act Release No. 25266 (Nov. 15, 2001) [66 FR 58412 (Nov. 15, 2001)] ("Proposing Release"), at nn.4-19 and accompanying text, for a more detailed discussion of Prior Article 8 and Revised Article 8.

⁸ We received the six comment letters from three commenters. Each of the commenters wrote an initial letter, and an additional letter discussing points raised by the other commenters. The comment letters are available for public inspection and copying in the Commission's Public Reference Room, 450 5th Street, NW, Washington, DC (File No. S7-22-01).

¹ Unless otherwise noted, all references to "rule 17f-4" or any paragraph of the rule will be to 17 CFR 270.17f-4, as amended.

² 15 U.S.C. 80a-17(f).

³ In 1999, the Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999), added section 17(f)(6) to the Investment Company Act. Section 17(f)(6) authorizes the Commission to prescribe conditions under which a bank-sponsored fund may maintain fund assets with an affiliated bank. This section is intended to allow the Commission to address self-custody issues such as conflicts of interest and misappropriation of fund assets that could arise when a fund holds its assets with an affiliated bank custodian. The amendments to rule 17f-4 affect the ability of all funds and their custodians to use certain depositories. The amendments do not address specific issues that arise when a fund maintains assets with an affiliated bank custodian, and we are not relying on the authority contained in section 17(f)(6) in adopting these amendments.

⁴ 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").