

of the rule with Revised Article 8. In addition, commenters disagreed on whether our rules governing a fund's use of foreign custodians and depositories should apply when a fund holds securities with a U.S. depository that itself holds the securities with a foreign custodian or depository.<sup>9</sup> We are adopting new rule 17f-4 with modifications that respond to many of the issues raised by the commenters.

## II. Discussion

Rule 17f-4 permits funds to place and maintain "financial assets" corresponding to the fund's "securities entitlements"<sup>10</sup> with a securities depository subject to certain conditions, discussed below.<sup>11</sup> As suggested by a commenter, we have drafted the rule to employ terms used by Revised Article 8 to assure the rule will interact well with that Article, which, as we noted above, is the primary law governing securities ownership under state law.<sup>12</sup>

### A. U.S. Depositories

Rule 17f-4 permits funds to keep and maintain securities and other assets in a "securities depository" subject to regulation in the United States.<sup>13</sup> Under the rule, a "securities depository" is a "clearing corporation" that is registered with the Commission as a clearing

agency,<sup>14</sup> or a federal reserve bank or other person authorized to operate the federal book-entry system for U.S. Treasury securities. At the suggestion of a commenter, we simplified the definition to describe what a depository is rather than what it does. The rule no longer restricts the functions that a depository may perform. As a result, a fund may use a depository that holds securities that are acquired or disposed of by bookkeeping entry as well as those that are conveyed by physical delivery.

### B. Reliance on Rule by Non-Management Companies; Approval of Custody Arrangements

The amendments expand rule 17f-4 to permit any registered investment company, including a unit investment trust ("UIT") or a face-amount certificate company, to use a securities depository.<sup>15</sup> The amendments also eliminate from the rule the requirement that fund directors approve arrangements with depositories, which

today largely are routine matters. Commenters supported these changes.<sup>16</sup>

### C. Compliance Requirements for the Custodian or Securities Depository

The amendments also eliminate, as proposed, the specific safeguarding requirements that have been in rule 17f-4, and substitute two more general obligations.<sup>17</sup> First, a fund's custodian must be obligated, at a minimum, to exercise due care in accordance with reasonable commercial standards in discharging its duty as a "securities intermediary" to obtain and thereafter maintain financial assets.<sup>18</sup> If the fund deals directly with a depository, the depository's contract or rules for participants must provide that the depository will meet similar obligations.<sup>19</sup> This condition thus incorporates the minimum standard of care that Revised Article 8 sets forth for circumstances where the parties have not agreed to a standard.<sup>20</sup>

Second, the custodian must provide, promptly upon request by the fund, such reports as are available about the internal accounting controls and

<sup>14</sup> A clearing agency is "any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates." 15 U.S.C. 78c(23)(A).

<sup>15</sup> Rule 17f-4(c)(3). In addition to expanding the types of funds that could rely on rule 17f-4, the Proposing Release would have expanded the types of organizations that could operate as depositories under the rule. The Proposing Release would have allowed a registered transfer agent to operate as a securities depository for purposes of holding shares of other funds. See Proposing Release, *supra* note 7, at nn.29-31 and accompanying text. All of the commenters raised issues concerning this proposed change. Two argued that a fund's use of another fund's transfer agent involves self-custody issues that could be addressed in conjunction with rule 17f-2 [17 CFR 270.17f-2], the rule governing fund self-custody arrangements. In light of the issues raised by commenters, we have decided not to adopt the amendment related to mutual fund transfer agents, but instead intend to consider these issues in connection with any future revisions to rule 17f-2. Until then, funds should continue to rely on the staff no-action letters that address arrangements in which funds invest in shares of other funds. See, e.g., United States Trust Co. of New York, SEC Staff 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).

<sup>16</sup> At the suggestion of one commenter, we have eliminated the requirement we included in the proposed amendments that a fund officer approve a depository arrangement. The requirement is unnecessary because a fund officer (or a person with similar authority) would have to execute agreements necessary to permit the fund to use the depository. See section 17(f)(2) of the Investment Company Act [15 U.S.C. 80a-17(f)(2)] (requiring that a fund consent to its custodian's deposit of securities with a depository).

<sup>17</sup> These specific requirements were the earmarking, segregation, confirmation, and successor custodian requirements. For a detailed discussion of these requirements, see Proposing Release, *supra* note 7, at nn.39-46.

<sup>18</sup> Rule 17f-4(a)(1). We proposed to require a custodian using a depository to "take all actions reasonably necessary or appropriate under applicable commercial or regulatory law" to safeguard fund assets. See Proposing Release, *supra* note 7, at nn.48-51 and accompanying text. Two commenters suggested that a better approach to accomplish the intent of that provision would be to require the custodian, as a securities intermediary, to take reasonable steps to preserve rights of the fund as an entitlement holder in financial assets held by the depository. One of these commenters urged us to incorporate into the rule the standard of care provided for by section 504(c) of Article 8 when the parties have not agreed to a standard. Section 504(c) provides that a securities intermediary satisfies the duty relating to maintaining a financial asset in those circumstances if it "exercises due care in accordance with reasonable commercial standards to obtain and maintain the financial asset." This standard is reflected in the rule.

<sup>19</sup> Rule 17f-4(b)(1)(i).

<sup>20</sup> One commenter questioned our authority to establish compliance requirements for custodians. Section 17(f)(2) of the Investment Company Act authorizes the Commission to adopt rules that establish conditions under which a "registered management company or any \* \* \* custodian" may deposit securities with a securities depository.

<sup>9</sup> See *infra* Section II.D.

<sup>10</sup> The amended rule incorporates the definition of "security entitlement" contained in Revised Article 8. See rule 17f-4(c)(1). A security entitlement means "the rights and property interest of an entitlement holder with respect to a financial asset" in an indirect holding arrangement. See Revised Article 8, *supra* note 6, section 8-102(a)(17). 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 *id.*, section 8-503(b) and cmt. 1, and section 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).

<sup>11</sup> In addition, the amendments permit a custodian to use an intermediary custodian. See rule 17f-4(a).

<sup>12</sup> The proposed amendments would have defined a securities depository as a "system for the central handling of assets in which those 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." See Proposing Release, *supra* note 7 at n.22 and accompanying text. One commenter stated that we could accomplish the same objectives by simply amending the rule to define securities depository by reference to a "clearing corporation" under Article 8 and a "clearing agency" under the Securities Exchange Act of 1934. We agree that this change simplifies the rule text and embodies relevant terms defined elsewhere in the federal securities laws, and the amended rule therefore reflects this revision.

<sup>13</sup> The use of foreign depositories by funds is governed by rule 17f-7 [17 CFR 270.17f-7].