

financial strength of the custodian.²¹ If the fund deals directly with a depository, the depository's contract or written rules for its participants must provide that the depository will provide similar financial reports.²²

D. Treatment of U.S. and Foreign Depositories

The Depository Trust Company ("DTC"), the predominant U.S. securities depository, has established linkages with several foreign custodians and depositories through which it holds assets with those foreign institutions. In the Proposing Release, we requested comment on whether a fund, when it holds securities with a U.S. depository that are ultimately custodied with a foreign custodian or depository, should be subject to rules 17f-5 or 17f-7,²³ which establish conditions for the custody of fund assets with foreign custodians and depositories.²⁴

Three commenters responded to our request. One commenter, an association of global custodian banks, argued that the failure of the Commission to extend the requirements of rules 17f-5 and 17f-7 would permit funds to circumvent these rules and would deny fund investors the protections of the rules. The Investment Company Institute and DTC opposed the application of the foreign custody rules. They pointed out that U.S. depositories are regulated by the Commission as registered clearing agencies, and that any linkages between them and foreign custodians and depositories are subject to our approval and monitoring. They argued that further regulation would increase the burden on these domestic depositories without enhancing the protection of fund assets.

We have decided not to revise the rule to require the application of our foreign custody rules when a fund holds securities through a U.S. depository that has a linkage to a foreign custodian or depository. As we explained in the Proposing Release, U.S. depositories register with us as clearing agencies under the Securities Exchange Act of

1934,²⁵ and are subject to rigorous standards for their operations.²⁶ We approve each proposed linkage to a foreign custodian or depository only when the custodian or depository will provide a level of protection equivalent to that which a U.S. clearing agency must provide.²⁷ This is a standard considerably higher than we require fund boards to apply in selecting a foreign custodian.²⁸ We agree with the commenters who argued that the application of the foreign custody rules would impose regulatory burdens without appreciably enhancing the protection of fund assets.²⁹

III. Cost-Benefit Analysis

The Commission is sensitive to the costs and benefits that result from its rules. As discussed above, the amendments to rule 17f-4 respond to developments in securities custody practices and commercial law that have occurred since the rule was adopted. The amendments expand the types of funds that may rely on the rule, update the rule's compliance requirements, and reduce burdens on fund directors. In the Proposing Release, we requested comment and specific data regarding the costs and benefits of the proposed amendments. We received one comment on the costs and benefits of the amendments. The comment is discussed below.

²⁵ See section 17A of the Securities Exchange Act [15 U.S.C. 78q-1].

²⁶ See Proposing Release, *supra* note , at n.73 and accompanying text.

²⁷ 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. 6, 1998) [63 FR 54739 (Oct. 13, 1998)] (order approving proposed link).

²⁸ Rule 17f-5 generally requires that a fund's board of directors or its delegate determine that (i) a fund's financial assets will be subject to reasonable care, based on the standards applicable in the relevant market, and (ii) the arrangement with the foreign custodian is governed by a written contract that meets specified standards.

²⁹ Similarly, we have not revised rule 17f-4 to except a fund from the foreign custody rules if the fund maintains financial assets with a foreign custodian or depository with which a U.S. depository has established a link that we have approved. One commenter suggested in an earlier letter that the costs of complying with the foreign custody rules are relatively fixed, and that the addition or subtraction of institutions therefore would not have a significant effect on those costs. See Letter from Daniel L. Goelzer, Baker & McKenzie, to C. Hunter Jones, SEC, at p.4 (Oct. 17, 2001). Moreover, the analysis required by rule 17f-7 can provide custodians and funds with current information regarding a foreign depository's expertise and market reputation, the quality of its services, and its financial strength. This information can play an important role in any future custody decisions made by funds and their advisers.

A. Benefits

The Commission staff estimates that approximately 5,155 entities (including 5,000 registered investment companies, 130 custodians, and 25 possible securities depositories) would benefit from the amendments.³⁰

Removes specific custodial compliance requirements. The amendments to rule 17f-4 remove three custodial compliance requirements³¹ that have accounted for a significant amount of custodians' time and resources. The Commission staff estimates that custodians currently spend approximately 66,300 hours³² and \$3,694,600³³ annually to comply with these three requirements. In place of these costly requirements, the amendments provide that a fund's custodian, when using a depository, must at a minimum exercise due care in accordance with reasonable commercial standards and that custodians (or securities depositories) provide reports on internal accounting controls to funds. The new compliance requirements are much less prescriptive than those previously contained in rule 17f-4, which will allow custodians some flexibility in determining the most efficient method of safeguarding financial assets. The reduction in the compliance burdens in rule 17f-4 may ultimately benefit fund investors through reduced costs.

Reduces burdens on fund directors. The amendments to rule 17f-4 eliminate the requirement that fund directors approve all custody arrangements and changes to those arrangements. The amendments will benefit fund directors and fund shareholders by eliminating the need for fund directors to approve arrangements that have become increasingly routine. The elimination of this requirement will free directors to

³⁰ These estimates are based on statistics compiled by Commission staff from January 1, 2002 through December 31, 2002.

³¹ The three custodial compliance requirements are the segregation, earmarking, and confirmation requirements.

³² The staff estimates that, in order 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).

³³ 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 (\$31 per hour) and 130 hours of professional staff (\$128 per hour). (380 × \$31) + (130 × \$128) = \$28,420 + 130 custodians = \$3,694,600.

²¹ Rule 17f-4(a)(2). As proposed, rule 17f-4 also would have required custodians to provide available reports on the internal accounting controls of any securities depository (or its operator) and any intermediate custodian. In response to comments questioning funds' need for these financial reports, we are not adopting the proposed provision. Because Revised Article 8 generally limits a fund's recourse to its own custodian, reports on intermediaries with which it does not directly deal are likely to be less important to the fund.

²² Rule 17f-4(b)(1)(ii).

²³ 17 CFR 270.17f-5, 270.17f-7.

²⁴ See Proposing Release, *supra* note 7, at nn.67-76 and accompanying text.