

spend more time on other, more significant matters.

*Updates the rule to reflect current custody practices and commercial law.* The amendments to rule 17f-4 will benefit funds, advisers, and custodians by updating 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 amendments reflect these developments.

The Commission staff has issued numerous no-action letters in an attempt to keep the rule current with custody practice and commercial law.<sup>34</sup> The amendments will make the rule more transparent by eliminating the need for funds to rely on the staff's no-action letters, and will resolve current and future ambiguities that have arisen and are sure to arise between the application of Revised Article 8 and rule 17f-4.

*Expands functions of securities depositories.* The amendments expand the functions that a securities depository may perform on behalf of a fund.<sup>35</sup> These amendments therefore may 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, rather than with several entities that hold separate portions of fund assets. Reducing the costs and fees associated with securities depositories and custodians will benefit investors.

#### B. Costs

The Proposing Release identified one provision in the rule that would impose costs—the requirement that custody contracts be modified to reflect the rule's new, general compliance requirements.<sup>36</sup> One commenter objected to the contract amendment language, and instead recommended that the rule allow the affected parties to determine the specific means of compliance. In response to this comment, we have modified the relevant regulatory language to state that the custodian must be “at a minimum obligated” to exercise due care in accordance with reasonable commercial

standards in discharging its duty to obtain and thereafter maintain financial assets.<sup>37</sup> This change provides custodians and funds with some flexibility in determining the specific means of compliance with the rule. The requirements of the rule could be met, for instance, by simply having the custodian send a letter to the fund, citing as consideration the continued ability of the custodian to provide custodial services for the fund. The costs associated with this method of compliance would be minimal.<sup>38</sup>

Rule 17f-4 requires that custodians (or securities depositories) provide reports on internal accounting controls to funds. The costs associated with providing copies of existing reports to funds should be minimal. The amendments do not require the preparation of new reports.

#### 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.<sup>39</sup> The Commission has considered these factors.

As noted above, we received three letters on whether a fund, when it holds securities that are ultimately custodied with a foreign custodian or depository, should be subject to rules 17f-5 or 17f-7. We have decided not to apply the foreign custody rules in these circumstances in part because U.S. depositories are regulated by the Commission as registered clearing agencies, and it would be inefficient to subject these depositories to the additional requirement in rules 17f-5 and 17f-7.<sup>40</sup>

The rule amendments should promote efficiency by eliminating the restrictions on the functions that a depository may perform. The amendments permit a fund to 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. The amendments therefore should facilitate the use of centralized custody arrangement for investors. This change may promote efficiency because it is

easier and less costly to clear and settle transactions with a single entity that can hold almost all of the assets of a fund, rather than with several entities. In addition, the rule amendments will promote efficiency by eliminating the requirement that fund directors approve custody arrangements, which will allow directors to focus on other, more important matters, and by eliminating four custodial compliance requirements that are no longer necessary for the protection of fund assets.

The rule amendments will not have a significant impact on competition and capital formation. The amendments may marginally promote competition by permitting all registered investment companies, including UITs and face-amount certificate companies, to rely on the rule. As noted above, previously only registered management investment companies could use a securities depository under the rule.

#### V. Summary of Final Regulatory Flexibility Analysis

We have prepared a Final Regulatory Flexibility Analysis (“FRFA”) in accordance with 5 U.S.C. 604, related to the amendments to rule 17f-4 under the Investment Company Act of 1940 that we are adopting today. A summary of the Initial Regulatory Flexibility Analysis (“IRFA”), which was prepared in accordance with 5 U.S.C. 603, was published in the Proposing Release.<sup>41</sup> Copies of the FRFA and the IRFA may be obtained by contacting Hugh P. Lutz, Attorney, Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549-0506

##### A. Need for Rule Amendments

The FRFA summarizes the background of the amendments. The FRFA also discusses the reasons for the new rule and amendments and the objectives of, and legal basis for, these rulemaking initiatives. Those items are discussed above in this Release.<sup>42</sup> The FRFA discusses the effect of the amendments on small entities.

##### B. Significant Issues Raised by Public Comment

The Commission received no comments on the IRFA.

##### C. Small Entities Subject to the Rule Amendments

The FRFA addresses the effect that amendments to rule 17f-4 will have on small entities. For purposes of the

<sup>37</sup> Rule 17f-4(a)(1).

<sup>38</sup> Approximately 49 funds deal directly with securities depositories. In these cases, compliance with rule 17f-4 can occur simply by having the depository modify its written rules for its participants, if necessary.

<sup>39</sup> 15 U.S.C. 80a-2(c).

<sup>40</sup> See *supra* Section II.D.

<sup>41</sup> See Proposing Release, *supra* note, at Section VI.

<sup>42</sup> See *supra* Section II.

<sup>34</sup> See Proposing Release, *supra* note, at nn.30-34 and accompanying text.

<sup>35</sup> See *supra* Section II.A.

<sup>36</sup> See Proposing Release, *supra* note, at nn.85-89 and accompanying text.