

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

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RIN 3235-AE98

Custody of Investment Company Assets Outside the United States

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule amendments and request for comment.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Company Act of 1940 that governs the custody of investment company assets outside the United States. The amendments would revise the findings that currently must be made in establishing foreign custody arrangements to focus exclusively on the safekeeping of investment company assets. In addition, the amendments would provide investment companies with greater flexibility to address foreign custody arrangements by permitting a company's board of directors to delegate its responsibilities under the rule to evaluate these arrangements. The amendments also would expand the class of foreign banks and securities depositories that could serve as investment company custodians. The proposed amendments are intended to facilitate the use of foreign custody arrangements, consistent with the safekeeping of investment company assets.

DATES: Comments must be received on or before October 6, 1995.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6-9, Washington, D.C. 20549. All comment letters should refer to File No. S7-23-95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Elizabeth R. Krentzman, Assistant Chief, or Kenneth J. Berman, Assistant Director, (202) 942-0690, Office of Regulatory Policy, Division of Investment Management, 450 Fifth Street, N.W., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed amendments to rule 17f-5 (17 CFR 270.17f-5) under the

Investment Company Act of 1940 (15 U.S.C. 80a) (the "Act").

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Text of Proposed Rule Amendments

I. Executive Summary

The Commission is proposing amendments to rule 17f-5 to facilitate the use of foreign custody arrangements by registered management investment companies ("funds"). Among other things, the amendments would revise the findings that must be made in establishing foreign custody arrangements. Under the current rule, a fund's board of directors must find that the fund's arrangements are consistent with the best interests of the fund and its shareholders. This standard may be overbroad since it suggests, for example, that, in considering foreign custody arrangements, a fund's board needs to assess factors other than custodial risks. The amended rule would require findings that the fund's foreign custody arrangements will provide reasonable protection for fund assets. The proposed "reasonable protection" standard should facilitate evaluations of foreign custody arrangements by focusing exclusively on safekeeping considerations.

The amendments also would allow fund directors to play a more traditional oversight role with respect to foreign custody arrangements than that required under the current rule. Under the amendments, the board would be permitted to delegate its responsibility

under the rule to evaluate foreign custody arrangements to the fund's investment adviser or officers or a U.S. or foreign bank. The amended rule would provide the board with the flexibility to assign different delegates responsibility for addressing different aspects of the fund's arrangements. The amended rule also would provide for general board oversight of a delegate's actions by requiring the delegate to provide the board with periodic reports concerning the fund's arrangements. The board would no longer be required to approve foreign custody arrangements annually.

In addition to updating and refining certain other provisions of rule 17f-5, the amendments would expand the class of foreign banks and depositories that could serve as fund custodians. Foreign banks would no longer have to meet specific capital requirements and foreign depositories would no longer have to operate the only system for the handling of securities in a country. The amended rule would require foreign custodians to be subject to foreign regulation. In addition, in connection with a custodian's selection, the amended rule would require a finding that the custodian will provide reasonable protection for the fund's assets based on all relevant factors, including the custodian's financial strength. This approach seeks to address safekeeping considerations without imposing capital and other requirements that may unnecessarily limit fund use of appropriate foreign custodians.

II. Background

Over the last ten years, the fund industry has become increasingly international in its investment perspective. At the end of 1984, shortly after rule 17f-5 was adopted, only 35 funds invested significant amounts of their assets in foreign securities.¹ By the end of 1994, the number of funds participating in foreign markets had increased almost twentyfold, with over 650 funds investing significant amounts of their assets outside the United States.²

¹ Investment Company Institute, *The Growth Continues 1993 Perspective on Mutual Fund Activity 7* (Summer 1993); Lipper Analytical Services, Inc. ("Lipper"), *Year Over Year Comparison of Growth by Objective of Closed-End Funds (1980-1990)* (prepared for the Commission).

² Investment Company Institute, *Trends in Mutual Fund Activity* (Dec. 1994) (ICI News No. ICI-95-05); Lipper, *Closed-End Fund Performance Analysis Service* (Jan. 31, 1995) (as supplemented by the Commission staff to reflect closed-end funds that liquidated or converted to open-end status during the ten-year period ending December 31, 1994). Based on Commission filings, the Division of Investment Management estimates that over 2,200