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

[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'').

[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).

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.[9] 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'' [10] with a securities depository subject to certain conditions, discussed below.[11] 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.[12]

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.[13] Under the rule, a ''securities depository'' is a ''clearing corporation'' that is registered with the Commission as a clearing agency,[14] 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.[15] 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.[16]

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.[17] 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.[18] 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.[19] 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.[20]

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

[9] *See infra* Section II.D.

[10] 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).

[11] In addition, the amendments permit a custodian to use an intermediary custodian. *See* rule 17f–4(a).

[12] 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.

[13] The use of foreign depositories by funds is governed by rule 17f–7 [17 CFR 270.17f–7].

[14] 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).

[15] 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).

[16] 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).

[17] 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.

[18] 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.

[19] Rule 17f–4(b)(1)(i).

[20] 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.

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.

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 requirements[31] that have accounted for a significant amount of custodians' time and resources. The Commission staff estimates that custodians currently spend approximately 66,300 hours[32] and $3,694,600[33] 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

[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.

[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.

[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.

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.[34] 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.[35] 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.[36] 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.[37] 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.[38]

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.[39] 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.[40]

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 Flexiblity 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.[41] 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.[42] 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

[34] *See* Proposing Release, *supra* note , at nn.30–34 and accompanying text.

[35] *See supra* Section II.A.

[36] *See* Proposing Release, *supra* note , at nn.85–89 and accompanying text.

[37] Rule 17f–4(a)(1).

[38] 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.

[39] 15 U.S.C. 80a–2(c).

[40] *See supra* Section II.D.

[41] *See* Proposing Release, *supra* note , at Section VI.

[42] *See supra* Section II.

Regulatory Flexibility Act,[43] a fund is a small entity if the fund, together with other funds in the same group of related funds, has net assets of $50 million or less as of the end of its most recent fiscal year.[44] Approximately 4,850 registered investment companies, including approximately 233 registered investment companies that are small entities, will be affected by amended rule 17f–4.[45] Approximately 130 custodians, most of which are banks or registered broker-dealers, will be affected by rule 17f–4. Few if any of these custodians are small entities.[46] Approximately 25 entities that could serve as securities depositories will be affected by the rule;[47] few if any of these entities are small entities. The rule imposes conditions for the use of securities depositories by all funds regardless of the size of the fund, its custodian, or the securities depository. The risks attendant to funds' use of securities depositories do not vary based on the size of the entities involved.

D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The amendments will significantly ease rule 17f–4's reporting, recordkeeping, and other compliance requirements. The amendments eliminate a number of specific requirements[48] and substitute two general compliance requirements for custodians and depositories.[49] First, the custodian must, at a minimum, exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain financial assets.[50] If the fund deals directly with a depository, the fund's contract with the securities depository (or the depository's own written rules for its participants) must provide that the depository will meet similar obligations.[51] Second, the custodian must provide, promptly upon request by the fund, such reports as are available about the internal accounting controls and financial strength of the custodian.[52] 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.[53]

E. Duplicative, Overlapping or Conflicting Federal Rules

The Commission believes that there are no federal rules that duplicate, overlap, or conflict with the rule amendments.

F. Agency Action to Minimize Effect on Small Entities

In connection with the amendments, the Commission considered the following alternatives: (i) Establishing different compliance or reporting standards that take into account the resources available to small entities; (ii) clarifying, consolidating or simplifying the compliance requirements for small entities; (iii) using performance rather than design standards; and (iv) exempting small entities from coverage of all or part of the rule.

We do not believe that special compliance, timetable, or reporting requirements or an exemption from coverage of the rule for small entities would be consistent with investor protection. Similarly, any further clarification, consolidation, or simplification of the reporting requirements for small entities could compromise the safeguards embodied in the new rule and amendments. The rule amendments use performance, rather than design standards, in the sense that the amendments require that custodians exercise due care in accordance with reasonable commercial standards in discharging their duty as a securities intermediary to obtain and thereafter maintain financial assets.

VI. Paperwork Reduction Act

As explained in the Proposing Release, certain provisions of the amendments to rule 17f–4 contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act [44 U.S.C. 3501–3520] (''PRA''). We published notice soliciting comments on the collection of information requirements in the Proposing Release and submitted these requirements to the Office of Management and Budget (''OMB'') for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title for the collection of information is ''Custody of Investment Company Assets with a Securities Depository.'' An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number. The OMB control number for rule 17f–4 is 3235–0225.

As discussed above, today we are adopting amendments to rule 17f–4 that are substantially similar to the amendments that we proposed in November 2001. 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 substitute two more general compliance requirements. None of the commenters addressed the PRA burden associated with these amendments.

VII. Statutory Authority

The Commission is amending rule 17f–4 pursuant to the authority set forth in sections 6(c), 17(f), 26, 28, 30, 31, and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a–6(c), 80a–17(f), 80a–26, 80a–28, 80a–29, 80a–30, and 80a–37(a)].

Text of Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is revised to read as follows:

List of Subjects in 17 CFR Part 270

Incorporation by reference, Investment companies, Reporting and recordkeeping requirements, Securities.

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for Part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–34(d), 80a–37, and 80a–39, unless otherwise noted;

* * * * *

2. Section 270.17f–4 is revised to read as follows:

§ 270.17f–4 Custody of investment company assets with a securities depository.

(a) *Custody arrangement with a securities depository.* A fund's custodian may place and maintain financial assets, corresponding to the fund's security entitlements, with a securities depository or intermediary custodian, if the custodian:

[43] 5 U.S.C. 601–612.

[44] 17 CFR 270.0–10.

[45] There are approximately 5,000 registered investment companies, including 240 small entities. Approximately 97 percent of registered investment companies (4,850) report that they maintain assets in securities depositories. Assuming that a proportionate number of small entities use securities depositories, then approximately 233 registered investment companies that are small entities will be affected by the rule amendments.

[46] A bank is considered by the Small Business Administration to be a small entity if it has less than $150 million in assets. *See* 13 CFR 121.201 (1999). *See also* 5 U.S.C. 601(3).

[47] This includes approximately 12 Federal Reserve Banks and 13 registered clearing agencies.

[48] *See supra* Section II.C.

[49] Rule 17f–4(a) and (b)(1).

[50] Rule 17f–4(a)(1).

[51] Rule 17f–4(b)(1)(i).

[52] Rule 17f–4(a)(2).

[53] Rule 17f–4(b)(1)(ii).

(1) Is at a minimum obligated to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain such financial assets;

(2) Is required to provide, promptly upon request by the fund, such reports as are available concerning the internal accounting controls and financial strength of the custodian; and

(3) Requires any intermediary custodian 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 corresponding to the security entitlements of its entitlement holders.

(b) *Direct dealings with securities depository.* A fund may place and maintain financial assets, corresponding to the fund's security entitlements, directly with a securities depository, if:

(1) The fund's contract with the securities depository or the securities depository's written rules for its participants:

(i) Obligate the securities depository 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 corresponding to the fund's security entitlements; and

(ii) Requires the securities depository to provide, promptly upon request by the fund, such reports as are available concerning the internal accounting controls and financial strength of the securities depository; and

(2) The fund has implemented internal control systems reasonably designed to prevent unauthorized officer's instructions (by providing at least for the form, content and means of giving, recording and reviewing all officer's instructions).

(c) *Definitions.* For purposes of this section the terms:

(1) *Clearing corporation, financial asset, securities intermediary, and security entitlement* have the same meanings as is attributed to those terms in § 8–102, § 8–103, and §§ 8–501 through 8–511 of the Uniform Commercial Code, 2002 Official Text and Comments, which are incorporated by reference in this section pursuant to 5 U.S.C. 552(a) and 1 CFR part 51. The Director of the Federal Register has approved this incorporation by reference in accordance with 5 U.S.C. 552(a) and 1 CFR part 51. You may obtain a copy of the Uniform Commercial Code from the National Conference of Commissioners on Uniform State Laws, 211 East Ontario Street, Suite 1300, Chicago, Il 60611. You may inspect a copy at the following addresses: Louis Loss Library, U.S. Securities and Exchange Commission, 450 5th Street, NW., Washington, DC 20549, and Office of the Federal Register, National Archives and Records Administration, 800 North Capitol Street, NW, Suite 700, Washington, DC.

(2) *Custodian* means a bank or other person authorized to hold assets for the fund under section 17(f) of the Act (15 U.S.C. 80a–17(f)) or Commission rules in this chapter, but does not include a fund itself, a foreign custodian whose use is governed by § 270.17f–5 or § 270.17f–7, or a vault, safe deposit box, or other repository for safekeeping maintained by a bank or other company whose functions and physical facilities are supervised by a federal or state authority if the fund maintains its own assets there in accordance with § 270.17f–2.

(3) *Fund* means an investment company registered under the Act and, where the context so requires with respect to a fund that is a unit investment trust or a face-amount certificate company, includes the fund's trustee.

(4) *Intermediary custodian* means any subcustodian that is a securities intermediary and is qualified to act as a custodian.

(5) *Officer's instruction* means a request or direction to a securities depository or its operator, or to a registered transfer agent, in the name of the fund by one or more persons authorized by the fund's board of directors (or by the fund's trustee, if the fund is a unit investment trust or a face-amount certificate company) to give the request or direction.

(6) *Securities depository* means a clearing corporation that is:

(i) Registered with the Commission as a clearing agency under section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1); or

(ii) A Federal Reserve Bank or other person authorized to operate the federal book entry system described in the regulations of the Department of Treasury codified at 31 CFR 357, Subpart B, or book-entry systems operated pursuant to comparable regulations of other federal agencies.

Dated: February 13, 2003.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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