PUBLIC

ACT ICA

SECTION 17(a), 21(b)

RULE 17(d), 17d-1 JUN 10 1997

PUBLIC AVAILABILITY 6-10-97

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 97-17-CC
~~PNC Bank,~~ N.A.
File No. 132-3

Your letter dated June 9, 1997 requests our assurance that we would not recommend enforcement action to the Commission under Sections 17(a), 21(b) or 17(d) of the Investment Company Act of 1940 ("1940 Act") and Rule 17d-1 thereunder, if registered investment companies advised by PNC Bank, National Association ("PNC Bank") or an affiliate of PNC Bank (the "Funds") for which PNC Bank or an affiliate of PNC Bank acts as custodian (the "Custodian") are compensated by the Custodian for cash balances maintained overnight with the Custodian, as described in your letter.

Facts

PNC Bank, a wholly owned indirect subsidiary of PNC Bank Corp., serves as the Funds' custodian. The Funds are advised by direct and indirect wholly owned subsidiaries of PNC Bank. 1/ You state that a number of the Funds are sold exclusively to institutional investors. In order to respond to the needs of those investors, the Funds have determined that they need the flexibility to extend the time of day up to which they will accept purchase and redemption orders. 2/ You state that the Funds are concerned, however, that extending the time for purchase and redemptions may cause the Funds to hold pools of excess cash late in the day for which appropriate investments are not available. 3/ The Funds have determined that they would be adversely affected if they extend their purchase and redemption times without being compensated by the Custodian for the use of excess cash. The Funds therefore propose to receive compensation from the Custodian in a number of forms, including custodian fee credits, reimbursement of fees of other service providers affiliated with the Custodian, and cash payments. The

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1/ In some instances, PNC Bank serves as a sub-adviser for certain Funds for which it performs back office sub-advisory functions.

2/ Your letter does not request relief with respect to any issues that may be raised by a Fund's determination to extend the time of day up to which it will accept purchase and redemption orders, including issues under Rule 22c-1 under the Investment Company Act, and therefore we express no opinion with respect to such matters.

3/ You note that funds typically invest their excess cash in overnight repurchase agreements. The Funds believe, however, that overnight repurchase agreements will not be available on a consistent basis late in the day, primarily due to the limited supply of eligible collateral at that time.

compensation will in all cases be equal to the net effective federal funds rate ("daily market rate") applicable to the cash balances maintained with the Custodian. 4/

The Custodian proposes to return to each Fund the full amount of the return that the Custodian receives on a Fund's overnight cash balance, based on the application of the daily market rate to that balance. 5/ You represent that no significant benefit will accrue to the Custodian or its affiliates as a result of the maintenance of the Fund's excess cash balances with the Custodian. 6/ You state that the Custodian may charge a nominal transaction fee commensurate with similar fees charged by others for performing services of the same nature and quality, for effecting the proposed transactions. The transaction fee would cover the Custodian's cost for making daily determinations of available cash, calculating the applicable compensation due the Funds, and maintaining appropriate records. 7/ You represent that the Custodian will not provide a greater benefit to any non-affiliated investment company with respect to its overnight cash balances than the Custodian provides to a Fund with respect to its overnight cash balances.

4/ The daily market rate will be the average effective daily federal funds rate determined by the Federal Reserve Bank of New York, less the reserve requirement "haircut" charged by the Federal Reserve on those balances.

5/ If the return on the excess cash balance is treated as a custodian fee credit, the Fund would be required to reflect this credit in its financial statements as a reduction in fees or expenses. Rule 6-07.2(g)(2) of Regulation S-X.

6/ You note that PNC Bank and certain of its affiliates provide investment advisory, custodial, accounting, administrative, and transfer agency services to the Funds and, with respect to certain of those services, are compensated based upon a percentage of assets under management. To the extent that any benefit provided to a Fund pursuant to the proposed transactions incrementally increases the Fund's assets or induces additional shareholder purchases, PNC Bank and it affiliates may indirectly benefit.

7/ Section 36(b) of the 1940 Act imposes a fiduciary duty on a fund's investment adviser with respect to the receipt of compensation paid by the fund to the adviser or an affiliate of the adviser. The above-described fees paid to the Custodian would be subject to Section 36(b) of the 1940 Act.

You represent that the board of directors of each Fund will review the proposed transactions initially and on at least an annual basis thereafter in order to confirm the propriety of the transactions. In particular, each Fund's board, including a majority of the Fund's independent directors, will determine that: (1) participation in the proposed transactions is in the best interest of the Fund and its shareholders; (2) participation is necessary or desirable for the operation of the Fund; (3) the Custodian can perform the proposed transactions in a manner at least equal in nature and quality to that which could be provided by others; (4) the rate of compensation received by the Fund for cash balances maintained overnight pursuant to the proposed transactions is fair and reasonable; and (5) any fees charged in connection with the proposed transactions are fair and reasonable in light of the usual and customary fees charged by others for performing services of the same manner and quality. 8/

Analysis

Section 17(a)(3) of the 1940 Act generally prohibits an affiliated person of an investment company, or an affiliated person of such person, from borrowing money or other property from the investment company. Section 21(b) generally prohibits a registered management investment company from lending money or other property to any person that controls or is under common control with the investment company, unless the loan is from an investment company to a company that owns all of the outstanding securities of the investment company. Together, these provisions generally prohibit an affiliated party with potentially conflicting interests from causing an investment company to engage in lending transactions that are detrimental to the interest of the investment company and its shareholders. 9/

8/ Moreover, you represent that each Fund's portfolio manager, after reviewing anticipated sources of purchases and redemptions and other sources of cash flow, will make a good faith determination as to the amount of cash the portfolio manager expects to have available for investment during normal business hours, and absent unusual circumstances, will invest that cash in accordance with the Fund's investment policies and practices. You represent that as a result, the amount of a Fund's excess cash will not be subject to the Custodian's desire to have additional sources of cash for its banking operations.

9/ Section 2(a)(3)(E) of the 1940 Act provides that a fund's investment adviser is an affiliated person of that fund, and Section 2(a)(3)(C) provides that an entity directly or indirectly controlling or controlled by another entity is an affiliated person of that entity. As a result, PNC Bank may be considered to be an affiliated person of an affiliated

You assert that an investment company's excess cash balances arise as an incident to an investment company's normal operations, and that no indicia of a loan, such as terms regarding amount or duration, accompany the maintenance of excess balances with a custodian. You argue, therefore, that the maintenance of an investment company's excess cash balances with its custodian should not be viewed as a loan for purposes of these provisions.

You also maintain that the proposed arrangement does not present the potential for overreaching that Sections 17(a)(3) and 21(b) were designed to address. You represent that each Fund will receive the entire amount of the daily market rate applicable to the Fund's overnight cash balances, which will be determined independently by the marketplace. The Custodian, therefore, will have no discretion to determine the rate of compensation that a Fund receives, and will receive only a nominal transaction fee.

Section 17(d) of the 1940 Act and Rule 17d-1 thereunder prohibit an affiliated person of an investment company, or an affiliated person of such person, acting as principal, from participating in a joint enterprise or other joint arrangement or profit-sharing plan with such company without first obtaining an order from the Commission. The purpose of Section 17(d) and Rule 17d-1 is to protect investment companies from participating in transactions with affiliated persons on inequitable terms. 10/ Rule 17d-1(c) generally defines a joint enterprise to include any contract or arrangement whereby an investment company and an affiliate "have a joint or joint and several participation, or share in the profits of such enterprise or undertaking."

You believe that the arrangement described above does not constitute a joint enterprise or other joint arrangement or profit-sharing plan within the meaning of Section 17(d) and Rule 17d-1. You note that the staff has permitted custodians to provide custodial services to their affiliated investment

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person of the Funds because the Funds' investment advisers are affiliated persons of the Funds they advise, and because of the control relationship that exists between PNC Bank and the investment advisers. In addition, PNC Bank also may be considered a direct affiliate of certain Funds for which it performs certain back office sub-advisory functions.

10/ Hearings Bef. a Subcomm. of the Comm. on Banking and Currency on S. 3580 at 37, 767-68 (1940).

companies. 11/ Further, in Norwest Bank Minnesota, N.A. (pub. avail. May 25, 1995) ("Norwest"), the staff indicated that service arrangements between an investment company and an affiliate under which compensation paid to the affiliate would not be based on a share of the revenue generated by the service provider's efforts would not constitute a joint arrangement under Section 17(d) and Rule 17d-1. As noted above, the Custodian receives no share of the daily market rate applicable to a Fund's overnight cash balances and, other than a nominal transaction fee, the Custodian will receive no fees with respect to the proposed transaction. Although the Funds' advisers and certain other affiliates may benefit from an increase in the Funds' assets as a result of the proposed transaction, the staff and courts have taken the position that the prohibitions of Section 17(d) and Rule 17d-1 do not reach every economic relationship between an investment company and its affiliates; rather, "some element of combination" must first be established. 12/ You maintain that the proposed arrangement does not establish the degree of combination required by Section 17(d) and Rule 17d-1.

Based on the facts and representations in your letter, and in particular, your representation that no significant benefit will accrue to the Custodian or its affiliates as a result of the maintenance of the Fund's excess cash balances, we would not recommend enforcement action to the Commission pursuant to Sections 17(a)(3), 21(b), or 17(d), or Rule 17d-1 thereunder, if the Custodian compensates a Fund based upon the daily market rate

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11/ See, e.g., Composite Group of Funds (pub. avail. Mar. 2, 1987); IPI-Income & Price Index Fund (pub. avail. Dec. 12, 1980).

12/ See SEC v. Talley Industries, Inc., 399 F.2d 396, 403 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969). See also Norwest ("In our view, a service arrangement between a fund and an affiliated person of the fund under which compensation is not based on a share of the revenue generated by the service provider's efforts is not a 'joint enterprise' or other joint arrangement or profit-sharing plan."); The Flex-fund (pub. avail. Nov. 22, 1985) (a service arrangement was not deemed a joint arrangement subject to Rule 17d-1, when the affiliated service provider's compensation was based on a percentage of the fund's net assets.).

applicable to a Fund's overnight cash balances as described above and in your letter. 13/ You should note that different facts or representations might require a different conclusion.

Jana M. Cayne

Jana M. Cayne
Senior Counsel

13/ You also have requested relief under Sections 17(a)(1) and 17(a)(2) of the 1940 Act. Because we believe that your proposal does not raise an issue under these provisions, we have not addressed them in our response.

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PNCBANK

Investment Company Act of 1940:
Section: 17(a)(1)
17(a)(2)
17(a)(3)
17(d)
21(b)
Rule: 17d-1

June 9, 1997

Mr. Douglas J. Scheidt
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
Mail Stop 10 - 6
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: No-Action Request Regarding Compensation for Overnight Cash Balances

Dear Mr. Scheidt:

On behalf of PNC Bank, National Association ("PNC Bank"), registered investment companies advised by PNC Bank or an affiliate of PNC Bank for which PNC Bank or an affiliate of PNC Bank acts as custodian (the "Funds"), and affiliates of PNC Bank that serve as custodian for any of the Funds (such entities, together with PNC Bank, referred to as the "Custodian"), this request is being made to garner assurance that the staff of the Division of Investment Management (the "Staff") would not recommend any enforcement action to the Securities and Exchange Commission (the "Commission") under Sections 17(a)(1), 17(a)(2), 17(a)(3), 17(d), or 21(b) of the Investment Company Act of 1940 (the "1940 Act") or Rule 17d-1 thereunder if the respective investment portfolios (the "Portfolios") of the Funds are compensated by the Custodian for cash balances maintained overnight with the Custodian as described below.

Underlying this request is the premise that (i) investment companies with non-affiliated custodians are permitted to be compensated by their custodian for cash balances maintained overnight with the custodian, (ii) if the Funds are not permitted to be similarly compensated, they will be competitively disadvantaged vis-a-vis their investment company competitors, and (iii) the proposed transactions have been structured with the intent of eliminating the potential for any conflicts of interest that might arise.

PARTIES

PNC Bank, a wholly-owned indirect subsidiary of PNC Bank Corp., serves as the Funds' custodian.[1] In that capacity, PNC Bank generally receives and maintains the Funds' cash and portfolio securities, disburses assets upon instruction, collects income due to the Funds, and maintains records regarding the foregoing. PNC Bank provides custodial services for approximately $350 billion in assets, including approximately 635 investment company accounts with approximately $210 billion in assets. PNC Bank is a member of the Federal Reserve Banks of Philadelphia and Cleveland, and its activities are regulated by the Office of the Comptroller of the Currency.

Each of the Funds is registered under the 1940 Act as a management investment company. The Portfolios represent a broad mix of money market, fixed income, and equity portfolios. A number of the Funds are sold exclusively to institutional investors, and therefore these Funds compete on a daily basis in the highly competitive institutional investment company marketplace. The Funds are advised by direct and indirect wholly-owned subsidiaries of PNC Bank.[2] As such, PNC Bank may be considered to be an affiliate of the Funds.[3]

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[1]PNC Bank Corp., the thirteenth largest bank holding company in the United States, is a multi-bank holding company with both bank and non-bank subsidiaries. Through its subsidiaries it provides a full range of banking services to its customers, including corporate banking, consumer banking, real estate banking, mortgage banking, and asset management. As of December 31, 1996, PNC Bank Corp. had total assets of $73.2 billion, total deposits of $45.6 billion, and total shareholders equity of $5.8 billion. As of the same date, PNC Bank had total assets of $57.3 billion, total deposits of $38.4 billion, and total shareholders equity of $4.6 billion.

[2]PNC Bank's investment adviser subsidiaries currently provide investment advisory services to registered investment companies and other accounts totaling approximately $115 billion in assets, and in the aggregate constitute the second largest bank-affiliated manager of investment companies in the country. PNC Bank performs certain back office sub-advisory functions for several of the Funds in the form of providing research, credit analysis, and recommendations regarding portfolio investments as well as supplying computer facilities, personnel, and various related services, but it does not exercise investment discretion with respect to any of the Funds.

[3]Section 2(a)(3) of the 1940 Act defines the term "affiliated person" as that term is used throughout the 1940 Act. Section 2(a)(3)(E) states that an investment company's investment

PROPOSED TRANSACTIONS

Use of Affiliated Custodian by the Funds

In order to remain competitive with other investment company complexes, the Funds have determined that they need the flexibility to be able to extend the time of day up to which they will accept purchase and redemption orders.[4] The Funds are concerned that, as described more fully below, by virtue of extending their purchase and redemption times they may hold pools of excess cash late in the day for which appropriate investments are not available. Absent the ability to garner some benefit from this excess cash, shareholder return would be adversely affected and the Funds as a practical matter could be prohibited from extending their purchase and redemption times.

i. Structure of the Proposed Transactions

The Funds are proposing that to the extent they may hold excess cash for which appropriate investments are not available, they be permitted to receive some form of compensation with respect to cash balances that are maintained overnight with the Custodian. This compensation, which might take a number of forms, including custodian fee credits, reimbursement of fees of other service providers affiliated with the Custodian, and cash payments, will in all cases be equal to the average effective daily federal funds rate determined by the Federal Reserve Bank of New York, less the applicable reserve requirement "haircut" charged by the Federal Reserve (the "daily market rate"), as applied to those balances.

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adviser is an affiliated person of that investment company. Section 2(a)(3)(C) states that an entity directly or indirectly controlling or controlled by another entity is an affiliated person of that entity. Section 2(a)(9) of the 1940 Act states that "control" means the power to exercise a controlling influence over the management or policies of a company, and furthermore that control is presumed to exist in situations in which an entity, directly or indirectly through another controlled company, beneficially owns more than 25% of a company's voting securities. Pursuant to these definitions, the Funds' investment advisers are affiliated persons of the respective Funds that they advise, and as a result of the control relationship that exists between PNC Bank and the investment advisers, PNC Bank may be considered to be an affiliated person of those investment advisers. As a result, PNC Bank may be considered to be an affiliated person of an affiliated person of the Funds. PNC Bank may also be considered a direct affiliate of certain Funds for which it performs certain back office sub-advisory functions.

[4]Particularly in the institutional investment company context, in response to the demands of investors, investment companies are extending the time of day up to which purchase and redemption orders will be accepted. Significantly, the Funds expect that because of competitive pressures and the continuing desire of investors for increased purchase and redemption time flexibility, additional investment companies will extend their purchase and redemption times, and purchase and redemption times themselves will continue to expand.

The daily market rate serves as a proxy for the rate of return a bank would typically expect to be able to realize on a customer's cash balances. As a normal incident to the business of banking, when the cash balances of a bank's customers, which are reflected in the bank's account at the Federal Reserve, are not being used by a customer, they are generally available to the bank in order for it to carry on its banking operations. Therefore, as with any banking institution, cash balances maintained by the Custodian in its account at the Federal Reserve, including cash balances maintained by both affiliated and non-affiliated investment company custodial clients, are used by the Custodian in the course of its daily operations. Cash balances currently available to and utilized by the Custodian include those of the Funds. The intent of the proposed transactions is to enable the Custodian to provide compensation to the Funds for those balances in an amount commensurate with a current market rate applicable to those balances.

ii. Shareholder Protections

The proposed transactions will be structured so that no significant incremental benefit will accrue to the Custodian or its affiliates as the result of such transactions.[5] In particular, the Custodian will return to the Fund the full amount of the return the Custodian receives on a Portfolio's overnight cash balances based on the application of the daily market rate to those balances.[6] Moreover, each Portfolio's portfolio manager, after reviewing anticipated sources of purchases and redemptions and other sources of cash flow into and out of the Portfolio, will make a good faith determination as to the amount of cash the portfolio manager expects to have

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[5]PNC Bank and certain of its affiliates provide investment advisory, custodial, accounting, administrative, and transfer agency services to the Funds, and with respect to certain of those services are compensated based upon a percentage of assets under management. As a result, to the extent that any benefit provided to a Fund pursuant to the proposed transactions either incrementally increases the Fund's assets or induces additional shareholder purchases, PNC Bank and its affiliates may indirectly benefit from such accretion.

[6]The Custodian may charge a nominal transaction fee in connection with effecting the proposed transactions. This fee will be one which is fair and reasonable in light of the usual and customary fees charged by others for performing services of a similar nature and quality. The fee would be designed to cover the additional expense to the Custodian to monitor the excess cash balances of the respective Portfolios on a daily basis, determine the appropriate daily market rate to be applied to those balances, perform the accounting necessary to calculate the benefit due to each Portfolio, and maintain records relating to the transactions for the respective Portfolios. The transaction fee will be comparable to the transaction fee charged by PNC Bank to its investment company clients for overnight repurchase agreement transactions entered into with PNC Bank, which transactions similarly relate to overnight positions and require PNC Bank to make daily determinations of available cash, calculate applicable compensation, and maintain appropriate records.

available for investment during normal business hours, and absent unusual circumstances affecting the Portfolio, will invest that cash in accordance with the Portfolio's investment policies and practices. As a result, the amount of a Portfolio's excess cash will be tied to its investment operations, its cash flow and projected cash needs, and the availability of appropriate investment options, and will not be subject to influence by external factors such as the Custodian's desire to have an additional, albeit given the scope of the Custodian's operations a de minimis, source of cash to carry on its banking operations. The benefit provided to the Portfolios will be based upon the daily market rate, which is determined independently by the marketplace, and therefore the Custodian will have no discretion to determine the rate of compensation a Portfolio receives. Finally, the Custodian will not be permitted to provide a larger benefit to any non-affiliated investment company portfolio with respect to its overnight cash balances than it provides to a Portfolio with respect to its overnight cash balances.

As an independent check on the operation of the proposed transactions, the Board of Directors of each Fund, including a majority of the Board's non-interested members, will review the transactions initially and on at least an annual basis thereafter in order to confirm the propriety of the transactions. Each Board would also be free to examine the proposed transactions on a more frequent basis should it so desire. In particular, each Fund's Board, including a majority of the directors who are not interested persons (as defined in section 2(a)(19) of the 1940 Act) of the Fund, will determine that (i) participation in the proposed transactions is in the best interest of the Fund and its shareholders, (ii) such participation is necessary or desirable for the operation of the Fund, (iii) the Custodian can perform the proposed transactions in a manner at least equal in nature and quality to that which could be provided by others, (iv) the rate of compensation received by the Fund for cash balances maintained overnight pursuant to the proposed transactions is fair and reasonable, and (v) any fees charged in connection with the proposed transactions are fair and reasonable in light of the usual and customary fees charged by others for performing services of the same nature and quality.

In order to ensure that each Portfolio will receive the benefit it is due with respect to its overnight cash balances, and that no Portfolio will have a claim on the benefit due to any other Portfolio, the Custodian will perform the proposed transactions and will account for such transactions separately with respect to each Portfolio. The Custodian will maintain and preserve for a period of at least six years from the end of the fiscal year in which a particular Portfolio receives compensation from the Custodian pursuant to the proposed transactions, the first two years in an easily accessible place, a written record relating to cash balances maintained overnight by the Portfolio with the Custodian. The record will include, with respect to each date on which cash balances are maintained, (i) the amount retained, (ii) the daily market rate applicable to those balances, and (iii) the amount of compensation received by the Portfolio with respect to those balances.

As a result of the foregoing procedures and protections, there will be neither the incentive nor the opportunity for the Custodian to engage in overreaching in connection with the proposed transactions.

Use of Custodians by Other Investment Companies

Although PNC Bank and the Funds are aware of several investment company complexes that receive compensation for cash balances maintained overnight with their custodian, empirical evidence regarding the extent of this practice is not generally available. Nonetheless, such a practice is clearly permissible, and PNC Bank and the Funds believe that a substantial number of investment company complexes are engaging in the practice.[7]

At the request of investment company clients, custodians may enter into an arrangement whereby, in exchange for the investment company maintaining cash with the custodian in below market or non-interest bearing accounts, the custodian will reduce the custody fee payable by the investment company. These arrangements are provided as an integral part of a custodian's custodial services.

Because an investment company's excess cash, as with any other excess cash held by a custodian, flows through the banking system and may be used by the custodian to help facilitate its daily operations, that excess cash has a certain value that attaches to it. In a compensating balance arrangement, the custodian returns all or a portion of that value to the investment company. In effect, the custodian acts as the repository of the value that attaches to the excess cash, and then returns that value to the investment company just as it would any other dividend or interest payment that attaches to any other asset of the investment company that is held by the custodian.

Apart from the affiliation issue referenced above, the only substantive difference between the compensating balance arrangements typically undertaken by custodians and the transactions that are proposed in this letter is that pursuant to the transactions proposed in this letter the Custodian will receive no significant incremental benefit for the cash balances maintained by a Portfolio, but rather will return to the Portfolio an amount based on the application of the daily market rate to those balances.

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[7]The Commission itself appears to have implicitly approved of the practice. For example, in adopting amendments to investment company accounting rules and disclosure requirements regarding brokerage/service arrangements and expense offset arrangements, the Commission recognized that compensating balance arrangements exist, and chose to regulate rather than to prohibit this practice. See Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 21221, at pp. 9-14 (July 21, 1995) (adopting release); see also Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Release No. 20472 (August 11, 1994) (proposing release).

To the extent that the Funds are not able to receive compensation from the Custodian for overnight cash balances maintained with the Custodian as other investment companies are able to receive compensation from their custodian for such balances, these other investment companies hold an undue competitive advantage over the Funds. The intent of the relief requested in this letter is to rectify this competitive imbalance, and in turn to provide the Funds the ability to extend their purchase and redemption times in response to the demands of the investing public and the competitive pressures of the marketplace.

REASONS FOR RELIEF

As indicated above, the expansion of a Portfolio's purchase and redemption times could create a pool of late day money that, given the historical dearth of late day investment opportunities, could end up as idle cash in a Portfolio's investment portfolio. The pool of late day money might be the result of a late day purchase, or it might be the result of assets that were held in cash until the close of the redemption period in anticipation of potential redemption requests that were never made. Whatever the cause, the Funds will be placed at a competitive disadvantage vis-a-vis their investment company competitors if they are not able to realize some benefit from this excess cash.

At least two distinct disadvantages will burden the Funds if they are not able to utilize the Custodian with respect to compensation for overnight cash balances as other investment companies are permitted to utilize their custodian for such balances. First, the Funds will in practical terms be inhibited from extending their purchase and redemption times. Second, even should the Funds attempt to extend their purchase and redemption times in order to keep apace of the industry trend, they may be forced to dilute shareholder return as a result of holding idle cash without receiving any benefit from that cash.[8]

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[8]The Funds spent a considerable amount of time and effort attempting to employ a non-affiliated subcustodian in order to alleviate at least a portion of the problems discussed above. Because a significant portion of the Funds' client base is composed of banks and other financial institutions, however, many of which own more than 5% of one or more of the Portfolios, a large number of likely subcustodians were considered to be unavailable because of their potentially affiliated status. Other viable candidates either were not interested in the relatively small size of the business as a standalone proposition or were willing to undertake the business only in exchange for additional business relationships to which the Funds were not willing to accede. Ultimately, given the size and experience of the subcustodian options that remained available to the Funds, and the economic and operational inefficiencies that the use of a subcustodian would entail (e.g., the need to transfer cash back and forth between the Custodian and the subcustodian and to maintain the cash on both the Custodian's and the subcustodian's books, with the accompanying risk of errors in calculation and transmission that inevitably accompanies the movement of money, as well as the cost of establishing the subcustodial relationship), the Funds determined that the use of a subcustodian in order to receive some return on their excess cash

Effect on Purchase and Redemption Time Flexibility

Without the ability to receive some form of compensation with respect to the excess cash that is expected to result from the expansion of purchase and redemption times, the Funds anticipate that the drag on the Funds' performance created by this excess cash could as a practical matter deny them the flexibility to respond to consumer demand by extending their purchase and redemption times. If the Funds are denied this flexibility that is available to other investment companies, given the intense competition for assets and growing investor sentiment for expanded purchase and redemption times, the Funds contemplate that they will be forced to forfeit assets to those investment companies that have been able to extend their purchase and redemption times. Such forfeiture could result in rising costs for the Funds' shareholders and a decreased ability of the Funds to effectively manage and diversify their remaining assets.

The expectations of investors, and particularly institutional investors to which a number of the Funds are marketed, regarding how late in the day purchases and redemptions should be available has recently begun to shift significantly. Not surprisingly, the purchase and redemption times of investment companies have begun to shift with them.

Institutional investors in particular have a strong preference for later purchase and redemption cut-off times. As investors learn to interact on a more global basis, as economies become ever more interconnected, and as the pace of business continues its rapid acceleration due to the increasing breadth and versatility of communications technology, this preference can be expected to intensify.

Institutional investors seek later purchase and redemption cut-off times because earlier in the day, as the result of a number of factors including that their investment portfolios and cash needs may be in a state of flux, their system processing capabilities may lag real time transactions, and they may periodically receive cash receipts late in the day, they often do not know the extent of their cash needs or cash availability. Additionally, due to the time difference between the West Coast and the financial centers on the East Coast, the growing number of West Coast investors are typically required to make their investment decisions earlier in their business day. As a result, other matters being relatively equal, investors with these types of issues will migrate to those investment companies that offer them greater purchase and redemption time flexibility.

The Funds are concerned that if they are constrained from offering the same type of purchase and redemption time flexibility as their competitors, they may begin to experience a diminution of assets and their shareholders may collaterally begin to experience the negative effects that such a diminution would engender. These negative effects could include reduced

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was not a feasible alternative.

economies of scale, higher fixed expense ratios, reduced opportunities for the Funds to diversify assets, and diminished influence of the Funds in the securities markets.

Conversely, if the Funds are permitted to utilize the Custodian in order to garner some benefit from their excess cash, they will from a practical standpoint be in a position to extend their purchase and redemption times, thereby helping to maintain a competitive balance in the industry as well as potentially inducing asset growth in the Funds. Such asset growth would carry with it the potential attendant benefits of increased economies of scale, lower fixed expense/asset ratios, broader asset diversification, and greater strength and leverage in the securities markets.

Effect on Performance

If a Portfolio were to extend its purchase and redemption times, it is expected that there will be days on which it will hold uninvested cash at the end of the day. If the Portfolio is not able to find an appropriate investment outlet for that cash, its performance and in turn shareholder return would suffer.

Typically, a Portfolio would invest its excess cash in overnight repurchase agreements pending investment in other eligible investments. Given the ease and reliability with which repurchase agreements can be entered into on an overnight basis, they are by far the overnight investment option of choice.

However, based upon the extensive experience of the Funds' investment advisers in the money markets, the Funds expect that overnight repurchase agreements will simply not be available on a consistent basis late in the day. Because repurchase agreement counterparties attempt to sell out their collateral inventory relatively early in the trading day to avoid holding excess collateral at the end of the day, the supply of eligible collateral typically dries up by 3:00 p.m. Eastern time. Without available eligible collateral, repurchase agreements are not a viable investment option for the Funds.

Further exacerbating the severely limited to non-existent supply of eligible collateral later in the day, a number of the Portfolios are money market portfolios that are governed by Rule 2a-7 under the 1940 Act. These Portfolios are as a practical matter strictly constrained by the diversification requirements of that Rule as to the types of repurchase agreement collateral they may accept.[9] Additionally, these Portfolios, as well as the other Portfolios that are not money

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[9]Pursuant to Rule 2a-7, repurchase agreements receive special portfolio diversification treatment if among other things they are collateralized entirely by securities of the U.S. Government (or certain of its agencies or instrumentalities) or by securities that have received the highest rating from the requisite number of rating organizations.

market portfolios, are subject to stringent eligible collateral requirements pursuant to their own internal repurchase agreement guidelines.[10]

Repurchase agreements are not necessarily the only overnight investment option open to a Portfolio; depending upon a particular Portfolio's investment policies, other overnight investment options may also be theoretically available. In addition, not all of the Portfolios are permitted to invest in repurchase agreements. However, as with eligible repurchase agreement collateral, other short-term investments, such as short-term Treasury and agency notes and short-term tax-exempt instruments, also tend to disappear from the market supply relatively early in the day. Furthermore, the government securities wire closes at 3:00 p.m. Eastern time, and since almost all government securities are traded through the Federal Reserve's Book-Entry System, these securities are generally not available after that time. Finally, a number of these short-term securities are simply not available, or are available only by coincidence, on an overnight basis.

As a result of the general lack of supply of eligible repurchase agreement collateral and other types of securities later in the day, the Funds anticipate that to the extent they hold cash late in the day there will likely not be an acceptable investment outlet for that cash. Therefore, should a Portfolio extend its purchase and redemption times, with the likely result that it will hold excess cash at the end of the day, absent the ability to receive some benefit from the Custodian with respect to that excess cash, the Portfolio's performance and the return provided to shareholders will suffer.

LEGAL ANALYSIS

The 1940 Act's conflict of interest rules generally seek to protect investment companies and their shareholders from the undue and potentially adverse influence that an investment company's affiliates may have over the investment company by ensuring that the terms of any transactions between the investment company and its affiliates do not involve overreaching or self-dealing on the part of the affiliate, and that the terms of such transactions are reasonable and fair and do not improperly discriminate against the investment company. PNC Bank submits that, notwithstanding the Funds' affiliation with the Custodian, inasmuch as the Funds can expect to realize a substantial benefit by utilizing the Custodian as proposed in this letter, and pursuant to the structure of the proposed transactions (and notwithstanding the nominal transaction fee that the Custodian may charge) the Custodian is not expected to receive any significant incremental benefit from engaging in those transactions, the interests of the Funds and

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[10]Although the repurchase agreement guidelines applicable to the Portfolios are not entirely uniform, as a general matter they follow the requirements of Rule 2a-7, with the non-money market Portfolios also able to accept collateral that is deemed to be of comparable quality to eligible collateral that has received the highest rating from the requisite number of rating organizations.

their shareholders can best be served by allowing the Funds to receive some compensation with respect to cash balances maintained overnight with the Custodian.

Section 17(d) and Rule 17d-1

Section 17(d) of the 1940 Act and Rule 17d-1 thereunder generally prohibit an investment company affiliate, acting as principal, from participating in or effecting any transaction in connection with a "joint enterprise or other joint arrangement or profit-sharing plan" in which the investment company is a participant. Rule 17d-1(c) defines a "joint enterprise or other joint arrangement or profit-sharing plan" to include any contract or arrangement concerning an enterprise or undertaking whereby an investment company and an affiliate of the investment company "have a joint or joint and several participation, or share in the profits of such enterprise or undertaking."

In Norwest Bank Minnesota, N.A. (available May 25, 1995) ("Norwest Bank"), the Staff noted that the prohibitions of Section 17(d) and Rule 17d-1 do not reach every economic relationship between an investment company and its affiliates; rather, some "element of combination" must first be established. The Staff elaborated that it did "not believe that the mere provision of services to a fund by an affiliated person, without more, establishe[d] the degree of combination required by section 17(d) and rule 17d-1," and furthermore that in its opinion "a service arrangement between a fund and an affiliated person of the fund under which compensation [paid to the affiliated service provider] is not based on a share of the revenue generated by the service provider's efforts is not a 'joint arrangement [prohibited by section 17(d) and rule 17d-1].'"

As described above, the Custodian receives no share of the daily market rate as applied to a Portfolio's overnight cash balances. Rather, that entire amount is returned to the Portfolio. In fact, other than the nominal transaction fee that the Custodian may charge, the Custodian will receive no fees with respect to the proposed transactions. The fact that the return provided to a Portfolio is based upon the daily market rate, which is determined independently by the marketplace, and that the Custodian has no stake in the amount of benefit provided to a Portfolio, serves to eliminate any incentive that the Custodian might have to take any undue risk with a Portfolio's excess cash or to otherwise engage in activities that might be detrimental to the Funds.

Moreover, the Staff has consistently permitted affiliated service providers to provide services in the ordinary course of business to the investment companies with which they are affiliated.[11] In particular, the Staff has permitted affiliated custodians to provide custodial

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[11]See, e.g., Unified Growth Fund (available June 28, 1990) (typesetting, printing, and shareholder report distribution); Flex-Fund (available November 22, 1985) (transfer agency and accounting services); Federated Securities Corp. (available October 21, 1983) (concluding that

services to the investment companies with which they are affiliated.[12] As discussed above, PNC Bank currently provides custodial services to the Funds. The provision of compensation for excess cash balances is merely an extension of those services, and is similar to services performed by other investment company custodians for their clients.

In permitting affiliates to provide services to their affiliated investment companies, the Staff has typically required that the compensation paid to the affiliated service provider be fair and reasonable and that other adequate safeguards be in place to prevent overreaching. Apart from a nominal transaction fee, which is required to be commensurate with similar fees charged by others and which must be reviewed by each Fund's Board of Directors on a periodic basis, the Custodian will not charge the Funds any additional fee for carrying out the proposed transactions, so that the concern regarding the amount of fees that may be charged, while important, is in the present context essentially a moot point. In addition, as described above, other safeguards will also be instituted with respect to the proposed transactions in order to ensure against overreaching, including requiring the respective Funds' Boards of Directors to reach certain determinations regarding the propriety of those transactions. These Board determinations are similar to those typically required by the Staff in the affiliated service provider context.[13]

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because pursuant to Section 17(c) of the 1940 Act Congress had permitted services provided incident to a lessor-lessee relationship between affiliated persons, and because presumably Congress had not intended to prohibit such services as impermissible joint transactions pursuant to Section 17(d) after having permitted them pursuant to Section 17(c), therefore Congress as a general matter did not intend to prohibit service arrangements between affiliated persons).

[12]See, e.g., Composite Group of Funds (available March 2, 1987); IPI-Income & Price Index Fund (available December 12, 1980).

[13]See Norwest Bank. The Board determinations proposed in this letter differ in three respects from the determinations provided for in Norwest Bank. First, in amplification of the determination that the proposed transactions be in the best interests of a Fund, a Fund's Board will specifically determine that the rate of compensation received by the Fund pursuant to the proposed transactions is fair and reasonable. This specific determination was not required in Norwest Bank. Second, in view of the fact that it would be an extremely difficult proposition for a Fund's Board to conclude that any single vehicle for a Fund's excess cash is so vital that the Fund's survival depends upon the ability to use that vehicle, rather than determine that the proposed transactions are "necessary" for the operation of the Fund, the Fund's Board will determine that the proposed transactions are "necessary or desirable" for the operation of the Fund. Third, because the nominal transaction fees that may be charged in connection with effecting the proposed transactions will be insignificant in comparison to a Fund's overall operations, the amount of these fees will be reviewed on an annual as opposed to a quarterly basis. Because of the de minimis nature of the transaction fees, it is submitted that to require a

Sections 17(a)(1) and 17(a)(2)

In general, Sections 17(a)(1) and 17(a)(2) of the 1940 Act, respectively, prohibit an investment company affiliate, acting as principal, from selling securities or other property to, or purchasing securities or other property from, an affiliated investment company. In order to fall within the parameters of Section 17(a)(1) or 17(a)(2), a transaction must involve the "purchase" or "sale" of "securities" or "property." Because, it is submitted, the proposed transactions do not involve the purchase or sale of securities or property, but rather are merely an extension of the custodial services provided by the Custodian, the provisions of Section 17(a)(1) and 17(a)(2) do not apply to the proposed transactions.

The purchase or sale of a security or property involves the exchange of value between two parties with respect to that security or property. In point of fact, in offering the transactions proposed in this letter the Custodian is simply offering an upgrade or an enhanced service with respect to the manner in which it maintains a Fund's cash. No separate purchase or sale transaction occurs between a Portfolio and the Custodian.

Furthermore, it would be an unusual interpretation to consider an investment company's custody account to be a security. It is worth noting that if Congress had intended to include a bank custody account as a "security" pursuant to Section 2(a)(36) of the 1940 Act, it could have done so, but it did not. Moreover, while we are aware that in certain circumstances the Staff has considered certificates of deposits and money market deposit accounts to be securities,[14] not only did those circumstances entail different policy considerations than those presented in the present case,[15] but more importantly, due to the different expectations that attach to them, certificates of

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Fund's Board to review these fees on a more frequent basis would be an inefficient use of the Board's time. Of course, a Board would be free to request information regarding such fees at any time, and the Custodian would stand ready to provide such information.

[14]See Merrill, Lynch, Pierce, Fenner & Smith, Inc. (available October 28, 1982) (certificates of deposit); Kemper Financial Services, Inc. (available November 29, 1985) (money market deposit accounts). Contra Marine Bank v. Weaver, 455 U.S. 551 (1982) (due to the protections afforded by the highly regulated nature of banks, as well as the presence of FDIC insurance, certificates of deposit are not securities because they do not involve the risk of loss to an investor that typically accompanies a security); Wolf v. Banco de Mexico, S.A., 739 F.2d 1458 (9th Cir. 1984), cert. denied, 469 U.S. 1108 (1985) (focusing on the protections afforded by bank regulations, even in the absence of deposit insurance, to conclude that certificates of deposit are not securities).

[15]Prior situations in which the Staff has determined certificates of deposit and money market deposit accounts to be securities have typically involved situations in which a commingled investment vehicle was expected to hold certificates of deposit or money market

deposit and money market deposit accounts are fundamentally different from an investment company's custody account. When a depositor obtains a certificate of deposit it expects to receive a certain return on its money in exchange for surrendering a certain amount of money to a bank for a certain period of time, whereas when an investment company maintains a custody account with a bank it expects the bank to safeguard its assets and to have ready access to those assets, and any further benefit from excess cash balances maintained in that account is a serendipity. In short, an investment company's custody account serves a custodial rather than a profit-making function, and any enhancements to the custody account do not change the essential custodial nature of that account.

Finally, even if it is conceded that an investment company's custody account constitutes "property," the operation of that account does not involve the purchase or sale of property. Banks sell their investment company custody clients services, not property.[16] To the extent a custodian provides compensation to an investment company custody client for excess cash balances maintained with the custodian, it does not do so in the form of a purchase or sale. Rather, as an accommodation to the investment company, it returns to the investment company all or a portion of the intrinsic value that attaches to the investment company's excess cash.

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deposit accounts, and the issue at hand was whether the commingled investment vehicle would thereby be considered to be holding securities and thus would be subject to registration as an investment company under the 1940 Act. A decision by the Staff that these instruments did not constitute securities would have removed the commingled investment vehicle from the ambit of the 1940 Act, and the investors in that commingled investment vehicle from the protections afforded by the 1940 Act, and therefore policy considerations dictated that the instruments be deemed securities. In the present case, in contrast, the Funds remain subject to the general provisions of the 1940 Act, and shareholders receive the additional protection of the measures described above that are designed to mitigate any potential conflicts of interest between the Custodian and the Funds.

[16] Cf. Steadman Security Corporation, Investment Company Act Release No. 9830 (June 29, 1977), at pp. 30-40. In Steadman, in considering whether a party that controlled a number of investment companies had improperly received benefits from several banks with which the party had caused the controlled investment companies to maintain custody accounts, the Commission determined that banks sell their custody customers services and not property, and that therefore the maintenance of custody accounts with the banks at issue did not involve the purchase or sale of the investment companies' property. Although the custody accounts at issue in Steadman did not provide for compensating balance arrangements, that fact should not alter the conclusion that in their custodial capacity banks provide services to their custody clients rather than sell property to or purchase property from those clients.

Sections 17(a)(3) and 21(b)

Section 17(a)(3) of the 1940 Act serves generally to prohibit investment company affiliates from borrowing money or other property from an affiliated investment company. Similarly, Section 21(b) of the 1940 Act generally prohibits investment companies (other than unit investment trusts and face-amount certificate companies) from lending money or other property to any person that controls or is under common control with the investment company. Taken together, with certain exceptions these two provisions generally prohibit an investment company from making loans to its affiliates. Because excess cash balances maintained by an investment company are not loans, it is submitted that the provisions of Sections 17(a)(3) and 21(b) do not apply to such balances.

Absent unusual circumstances, an investment company attempts to keep itself fully invested at all times in order to maximize the return on its assets. In other words, typically an investment company attempts to maintain a zero excess cash balance. If, however, as a result of its investment operations or other operational requirements (e.g., the need to maintain assets in cash in order to meet anticipated redemptions) an investment company happens to carry an excess cash balance on a particular day, it does not therefore mean that the investment company has made a loan of that excess cash. The excess cash balance arises as an incident to, and as a result of, the investment company's operations.

Many investment companies abide by a fundamental investment limitation that, with certain exceptions, prohibits the making of loans to other parties. It would be a surprise indeed to most, if not all, of these investment companies should they suddenly be informed that by reason of carrying excess cash balances they are making loans, and are thereby violating their fundamental policy against making such loans.

There simply is no contemplation when an investment company maintains an excess cash balance that it is making a loan. No indicia of a loan, such as terms regarding amount or duration, accompany the maintenance of those excess balances. The excess cash balances exist as a fact of the normal operating functions of an investment company, and are no more than a well-accepted by-product of those functions.

As a fundamental component of its custodial duties, an investment company custodian maintains the excess cash balances of its investment company clients. Because an investment company happens to maintain excess cash balances on a particular day, which balances are necessarily held by its custodian, does not mean that the investment company has made a loan to that custodian. Finally, the provision of compensation for those excess cash balances, a benefit to the investment company, does not thereby extemporaneously change the character of that excess cash balance into a loan.

CONCLUSION

Given the fact that the proposed transactions are an extension of the services currently provided by PNC Bank to the Funds, and that such transactions are routinely made available by custodians as part of an integrated package of custodial services provided to their investment company clients, we do not believe that the proposed transactions involve anything more than the provision of standard custody services to the Funds. The Staff has on numerous occasions permitted affiliates to provide services to their affiliated investment companies, and given the protections that underlie and are a part of the proposed transactions, the proposed transactions do not warrant any different analysis.

In this regard, it bears noting that pursuant to the structure of the banking industry as well as the operating features of investment company custody accounts generally, the Funds' excess cash balances are currently available to the Custodian in order for it to carry on its banking operations. The proposed transactions are designed simply to allow the Custodian to provide the Funds with a market-based rate of compensation with respect to those balances.

Significantly, the proposed transactions will provide an important benefit to the Funds. In sum, they will allow the Funds to compete on a more equal basis with their investment company competitors, who are currently able to receive compensation from their custodian for their excess cash balances. At the same time, the proposed transactions are structured so as to avoid overreaching on the part of, or undue benefit to, the Custodian or its affiliates. Finally, in order to further ensure the propriety of the proposed transactions, the transactions are required to be undertaken pursuant to the independent approval and continuing oversight of each Fund's Board of Directors.

RELIEF REQUESTED

Based on the foregoing facts and circumstances, PNC Bank submits that the proposed transactions represent a significant benefit to the Funds and that the proposed transactions are not such as were meant to be prohibited by the 1940 Act's conflict of interest rules. Therefore, we request the Staff's confirmation that it would not recommend enforcement action to the Commission pursuant to Sections 17(a)(1), 17(a)(2), 17(a)(3), 17(d), or 21(b) of the 1940 Act or Rule 17d-1 thereunder should the Custodian compensate the Portfolios for cash balances maintained overnight with the Custodian.

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Thank you for your attention to this matter. For the convenience of the Staff, nine copies of this letter are enclosed. Please feel free to contact me by telephoning me collect at 215-585-5441 regarding any questions you may have. Also, we would appreciate having the opportunity to discuss this matter further if the Staff is considering anything other than a positive response.

Very truly yours,

J. Robert Dugan
Counsel
PNC Bank, National Association

cc: Karen L. McMillan, Esq.
Jana M. Cayne, Esq.

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