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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 95-35-CC
State Street Bank &
Trust Company
File No. 132-3

By letter dated January 16, 1995, you request that the staff confirm that the use of "omnibus accounts" is permissible under Rule 17f-5 under the Investment Company Act of 1940 (the "Investment Company Act").

State Street Bank and Trust Company ("State Street") is a provider of custody services to the investment company industry. Currently, State Street maintains individual accounts for each of its customers at each foreign custodian in its global custody network. State Street proposes to convert to an omnibus account arrangement pursuant to which securities of its customers would be maintained in a single account at each foreign custodian in the name of State Street on behalf of its customers. The omnibus account would hold only securities of State Street's customers, and would not include any proprietary positions of State Street. Under this arrangement, the foreign custodian would identify on its books that the securities deposited in each omnibus account are being held for State Street, as custodian for its customers, and State Street would identify on its books each customer's ownership of securities deposited in the omnibus account.

Pursuant to Rule 17f-5(a)(1)(iii)(D), the written contract governing the manner in which a custodian will maintain an investment company's assets must provide that "adequate records will be maintained identifying the assets as belonging to the company." You state that there is confusion within the investment company industry regarding whether omnibus account arrangements comply with Rule 17f-5(a)(1)(iii)(D). We believe that omnibus account arrangements, in which a foreign custodian identifies assets on its books as belonging to a primary custodian on behalf of its customers, and the primary custodian identifies the assets on its books as belonging to specific customers, are consistent with the provisions of Rule 17f-5, including paragraph (a)(1)(iii)(D).


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Jack Murphy, Esq.
Chief Counsel,
Division of Investment Management
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Mr. Murphy:

This firm represents State Street Bank and Trust Company ("State Street") a leading provider of custody services to the mutual fund industry. As described below, in connection with a proposed change by State Street in the manner in which accounts of its investment company clients would be maintained, an issue has been raised regarding the extent to which omnibus accounts, which are commonly maintained by global custodians on behalf of their investment company clients, are permissible under Rule 17f-5 under the Investment Company Act of 1940. This letter describes the issue and the reasons why interpretative or no action relief with respect thereto is appropriate.

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Currently State Street maintains individual accounts for each of its customers at each foreign custodian in its global custody network. It now proposes to convert to an omnibus account arrangement pursuant to which securities of State Street's customers would be maintained at each such foreign custodian in a single account in the name of State Street on behalf of its customers. State Street believes that omnibus accounts will be easier and less costly to administer than individual accounts. We have advised State Street that omnibus accounts are permissible under Rule 17f-5. Certain of State Street's clients, however have expressed concern about the extent to which Rule 17f-5 currently authorizes the use of omnibus accounts and have indicated that they would not be willing to consent to the use of omnibus accounts without an explicit statement by the Securities and Exchange Commission (the "Commission") or its staff confirming the appropriateness of their use. Thus, absent an explicit staff pronouncement on this issue State Street will be effectively precluded from converting to the use of omnibus accounts. To the extent State Street is so precluded it will be placed at a major competitive disadvantage relative to its competitors because the use of omnibus accounts is prevalent in the industry. Indeed, to State Street's knowledge, most other custodian banks currently maintain omnibus accounts with the foreign custodians in their custody networks. The resistance State Street has encountered from certain of its clients indicates, however, that notwithstanding the common use of omnibus accounts and their apparent acceptance by customers of its competitors and by the Commission itself, there is confusion within the mutual fund industry as to the extent to which omnibus accounts are permitted under Rule 17f-5.

In view of the foregoing, State Street requests that the Commission's staff issue an interpretive or no action letter confirming that the use of omnibus accounts is

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permissible under Rule 17f-5.¹ This letter sets forth the basis for our request.

Background

State Street maintains custody of foreign securities of its customers through a network of foreign custodians. Each foreign custodian qualifies as an "eligible foreign custodian" (within the meaning of Rule 17f-5) or is otherwise exempt from such requirement by the terms of an exemptive order issued by the Commission. In addition, each foreign custodian has entered into a contract with State Street that satisfies the requirements of Rule 17f-5. Under State Street's existing foreign custody arrangements, the securities of a customer to be held by a foreign custodian are deposited with the foreign custodian in a separate account established by State Street with the foreign custodian for the specific customer. At all times, the securities held in the account by the foreign custodian are identified on the books of the foreign custodian as belonging to the customer. In addition, at all times, State Street maintains records identifying the customer as the owner of all securities held through the foreign custody network for that customer.

As an alternative to this arrangement, State Street proposes to establish an omnibus account with each foreign custodian. Each omnibus account will be used exclusively for the deposit of foreign securities of customers of State Street. Under this arrangement (referred to herein as an "Omnibus Account Arrangement"), the foreign custodian will identify on its books that the securities deposited in each omnibus account are being held for State Street, as custodian for its customers, and State Street will identify on its books each customer's ownership of the securities deposited in the omnibus account. Through the

¹State Street is a member of the Coalition of Custodian Banks which has previously submitted to the Commission proposed revisions to Rule 17f-5. This letter is written in State Street's individual capacity and not as a member of the Coalition.

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Omnibus Account Arrangement, the customer's securities will at all times be segregated from the assets of the foreign custodian and State Street. Opinions will be secured by State Street from local counsel confirming that holding securities in omnibus accounts will not adversely affect the ability of State Street or the customer to recover the customer's assets in the event of bankruptcy or insolvency of the foreign custodian.

The Issue

Rule 17f-5 provides a means by which foreign securities owned by a registered investment company may be held in custody outside the United States by a custodian that would otherwise not be eligible to serve as a custodian under Section 17(f) of the 1940 Act or through a securities depository that would otherwise not qualify for use under Rule 17f-4. Rule 17f-5 provides, in relevant part, that an investment company may place and maintain in the care of an "eligible foreign custodian" (as defined in the Rule) the company's foreign securities, provided that certain conditions of the Rule are satisfied. Among other things, the Rule requires the directors of the investment company to approve, as consistent with the best interests of the investment company and its shareholders, a written contract governing the manner in which such custodian will maintain the company's assets. Under Rule 17f-5, the contract for such custody arrangements must provide, among other things, that "adequate records will be maintained identifying the assets as belonging to the company."

The issue presented is whether Rule 17f-5 requires a foreign custodian to maintain records identifying all assets as belonging to each specific investment company or whether Rule 17f-5 permits the use of Omnibus Account Arrangements, in which a foreign custodian identifies assets on its books as belonging to a U.S. custodian on behalf of its customers and the U.S. custodian identifies the assets on its books as belonging to specific customers. As discussed below, the relevant history of Rule 17f-5 indicates that omnibus accounts were intended to be permitted.

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History of Rule 17f-5

The Commission initially proposed Rule 17f-5 for comment in April 1982. See SEC Rel. No. 40-12354 (April 15, 1982) (the "Proposing Release" and the "Proposed Rule"). The Proposed Rule required directors of an investment company to approve, as consistent with the best interests of the investment company, a custody contract that would govern the manner in which the securities will be maintained. The Proposed Rule did not identify specific terms required to be included in the custody contract. Rather, the Proposed Rule included instructions identifying the factors that should be considered by directors with respect to such custody contract. Instructions 3(c) and 3(d) of the Proposed Rule provided that directors of an investment company should consider whether the investment company's securities "will be adequately segregated in an account which contains only assets of the company or only assets of the depositing intermediary for its customer" and whether "adequate records will be maintained by the foreign entity identifying the securities as belonging to the company or as belonging to the depositing intermediary for its customers" (emphasis added). In this manner, the Proposed Rule explicitly endorsed the use of Omnibus Account Arrangements.

In the Proposing Release, the Commission explained its interpretation of "adequate segregation" and "adequate records" and distinguished between situations in which an investment company deposits assets directly with a foreign custodian and situations in which securities are deposited with the foreign custodian through an intermediary U.S. custodian:

Adequate segregation has been most recently interpreted to mean that the custodian with which the company is dealing directly should maintain the securities in an account which contains only the company's assets. If the company is dealing with the custodian indirectly, the custodian should segregate securities in an account which contains only assets held by the depositing intermediary for its customers.... If the company chooses to deposit the securities first with a qualified U.S. custodian which in turn deposits

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the securities with a foreign entity, the books of the U.S. custodian should identify the securities as belonging to the company and the books of the foreign entity should identify the securities as belonging to the U.S. custodian for its customers.

As support for the foregoing interpretation, the Proposing Release cited the exemptive order that had been issued to Chase Manhattan Bank, N.A. ("Chase"). See SEC Rel. No. 40-12053 (Nov. 20, 1981) (referred to herein as the "Chase Order"). The Chase Order, which had exempted Chase from the provisions of Section 17(f) and Rule 17f-4 to the extent necessary to permit Chase to deposit foreign securities with foreign custodians, explicitly contemplated that Chase would maintain custody of foreign securities as an intermediary U.S. custodian through the use of Omnibus Account Arrangements. Accordingly, the Chase Order required the custody contract between Chase and the foreign custodian to include the following provisions (referred to herein as the "Omnibus Account Provisions"):

Where securities are deposited by [Chase] with a foreign bank or securities depository, [Chase] shall identify on its books as belonging to the investment company the securities shown on [Chase's] account on the books of the foreign bank or securities depository.

Where securities are deposited by a foreign bank with a securities depository, [Chase] shall cause the foreign bank to identify on its books as belonging to [Chase], as agent, the securities shown on the foreign bank's account on the books of the securities depository.

* * * *

[Chase] will deposit securities in an account with a foreign bank which includes only assets held by [Chase] for its customers.

Subsequent to the Proposing Release, the Commission issued an exemptive order to Bank of New York

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("BONY") that also contained the Omnibus Account Provisions. See SEC Rel. No. 40-12858 (Sept. 14, 1982) (referred to herein as the "BONY Order").²

The Commission repropoed Rule 17f-5 in January 1984. See SEC Rel. No. 40-13724 (January 17, 1984) (referred to herein as the "Reproposing Release" and the "Reproposed Rule"). As in the Proposed Rule, the Reproposed Rule required the directors of an investment company to approve, as consistent with the best interests of the company and its shareholders, a written contract between the company and the foreign custodian and, in connection therewith, to consider specific factors, which were set forth as instructions to the Reproposed Rule. Instructions 3(c) and 3(d) of the Reproposed Rule required the directors of an investment company to consider whether the company's "certificated assets would be maintained in an account which contains only assets of the company" and whether "adequate records would be maintained by the foreign custodian identifying the assets as belonging to the company."

The Reproposing Release identified six modifications to the scope of the Proposed Rule. Neither the manner in which securities were to be adequately segregated nor the manner in which records should be maintained were identified as areas in which modifications were made.

In September 1984 the Commission adopted Rule 17f-5 in substantially its present form. See SEC Rel. No. 40-14132 (Sept. 7, 1984) (referred to herein as the

²Subsequent to the BONY Order, the Division of Investment Management took the position that it would not recommend enforcement action to the Commission if other U.S. custodian banks and registered investment companies made use of foreign custody arrangements that conformed to the conditions outlined in the Chase Order, the BONY Order and the Proposed Rule. See, e.g., Mitsubishi Bank of California, SEC No-Section letter (October 1, 1982).

"Adopting Release").³ As adopted, Rule 17f-5 requires directors to approve, as consistent with the best interests of the investment company, a written contract that will govern the manner in which the foreign custodian will maintain custody of the company's assets. However, rather than offering instructions to directors with respect to appropriate considerations bearing on the approval requirement (as was the approach in the Proposed Rule and the Reproposed Rule), Rule 17f-5, as adopted, requires each contract to satisfy specific requirements, including the requirement that "adequate records will be maintained identifying the assets as belonging to the company." Rule 17f-5(a)(1)(iii)(D). While the requirements parallel in large part the instructions contained in the Reproposed Rule, Instruction 3(c), relating to the requirement of adequate segregation of assets was deleted, in consideration of commentator suggestions that in a book-entry environment physical segregation of assets is no longer practicable. Furthermore, Instruction 3(d), was revised to delete any reference to the specific records that must be maintained by a foreign custodian. Instead the rule simply requires that adequate records be maintained identifying the assets as belonging to the investment company. The rule as adopted does not specify the records which must be maintained nor does it specify the manner in which records must be maintained by either the foreign custodian or the U.S. custodian.

In discussing the conditions to Rule 17f-5, including the condition relating to the maintenance of adequate records, the Commission stated in the Adopting Release that:

With the exception of the conditions relating to cash and cash equivalents, all of these conditions are conditions to the exemptive relief granted Chase and BONY customers....

³Rule 17f-5 was amended in 1985. The amendments did not affect the portions of the Rule relevant to this opinion. See SEC Rel. No. 40-14711 (Sept. 11, 1985.)

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In the Adopting Release the Commission noted that it was issuing notices to Chase and BONY indicating its intent to modify certain conditions of the Chase and BONY Orders to conform to the conditions in Rule 17f-5. The orders subsequently issued by the Commission modifying the Chase and BONY Orders to conform to the requirements of Rule 17f-5 did not modify the Omnibus Account Provisions of either Order. See SEC Rel. No. 40-14184 (October 9, 1984) (modifying the Chase Order) and SEC Rel. No. 40-14183 (October 9, 1984) (modifying the BONY Order).

Discussion

As indicated above, Proposed Rule 17f-5 contained explicit requirements with respect to segregation of assets and the manner in which records must be maintained. Under the Proposed Rule, assets were required to be adequately segregated. That requirement was deleted from the rule as adopted. Moreover, the Proposed Rule specified the manner in which records were required to be maintained by each of the U.S. custodian and the foreign custodian. The rule as adopted does not. Rather, it simply requires that adequate records be maintained that in some way identify the assets as belonging to the investment company. In light of the above, it is significant that the rule as originally proposed explicitly permitted omnibus accounts. To the extent that such arrangements were permitted under the relatively rigid standards of the proposed rule they clearly must be permissible under the more flexible standards of the rule as adopted.

Our view in this regard is supported by the fact that neither the Reproposed nor Adopting Releases suggest in any way that the use of omnibus accounts was intended to be prohibited. Furthermore, as indicated above, on the same day that Rule 17f-5 was adopted the Commission issued a release revising the Chase and BONY Orders to the extent that such orders were inconsistent with Rule 17f-5 as adopted. Significantly, the Omnibus Account Provisions of such orders were not required to be so modified, apparently reflecting the Commission's view that such arrangements are consistent with Rule 17f-5.

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Finally, we think it appropriate to note that the practice of using Omnibus Account Arrangements is common within the global custody industry. Apart from the Chase and BONY orders referred to above we are not aware of any exemptive order or no-action letter obtained by such other custodians authorizing such practice and, therefore, assume that each bank is relying on Rule 17f-5 as the basis for its practice. Of course, each such form of agreement is on file with the Commission as an exhibit to one or more registration statements of registered investment companies, but we are unaware of any objection that the Commission or its staff has raised to the use of such Omnibus Account Arrangements.

Based upon the foregoing, we have advised State Street that Omnibus Account Arrangements are permissible under Rule 17f-5. Nevertheless, as noted above, certain of State Street's clients have objected to the use of such arrangements. They have done so, not because of any decision by their fund directors that such arrangements are adverse to the best interests of the company and its shareholders, but because of their concern that such arrangements may not be permissible under Rule 17f-5.

Given the confusion within the mutual fund industry regarding the propriety of the use of omnibus accounts, we believe staff guidance on this matter is necessary. In view of the foregoing, we request the issuance of a no-action or interpretive letter concurring with our view that Omnibus Account arrangements are permissible under Rule 17f-5.

Sincerely,


Stuart M. Strauss

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