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1940 Act
Section 17(d)
17(e)
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ACT ICA
SECTION
RULE 17d-1
PUBLIC AVAILABILITY May 25, 1995

November 16, 1994

Jack W. Murphy, Esq.
Associate Director (Chief Counsel)
Division of Investment Management
Securities and Exchange Commission
Mail Stop 10-6
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Murphy:

On behalf Norwest Bank Minnesota, N.A. ("Norwest Bank") and Society National Bank ("Society National Bank"), (each a "Custodian"), and the investment companies registered under the Investment Company Act of 1940 (the "1940 Act") (each a "Fund") for which Norwest Bank or Society Asset Management, Inc., an affiliate (as defined below) of Society National Bank, serves as investment adviser, we request assurances 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 Section 17(e) or Section 17(d) of the 1940 Act or Rule 17d-1 thereunder if a Fund were to compensate its Custodian for services provided by the Custodian in connection with a securities lending program as described below.

BACKGROUND

The Funds and Custodians

Norwest Investment Management, a part of Norwest Bank, serves as investment adviser to Norwest Funds, a registered open-end investment company consisting of 31 separately managed series. Norwest Bank serves as Custodian of the assets of Norwest Funds. As of June 30, 1994, Norwest Investment Management provided investment advice with respect to assets totaling approximately $9.5 billion. Norwest Bank is a subsidiary of Norwest Corporation, a bank holding company with operations in all 50 states and approximately $56 billion in total assets.

Society Asset Management, Inc. serves as investment adviser to The Victory Portfolios, a registered open-end investment company consisting of a number of separately managed series. Society National Bank serves as Custodian of The Victory Portfolios' assets. Society Asset Management, Inc. is a wholly-owned subsidiary of KeyCorp Asset Management Holdings, Inc., which is a wholly-owned subsidiary of Society National Bank, a wholly-owned subsidiary of KeyCorp, a bank holding company. Society Asset Management, Inc. advises and manages over $20 billion in assets. As of June 30, 1994, KeyCorp had assets of approximately $63.4 billion, and had banking offices in 23 states and investment management offices in 16 states.

Because Norwest Funds retains as its Custodian a bank that is also the adviser to the Fund and The Victory Portfolios retains as its Custodian a bank that is under common control with The Victory Portfolios' adviser, each Fund's Custodian may be deemed to be an "affiliated person" of that Fund as that term is defined in Section 2(a)(3) of the 1940 Act.[1]

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1. Section 2(a)(3) of the Act defines an "affiliated person" of another person as including any person under common control with such other person and, if such other person is an investment company, any investment adviser thereof.

   The Staff deems custody by a fund's adviser or by an affiliated person of the adviser as self-custody by a fund and requires that the fund comply with Rule 17f-2 under the 1940 Act. See, e.g., Charter Funds (pub. avail. Jan. 27, 1994). The custodial arrangements with respect to each of the Funds comply with Rule 17f-2.

The Custodian's responsibilities include safeguarding and controlling the Funds' cash and securities and collecting interest on the Funds' investments. The Custodian wishes to provide services to the Funds in connection with the Funds' securities lending programs and to receive fees for the services it would provide.

The Proposed Securities Lending Arrangement

Each Fund proposes to establish a program to lend its portfolio securities (the "Program").[2] The Program would permit the Fund to earn additional revenues by loaning securities that it already owns. In a typical securities loan, the Fund's securities would be loaned, often for very short periods of time, to a broker-dealer or financial institution to cover the borrower's short sale or failed trade or for other reasons. As security for the loan, the borrower would pledge collateral to the Fund, which could include cash, U.S. Government securities, and irrevocable letters of credit issued by a bank, or any combination thereof. The loan would be "marked to market" daily with any increase in the value of the loaned securities being paralleled by an increase in the collateral provided by the borrower. Thus, any security loan by the Fund would be continuously collateralized by cash or securities with a value equal to at least 100% of the value of the loaned securities.[3]

Under the Program, (i) negotiation of the loans, (ii) selection of the borrowers, (iii) review of the borrowers' creditworthiness and (iv) investment of any cash collateral received from the borrowers or obtained through repurchase transactions with respect to non-cash collateral received from the borrowers would be the responsibility of the Adviser, subject to the supervision of the Fund's Board

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2. The Program would comply with applicable Staff positions regarding securities lending arrangements; i.e., with respect to the type and amount of collateral, the voting of loaned securities, limitations on the percentage of portfolio securities on loan and prospectus disclosure. See, e.g., SIFE Trust Fund (pub. avail. Feb. 17, 1982).

3. In practice, borrowers often pledge collateral worth more than 100% of the value of the loaned securities to avoid the need to make daily additions to collateral based on daily fluctuations of the securities' market price.

of Directors.[4] The Adviser would be able to delegate the performance of some or all of those activities to a third party, including the Custodian, subject to the Adviser's direction and supervision. In the event that the Adviser delegated any of the activities to the Custodian, the Adviser would specify procedures to be followed by the Custodian performing the activities.

Among other things, the Adviser would monitor the Custodian's activities and would approve (i) a list of creditworthy borrowers to whom the Fund would lend its portfolio securities, (ii) permissible investments for any cash collateral received in connection with securities loans, and (iii) the terms and conditions of securities loans. All of the Adviser's activities in connection with the Program would be carried out pursuant to the Adviser's investment advisory agreement with the Fund and would be consistent with the Fund's investment objectives. The Adviser would not charge the Fund a separate fee for the provision of the services in connection with the Program.

The Role of the Custodian

Under either a separate agreement or an amendment to the Fund's current custody agreement (as applicable), the Custodian would agree to perform the following custodial and administrative tasks associated with the Program:

(i) delivery of the loaned securities from the Fund to borrowers;

(ii) return of the loaned securities from borrowers to the Fund at the expiration of the loan terms;

(iii) daily monitoring of the value of the loaned securities and the collateral received;

(iv) notification to borrowers to make additions to the collateral, when required;

(v) accounting and recordkeeping services as necessary for the operation of the Program; and

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4. Some Funds are organized as business trusts and accordingly have a Board of Trustees. References herein to a Fund's Board of Directors apply as well to a Fund's Board of Trustees.

(vi) establishment and operation of a system of controls and procedures by the Custodian to ensure compliance with its obligations under the Program.[5]

In approving the services to be provided by the Custodian under the Program, the Fund's Board of Directors would determine, as it did in approving the custody agreement initially, that the Program satisfied the requirements for an investment company's receipt of services from an affiliate.[6]

As stated above, subject to the supervision of the Adviser, the Custodian could also perform certain additional activities. The Adviser could delegate to the Custodian the task of entering into loans with pre-cleared borrowers that the Adviser has determined are creditworthy. Similarly, the Custodian would effect the investment of any cash collateral received from a securities loan in investments pre-approved by the Adviser. In addition, the Custodian would enter into loans only on terms and conditions approved in advance by the Adviser. The Adviser would also monitor the Custodian's performance to ensure that all securities loans were effected in accordance with the requirements established by the Adviser.

The Fund would pay the Custodian a fee, based on the number and complexity of actions the Custodian was required to perform in connection with the Program, that would take into account the additional responsibilities and associated expenses incurred by the Custodian as a result of its participation in the Program. The fee would not be based on the revenues or profits derived by the Fund from the Program or from any loan of a security made pursuant to the Program. As discussed below, before the Fund could lend its securities under the Program, the Fund's Directors would be required to determine that the aggregate amount of the fees to be paid to the Custodian would be fair and reasonable. The Fund's Board of Directors would review quarterly the fees paid to the Custodian under the Program.

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5. These activities are of the type that custodians routinely provide to their investment company clients.

6. See infra, note 15.

LEGAL ANALYSIS

In United Services Funds (pub. avail. Apr. 23, 1993) ("United Services Funds"), the Staff declined to give no-action assurances to certain portfolios of United Services Funds to permit their affiliated custodian to act as the agent of the portfolios in negotiating securities loans and selecting creditworthy borrowers and to permit the custodian to retain a percentage of the revenues derived from the loan activity as its fee for its services in connection with the loans. The Staff treated securities loans as "sales" subject to the restrictions in Section 17(e) of the 1940 Act on compensation paid to affiliates acting as agent or broker for the purchase or sale of property to or for a fund.

We request that the Staff (i) reconsider its interpretation that a securities loan constitutes a "sale" of securities for purposes of Section 17(e) of the 1940 Act and (ii) determine that Section 17(e) does not apply to securities loans. In the alternative, we request confirmation that the Staff's position in United Services Funds does not apply to a securities lending program like the one described above in which (i) the Custodian's activities in connection with the program are solely ministerial and any selection of borrowers, loan negotiation or investment of cash collateral is either effected by the Adviser or carried out by the Custodian at the Adviser's direction and under its supervision, and (ii) the Custodian receives a transaction-based fee for its services rather than a fee based on a percentage of the revenues derived from the loan activity. In addition, we believe that the activities to be undertaken by the Custodian in the proposed securities lending program described below are similar to the safekeeping and administrative services that custodians routinely provide and that neither Section 17(d) of the 1940 Act nor Rule 17d-1 thereunder precludes the Custodian from receiving transaction-based fees for those activities.

Section 17(e)(1)

Section 17(e)(1) of the 1940 Act makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such a person, acting as agent, to accept any compensation from any source for the purchase or sale of any property to or for the investment company. In United Services Funds, the Staff declined to permit a custodian that was an affiliate of certain

portfolios of United Services Funds to select borrowers and negotiate loans of certain portfolios' securities and to receive a portion of a portfolio's lending fee for these services. Under the Staff's analysis, this arrangement was prohibited under Section 17(e) because the custodian would receive a fee for acting as the portfolios' agent in arranging securities loans,[7] which the Staff interpreted as constituting a "sale" of securities.[8]

The effect of the Staff's response in United Services Funds is to prohibit an affiliate of a fund from receiving a fee under Section 17(e)(1) for providing services in connection with the fund's securities lending program. While the Staff's response does not address whether an affiliate of a fund may receive fees for securities lending under Section 17(e)(2) if the affiliate acts and is compensated as if it were a broker effecting a sale of the property interest represented by the loans, we believe that such an approach is unworkable. Under Section 17(e)(2), any broker affiliated with a fund can execute purchase and sale transactions in securities for a fund if the broker receives compensation that is "usual and customary" or otherwise complies with the compensation limits in Section 17(e)(2).[9] While the compensation limits of Section 17(e)(2), which are expressed as a percentage of the value of the securities bought or sold, may be reasonable when applied to brokerage transactions, they have no application to securities loans. The Staff's response gives no guidance as to how the compensation limits in

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7. In its response, the Staff stated that "we believe that where an affiliated person of an affiliated person of an investment company negotiates and accepts a fee for arranging a loan of the fund's securities, the transaction presents the potential for conflict of interest that Section 17(e) was designed to address."

8. In the Staff's view, "a loan of a Portfolio's securities involves a 'sale' of property of the Portfolio."

9. Section 17(e)(2) prohibits an affiliated broker from receiving compensation which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected.

Section 17(e)(2) would apply to a securities loan. As a result, the Staff's interpretation that Section 17(e) applies to securities loans effectively precludes an affiliate from receiving compensation for engaging in securities lending activities when acting as the fund's agent or broker.

We believe it is clear that Section 17(e) was never intended to apply to securities loans. In addition, we know of no policy reason or legal basis for treating securities loan transactions as the type of "sale" Section 17(e) was designed to address. The court cases cited by the Staff in support of its position that a pledge of securities constitutes a sale all involve the antifraud provisions of the Securities Act of 1933 or Securities Exchange Act of 1934 (the "1934 Act"). While some courts may interpret the term "sale" broadly to include a "pledge" of securities to further the purposes of the antifraud provisions of the federal securities laws, we see no reason in the absence of allegations of fraud for the Staff to "shoe-horn" a securities lending transaction within the restrictions of Section 17(e) by viewing the transaction as a sale.[10] The Staff has not cited any authority holding that a securities loan is a "sale" for any other purpose under the 1940 Act. In addition, the Staff's position is inconsistent with the treatment of securities lending under other provisions of the 1940 Act. For example, Form N-1A does not require the registration statement of a fund engaged in securities lending to describe an unaffiliated custodian's services in connection with securities lending, but Form N-1A does require disclosure of brokerage services with respect to true sales of securities.[11]

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10. See, Shelter Mutual Inc. Co. v. Public Water Supply Dist. No. 7 of Jefferson County, Mo., 569 F.Supp. 310 (E.D.Mo. 1983), aff'd, 747 F.2d 1195 (1984); (noting a split of authority on whether a pledge of securities is a sale even under the antifraud provisions). The court held that a pledge is not a sale within the meaning of Section 10(b) of the 1934 Act, stating that to find otherwise "ignores the underlying economic context of the transaction". Id. at 324. See also, Lincoln National Bank v. Herber, 604 F.2d 1038, 1043 (7th Cir. 1979) (stating that the economics of a pledge of securities do not involve investment risk, but rather "ordinary commercial risk taken by any secured lender").

11. See Item 17 of Form N-1A.

The Staff's position in United Services Funds denies shareholders of many of the approximately 110 bank-advised fund complexes currently in existence the steady stream of revenue generated by securities lending programs and as a result puts them at a competitive disadvantage. The Staff forces these fund complexes to decide whether to pursue an application for an order from the Commission to establish a securities lending program, change custodians, or forgo securities lending revenues. Each choice is detrimental to shareholders. The legal and other costs associated with obtaining an exemptive order would erase a large part of the revenues that the Funds are seeking to realize.[12] The Staff has previously permitted funds to proceed without an exemption from other provisions of the

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12. There is no benefit to be gained by having the Staff review and process a flood of new exemptive applications to permit affiliated custodians to receive fees in connection with securities lending programs. Funds using affiliated custodians must comply with the limits imposed by Rule 17f-2. Rule 17f-2 requires that a fund's securities and similar investments be (i) deposited in a bank or other company whose functions and physical facilities are supervised by Federal or State authority (except securities on loan which are collateralized to the extent of their full market value); and (ii) verified by complete examination by an independent public accountant at least three times during each fiscal year, at least two of which are chosen by the accountant without prior notice to the fund. The accountant must transmit a certificate to the Commission describing the nature and extent of his or her examination. In addition, Rule 17f-2 permits access to a fund's assets only by those persons authorized by resolution of the fund's board of directors. The consideration and approval by the Fund's Board of Directors, together with compliance with Rule 17f-2, supply adequate safeguards to protect a fund from any potential conflicts of interest. In addition, we note that under Section 17(e)(2) and Rule 17e-1 an affiliated broker can engage in conduct involving greater discretion and therefore greater potential for self-dealing and still receive usual and customary compensation under standards less rigorous than those under which the Programs would operate.

1940 Act when the cost of obtaining an exemption outweighed its expected benefit.[13]

Even if the Staff were to continue to adhere to its position that Section 17(e) applies to securities loans, the Custodian's activities in connection with the Program should not be deemed to fall within the prohibitions of Section 17(e) because the Custodian would not be acting as the Fund's agent or broker in arranging securities loans. Unlike United Services Funds, the Program contemplates that the Custodian would receive reasonable fees for the performance of solely ministerial functions in connection with the Fund's securities lending Program carried out under the supervision of the Adviser. By establishing the terms pursuant to which the Fund could lend its securities, the Adviser would be the entity responsible for "arranging and negotiating" securities loans. The Custodian is the entity responsible for the delivery and return of securities on loan and for various recordkeeping and ministerial tasks and any other duties delegated by the Adviser. Given the limited nature of the Custodian's role in the Program, we believe that the Custodian would not be acting as the Fund's

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13. See National Aviation & Technology Corporation (pub. avail. June 27, 1983) (Commission order not required under Section 17(b) for sale of office furniture from fund to adviser where, according to the no-action request, "the costs of preparing, filing and processing an exemption are disproportionately large in comparison to the size of the proposed transaction and would significantly reduce the financial benefit to the Fund and its stockholders. . . ." Among the factors that the Staff considered "significant" in granting no-action relief were (i) the total sales price of the transaction was relatively small ($10,945), and (ii) the transactions were unanimously approved by all of the Funds directors, including the independent directors). See also, Wilkie, Farr & Gallagher (pub. avail. Jan. 14, 1976) (Commission order under Section 17(b) not required for president of fund in liquidation to purchase "key man" life insurance policy from fund having cash value of approximately $25,000; relief expressly limited to facts of particular case). But see, Massachusetts Investors Trust (pub. avail. Dec. 8, 1992) (Staff did not grant no-action relief from Section 17(a) where adviser wished to purchase from fund antiques, artwork and silverware having an appraised value of approximately $834,000).

agent or broker for the purchase or sale of property to or for the Fund.

Section 17(d)

Section 17(d) of the 1940 Act and Rule 17d-1 thereunder generally prohibit an affiliate of a fund from participating in or effecting any transaction in connection with a "joint enterprise or other joint arrangement" in which the investment company is a participant. Rule 17d-1 defines a "joint enterprise or other joint arrangement" as including any written plan, contract, arrangement, or any practice or understanding concerning an enterprise whereby an investment company and an affiliated person have a joint or joint and several participation, or share in the profits of the undertaking. However, the Staff has issued a series of no-action letters permitting funds to receive and pay for administrative and other services provided by affiliates. The Staff has stated that, as a general matter, "a service arrangement does not constitute a joint enterprise or other joint arrangement or profit-sharing plan within the meaning of [S]ection 17(d) and [R]ule 17d-1."[14]

It is well-settled that a fund may enter into an agreement with an affiliate for custodial services if the compensation is fair and reasonable and there are adequate safeguards to prevent overreaching.[15] As noted above, each Fund intends to structure its Program in accordance with the standards set forth in those letters. Accordingly, each Fund would enter into an agreement or an amendment to its existing custody agreement (as applicable) for the Custodian to perform services under the Program only if a majority of the independent directors of the Fund determined: (i) that the amendment was in the best interest of the Fund and its shareholders; (ii) the services to be rendered were necessary for the operation of the Fund; (iii) the Custodian could provide the services, the nature and quality of which are at least equal to that provided by others and (iv) the

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14. The Flex-Fund (pub. avail. Nov. 22, 1985); See United Management Corporation (pub. avail. June 28, 1990).

15. See, e.g., Composite Group of Funds (pub. avail. Mar. 2, 1987) (no-action relief granted under Section 17(d) to permit affiliate of bank to act as fund's adviser if Rule 17f-2 is complied with); The Northern Trust Company (pub. avail. June 1, 1983) (same); IPI-Income & Price Index Fund (pub. avail. Dec. 12, 1980) (same).

fees to be charged are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality. In addition, each Fund will continue to comply with Rule 17f-2 (see supra, note 15). Since the Custodian's activities under the Program are of the type that custodians routinely provide to funds, we believe that the Custodian's proposed activities do not raise any additional concerns under Section 17(d).

RELIEF REQUESTED

Based on the foregoing analysis, we request that the Staff reconsider its position that Section 17(e) applies to securities lending activities. In the alternative, if the Staff continues to take the position that Section 17(e) applies to securities loans generally, we request the Staff to confirm that Section 17(e) does not prohibit the Custodian from receiving compensation for the custodial and administrative services proposed to be performed by the Custodian in connection with the Program. Under either alternative, we request the Staff to confirm also that neither Section 17(d) nor Rule 17d-1 thereunder would preclude the Custodian from receiving the compensation described above for providing custodial and administrative services for the Program and that the Staff will not recommend any enforcement action to the Commission if the Funds and the Custodians engage in lending securities as described herein.

We would appreciate having the opportunity to discuss this matter further if the Staff is considering a negative response to this request. Please telephone the undersigned or Anthony C.J. Nuland at (202) 737-8833 if you have any questions.

Very truly yours,

Kevin M. Broadwater

KMBroadwater
trg

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PUBLIC MAY 25 1995

RESPONSE OF THE OFFICE OF
CHIEF COUNSEL
DIVISION OF INVESTMENT
MANAGEMENT

Our Ref. No. 94-750-CC
Norwest Bank Minnesota, N.A.
and Society National Bank
File Nos. 811-4881 and -4852

Your letter of November 16, 1994 requests our assurance that we would not recommend that the Commission take any enforcement action under sections 17(d) or 17(e) of the Investment Company Act of 1940 ("Investment Company Act") or rule 17d-1 thereunder if investment companies for which Norwest Bank Minnesota, N.A. ("Norwest Bank") or Society Asset Management, Inc. serves as investment adviser compensate their affiliated custodians for services provided in connection with the securities lending program described below.

Norwest Bank serves as custodian for Norwest Funds, a registered open-end series investment company. Norwest Investment Management, a part of Norwest Bank, serves as investment adviser to Norwest Funds. Society National Bank serves as custodian for The Victory Portfolios, a registered open-end series investment company. Society Asset Management, Inc., an indirect, wholly owned subsidiary of Society National Bank, is the investment adviser to The Victory Portfolios. Norwest Bank and Society National Bank (each, a "Custodian") therefore are affiliated persons of (or affiliated persons of affiliated persons of), respectively, Norwest Funds and The Victory Portfolios (each, a "Fund").[1]

Each Fund proposes to establish a program to lend its portfolio securities (the "Program"). Each Fund's investment adviser, subject to the supervision of the Fund's board of directors, would be responsible for negotiating the terms of the loans, selecting borrowers, and investing cash collateral. You represent that the Program would comply with applicable staff positions regarding securities lending arrangements, such as those governing the type and amount of collateral, the voting of loaned securities, and prospectus disclosure.[2] You further represent that the Funds are in compliance with the self-custody provisions of rule 17f-2 under the Investment Company Act and would remain in compliance after implementation of the Program.[3]

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[1] The definition of "affiliated person" is set forth in section 2(a)(3) of the Investment Company Act. References in this letter to affiliated persons of an investment company include second-tier affiliated persons as well.

[2] E.g., SIFE Trust Fund (pub. avail. Feb. 17, 1982); State Street Bank and Trust Co. (pub. avail. Dec. 27, 1971 and May 22, 1972).

[3] Rule 17f-2 requires an investment company to follow certain procedures when acting as its own custodian. The staff

(continued...)

Currently, the Custodians' responsibilities include safeguarding and controlling the Funds' cash and securities and collecting interest on the Funds' investments. If the Program is implemented, the Custodians would provide additional services to the Funds. You state that these additional services would be of the type routinely provided to investment companies by unaffiliated custodians as part of securities lending programs. Specifically, the Custodian would perform the following tasks: deliver loaned securities from the Fund to borrowers; arrange for the return of loaned securities to the Fund at the termination of the loans; monitor daily the value of the loaned securities and collateral; request that borrowers add to the collateral when required by the loan agreement; and provide recordkeeping and accounting services necessary for the operation of the Program. In addition, a Fund's adviser could delegate to the Custodian the tasks of entering into loans with pre-approved borrowers on pre-approved terms, and investing cash received as collateral for the loans in instruments pre-approved by the adviser. The adviser's delegation of authority to the Custodian, as well as the borrowers, loan terms, and investment instruments pre-approved by the adviser, would be detailed in writing.[4] The adviser would monitor the Custodian's performance to ensure that all securities loans are effected in accordance with the adviser's instructions.

A Fund would compensate its Custodian based on the number and complexity of actions the Custodian was required to perform in connection with the Program. It is expected that this compensation would consist of: fees for each movement or transfer of securities; recordkeeping fees; and fees for loan monitoring, which could vary based on, among other things, the number of loans, loan amounts, and the amount and types of collateral received.[5] The fees would not be based on the revenues or profits derived by the Fund from its securities lending activities.

You state that no Fund would implement the Program unless a majority of its independent directors specifically determines that: (i) the Program is in the best interest of the Fund and its shareholders; (ii) the services to be rendered are necessary for

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[3](...continued)
requires investment companies with affiliated custodians to comply with the requirements of rule 17f-2. Composite Group of Funds (pub. avail. Mar. 2, 1987); IPI-Income and Price Index Fund (pub. avail. Dec. 12, 1980).

[4] Telephone conversation on March 2, 1995 between Barry A. Mendelson of the staff and Kevin Broadwater of Seward & Kissel, counsel for the Funds.

[5] Id.

the operation of the Fund; (iii) the Custodian can provide services at least equal in nature and quality to the services that could be provided by others; and (iv) the fees to be charged are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality. Each Fund's board of directors would review quarterly all fees paid to the Custodians under the Program.

Section 17(e)

Section 17(e)(1) of the Investment Company Act, in relevant part, makes it unlawful for any affiliated person of a registered investment company, acting as agent, to accept any compensation from any source for the purchase or sale of any property to or for the investment company. In United Services Funds (pub. avail. Apr. 23, 1993), the staff concluded that the loan of a fund's portfolio securities constitutes a "sale" of the fund's property for purposes of section 17(e)(1). Accordingly, the staff declined to take a no-action position that would have permitted the fund to compensate an affiliated custodian for its services in connection with a securities lending program.

You request that the staff reconsider its position that a securities loan constitutes a "sale" of securities for purposes of section 17(e)(1). We have reexamined the issue and continue to believe, in light of the broad definition of "sale" in the Investment Company Act, that a sale includes a loan of securities for purposes of section 17(e)(1).

Alternatively, you seek to distinguish the securities lending program in United Services Funds from the Program proposed here. You contrast the broad powers and discretion of the United Services Funds' custodian with the "solely ministerial functions" to be performed by the Funds' Custodians in connection with the Program. For example, the United Services Funds proposed that the custodian negotiate the terms of securities loans, select the borrowers based on the custodian's review of their creditworthiness, and determine how to invest cash collateral.[6] By contrast, under the proposed Program, a Fund's Custodian could lend securities only to borrowers, and only on

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[6] Although the staff's response in United Services Funds did not address the issue, the delegation of these responsibilities to a custodian without appropriate guidance and limitations raises an issue under section 15 of the Investment Company Act. See Salomon Brothers (pub. avail. Sept. 29, 1972) ("The type of investment for the cash collateral is a decision for directors of the fund and should not be delegated to anyone unless such person serves as an investment adviser under a contract meeting the requirments of Section 15 of the Investment Company Act."); State Street Bank & Trust Co. (pub. avail. Sept. 29, 1972) (same).

terms, that have been pre-approved by the Fund's adviser, and may invest cash collateral only in instruments that have been pre-approved by the adviser. Given the limited nature of the Custodian's discretion under the Program, you argue that a Custodian would not be acting as its Fund's "agent" for arranging securities loans, and therefore would not be subject to the prohibitions of section 17(e)(1). Although we disagree with your contention that the Custodian would not be acting as the Fund's agent,[7] for the reasons discussed below we would not recommend enforcement under section 17(e) if the Funds compensate the Custodians for providing the services described in your letter.

Section 17(e)(1) prohibits a fund's agent from receiving compensation "for the purchase or sale of any property to or for the [fund]." In this case, much of the compensation to be received by the Custodians can fairly be characterized as payment for providing administrative services, such as recordkeeping, delivering and accepting delivery of securities, and monitoring the value of securities and collateral. These services are typical of those performed by custodians for funds that do not lend portfolio securities, and, in our view, are not within the scope of section 17(e)(1). Therefore, we conclude that a Fund may compensate its affiliated Custodian for these services without violating that section.

Funds also would compensate Custodians under the Program for selecting borrowers, executing loan agreements, and investing cash collateral. In our view, these services involve purchasing and selling (i.e., lending) property as agent for the Funds. However, a Fund's Custodian would be empowered to perform these services only within specific written parameters established by the Fund's adviser, making the Custodian's role largely ministerial in nature. Section 17(e)(1) was designed "to prevent affiliated persons from having their judgment and fidelity impaired by conflicts of interest."[8] Because a Custodian would

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[7] An "agent" is a person authorized to act on behalf of another person. Black's Law Dictionary 59 (6th ed. 1990). The limited nature of a person's power to act on behalf of another, or of his ability to act without the other person's specific consent for each action, does not affect his status as an agent. See generally Restatement (Second) of Agency (1958).

[8] United States v. Deutsch, 451 F.2d 98, 109 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972). Accord, Investors Research Corp. v. SEC, 628 F.2d 168, 177 (D.C. Cir. 1980) (section 17(e)(1) "sets forth a flat ban on certain conduct tending to compromise the fiduciary judgment of affiliated persons"), cert. denied, 449 U.S. 919 (1981); Stein Roe & Farnham Inc., Inv. Co. Act Release No. 17316, 50 S.E.C. 186, 187 (Jan. 22, 1990) (quoting Deutsch, supra).

select borrowers, execute loan agreements, and invest cash collateral only in accordance with guidelines specified by the Fund's adviser and under the adviser's supervision, we believe that these activities would present little opportunity for the types of conflicts that section 17(e)(1) was designed to prevent.[9] Thus, we would not recommend enforcement action to the Commission under section 17(e)(1) if a Fund compensates its Custodian for these activities under the Program. This portion of our response expresses the staff's position on enforcement only.

Our position does not mean that there are no limits on how much a Fund may compensate its affiliated Custodian. A Fund's board of directors has a fiduciary obligation to ensure that the compensation paid to any service provider, especially one that is affiliated with the Fund or its adviser, is not excessive. Additionally, we note that the Custodian's compensation would be subject to section 36(b) of the Investment Company Act and, therefore, must fall within the range of what would have been negotiated by the parties at arm's length.[10]

Section 17(d) and rule 17d-1

Section 17(d) of the Investment Company Act and rule 17d-1 thereunder generally prohibit an affiliated person of an investment company, 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, unless the Commission issues an order permitting the transaction. 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 affiliated person of the company "have a joint or joint and several participation, or share in the profits of such enterprise or undertaking."

Section 17(d) and rule 17d-1 do not reach every economic relationship in which an investment company is on one side and

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[9] By contrast, the potential for conflict would be much greater if, as in United Services Funds, the custodian had unfettered discretion to select borrowers and negotiate loan terms. In that situation, the custodian could be tempted to enter into securities loans with uncreditworthy borrowers, or into loans on terms that are disadvantageous to the fund, in order to receive compensation.

[10] See Gartenberg v. Merrill Lynch Asset Management, 694 F.2d 923, 928 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983).

one of its affiliates is on the other.[11] Rather, "some element of combination is required."[12] We do not believe that the mere provision of services to a fund by an affiliated person, without more, establishes the degree of combination required by section 17(d) and rule 17d-1.

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."[13] Here, the Custodian's compensation would not be based on a share of the revenue generated by the proposed securities lending Program. We therefore conclude that the Program is outside the scope of rule 17d-1.[14]

For the reasons set forth above, we would not recommend enforcement action to the Commission under section 17(e), section 17(d), or rule 17d-1 if the Funds compensate the Custodians for the services and on the terms described in your letter. Our position is based upon the specific facts and representations in your letter, and different facts or circumstances might require a different conclusion.

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Senior Counsel

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[11] Steadman Security Corp., Inv. Co. Act Release No. 9830, 46 S.E.C 896, 911 (June 29, 1977).

[12] Id. (quoting SEC v. Talley Indus., Inc., 399 F.2d 396, 403 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969)).

[13] See Flex-Fund (pub. avail. Nov. 22, 1985) (transfer agent and accounting services); Diversified Securities (pub. avail. Jan. 22, 1985) (transfer agent services); Federated Securities Corp. (pub. avail. Oct. 21, 1983) (contract for fidelity insurance).

[14] Although rule 17d-1 does not apply to the Program, we note that section 36(b) of the Investment Company Act expressly places a fiduciary duty on investment advisers with respect to any compensation paid to affiliated persons of the adviser. See supra note 10 and accompanying text.