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Investment Company Act of 1940
Section 17(f); Rule 17f-4

May 24, 1996

Mr. Jack W. Murphy
Associate Director
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I CA
Section 17(f)
17f-4
Public Availability 8/16/96

Re: Utilization of NSCC's New York Window as a Clearing Agency
Securities Depository for Registered Management Companies

Dear Mr. Murphy:

We are writing on behalf of our client, National Securities Clearing Corporation ("NSCC"), to request your advice that the staff would not recommend that the Securities and Exchange Commission ("SEC" or the "Commission") take any enforcement action against NSCC or any registered management company ("RIC") or its investment adviser or custodian in the event that the RIC or its custodian utilizes NSCC's New York Window, a centralized processing center for the holding and transfer of physical securities, as a securities depository permitted to hold RIC securities under Section 17(f) of the Investment Company Act of 1940 (the "1940 Act") and Rule 17f-4 thereunder even though at the New York Window such

securities are not treated as fungible and may not be transferred or pledged by bookkeeping entry, as long as Section 17(f) and Rule 17f-4 are complied with in all other respects.¹

I. Background

A. NSCC

NSCC, established in 1976, is the nation's leading provider of centralized clearance and settlement services to over 1,900 broker-dealers, banks and mutual funds. NSCC is registered as a clearing agency with the SEC under Section 17A of the Securities Exchange Act of 1934 (the "1934 Act") and is owned jointly by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. NSCC currently provides clearance and settlement services for approximately 99 percent of all corporate equity and corporate and municipal bond transactions on U.S. national securities exchanges and the U.S. over-the-counter securities market. During calendar year 1995, an average of approximately 906,000 corporate and municipal security transactions were processed by NSCC each day, with a daily average value of approximately \$47 billion.

NSCC has focused its attention primarily on the clearance and settlement of securities transactions and the giving of instructions to securities depositories such as the system maintained by The Depository Trust Company ("DTC") for the book-entry movement of securities reflecting the net settlement of these transactions. NSCC's New York Window does not constitute a system providing for securities fungibility and book-entry transfer (a "book-entry depository"), and therefore would not be considered a "securities depository" eligible to hold RIC securities under Section 17(f) of the 1940 Act and Rule 17f-4 thereunder in the absence of the no-action relief requested in this letter.²

B. The New York Window

The holding and transfer of physical securities still plays an important role in the United States. Even though the great majority of U.S. corporate securities issues are held by RICs through book-entry depositories such as the one maintained by DTC, a significant

¹ One technical requirement of Rule 17f-4 cannot literally be met in this context. See footnote 5 below.

² Rule 17f-4(a) defines a "securities depository" for purposes of Rule 17f-4 as "a system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of the securities."

number of the securities held by RICs are not depository-eligible and do require physical holding and transfer.

NSCC established the New York Window in 1993 to provide a centralized processing center for these physical securities, as a replacement for individual securities windows among NSCC's members. The New York Window is a platform of services that supports the handling of physical securities for brokerage and banking institutions, including receipt and delivery of securities, envelope services, distribution of underwritings, end-of-day settlement and custody. The New York Window reduces back office expenses for participants through shared automated operations and a variable cost structure. The New York Window currently handles over 25,000 issues of securities, with about \$20 billion in total value held in custody and an average daily in-and-out movement of about \$4.0 billion in total value (over \$1 trillion a year). The largest categories of such physical securities commonly include equities, money market instruments (such as bankers acceptances and certificates of deposit), municipal securities and non-depository eligible Ginnie Maes.

The New York Window acts on participant instructions, which are electronically transmitted through existing communication links, and transmits account information directly to participants, enabling them to update their internal stock records in an automated fashion. Securities held by the New York Window are deposited in vault facilities which are subleased from DTC for this purpose. When possible, transactions between New York Window participants are internalized so that securities do not leave the New York Window's physical facilities.

The assets of each participant are held in a separate location within the vault. Within each participant's location, the assets are divided into three principal sub-locations:

- Box - Assets are held for the participant in the name of the prior holder (e.g., broker delivering to the participant) and are divided by category assigned by the participant (e.g., proprietary, correspondent broker, customer) and then by CUSIP number. Assets in this category turn over on a regular basis and therefore need not be re-registered in the name of participant for whom they are being held.
- Custody - Assets are held in the name of the participant and are divided by sub-category assigned by the participant and then by CUSIP number. Assets in this sub-location typically do not turn over as quickly as in the box sub-location and therefore have been re-registered in the name of the participant.
- Safekeeping - Assets are generally held in customer name (if participant is a broker) or in the name of a bank custodian or its nominee (if participant is a custodian bank). These assets are divided by CUSIP number and within CUSIP number may

Mr. Jack W. Murphy

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be divided by category, name or client account number assigned by the participant. The majority of the assets in this sub-location is held long-term.

The standard agreement entered into between NSCC and New York Window participants provides that NSCC may permit a participant to use its own employees ("contributed employees") to perform the New York Window services on behalf of the participant. Contributed employees work at the New York Window under agreements with New York Window participants. A contributed employee may on occasion be permanently placed at NSCC.

Contributed employees perform New York Window services only for their employers. All services provided by contributed employees are performed outside the vault. These services include organization of assets of their employer for transfer into the vault by NSCC employees and processing for their employer of assets withdrawn by NSCC employees from the vault. Safeguards including card-key access, guards and security cameras insure that contributed employees and other unauthorized persons do not have access to the vault. Additional measures, including a comprehensive securities tracking system, prevent contributed employees from handling the securities of participants other than their employers. Each participant is responsible for all costs arising out of the employment of its contributed employees. NSCC has no liability for any actions taken or not taken by such employees unless such action is taken or not taken at the direction of NSCC acting on its own behalf and not as an agent of the participant.

NSCC conducts frequent internal audits of the New York Window. Participants can take part in these audits or conduct audits of their own. The New York Window is also included in NSCC's external audits.

Because NSCC does not qualify as a securities depository eligible to hold RIC securities under Rule 17f-4, RICs and their custodians lack clear authority under Rule 17f-4 to take advantage of the centralized physical certificate handling and custody service offered by the New York Window. A significant number of RIC custodians have indicated to NSCC that they would consider utilizing the New York Window if the New York Window could be regarded as qualifying as a securities depository for purposes of Rule 17f-4 even though this facility does not act as a book-entry depository. NSCC believes that the no-action relief requested in this letter would produce a substantial benefit to RICs and their custodians by permitting custodians to make use of the New York Window for safe and efficient holding and transfer of billions of dollars of physical securities.

II. Analysis

A. Section 17(f) of the 1940 Act

Section 17(f) of the 1940 Act authorizes RICs to hold their securities only in self-custody or in the custody of a qualified bank, broker-dealer or book-entry securities depository, in each case subject to SEC rulemaking. Rule 17f-4 permits a RIC or its custodian to deposit domestic or foreign securities owned by the RIC in a clearing agency registered with the Commission under Section 17A of the 1934 Act which acts as a book-entry securities depository,³ subject to certain conditions specified in Rule 17f-4(c) (with respect to securities deposited by RICs themselves) and Rule 17f-4(d) (with respect to securities deposited by RIC custodians) designed to safeguard the funds and securities of RICs.⁴

Rule 17f-4(c) allows RICs to deposit securities in a registered clearing agency which acts as a securities depository (a "clearing agency securities depository") under an arrangement containing the following elements: (1) the RIC has a system reasonably designed to prevent unauthorized officer's instructions and which provides for the form, content and means of giving, recording and reviewing the instructions; (2) upon ceasing to act for a RIC the clearing agency must deliver all securities held for the fund to a successor clearing agency, custodian or safekeeper; and (3) the RIC, by resolution of its Board of Directors, must have initially approved the arrangement and any subsequent changes thereto.

Rule 17f-4(d) allows RIC custodians to deposit securities in a clearing agency securities depository under an arrangement containing the following elements: (1) the custodian may deposit the securities directly or through one or more agents which are also qualified as custodians; (2) the custodian shall deposit the securities in an account that includes only assets held by it for customers; (3) the custodian shall send the RIC a confirmation of any transfers to or from the account of the RIC and, when securities are transferred to that account, shall identify as belonging to the RIC a quantity of securities in a fungible bulk of securities registered in the name of the custodian (or its nominee) or shown on the custodian's account on the books of the clearing agency; (4) the custodian shall promptly send to the RIC reports it receives from the clearing agency on the its system of internal accounting control and such reports on its own system of internal accounting control as the RIC may reasonably

³ Specifically, Rule 17f-4(b)(1) permits a RIC or its custodian to deposit securities with a clearing agency which acts as a securities depository, as that term is defined in Rule 17f-4(a). See footnote 1 above.

⁴ Foreign securities may also be deposited in a foreign securities depository or clearing agency in accordance with Rule 17f-5 under the 1940 Act.

request; and (5) the RIC, by resolution of its Board of Directors, must have initially approved the arrangement and any subsequent changes thereto.

B. The New York Window and Section 17(f)

It would be fully consistent with the purpose of Section 17(f) of the 1940 Act to allow RICs and their custodians to utilize the New York Window as a clearing agency securities depository, even though this facility does not act as a book-entry depository, as long as Section 17(f) and Rule 17f-4 have been complied with in all other respects.⁵ Additionally, since RICs and their affiliated bank custodians can already utilize the New York Window pursuant to Rule 17f-2 under the 1940 Act, allowing RICs and RIC custodians to do the same under Rule 17f-4 would eliminate the adverse impact of a regulatory distinction which has no policy justification. Finally, allowing the New York Window to be treated as a clearing agency securities depository would be a logical extension of staff positions in previous no-action letters.

Allowing a clearing agency subject to SEC registration and regulation, such as NSCC, to hold RIC securities would be consistent with the intent of Congress in adopting Section 17(f) of the 1940 Act in its current form. When Section 17(f) was last amended in 1970, the framework for SEC registration and regulation of clearing agencies under the 1934 Act did not yet exist. In limiting the permitted holders of RIC securities to book-entry depositories, Congress simply recognized book-entry depositories (such as the one maintained by DTC) as the only form of centralized custodial facility related to SEC-regulated trading organizations in existence at that time. The addition of Section 17A to the 1934 Act in 1975, however, established a regime for SEC regulation of all registered clearing agencies. Since the adoption of Section 17A, all clearing agencies, including NSCC and operators of book-entry depositories such as DTC, have been equally subject to a degree of SEC oversight comparable to, if not greater than, that imposed on book-entry depositories at the time Congress adopted Section 17(f) of the 1940 Act in its current form.

There is no sound policy reason to forbid RICs and RIC custodians from utilizing the New York Window pursuant to Rule 17f-4 when RICs and their affiliated bank custodians may already utilize it for securities held in self-custody pursuant to Rule 17f-2 under the 1940 Act. Rule 17f-2 permits RICs to maintain securities in self-custody subject to

⁵ A custodian using the New York Window cannot literally comply with the language of Rule 17f-4(d)(3) referring to identification of a quantity of securities in a "fungible bulk" as belonging to a RIC, since the New York Window does not hold securities in a fungible bulk. However, custodians will be able to identify specific physical securities held at the New York Window as belonging to a particular RIC under the sub-location division procedures described on pages 3-4 above.

certain conditions designed to protect RIC assets. Securities are deemed to be held in self-custody under Rule 17f-2 if they are maintained with a bank or other company whose functions and facilities are supervised by federal or state authority under any arrangement whereunder the directors, officers, employees or agents of such company are authorized or permitted to withdraw such securities upon their mere receipt. As a registered clearing agency under the 1934 Act, NSCC and its facilities are subject to SEC supervision. Securities are held by the New York Window in vault facilities subleased from DTC, which is itself subject to supervision by the Commission as a clearing agency and by federal and New York State banking agencies as a trust company. The New York Window is also capable of meeting the conditions required by Rule 17f-2 to ensure preservation of RIC assets.⁶ Since the New York Window has sufficient safeguards to allow RICs and their affiliated bank custodians to deposit securities under Rule 17f-2, it should also be regarded as having sufficient safeguards to allow a RIC or RIC custodian to deposit securities under Rule 17f-4.

The no-action relief requested in this letter is consistent with prior staff positions with respect to the custody of RIC securities under Rule 17f-4. In Franklin Investors Securities Trust,⁷ a RIC unable to comply with the self-custody provisions of Rule 17f-2 sought no-action relief under Rule 17f-4. The staff stated that it would not recommend enforcement action if a transfer agent not registered as a clearing agency,⁸ but performing the functions of a securities depository, held the RIC's securities in reliance on Rule 17f-4 where the transfer agent complied with conditions similar to those of Rule 17f-4 designed to ensure the protection of RIC assets.

Similarly, in American Pension Investors Trust,⁹ the staff stated it would not recommend enforcement action if a transfer agent not registered as a clearing agency and

⁶ The conditions include: (1) the safekeeping of RIC securities, physically segregated from other securities, in a vault or depository whose physical facilities and functions are subject to federal or state authority, except under certain circumstances not here relevant; (2) limitation of access to the securities to no more than five persons, designated pursuant to a resolution of the RICs board of directors; (3) the ability of the Commission to inspect the securities; (4) compliance with recordkeeping requirements related to the deposit or withdrawal of securities from the depository; and (5) examination of the securities at least three times (and at least twice without prior notice) by an independent public accountant retained by the RIC.

⁷ Franklin Investors Securities Trust (September 24, 1992).

⁸ The transfer agent in question was unable to qualify as a clearing agency under the 1934 Act. See 1934 Act Section 3(a)(23), (25).

⁹ American Pension Investors Trust (February 1, 1991).

Mr. Jack W. Murphy
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holding securities for a RIC custodian were treated as a qualified securities depository under Rule 17f-4 where conditions designed to comply with the provisions of Rule 17f-4(d) were met.


In both Franklin Investors and American Pension, the only significant impediment to full compliance with Rule 17f-4 was the fact that the definition of clearing agency under the 1934 Act did not include the transfer agents in question. No-action relief was granted upon a showing that RIC assets were adequately protected by procedures similar to those under Rule 17f-4.

III. Conclusion

For the foregoing reasons, we respectfully request that the staff take the position that it would not recommend that the Commission take any enforcement action against NSCC or any RIC or its investment adviser or custodian in the event that the RIC or its custodian utilizes NSCC's New York Window as a securities depository permitted to hold RIC securities under Section 17(f) of the 1940 Act and Rule 17f-4 thereunder even though at the New York Window such securities are not treated as fungible and may not be transferred or pledged by bookkeeping entry, as long as Section 17(f) and Rule 17f-4 are complied with in all other respects.¹⁰

We would appreciate consideration of this matter as promptly as practicable. If for any reason the staff is not disposed to grant the requested no-action relief, we would also appreciate an opportunity to discuss the situation with the staff prior to the issuance of any formal letters. Questions regarding this no-action request should be directed to the undersigned (at 202-728-2888), John M. Kincaid (at 202-728-2705) or Michael W. Waldron (at 202-736-2042).

Sincerely yours,


J. Eugene Marans

¹⁰ Except for the requirement discussed in footnote 5 above.

PUBLIC

AUG 16 1996

RESPONSE OF THE OFFICE OF CHIEF COUNSEL,
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 96-276
National Securities
Clearing Corp.
File No. 132-3

Your letter of May 24, 1996, requests our assurance that we would not recommend that the Commission take any enforcement action under Section 17(f) of the Investment Company Act of 1940 (the "Investment Company Act"), or Rule 17f-4 thereunder, if a registered management investment company or its custodian utilizes the service operated by the National Securities Clearing Corporation (the "NSCC") known as the "New York Window" in the manner described in your letter.

The NSCC is registered with the Commission under Section 17A of the Securities Act of 1934 (the "Exchange Act") as a clearing agency. The NSCC provides centralized clearance and settlement services to over 1,900 broker-dealers, banks and mutual funds, and is responsible for clearing 99 percent of all corporate equity and corporate and municipal bond transactions on U.S. national securities exchanges and the U.S. over-the-counter market.

While the majority of the NSCC's clearance processing involves the giving of instructions to securities depositories, such as the Depository Trust Company ("DTC"), for the book-entry movement of securities held in such depositories, a significant portion of the NSCC's settlement activity continues to involve the transfer of physical securities certificates.¹ To facilitate the processing of transactions that involve the movement of physical certificates, the NSCC has established the New York Window, which is designed to provide a centralized processing center for these securities certificates. The New York Window is a platform of services that supports the handling of physical securities for brokerage and banking institutions, including the receipt, delivery, end-of-day settlement and custody of certificated securities, as well as envelope services and distributions of underwritings of such securities.

You state that the New York Window acts on participant instructions, which are electronically transmitted, and transmits account information directly to participants, enabling them to update their internal records in an automated fashion.² The

¹ Such securities include equities, money market instruments, municipal securities and non-depository eligible Ginnie Maes.

² You state that the services offered by the New York Window can be tailored to the needs of individual

(continued...)

securities held by the New York Window are deposited in vault facilities leased from DTC by the NSCC. You represent that, when possible, transactions between New York Window participants are internalized so the securities certificates do not leave the New York Window's physical facilities. You state that the NSCC conducts frequent internal audits of the New York Window and the service is also included in the NSCC's independent external audits. You further state that participants may participate in the audits or conduct their own audits of the New York Window.

Analysis

Section 17(f) sets forth the custodial requirements for registered management investment companies. Section 17(f) permits four types of custodians: U.S. banks (and their foreign branches), and subject to the Commission's rules, members of U.S. securities exchanges, U.S. securities depositories and investment companies themselves. Rule 17f-4 permits a registered management investment company or its custodian to deposit the company's securities in a registered clearing agency which acts as a securities depository. Rule 17f-4(a) defines a securities depository as "a system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without the physical delivery of the securities."

Although the NSCC is a registered clearing agency, it does not qualify under Section 17(f) and Rule 17f-4(a) as a depository because it does not, as a technical matter, constitute a system providing for securities fungibility and book-entry transfer. As noted above, the securities handled by the New York Window are either not eligible for book-entry transfer or are typically held

²(...continued)

participants. For example, you represent that the standard agreement between the NSCC and a New York Window participant allows the participant to use its own employees to perform services for the participant at the New York Window facilities, provided that the participant pays all the costs arising from the use of such employees and assumes all liability for such employees' actions at the New York Window facility.

We note that the use of employees of a registered management investment company, or of an affiliated custodian of such an investment company, at the New York Window facility could be deemed to be a self-custody arrangement subject to Rule 17f-2. See Guide 25, to Form N-1A; see also Item 20.8, Form N-2.

in certificate form, and thus are required to be transferred physically from one holder to another.

You maintain that the use of the New York Window is consistent with the purpose of Section 17(f) and Rule 17f-4. You note that when Section 17(f) was last amended in 1970, the framework for Commission registration and regulation of clearing agencies under the Exchange Act did not exist. You assert that in limiting the permitted custodians of fund securities to book-entry depositories, Congress simply recognized book-entry depositories as the only form of centralized custodial facility in existence at the time. You maintain that since the addition of Section 17A to the Exchange Act in 1975, all registered clearing agencies have been subject to a degree of Commission oversight comparable to, if not greater than, the oversight imposed on book-entry depositories at the time Congress adopted Section 17(f) in its current form.

You also maintain that under Rule 17f-2, a registered management investment company could utilize the New York Window facilities for the safekeeping of securities which it held in self-custody.³ You assert that there is no policy justification for treating the New York Window any differently under Rule 17f-4.

Finally, you maintain that recognizing the New York Window as a depository for purposes of Rule 17f-4 is consistent with past staff positions recognizing other entities as depositories for purposes of that rule, even though such entities did not meet the technical definition of depository set forth in Rule 17f-4(a).⁴

³ Rule 17f-2(b) generally requires that securities held in self-custody by a registered management investment company be deposited in the safekeeping of a bank or other company whose functions and physical facilities are supervised by a state or federal authority. Because NSCC is a registered clearing agency subject to the jurisdiction of the Commission, securities held in self-custody by a registered management investment company could be deposited in the New York Window.

⁴ See, e.g., Franklin Investors Securities Trust (pub. avail. Sept. 24, 1992) (transfer agent not registered as a clearing agency with the Commission treated as depository for purposes of Rule 17f-4); American Pension Investors Trust (pub. avail. Feb. 1, 1991) (transfer agent not registered as a clearing agency with the Commission treated as depository for purposes of Rule 17f-4). See also State Street Bank

(continued...)

Based on the facts and representations in your letter, we would not recommend that the Commission take any enforcement action under Section 17(f) or Rule 17f-4 if a registered management investment company treats the New York Window service as a "securities depository" for purposes of Rule 17f-4, provided that such company complies with Section 17(f) and Rule 17f-4 in all other respects.⁵ You should note that different facts or representations may require a different conclusion. Further, this response expresses the Division's position on enforcement action only, and does not purport to express any legal conclusions on the questions presented.



Philip S. Gillespie
Senior Counsel

⁴(...continued)

and Trust Company (pub. avail. Jun. 6, 1985) (book-entry system for uncertificated commercial paper at custodian bank permissible under Section 17(f) and Rule 17f-4).

⁵

We recognize that a custodian using the New York Window cannot literally comply with the language of Rule 17f-4(d)(3) referring to the identification of a quantity of securities in a "fungible bulk" as belonging to a particular registered investment company, because the New York Window does not hold securities in a fungible manner, but rather segregates the securities by participant and further separates the securities by the type of account for which the participant holds such securities. Because of the manner in which the securities are held, however, the custodian will be able to identify the securities belonging to a particular registered investment company.