

SUPPORTING STATEMENT
Rule 17f-4

A. JUSTIFICATION

1. Necessity for the Information Collection

Section 17(f) of the Investment Company Act of 1940 (the “Act”)¹ permits registered management investment companies and their custodians to deposit the securities they own in a system for the central handling of securities (“securities depositories”), subject to rules adopted by the Securities and Exchange Commission (“Commission”). Rule 17f-4 under the Act specifies the conditions for the use of securities depositories by funds² and their custodians.³ Rule 17f-4 contains two general conditions. First, a fund’s custodian must be obligated, at a minimum, to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain financial assets.⁴ If the fund deals directly with a depository, the depository’s contract or written rules for its participants must provide that the depository will meet similar obligations.⁵ Second, the custodian must provide, promptly upon request by the fund, such reports as are available about

¹ 15 U.S.C. 80a.

² As amended in 2003, rule 17f-4 permits any registered investment company, including a unit investment trust or a face-amount certificate company, to use a security depository. *See* Custody of Investment Company Assets With a Securities Depository, Investment Company Act Release No. 25934 (Feb. 13, 2003) (68 FR 8438 (Feb. 20, 2003)). The term “fund” is used in this Supporting Statement to mean a registered investment company.

³ 17 CFR 270.17f-4.

⁴ Rule 17f-4(a)(1). This provision incorporates into the rule the standard of care provided by section 504(c) of Article 8 of the Uniform Commercial Code when the parties have not agreed to a standard. Rule 17f-4 does not impose any substantive obligations beyond those contained in Article 8. Uniform Commercial Code, Revised Article 8 -- Investment Securities (1994 Official Text with Comments) (“Revised Article 8”).

⁵ Rule 17f-4(b)(1)(i).

the internal accounting controls and financial strength of the custodian.⁶ If a fund deals directly with a depository, the depository's contract with or written rules for its participants must provide that the depository will provide similar financial reports.⁷

If a fund deals directly with a securities depository, rule 17f-4 also requires that the fund implement internal control systems reasonably designed to prevent an unauthorized officer's instructions (by providing at least for the form, content, and means of giving, recording, and reviewing all officers' instructions).⁸

2. Purpose of the Information Collection

The general purpose of rule 17f-4 is to enable funds to participate, with minimum risks, in the potential benefits incident to the deposit of assets in securities depositories. The collections of information in rule 17f-4 are designed to assure that the fund's own custodian or securities depository would comply with the specified duties of a securities intermediary or issuer under Revised Article 8 of the Uniform Commercial Code.⁹ This assurance is important because Revised Article 8 sharply limits the ability of a fund to seek recourse from any party other than its own custodian for assets mishandled by the custodian.¹⁰

⁶ Rule 17f-4(a)(2).

⁷ Rule 17f-4(b)(1)(ii).

⁸ Rule 17f-4(b)(2).

⁹ The securities intermediary's duties under commercial law include: (i) maintaining sufficient unencumbered financial assets to cover all security entitlements of all entitlement holders, see Revised Article 8, 10, § 8-504; (ii) obtaining for the entitlement holder payments made by the issuer of a financial asset, id., § 8-505; (iii) exercising rights with respect to a financial asset (such as the right to vote proxy materials) as directed by the holder, id., § 8-506; (iv) complying with orders given by the holder concerning financial assets (such as to dispose of entitlements), id., § 8-507; and (v) changing the holder's entitlement into another available form of holding upon request (such as converting it into a security certificate in a direct holding arrangement), id., § 8-508. A transfer agent may be subject to the duties of an issuer under commercial law. See, e.g., Revised Article 8, § 8-207 (duties of issuer concerning registered owner); § 8-401 (duty of issuer to register transfer).

3. Role of Improved Information Technology

Rule 17f-4 permits funds to take advantage of information technology that enables the securities industry to handle a large volume of securities transactions without physical delivery of securities. Custodians also may use electronic data transmissions to funds to meet the reporting requirement. This rule does not require information systems; hence, start-up and maintenance costs required for this rule are zero.

4. Efforts to Identify Duplication

The Commission periodically evaluates rule-based reporting and recordkeeping requirements for duplication, and reevaluates them whenever it proposes a rule or a change in a rule. Rule 17f-4 does not require duplicative reporting or recordkeeping.

5. Effect on Small Entities

Rule 17f-4 specifies the conditions for the use of securities depositories by all funds regardless of the size of the fund, or the size of its custodian or securities depository. The risks accompanying a fund's use of a securities depository do not vary based on the size of the entity involved.

6. Consequences of Less Frequent Collection

Rule 17f-4 requires periodic reporting by the custodian or securities depository to the fund of internal accounting controls and financial strength. This information assures that the fund assets are safe and secure, and assists the Commission in implementing its examination

¹⁰ See Revised Article 8, §§ 8-116, 8-502, 8-503 and cmts. 2-3, 8-510 (adverse claims may not be asserted against a purchaser who acquires a security entitlement for value and without notice of the adverse claims; entitlement holders may assert a claim against a purchaser other than their securities intermediary only if their own intermediary is insolvent and lacks sufficient assets to satisfy their claims, and the purchaser knowingly colluded with the intermediary to violate duties to holders).

program.

7. Inconsistencies With Guidelines in 5 CFR 1230.5(d)(2)

Not applicable.

8. Consultation Outside the Agency

The Commission requested public comment on the collection of information requirements in rule 17f-4 before it submitted this request for extension and approval to OMB. The Commission received no comments in response to this request.

In addition, the Commission and its staff participate in an ongoing dialogue with representatives of the investment company industry through public conferences, meetings and informal exchanges. These various forums provide the Commission and the staff with a means of ascertaining and acting upon paperwork burdens confronting the industry.

9. Payment or Gift to Respondents

Not applicable.

10. Assurances of Confidentiality

Not applicable.

11. Sensitive Questions

Not applicable.

12. Estimate of Hour Burden

The Commission staff estimates that 129 respondents (including 40 active funds, 73 custodians, and 16 possible securities depositories)¹¹ are subject to the requirements in

¹¹ The Commission staff estimates that, as permitted by the rule, 1% of all active funds deal directly with a securities depository instead of using an intermediary. The number of custodians is from Lipper Inc.'s Lana Database. Securities depositories include the 12 Federal Reserve

rule 17f-4. The rule is elective, but most, if not all, funds use depository custody arrangements.¹²

Rule 17f-4 contains two general conditions. First, a fund's custodian must be obligated, at a minimum, to exercise due care in accordance with reasonable commercial standards in discharging its duty as a securities intermediary to obtain and thereafter maintain financial assets.¹³ This obligation does not contain a collection of information because it does not impose identical reporting, recordkeeping or disclosure requirements. Funds and custodians may determine the specific measures the custodian will take to comply with this obligation.¹⁴ If the fund deals directly with a depository, the depository's contract or written rules for its participants must provide that the depository will meet similar obligations. All funds that seek to rely on rule 17f-4 should have either modified their contracts with the relevant securities depository, or negotiated a modification in the securities depository's written rules when the rule was amended. Therefore, this was a one-time event and does not contain a collection of information.¹⁵

Second, the custodian must provide, promptly upon request by the fund, such reports as are available about the internal accounting controls and financial strength of the custodian. If a fund deals directly with a depository, the depository's contract with or written rules for its

Banks and 4 registered depositories.

¹² Based on responses to Item 18 of Form N-SAR (17 CFR 274.101), approximately 99 percent of all funds now use depository custody arrangements. As of March 30, 2007, approximately 3990 funds out of the 4030 active funds relied on rule 17f-4.

¹³ Rule 17f-4(a)(1). This provision incorporates into the rule the standard of care provided by section 504(c) of Article 8 of the Uniform Commercial Code when the parties have not agreed to a standard. Rule 17f-4 does not impose any substantive obligations beyond those contained in Article 8.

¹⁴ Moreover, the rule does not impose any requirement regarding evidence of the obligation.

¹⁵ The Commission staff assumes that new funds relying on 17f-4 would choose to use a custodian instead of directly dealing with a securities depository because of the high costs associated with maintaining an account with a securities depository. Thus new funds would not be subject to this condition.

participants must provide that the depository will provide similar financial reports. Custodians and depositories usually transmit financial reports to funds twice a year.¹⁶ The Commission staff estimates that 73 custodians spend 920 hours (by support staff) annually in transmitting such reports to funds.¹⁷ In addition, approximately 40 funds (*i.e.*, one percent of all funds) deal directly with a securities depository and may request periodic reports from their depository. Commission staff estimates that, for each of the 40 funds, depositories spend 9 hours (by support staff) annually transmitting reports to the funds.¹⁸ The total annual burden estimate for compliance with rule 17f-4's reporting requirement is therefore 929 hours.¹⁹

If a fund deals directly with a securities depository, rule 17f-4 requires that the fund implement internal control systems reasonably designed to prevent an unauthorized officer's instructions (by providing at least for the form, content, and means of giving, recording, and reviewing all officers' instructions). All funds that seek to rely on rule 17f-4 should have already implemented these internal control systems when the rule was amended. Therefore, this is a one-

¹⁶ The 73 custodians would handle requests for reports from 3950 fund clients (approximately 54 fund clients per custodian) and the depositories from the remaining 40 funds that choose to deal directly with a depository. It is our understanding based on staff conversations with representatives of custodians that custodians and depositories transmit these reports to clients as a good business practice regardless of whether they are requested. Therefore, for purposes of this paperwork reduction act calculation, the Commission staff assumes that custodians transmit the reports to all fund clients.

¹⁷ $(73 \text{ custodians} \times 2 \text{ reports}) = 146 \text{ reports} \times 54 \text{ fund clients per custodian} = 7,884$ transmissions. The staff estimates that each transmission would take approximately 7 minutes for a total of 920 hours (7 minutes \times 7,884 transmissions). The estimate of time to transmit reports is based on staff conversations with representatives of custodians.

¹⁸ $(16 \text{ depositories} \times 2 \text{ reports}) = 32 \text{ reports} \times 2.5 \text{ fund clients per depository} = 80$ transmissions. The staff estimates that each transmission would take approximately 7 minutes for a total of 9 hours (7 minutes \times 80 transmissions).

¹⁹ 920 hours for custodians and 9 hours for securities depositories.

time event and does not contain an ongoing collection of information requirement.²⁰

Based on the foregoing, the Commission staff estimates that the total annual hour burden of the rule's collection of information requirements is 929 hours. The total estimated annual cost of the burden hours is \$54,811. This figure is based on 929 hours of support staff time at \$59.00 per hour.²¹

The estimate of average burden hours is made solely for the purposes of the Paperwork Reduction Act. The estimate is not derived from a comprehensive or even representative survey or study of Commission rules.

13. Estimate of Total Annual Cost Burden

Commission staff believes that compliance with rule 17f-4 does not require special start-up costs or other capital expenditures, because electronic systems and other resources needed to comply with the rule are essential to doing business as a custodian, agent, fund or securities depository. Rule 17f-4 does not impose any paperwork related cost burden not discussed in item 12 above.

14. Estimate of Cost to the Federal Government

There is no cost to the federal government of administering the information collection requirements in rule 17f-4.

²⁰ The Commission staff assumes that new funds relying on 17f-4 would choose to use a custodian instead of directly dealing with a securities depository because of the high costs associated with maintaining an account with a securities depository. Thus new funds would not be subject to this condition.

²¹ $(929 \text{ hours} \times \$59.00 \text{ (salary for a secretary)}) = \$54,811$. The Commission staff's estimates concerning the wage rates for support staff time are from the Securities Industry Association's Report on Office Salaries in the Securities Industry 2006, modified to account for an 1800-hour work-year and multiplied by 2.93 to account for bonuses, firm size, employee benefits and overhead.

15. Explanation of Changes in Burden

The estimated total annual burden for rule 17f-4 has decreased from 3,536 hours to 1,346 hours. The decrease in hourly burden is attributable to the elimination of the one-time collections of information at adoption²² and a decrease in the number of active registered investment companies and custodians.²³

16. Information Collection Planned for Statistical Purposes

Not applicable.

17. Approval to Not Display Expiration Date

Not applicable.

18. Exceptions to Certification Statement

Not applicable.

B. COLLECTIONS OF INFORMATION EMPLOYING STATISTICAL METHODS

Not applicable.

²² As noted above, all funds relying on rule 17f-4 should have met the first obligation under the rule and implemented internal control systems designed to prevent unauthorized officer's instructions at the time they began to rely on rule 17f-4. See supra notes Error: Reference source not found-Error: Reference source not found, Error: Reference source not found and accompanying text.

²³ The Commission also corrected the number of securities depositories. The Commission had previously included all registered clearing agencies in the estimate of securities depositories. Only 4 of the registered 13 clearing agencies are securities depositories.