The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 24, NO. 4 • APRIL 2017

Investing in the World: Squaring Custody Practices in China, Russia and Saudi Arabia with the 1940 Act

By Karl J. Paulson Egbert and Kennan Castel-Fodor

Overview

The rationale for investing in emerging markets is often clear: returns on equities often climb into the double-digits and yields on fixed-income often dwarf what bonds in developed markets can eke out. But so, too, are the risks: greater volatility, confiscatory, unpredictable and arbitrary government action against securities issuers, and occasional outright fraud.

But under the flexible approach of the Investment Company Act of 1940 (1940 Act), the decision of whether to invest in emerging markets is left largely to the judgment of fund boards and managers. Unlike fund regulatory regimes in some jurisdictions, the 1940 Act largely does not prescribe classes of investments or prohibit risk—rather, it encourages disclosure to let investors determine their own tolerance for uncertainty.[1] The 1940 Act approach to custody displays similar flexibility: investor assets must be protected but the approach to this fundamental task necessarily must vary with the needs of each market.

This article outlines the basic structure of the 1940 Act's non-US custody rules, how they have changed over time with respect to markets that feature custody challenges (namely Russia and China), and how they might apply as new markets, such as Saudi Arabia, open up.

The Basic Framework for Custody

Section 17(f) of the 1940 Act sets out custody requirements for registered management investment companies: a fund is required to maintain strict custody of fund assets to protect shareholders from fraud or theft. The section is intended to address two risks: first, it prevents fund insiders and affiliates from misappropriating fund assets. Second, the text of the section suggests it was designed to ensure that custody practices provide reasonable protection for fund assets. Custody under Section 17(f) is nearly always accomplished through engagement of a US bank custodian,[2] with an exception (Rule 17f-4) permitting banks to relinquish custody to US clearinghouses while portfolio securities are in the process of being cleared and settled.[3]

As 1940 Act funds began to invest more outside of the United States, weaknesses with the US bank/US clearinghouse custody model appeared: holding non-US securities in the United States increased costs and made it difficult to make timely delivery of securities sold across global time zones; non-US banks and clearinghouses generally did not meet the definitions in Section 17(f) or the rules thereunder.[4] The US Securities and Exchange Commission (SEC) and its Staff, over time, recognized various exceptions to the 1940 Act custody requirements for non-US securities and, in 1984, adopted Rule 17f-5 to provide an exception for non-US bank and clearinghouse custody.

This early version of Rule 17f-5 required that a fund board determine that both the country of investments and the custody arrangements for non-US markets were "consistent with the best interests of the shareholders" and, among other requirements, actively monitor and review these arrangements. This initial standard left boards partially responsible for a fund's investments; after 11 years, the SEC noted that Rule 17f-5 was overbroad in asking directors to evaluate country risks and instead noted that "reasonable protection" required that director evaluations of foreign custody arrangements should focus "exclusively on safekeeping considerations."[5]

The Modern Approach to Rule 17f-5

The SEC's concerns eventually materialized into the amendment of Rule 17f-5 that embodies the SEC's modern approach to custody: boards hold ultimate responsibility for safekeeping but can rely on monitoring and information provided by the manager and custodian. Rule 17f-5 permits funds to maintain their non-US assets with "eligible foreign custodians" (that is, local sub-custodians). The eligible foreign custodian is an entity that is incorporated or organized under the laws of a country other than the United States and may be a "qualified foreign bank" or a majority-owned or indirect subsidiary of a US bank or bank-holding company. The board is permitted to delegate its foreign custody responsibilities to its manager or (as is done typically) the primary custodian.

When delegating such responsibilities, the board must: (i) determine that it is reasonable to rely on the delegate to oversee the placement of the foreign assets with the sub-custodian; (ii) require written reports from the delegate concerning the fund's custodial arrangements and updates on any material changes; and (iii) obtain the delegate's agreement to exercise at least the level of reasonable care, prudence, and diligence as a person having the responsibility for safekeeping the foreign assets would exercise.

Issues with Non-US Clearinghouses

No matter how secure assets are with a local custodian, they must eventually be sold. In non-OTC markets, there will generally be some sort of central clearinghouse where purchases and sales are matched-up (cleared) and allocated (settled) to the correct parties. In many cases, the clearinghouse can only be accessed through brokers or other clearinghouse members (that is, funds or managers cannot participate directly in the clearinghouse). Generally, once securities are within a clearinghouse, clearing members have a guarantee under the rules of the clearinghouse that money or assets will find their proper home, but members generally have no claim to any specific assets. In other words, there is no doubt that the custodian no longer has custody. Given that clearinghouses are not listed in Section 17(f) as appropriate custodians, how then do funds maintain proper custody of assets in a clearinghouse?

Rule 17f-4 provides a limited exception for "securities depositories"[6] (that is, clearinghouses and other central registers for securities) that are registered in the United States. Because this exception was generally unavailable to non-US clearinghouses as they were not so registered, Rule 17f-5 initially contained a carve-out from Rule 17f-4 to permit funds to use non-US clearinghouses. The Rule 17f-5 framework was always an uneasy fit, however; even as boards struggled to evaluate non-US custodians and country risk under the original Rule 17f-5 framework, evaluation of the technical specifications of local clearinghouses presented an even deeper challenge.

The Challenges of Investments in Russia

The collapse of the Soviet Union in 1991 created a massive new market for securities almost overnight, and funds quickly began to evaluate the investment opportunity. They immediately discovered a fragmented market with no true securities depository: each issuer maintained a share register with the help of a registrar, but there were approximately 3,000 registrars for only 15,000 privatized companies. Although Russian law regulated the registrars, it did not provide for active supervision or enforcement of legal requirements.[7] The registrar's records nonetheless represented the official book-entry record of share ownership.[8] As a result, investors faced a risk that fraud, negligence, or simple mistakes of a registrar could cause them to lose their investment. How then could Russia's fractured system of share ownership meet the requirements of Section 17(f)?

Fund managers pursued a series of exemptive and no-action approaches. Crucially, the SEC Staff granted no-action relief to the Templeton Russia Fund premised on the idea that funds could compensate for the lack of a coherent central securities depository through contractual arrangements with individual registrars. Among other things, these contractual arrangements were required to specify that registrars promptly record transfers, recognize nominee arrangements, and permit direct access to share registers by auditors for verification.[9] Fundamentally, these arrangements accepted that there was risk inherent in the registrar system: fund prospectuses were required to include prominent and detailed disclosures regarding the registrar system, and boards were charged with enhanced monitoring of Russian arrangements. Later no-action letters simplified the required contractual provisions with registrars, and the Russian market itself evolved. In 2013, Russia recognized the National Settlement Depository (NSD) as its central securities depository, and title to Russian equities became based on the NSD's records rather than the registrars. This obviated the need for the enhanced board supervision of Russian investments and brought Russia largely into line with the SEC's requirements.

While it is unclear whether the SEC Staff would grant similar no-action relief today, the accommodations for Russian investments demonstrate the adaptability of 1940 Act custody regulation. Local clearing and settlement practices will naturally differ from those in the United States, but this is no reason to prohibit potentially appropriate investments. Managers looking into new markets may, with the help of local custodians and markets, similarly seek ways to provide contractual backstops for local market deficiencies or, over time, provide feedback to local regulators and markets about how to better bring them in line with global practices.

Formalization of Foreign Clearinghouse Guidance: Rule 17f-7

One of the problems faced by managers in the 1990s was that Rule 17f-5 was well-suited for local bank custodians but was not tailored to dealing with local clearinghouses that presented fewer issues than Russia's registrar system. In response, the SEC adopted Rule 17f-7 in 2000 to establish standards for foreign clearinghouses.[10]

The rule imposes certain basic requirements on an acceptable non-US clearinghouse (that is, an "eligible securities depository"). The depository must:

- Be a system for the central handling of securities or book-entry equivalent in its home country or act as a similar system on a transnational basis;
- Be regulated by a foreign financial regulatory authority;
- Hold fund assets under safekeeping conditions no less favorable than the conditions that apply to other market participants;
- Be able to identify the assets of each participant and segregate the system's own assets from the assets of participants;
- Provide periodic reports to its participants with respect to its safekeeping of assets and notices of participant transfers; and
- Be subject to periodic examination by regulatory authorities or independent accountants.

Under the rule, a fund's contract with its global custodian must require the custodian to give the fund or its manager an initial risk analysis before investing through a particular clearinghouse, continuously monitor the risks associated with that clearinghouse, and provide notice of any material changes in these risks. The custody agreement must also require that the custodian exercise "reasonable care, prudence, and diligence in performing [these] requirements […] or adhere to a higher standard of care." If a custody arrangement with a clearinghouse stops meeting these requirements, fund assets must be withdrawn from the clearinghouse as soon as reasonably practicable. Unlike the original formulation of Rule 17f-5, the board's role is appropriately limited: fundamentally, it is the global custodian that must determine whether a local clearinghouse meets the SEC's standards, and both the fund and manager are permitted to rely on custodian reporting given that custodians should generally be better-positioned to evaluate the technical specifications of clearinghouses.

Challenges Posed by Nominee Arrangements—Examples from China's Stock Connect

China's principal stock markets in Shanghai and Shenzhen are open to non-Chinese investors only through certain market access programs, including the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs. Participation in these programs required a sometimes lengthy licensing processes until the advent of Hong Kong-Shanghai Stock Connect (Stock Connect) in 2014.[11] This novel program allowed international investors to access certain Shanghai-listed equities without a license by placing trades through Hong Kong-based brokers, using both Hong Kong and Shanghai's respective clearinghouses, Hong Kong Securities Clearing Company Limited (HKSCC) and China Securities Depositary and Clearing Corporation Limited (ChinaClear).

Stock Connect raised certain issues under the 1940 Act. While both HKSCC and ChinaClear had previously generally been rated as "eligible securities depositories" by fund custodians, there were concerns that the hybrid, cross-border nature of the arrangement introduced new risks. One feature of the program is that orders from international investors are aggregated by HKSCC and then sent to ChinaClear in an omnibus account held in the name of HKSCC.

Transnational, Nominee and Omnibus Arrangements under the SEC's Non-US Custody Rules

Transnational depositories are expressly acknowledged in the plain language of Rule 17f-7. But Stock Connect is not exactly a transnational clearinghouse like EuroClear: rather, it represents a joint undertaking by the clearinghouses of two separate jurisdictions. While there are a few older examples of no-action relief for joint clearinghouses in the Netherlands and federal Germany, there is limited SEC guidance on this subject. Therefore, it is necessary to review the functions of both HKSCC and ChinaClear within Stock Connect against the requirements of Rule 17f-7. Upon such a review, the principal obstacle is the fact that HKSCC might be deemed to be the legal owner of fund assets held in its name in the omnibus account at ChinaClear. In principle, omnibus arrangements are acceptable under Rule 17f-5 as long as the fund's ownership can still be properly identified.[12] Nor are nominee arrangements prohibited (indeed, clearinghouses almost always involve nominee arrangements, and both Russia and Saudi Arabia's systems establish a concept of foreign nominees). But Chinese law did not traditionally recognize the rights of beneficial owners (for example, a fund in this omnibus arrangement). This could have represented a fundamental roadblock to compliance with Rule 17f-7's requirement that a clearinghouse be able identify the assets of each participant and segregate the system's own assets from the assets of participants, as HKSCC might be deemed to have ownership over the assets of its clearing participants. But if the development of Russian custody arrangements illustrates the possibility of using bilateral contracts to compensate for deficiencies in a clearing and settlement system, Stock Connect shows the value of engaging with the markets and the regulators: after considerable consultation with the industry, the Hong Kong Stock Exchange and Chinese regulators announced clarifications to Stock Connect's rules that embedded the concept of beneficial ownership into the program's rules and paved the way for identification of participant assets in conformity with Rule 17f-7.[13]

Looking Ahead—the Opening of Saudi Arabia's Stock Market

Historically, US-registered funds did not have access to securities trading in Saudi Arabia on the Saudi Stock Exchange (Tadawul), the largest stock market in the Middle East. US funds were only able to gain exposure to the Saudi market through synthetic instruments such as Saudi Arabian participation notes (which can themselves raise issues under Section 12 of the 1940 Act). However, in 2015, the Tadawul was opened to foreign investors, subject to certain qualification requirements. A prospective investor must be a Qualified Foreign Investor (QFI) categorized as either: a bank, brokerage and security firm, or insurance company; government and government-related entity; investment funds; and/or other financial institution considered eligible by the Saudi Capital Market Authority (CMA). In addition, the QFI must also (i) be licensed, (ii) have a minimum of $1 billion assets under management, and (iii) have a minimum of five years' experience in securities activities. A QFI may only invest in listed shares of Saudi Arabian issuers on behalf of a client if the client has been approved by the CMA.

1940 Act US fund managers are actively evaluating the QFI program. The Saudi clearinghouse for equities, the Tadawul Central Securities Depository, has generally been accepted by global custodians as an eligible securities depository under Rule 17f-7. However, a potential glitch arises because only certain entities are allowed to access the depository: such persons must be "authorized persons," which include (among others) subsidiaries of local banks or foreign financial institutions, but does not include banks themselves. This might raise issues under Rule 17f-5, which permits assets to be custodied with a majority-owned direct or indirect subsidiary of a US bank or a qualified foreign bank: local Saudi participants in the clearinghouse may not be either. However, there are various potential fixes: during the early days of Russian investing, the SEC permitted the use of local sub-custodians that did not meet the strict requirements of Rule 17f-5 so long as the primary custodian remained primarily responsible for the assets; on the other hand, it may be determined that, under the rules of the clearinghouse, assets are no longer in control of these Saudi authorized persons and, instead, are under the control of the clearinghouse (and, therefore, subject to Rule 17f-7 instead of Rule 17f-5). In either event, a combination of the approaches taken with respect to Russian investments (for example, contractual back-stopping of market issues) or Chinese investments (that is, engagement with regulators to help bring local practices in line with global markets) should ultimately prove effective.

Conclusion

Keeping investor assets safe is among the most fundamental duties of a fund manager and board. Yet investors are rarely best served by regulation that simply exports US practices to the rest of the world. Indeed, despite their depth and liquidity, US markets are in need of reform and may benefit from the recent experience of non-US markets. In that regard, the SEC's approach to non-US custody is itself a model: it provides a strong foundation for custody but is sufficiently adaptable to permit 1940 Act funds to invest in the world.

Mr. Egbert is a financial services partner in Dechert LLP's New York and Hong Kong offices; **Mr. Castel-Fodor** is a financial services associate in Dechert LLP's Washington, DC office.

NOTES

1 In contrast, suitability requirements for broker-dealers impose a framework that attempts to assess

whether an investment is appropriate for an investor. As a result, one may decide that a strategy is appropriate for a 1940 Act fund, but not suitable for investors (*e.g.*, Russia-focused funds during periods of extreme volatility).

2 The text of Section 17(f) permits custody with (1) banks "with the qualifications prescribed in paragraph (1) of section 80a–26(a) of this title for the trustees of unit investment trusts" (in other words, US-regulated banks), (2) members of a national securities exchange, or (3) the registered investment company itself. In practice, nearly all custody arrangements are with US banks.

3 Rule 17f-4 is not expressly limited to US clearinghouses (the rule refers to any entity "[r]egistered with the Commission as a clearing agency under section 17A of the Securities Exchange Act of 1934"), but most non-US clearinghouses are not so registered.

4 Thomas P. Lemke, Thomas A. Smith, III, and T. Gerald Lins, *Regulation of Investment Companies*, Chapter 8.02.

5 Tamar Frankel, *Investment Management Regulation*.

6 The term "depository" provides ample opportunity for confusion as it is often not used in the marketplace. To further complicate matters, "deposit*a*ry" (a term used in the Alternative Investment Fund Marketing Directive and UCITS V in the European Union refers to a custodian-like entity and not a central clearinghouse. EU rules generally provide less clear guidance on how to evaluate safekeeping of assets within a clearinghouse, which can lead to delays in opening up European products to new investments.

7 Templeton Russia Fund, Inc., SEC No-Action Letter (pub. avail. Apr.18, 1995).

8 At the time of these initial Russia investments in 1990s, Rule 17f-5's provisions still lent themselves to physical certificates rather than book-entry systems. Subsequent amendments to the rule removed this issue, but it is worth noting that other US regulatory regimes could benefit from the same modernization of custody regulation that the SEC undertook in the late 1990s and early 2000s; while ERISA investments are outside the scope of this article, ERISA's indicia-of-ownership requirements are similarly stuck in a certificated world.

9 Templeton Russia Fund, Inc., SEC No-Action Letter (pub. avail. Apr. 18, 1995).

10 *Custody of Investment Company Assets Outside the United States*, SEC Release IC-24424 (May 3, 2000).

11 A virtually identical program for the Shenzhen Stock Exchange (home of many of China's start-ups) was launched in 2016. Unlike Shanghai Stock Connect, Shenzhen Stock Connect is open only to "professional investors" (as defined under Hong Kong's Securities and Futures Ordinance). However, most regulated funds (including both 1940 Act funds and UCITS) should generally meet the definition of professional investor.

12 For example, the SEC Staff permitted omnibus account arrangements at the non-US bank custodian level under Rule 17f-5 where fund assets were held in a single account at each non-US custodian but identified as fund assets by the primary custodian. State Street Bank and Trust, SEC No-Action Letter (pub. avail. Feb. 28, 1995).

13 Other market-access programs present similar challenges: China's QFII program initially required that fund managers, as the QFII license holders, hold securities in their own name. Subsequent amendments to the QFII program and the introduction of the RQFII program created somewhat more flexibility: fund-specific quotas could be held using the nomenclature "[manager name]—[fund name] account." Where the quota holder does not allocate quota for a specific fund (known as the "separate account approach" for QFII investments), the account will be in the name of the manager "for the benefit of its clients." Similarly, in Russia, where a fund's organizational structure is not recognized as a legal entity (as has been historically the case for trusts, which are used as fund vehicles in the United States, Brazil, and other jurisdictions), custodial accounts generally must be opened in the name of the local custodian. In each case, there are risks that the fund will not be properly identified as the proper beneficial owner of assets, but such

risks can generally be addressed through contractual arrangements and proper disclosure. More recent market-access programs, such as the China Interbank Bond Market program, eliminate this risk by allowing accounts to be opened in the name of each fund.