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Act ICA
Section 17(f)
Rule
Public Availability 4/17/96

November 17, 1995

Re: Investment Company Act of 1940 -- Section 17(f); Rules 17f-2 and 17f-5

Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attn: Mr. Jack Murphy
Associate Director
Office of Chief Counsel

Ladies and Gentlemen:

We represent Morgan Guaranty Trust Company of New York, a New York banking corporation ("Morgan Guaranty"), whose Brussels office ("Morgan Guaranty Brussels") acts as operator of the Euroclear System. We are writing on behalf of Morgan Guaranty Brussels to request your confirmation that the Staff will not recommend enforcement action under Section 17(f) of the Investment Company Act of 1940, as amended (the "1940 Act"), or Rules 17f-2 or 17f-5 promulgated by the Securities and Exchange Commission (the "Commission") thereunder, against a registered investment company that lends securities through the Euroclear Securities Lending and Borrowing Program (the "Euroclear Program" or the "Program"), if:

(i) each loan is collateralized by

(A) the guaranty of Morgan Guaranty described below, or

(B) a substantially identical guaranty of a separately incorporated and capitalized bank (as defined by Section 2(a)(5) of the 1940 Act) that

satisfies the qualifications of a bank custodian set forth in Sections 17(f) and 26(a)(1) of the 1940 Act or a banking institution or trust company that qualifies as an "eligible foreign custodian" (as defined by Rule 17f-5(c)(2)); and

(ii) the registered investment company acts

(A) as a direct Participant in the Euroclear System (a "Participant"), or

(B) through a bank or other custodian Participant that agrees to pass through to such registered investment company the benefits of such guaranty.

In order to facilitate the issuance of the requested no-action letter, Morgan Guaranty Brussels makes the following voluntary commitments:

1. No registered investment company as to which Morgan Guaranty or any of its affiliates is an "affiliated person or promoter of or principal underwriter" or an "affiliated person of such person, promoter, or principal underwriter", and no company controlled by such a registered investment company, is or will be permitted to lend securities belonging to it through the Euroclear Securities Lending and Borrowing Program, absent appropriate exemptive relief or changes in applicable law or regulations.

2. Morgan Guaranty Brussels will send a notice to all Euroclear Participants advising them in reasonable detail of the existence and conditions of the requested no-action letter, and offering to provide them with a copy of it upon request.

In addition, Morgan Guaranty Brussels is not asking for relief with respect to securities loans made on a fixed-term basis.

The Euroclear System

The Euroclear System is the largest clearance and settlement system for internationally traded debt and equity securities. It was created in 1968 by Morgan Guaranty Brussels in response to the need of the international

securities markets for a mechanism for the settlement of transactions. In 1972, the ownership of the Euroclear System was acquired by an English company now known as the Euroclear Clearance System Public Limited Company ("ECS"). ECS is owned by 125 banks, brokers and investment institutions, none of which holds more than 3.9% of its shares. At the time of acquisition in 1972, ECS entered into a contract with Morgan Guaranty under which Morgan Guaranty Brussels continued to operate the Euroclear System. In 1987, ECS licensed the Euroclear System to Euroclear Clearance System Société Coopérative, a Belgian cooperative corporation (the "Euroclear Cooperative" or the "Cooperative") in which all the Participants in the Euroclear System have the opportunity of becoming members. Morgan Guaranty Brussels currently operates the Euroclear System under a contract with the Euroclear Cooperative.

The Euroclear System has more than 2,700 Participants worldwide, including most of the major banks, broker-dealers and other institutions professionally engaged in cross-border securities transactions. Registered investment companies may participate in the Euroclear System either as direct Participants or through bank or other custodian Participants, subject to admissions criteria approved by the Board of Directors of the Euroclear Cooperative. Participants (and indirectly their customers) can confirm, clear and settle trades of securities by book-entry in any of 33 currencies on a simultaneous delivery-versus-payment basis. Under Section 12(i) of the Terms and Conditions (defined below), which is the basic agreement governing participation in the Euroclear System, "Morgan Guaranty may be a Participant and, in that capacity, will have the same rights, duties and liabilities it would have if Morgan Guaranty Brussels were not the operator of the Euroclear System." Affiliates of Morgan Guaranty are also allowed to become Participants in the Euroclear System on the same terms and conditions as unaffiliated Participants.

The value of securities held on behalf of Participants was approximately $1.8 trillion at the end of 1994. The system settled transactions valued at approximately $21.9 trillion in 1994, with daily instruction volume averaging over 38,000. Average daily securities loans outstanding were $6.7 billion in 1994.

The Euroclear Securities Lending and Borrowing Program

The Euroclear Securities Lending and Borrowing Program was designed in 1975 to improve the efficiency of securities settlement and increase market liquidity, anticipating the Group of Thirty's recommendation that securities lending and borrowing should be encouraged as a method of reducing the number of fails in the settlement of securities transactions. It allows Participants with stable portfolios of securities to increase overall yield (without loss of ownership benefits) by lending securities to other Participants who seek to avoid fails because of lack of inventory. Through the Euroclear System, borrowers have access to a substantial pool of lending resources, and lenders have access to the demand of active borrowers in the international markets.

Most debt securities accepted in the Euroclear System are eligible for securities lending and borrowing. Internationally traded Danish, Dutch, French, German, Italian, Japanese, Spanish, Swedish and Swiss equities are also eligible. Lenders in the Euroclear Program are mainly custodians, central and commercial banks and other institutions that are not active traders. Borrowers in the Program are usually active traders such as market-makers or dealers.

The Program works on the basis of "pools" of lendable securities, from which loans are allocated to borrowers. Each issue of securities is lent through a separate pool, with an equal number of securities being lent into and borrowed from each pool, but without any matching of a specific lender to a specific borrower.

Lenders and borrowers may choose to participate in the standard or reserved portions of the Euroclear Program. The standard program is designed to make securities available for borrowing as needs arise. The reserved program is designed to allow borrowers to reserve securities for future borrowing. Within the standard program, lenders and borrowers can be automatic or opportunity lenders or borrowers, depending on their needs.[1] Within the reserved

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[1]Automatic lenders agree to make available for lending all or a portion of the securities they hold in the Euroclear System; opportunity lenders may be called upon to lend securities from time to time when needed to supplement

program, lenders may be automatic or opportunity lenders, but all borrowers are opportunity borrowers. All loans in the standard program are open-ended. Lenders and borrowers in the reserved program have the option of entering into fixed-term or open-ended loans. A fixed-term loan has a start date and an expiry date; an open-ended loan has a start date only. A fixed-term loan must be repaid on its expiry date; an open-ended loan must be repaid in response to a recall request.

Morgan Guaranty Brussels has developed data on the volume and mix of open-ended and fixed-term loans made through the Program. Largely because loans made through the standard program far exceed those made through the reserved program, the vast majority of loans are made on an open-ended basis. To date, no equity securities have been lent on a fixed-term basis. The longest term of a fixed-term loan to date has been 26 days.

A Participant wishing to lend or borrow securities must acknowledge receipt of and agreement to the Terms and Conditions Governing Use of Euroclear, revised as of December 1, 1982 (the "Terms and Conditions") and the Supplementary Terms and Conditions Governing the Lending and Borrowing of Securities through Euroclear, revised as of September 1, 1995 (the "Supplementary Terms and Conditions"). These documents and the Operating Procedures of the Euroclear System (revised as of May 1, 1995 and as supplemented from time to time, the "Operating Procedures") set forth detailed rules and procedures with respect to the functioning of the Euroclear System in general, and, inter alia, the Program in particular. Copies of the Operating Procedures, the Supplementary Terms and Conditions, the Terms and Conditions and the form of Participants' letter agreement agreeing to be bound thereby (collectively, the "Operative Documents") have been provided to you in connection with this submission.

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the supply of securities made available by automatic lenders. Automatic borrowers authorize Morgan Guaranty Brussels to identify their borrowing needs and to seek to arrange loans to fill them; opportunity borrowers identify their own borrowing needs and submit specific borrowing requests.

The Supplementary Terms and Conditions provide that each borrower must return borrowed securities so that they can be credited to lenders' accounts on any repayment date (the "Repayment Date") for the borrowed securities. A borrower's failure to return borrowed securities on a Repayment Date will result in a default by the borrower.

Pursuant to the Supplementary Terms and Conditions and Section 9 of the Operating Procedures, Morgan Guaranty acting in its capacity as a bank and not as operator of the Euroclear System, guarantees the return of securities lent (or the cash equivalent) upon a default.

Lenders on both fixed-term and open-ended loans may recall their securities at any time. Historically, Morgan Guaranty Brussels has been able to replace lenders seeking a recall of securities by substituting other lenders over 99% of the time on a same-day or next-day basis. If a substitute lender is found, the original lender is released from its obligations.

If no substitute lender is found (historically less than 1% of the time), the result depends on whether the loan was fixed-term or open-ended. If it was fixed-term, the original lender will not be released from its obligation and the loan continues until the specified Repayment Date. If the loan was open-ended, Morgan Guaranty Brussels sends out a mandatory recall request to designated borrowers requiring them to return the recalled securities within a specified recall period.

The current recall periods for the various types of securities eligible for lending through the Euroclear Program are set forth in Sections 9.3(f) and 9.4(e) of the Operating Procedures, as amended by Amendment 95-OP-002 (August 14, 1995) and the relevant country section of the Participant User Guide -- Domestic Markets.[2] Such securities currently include most traditional Euro and global debt securities, equity securities of certain non-U.S. issuers, domestic debt securities of certain non-U.S. issuers, and debt securities of certain non-U.S.

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[2]Amendment 95-OP-002 amended the recall periods set forth in Sections 9.3 and 9.4 of the Operating Procedures to reflect the recent adoption of a standard settlement period for secondary market transactions in the U.S., Euro and other markets of three business days after the trade date.

governments. With two exceptions, the recall periods for each type of security set forth in the Operating Procedures have been calculated as the shorter of (i) the shortest customary settlement period for the securities in question plus one business day and (ii) any shorter period determined by Morgan Guaranty Brussels in light of the existence of an active "repo market"[3] for the securities; subject in either case to a minimum recall period of three business days.[4]

Thus, for example, under Rules 222 and 323 of the International Securities Market Association ("ISMA"), the standard settlement period for secondary market transactions in Euro debt securities is effectively three business days after the trade ("T+3"). Thus, the recall period for such securities lent through the Euroclear Program is four business days.

The time required for a registered investment company (or its custodian) to recall securities lent through the Euroclear Program may frequently be less, and should rarely be longer than one business day more, than the time required to recall securities through most U.S.-based programs. The recall period for open-ended securities loans made through most U.S. programs is typically the standard

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[3]In some markets, borrowers can satisfy recall requests by purchasing the securities subject to an agreement to resell an equivalent amount of such securities at a later date ("reverse repurchase agreement"). The settlement period for a reverse repurchase agreement ("repo") transaction can be shorter than the settlement period for an outright purchase.

[4]The exceptions are ECU-denominated securities and Irish government securities, which have recall periods of 6 business days. ECU-denominated securities have different customary settlement periods depending on their country of issuance. Irish government securities have different customary settlement periods depending on whether they are domestically traded or internationally traded. It is not practical for Morgan Guaranty Brussels to distinguish among ECU-denominated securities depending on their country of issuance or between domestically traded and internationally traded Irish government securities. The longest customary settlement period in each case is T+5. Therefore, the recall periods for all ECU-denominated securities and all Irish government securities are six business days.

settlement period for trades in the underlying securities. For example, Section 5 of the standard form securities loan agreement published by the Public Securities Association ("PSA"), which was developed to standardize general industry practices, provides that the recall period for open-ended securities loans may not be less than the standard settlement period for trades in the underlying securities. It further specifies that in the absence of a contrary agreement the recall period for U.S. government securities will be one business day, and the recall period for other (presumably U.S.) securities will be five business days -- periods that match or exceed the current standard settlement periods for U.S. corporate securities.[5]

As noted above, Morgan Guaranty Brussels has historically been able to satisfy the recall requests of lender Participants by replacing them with other lender Participants over 99% of the time, significantly reducing any delay in the recall of securities. Thus, in the vast majority of cases, recall will be much faster in the Euroclear Program than in a U.S. program that does not have a similar lender substitution procedure. Moreover, where lender substitution is not possible, the recall periods of the Euroclear Program are comparable to those in the typical U.S. program, corresponding to the shortest customary settlement period of the underlying securities, plus one business day.[6]

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[5]Presumably, the PSA standard form will be revised to reflect the reduction in the standard settlement period for transactions in U.S. corporate securities from T+5 to T+3, when such reduction is fully phased in, if a similar reduction in the recall period is feasible under most U.S. securities lending programs.

[6]Thus, registered investment companies that lend voting securities through the Euroclear Program will have substantially the same or better opportunities to recall their securities prior to any vote of the securities than they currently have under U.S. securities lending programs. In addition, they will have substantially the same or better opportunities to use recalled securities to satisfy their delivery requirements on a contemporaneous sale of such recalled securities (especially in the case of lender substitution).

If any outstanding securities are not returned by the end of the last processing cycle for the return of lent securities for a particular Repayment Date, which is typically approximately 2:30 a.m. (Brussels time) on the Repayment Date,[7] an affected lender may instruct Morgan Guaranty Brussels to credit it with an amount of cash equal to the market value of the lent securities as of the business day on which the instructions are received, together with accrued interest and other distributions, if any, on the securities to the date the credit is effected.[8] If Morgan Guaranty Brussels receives such instructions by 10:00 a.m. (Brussels time) on the Repayment Date, or if, at the time such instructions are received, Morgan Guaranty Brussels has not yet begun to purchase replacement securities as described below, Morgan Guaranty Brussels will credit the lender, generally within two business days, with the cash amount described above, calculated on the basis of

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[7]Securities transactions settled through the Euroclear System for a particular settlement day are currently processed in two overnight batch processing cycles, the second of which is typically completed by approximately 2:30 a.m. (Brussels time) on the settlement day (or in the case of securities loans, Repayment Date). Although there is also a daylight processing cycle for certain transactions settled through the Euroclear System, securities lending and borrowing transactions are not currently processed in the daylight cycle.

[8]The market value of lent securities is determined pursuant to Section 9.2(p) of the Operating Procedures. According to that provision, market value is determined by Morgan Guaranty Brussels on the basis of information obtained from independent sources, including, but not limited to, the offered price obtained from the lead manager of the relevant issue of securities, information obtained from publicly available independent sources, offered prices obtained from recognized market participants in the relevant issue of securities on or immediately before the Repayment Date and the cost of any buy-in that would be incurred by the affected lender under the rules of any relevant regulated securities market. If indications of value cannot be obtained for a particular issue of lent securities, Morgan Guaranty Brussels is required to determine the market value in its sole discretion, giving consideration to other outstanding issues of similar credit rating, maturity and characteristics.

the market value of the lent securities as of the business day on which the instructions are received.

If Morgan Guaranty Brussels does not receive instructions from a lender that it be credited with the cash amount described above by 10:00 a.m. (Brussels time) on the Repayment Date, Morgan Guaranty Brussels will make a reasonable effort, for a period of two business days, to purchase the securities. If Morgan Guaranty Brussels purchases replacement securities during the two-day buy-in period, the account of the lender will be credited with the securities when they are received by Morgan Guaranty Brussels pursuant to the settlement of the replacement purchase. If, after two business days, no replacement securities are purchased, Morgan Guaranty Brussels will advise the lender that its recall of the lent securities will remain outstanding, and thus the loan will continue in default, until either (i) the lent securities are returned (whether reimbursed by the borrower or pursuant to a replacement purchase) or (ii) the lender instructs Morgan Guaranty Brussels to credit it with the cash amount described above. If, however, such lender continues to make securities of the same issue as the unreturned securities available for lending and the amount of such issue of securities in such lender's securities clearance account becomes sufficient to cover the amount of the unreturned securities, the recall of the lent securities will lapse and the loan will continue, but will no longer be in default.[9] In this case, the lender may at any time initiate another recall of the lent securities.

Pursuant to Section 9.2(r) of the Operating Procedures, defaulting borrowers pay, and aggrieved lenders receive, a supplementary fee based on the market value of the lent securities to compensate lenders for the time value of money between the Repayment Date and the date on which the recall of the lent securities lapses. In calculating the supplementary fee, the market value of the lent securities is determined for each business day during the

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[9]In contrast, if such lender does not continue to make such issue of securities available for lending, then even if the amount of such issue in such lender's securities clearance account becomes sufficient to cover the amount of the unreturned securities, the recall of the lent securities would not lapse and the loan would not cease to be in default for that reason.

period in respect of which the fee is payable. In addition, for each recall that is not satisfied on the Repayment Date, the aggrieved lender receives a "Failed Return Administration Fee" of $500.

Discussion

Subsection (b) of Rule 17f-2 requires registered investment companies to deposit their securities and similar investments in the safekeeping of, or in a vault or other depository maintained by, a bank or other company whose functions and physical facilities are supervised by U.S. Federal or State authorities. Subsection (c) of Rule 17f-2 provides that the requirement of Subsection (b) of Rule 17f-2 does not apply to "securities on loan which are collateralized to the extent of their full market value." In addition, a management investment company is permitted by Rule 17f-5 to deposit foreign securities with an eligible foreign custodian if certain determinations are made. As operated by Morgan Guaranty Brussels, the Euroclear System qualifies as an eligible foreign custodian under Rule 17f-5(c)(2)(iv). See Investment Company Act Release No. 14132 (Sept. 7, 1984), 1984 Fed. Sec. L. Rep. (CCH) ¶ 83,655, at pp. 87,042-87,043.

In a letter to State Street Bank and Trust Co. (available Jan. 29, 1972 and Sept. 29, 1972) (the "State Street Letter"), the Staff provided no-action relief under Section 17(f) and Rule 17f-2(c) for registered investment companies to lend their securities through a securities lending program operated by State Street Bank and Trust Co., as long as the program complied with certain guidelines. As more fully discussed below, we believe that the Euroclear Securities Lending and Borrowing Program is consistent with the policies behind each of the guidelines announced in the State Street Letter, and request no-action relief to the extent the Program addresses these policies in a way that does not fit within the literal terms of the guidelines as previously articulated.

Guideline 1. The registered investment company must receive 100 percent cash collateral from the borrower.

This guideline is designed to give content to the requirement in Rule 17f-2(c) that loans of securities be "collateralized to the extent of their full market value." Through a series of subsequent no-action letters, the Staff has expanded Guideline 1 to permit collateral in the form of

U.S. government securities or irrevocable standby letters of credit issued by a bank that satisfies the qualifications of a bank custodian under Sections 17(f) and 26(a)(1).[10] See Lionel D. Edie Capital Fund, Inc. (available May 15, 1975)(U.S. government securities); Salomon Brothers (available May 4, 1975)(same) (the "Salomon Brothers Letter"); Standard Shares, Inc. (available Aug. 24, 1974)(same); The Adams Express Company (available October 20, 1979)(bank letter of credit) (the "Adams Express Letter").

It is our view that the guaranty of Morgan Guaranty of loans of securities by Participants in the Euroclear Program is the legal and functional equivalent as collateral of the irrevocable standby letter of credit permitted by the Adams Express Letter. Morgan Guaranty (of which Morgan Guaranty Brussels is a branch) is a member bank of the Federal Reserve System and, as of December 31, 1994, had aggregate capital, surplus, and undivided profits of approximately $7.31 billion.

Under the proposed arrangement described in the Adams Express Letter, the registered investment company would receive an irrevocable standby letter of credit issued by a bank with a face amount equal to 102% of the initial market value of the securities lent and an expiration date expected to be approximately six months after the issuance date. The registered investment company would be authorized

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[10]Under Sections 17(f) and 26(a)(1) of the 1940 Act and Rule 17f-2 thereunder, a qualified bank custodian includes:

> a bank (as defined by Section 2(a)(5)) that has "at all times an aggregate capital, surplus, and undivided profits of . . . not . . . less than $500,000".

Under Rule 17f-5(c), an "eligible foreign custodian" includes the following type of foreign banking institution:

> "(i) A banking institution or trust company, incorporated or organized under the laws of a country other than the United States, that is regulated as such by the country's government or an agency thereof and that has shareholders' equity in excess of $200,000,000 . . . as of the close of its fiscal year most recently completed . . . ."

to draw down all or any portion of the face amount of the letter of credit by presenting to the issuing bank a sight draft, together with an affidavit certifying that (i) the borrower had failed to return the securities when due or otherwise was in default and (ii) the amount being drawn down represented the current market value of the unreturned securities or the amount required to cure any other default.

In accordance with Section 5-112(1) of the Uniform Commercial Code ("UCC"), the issuing bank would be required to make payment under the letter of credit by the close of the third banking day following receipt of the documents or such later time as mutually agreed, but could not be required to pay earlier. The registered investment company could then use the cash drawn under the letter of credit to purchase replacement securities on the open market.

The issuing bank's obligation under the letter of credit was absolute and unconditional in the sense that the bank could not refuse to honor it based on defenses available to the borrower, if the registered investment company properly presented a demand for payment under the letter of credit. If the issuing bank defaulted on the letter of credit, the registered investment company would have a legal right under UCC § 5-115(1) to recover the face amount of the letter of credit plus incidental damages and interest. Once issued, the letter of credit could not be unilaterally modified or revoked by the issuing bank until its expiration date.

If, because of increases in the value of lent securities, the fixed amount of any letter of credit became insufficient to fully collateralize the borrower's reimbursement obligation, the borrower would be permitted to pledge cash or U.S. government securities to collateralize the shortfall. Alternatively, the old letter of credit could be canceled and a new one, at a sufficiently higher face amount, could be issued.

Adams Express successfully argued that a bank letter of credit with these characteristics was as good or better than cash or U.S. government securities as collateral, and in any case satisfied the policy concerns behind Guideline 1.

The guaranty of Morgan Guaranty performs the same economic function as a letter of credit in the typical securities lending transaction -- it effectively substitutes

the unconditional credit of Morgan Guaranty for that of the borrower in the transaction. The reimbursement obligation of the borrower to Morgan Guaranty, which matures if Morgan Guaranty is required to honor the guaranty to the lender, is typically secured by a pledge of cash or securities collateral on deposit with Morgan Guaranty in the Euroclear System. Hence, the arrangement appears in all respects consistent with the paradigm transaction described in the August 1989 survey of securities lending prepared by the Federal Reserve Bank of New York. See Securities Lending 4-10 (Federal Reserve Bank of New York, Aug. 1989).

From a legal standpoint, the rights of the beneficiary of this guaranty are in all material respects the same as or superior to those of a beneficiary of the type of standby letter of credit described in the Adams Express Letter. The guaranty is governed by Belgian law. We have been advised by Liedekerke Wolters Waelbroeck & Kirkpatrick, Belgian counsel to Morgan Guaranty Brussels, that, under Belgian law, Morgan Guaranty would have no defenses against the beneficiary under the facts described herein. If there were a default on the guaranty, the beneficiary would have a legal right under Belgian law to compel specific performance or obtain damages. Under the Operative Documents, the guaranty may not be modified or revoked by Morgan Guaranty, except upon ten days' prior written notice to Euroclear Participants.

In many respects, the guaranty of Morgan Guaranty provided for in the Euroclear Program is superior to the irrevocable standby letter of credit permitted in the Adams Express Letter as far as protecting a lender of securities. Under the guaranty, a lender need not present a sight draft or affidavit to receive payment as would be required under a letter of credit. In addition, payment under the guaranty is available, at the option of the lender, in the form of cash or replacement securities, if available. A letter of credit, on the other hand, provides for a cash payment only. Finally, the guaranty covers all cash entitlements on a security, as well as non-cash distributions. Indeed, the features of a letter of credit which would arguably distinguish it from a guaranty (namely, a fixed dollar amount representing the maximum amount which could be drawn and a fixed expiry date after which no drawings could be made) operate only to protect the issuer of the letter of credit, rather than the beneficiary.

The time required for a registered investment company to receive replacement securities (or their cash equivalent) in the event of a borrower default should typically be less and should not be longer in the Euroclear Program than in a lending transaction secured by a letter of credit in a typical U.S. program. Upon the default of a securities loan collateralized by a letter of credit, the lender must present a sight draft and affidavit to the issuing bank. Even if this can be done on the same business day as the default (which is uncertain), UCC § 5-112(1) allows the issuing bank until the close of the third banking day after presentment to make payment under the letter of credit. Assuming the lender is not in a position to execute a trade for replacement securities before collecting the proceeds under the letter of credit, the lender may have to wait for up to eight business days or more after default to receive replacement securities (three business days to receive the proceeds under the letter of credit plus five business days to settle the trade for replacement securities), even under ideal conditions.[11]

In contrast, if a borrower fails to return securities on the due date in the Euroclear Program and no substitute lender is found (historically less than 1% of the time), Morgan Guaranty has frequently been able to credit the lender's account with the cash equivalent, or enter into a transaction to purchase replacement securities, on the same business day as the default and, in any case, is required by the Operative Documents (i) to credit the lender's account with cash within two business days of its receipt of the lender's instructions requesting cash compensation by 10:00 a.m. (Brussels time) on the Repayment Date or (ii) to enter into a transaction to purchase replacement securities, if available, within two business days after default. If, at the end of such two-day period, no replacement securities are purchased and the lender does not provide instructions requesting cash compensation, Morgan Guaranty Brussels will, at its own discretion, continue to attempt to purchase replacement securities.

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[11]Moreover, as pointed out in the request seeking the Adams Express Letter, it may take more time to liquidate U.S. government securities collateral than to collect on a letter of credit. Thus, the time required to obtain replacement securities on defaulted securities loans collateralized by U.S. government securities may take longer than loans collateralized by letters of credit.

Thus, under the Operative Documents, immmediately after default, lenders may opt for cash compensation or automatically have a buy-in executed on their behalf. If the buy-in is unsuccessful after two business days, lenders may always request cash compensation.

Like securities loans made by registered investment companies, securities borrowings from customers made by broker-dealers are restricted by Rule 15c3-3(b) promulgated by the Commission under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Regulation T (12 C.F.R. § 220.16) promulgated by the Board of Governors of the Federal Reserve System (the "FRB") pursuant to the Exchange Act. Both Rule 15c3-3(b) and Regulation T impose substantially similar collateral requirements on securities borrowings by broker-dealers from customers, including specifically the permissive use of letters of credit as collateral. Hence, substantially the same issue discussed above is presented under Rule 15c3-3(b) and Regulation T. The Division of Market Regulation has granted no-action relief under Rule 15c3-3(b) with respect to securities borrowings collateralized by the guaranty of Morgan Guaranty described herein, and the FRB staff has concluded that such guaranty satisfies the collateral requirement under Regulation T. A copy of the no-action letter issued by the Division of Market Regulation and a copy of the FRB Staff opinion have been provided to the Staff in connection with this request. We believe that their analysis and conclusion is correct, and that the same result is indicated for purposes of Section 17(f), and Rules 17f-2 and 17f-5 thereunder.

Although registered investment companies may become direct Participants in the Euroclear System, almost none are direct Participants and Morgan Guaranty Brussels anticipates that most will continue to find it more convenient to hold their positions through global or other custodians. Under this arrangement, only their custodians would have the legal right under Belgian law to enforce the guaranty of Morgan Guaranty.

As a practical matter, custodians can be expected to pass on the benefits of the guaranty to their registered investment company customers in the rare event that both a replacement lender cannot be found for recalled securities and the relevant borrower defaults on its return obligation. It is the nature of custody arrangements that the custodian acts as agent for its customers, and not as principal. In

addition, most bank and other custodians are highly regulated institutions with legal duties to their customers. Furthermore, the custody business is highly competitive. Most registered investment companies can easily bargain for a provision in their agreements with custodians requiring the custodians to pass through the benefits of entitlements such as the guaranty, and most custody agreements probably contain a general provision to that effect already.

Nevertheless, in order to facilitate the issuance of the requested no-action letter, Morgan Guaranty Brussels is willing to have the no-action letter provide that a registered investment company may not rely upon the letter unless (i) it is a direct Participant in the Euroclear System or (ii) if it is not a direct Participant, a direct Participant (or any other intermediaries) through which it acts has a contractual or other legal obligation to enforce the guaranty pursuant to instructions from such registered investment company and to pass through the benefits of the guaranty to such registered investment company as if the registered investment company were a direct Participant. In addition, if the requested no-action letter is granted, Morgan Guaranty Brussels will send a notice to all Euroclear Participants advising them in reasonable detail of the existence and conditions of the requested no-action letter, and offering to provide them with a copy of it upon request.

As noted above, certain affiliates of Morgan Guaranty are permitted to be Participants in the Euroclear System and the Euroclear Securities Lending and Borrowing Program on the same basis and subject to the same conditions as other Participants. As a result, it is theoretically possible that one of its affiliates could be one of the borrowers with respect to an issue (pool) of lent securities part of which could, on any particular day, be lent by a registered investment company.

Any guaranty by Morgan Guaranty of an affiliated Participant's obligation to return securities upon recall of an open-ended borrowing or upon expiry of a fixed-term borrowing is subject to Sections 23A and 23B of the Federal Reserve Act. Sections 23A and 23B were designed by Congress to regulate the safety and soundness, and control any conflicts of interest, associated with the issuance of guaranties and other extensions of credit by banks on behalf or in favor of any affiliate. Section 23A requires that any such guaranty or other "covered transaction" be "on terms and conditions that are consistent with safe and sound

banking practices." Section 23B requires that it be "on terms and under conditions, including credit standards, that are substantially the same . . . as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies."

To ensure that such guaranties and other covered transactions are provided in a safe and sound manner and without any adverse effects as a result of any possible conflict of interest, Section 23A requires that they be fully secured by collateral. In addition, except for guaranties and other covered transactions fully secured by U.S. government securities or cash collateral on deposit with the bank, Section 23A also imposes ceilings on the aggregate amount of such guaranties and other covered transactions to any single and to all affiliates. It restricts the aggregate amount of covered transactions (including any guaranties) on behalf or in favor of any single affiliate to 10% of Morgan Guaranty's capital stock and surplus. It restricts the aggregate amount of covered transactions on behalf or in favor of all affiliates to 20% of Morgan Guaranty's capital stock and surplus.

As a result of Sections 23A and 23B, the guaranty by Morgan Guaranty of any affiliated borrower's obligation to return securities must be on substantially the same terms and conditions as its guaranty of any unaffiliated borrower's obligation. This requirement is satisfied since the terms and conditions of the guaranty in Section 14 of the Supplementary Terms and Conditions and Section 9 of the Operating Procedures are the same whether the borrower is an affiliate or a nonaffiliate of Morgan Guaranty. In addition, Morgan Guaranty Brussels has procedures in place to ensure that it complies with the other provisions of Sections 23A and 23B when an affiliate is a borrower under the Euroclear Program.

Issued in compliance with Sections 23A and 23B, the guaranty of Morgan Guaranty is just as liquid and valuable to a registered investment company lender whether it is issued to secure the obligations of an affiliated or an unaffiliated Participant. It is also at least as liquid and valuable, if not more so, as a guaranty or letter of credit issued by most unaffiliated banks. Morgan Guaranty has long been widely recognized as one of the world's leading and well-capitalized banking institutions, and there has never been a default on its guaranty in the twenty-year

history of the Euroclear Securities Lending and Borrowing Program.

Although we believe that the guaranty serves the same credit function when Morgan Guaranty, in its capacity as a Euroclear Participant, is one of the borrowers from a pool of lent securities, in order to facilitate the issuance of the requested no-action letter, Morgan Guaranty Brussels will obtain one or more guaranties substantially on the same terms and conditions as its guaranty set forth in Section 14 of the Supplementary Terms and Conditions and Section 9 of the Operating Procedures from one or more of the following types of banking institutions to secure the obligation of Morgan Guaranty, in its capacity as borrower in the Euroclear Securities Lending and Borrowing Program, to return borrowed securities when due to any registered investment company lender:

> (i) a separately incorporated and capitalized bank (as defined by Section 2(a)(5) of the 1940 Act) that satisfies the qualifications of a bank custodian set forth in Sections 17(f) and 26(a)(1) of the 1940 Act;[12] or
>
> (ii) a banking institution or trust company that qualifies as an "eligible foreign custodian" (as defined by Rule 17f-5(c)(2)).

Banking institutions satisfying these criteria could include a separately incorporated and capitalized bank affiliate of Morgan Guaranty (such as J.P. Morgan Delaware),[13] subject to compliance with applicable U.S. banking laws and regulations including Sections 23A and 23B of the Federal Reserve Act,

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[12]Under Section 17(f), which makes applicable to bank custodians of registered investment companies the qualifications for the trustees of unit investment trusts under Section 26(a)(1), a bank custodian must be a bank which at all times has aggregate capital, surplus, and undivided profits of not less than $500,000.

[13]J.P. Morgan Delaware is a separately incorporated and capitalized Delaware-chartered bank that is a member of the Federal Reserve System. As of December 31, 1994, it had aggregate capital, surplus, and undivided profits of approximately $668 million.

or a leading foreign bank that would qualify as an eligible foreign custodian under Rule 17f-5(c)(2) and might be a Participant in or depository of the Euroclear System.

Guideline 2. The borrower adds to such collateral whenever the price of the securities rises (i.e., mark to market on a daily basis).

As more fully discussed above, the guaranty covers the return of the lent securities or the cash equivalent of their full mark-to-market value as of the date on which Morgan Guaranty Brussels receives the lender's instructions requesting cash compensation. The guaranty thus covers the full mark-to-market value of any lent securities regardless of any fluctuations in such value between the date the loan is made and any date on which the lent securities are returned or, in the case of compensation, the date on which such compensation is requested by the lender.

Guideline 3. The registered investment company may terminate the loan at any time, and any stock loans are made in accordance with the rules of the New York Stock Exchange which require the borrower, after notice, to redeliver the borrowed securities within the normal settlement time of five business days.

As more fully discussed above, lenders on both fixed-term and open-ended loans may recall their securities at any time. Historically, Morgan Guaranty Brussels has been able to replace lenders seeking recall of securities by substituting other lenders over 99% of the time, virtually eliminating any recall delay. The loan automatically terminates when a substitute lender is found.

If no substitute lender is found, the timing of the right to recall securities and terminate the loan depends on whether the loan was fixed-term or open-ended. If it was fixed term, the original lender is not released from its obligation and the loan continues until the specified Repayment Date. If the loan was open-ended, the length of the recall period varies depending on the type of securities involved, and, subject to the few temporary exceptions described above, is calculated as the shorter of (i) the shortest customary settlement period for the securities in question plus one business day and (ii) any shorter period determined by Morgan Guaranty Brussels in light of the existence of an active repo market for the securities; subject in either case to a minimum recall

period of three business days. An open-ended loan for which a substitute lender could not be found terminates at the end of the recall period.

Because of the global nature of the Euroclear System and the fact that many Participants and many of the relevant securities markets for lent securities operate in different time zones,[14] it would be impracticable to have a recall period equal to any local settlement period in a particular security, without an extra business day to accommodate the cross-border nature of the system.

In our view, the recall and loan termination rights of the Euroclear Program should satisfy the policies of Guideline 3. The Euroclear situation is distinguishable from the situation in the Salomon Brothers Letter, where the Staff declined to provide no-action relief for a six-day recall period in a domestic U.S. securities lending program when the customary settlement period was five business days. The Staff explained that a registered investment company might be unable to settle a sale of securities executed on the same day as a loan recall if the loan recall period were longer than the trade settlement period.

The loan recall period in the Euroclear Program is likely to be much shorter than the relevant trade settlement period in over 99% of the cases since Morgan Guaranty Brussels has historically been able to find a substitute lender in response to over 99% of all recall requests. Even in the remaining cases (representing less than 1% of the total), the recall period may be shorter than the relevant trade settlement period if there is an active repo market in the securities in question. In addition, the extra business day is a practical necessity in the Euroclear context because of the inevitable reality of different time zones and operating hours around the globe. Such a practical necessity did not exist or was not articulated in the Salomon Brothers Letter.

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[14] See Cross-Border Clearance, Settlement, and Custody: Beyond the G30 Recommendations 17-19 (Euroclear Operations Centre, June 1993); Release of the Board of Governors of the Federal Reserve System Announcing Expansion of the Operating Hours of the Fedwire On-Line Funds Transfer Service, 59 Fed. Reg. 8981, 8985-8989 (Feb. 24, 1994).

Finally, although fixed-term loans made through the Euroclear Program have typically had a short enough term to permit lenders ample time to recall lent securities prior to any vote of such securities and the length of any such term is within the power of the lender upon entering into any lending transaction, in order to facilitate the issuance of the requested no-action letter, Morgan Guaranty Brussels is not seeking relief with respect to securities loans made on a fixed-term basis.

Guideline 4. **The registered investment company receives reasonable interest on such loan, any dividends, interest or other distributions on the loaned securities, and any increase in the market value of such securities. The Staff indicated that "reasonable interest on such loan" could include the registered investment company investing the cash collateral in high yielding short-term investments which give maximum liquidity to pay back the borrower when the securities are returned.**

Lenders in the Euroclear Securities Lending and Borrowing Program are entitled to the benefits of all dividends, interest or other distributions on lent securities, and any increase in the market value of such securities. They also receive an explicit fee to compensate them for the use of the lent securities. The fee may vary depending on the type of securities involved. The fees payable by or to borrowers and lenders are published in Section 13.3 of the Operating Procedures, and updated from time to time in amendments to the Operating Procedures. All lenders in the program receive the same fees for the same class of securities. Lenders' fees currently range from 1 to 4.5% per annum on the daily mark-to-market value of lent securities, plus accrued interest, if any, except in the case of loans of domestic securities made in anticipation of intraday receipts of such domestic securities by borrowers where such domestic securities are actually received as anticipated and returned to the lender, in which case the fee may be less than 1% or even zero.

Guideline 5. **The registered investment company is not required to pay any service, placement or other fees in connection with such loan, but the registered investment company may pay reasonable custodial fees to its custodian in connection with the lending of portfolio securities pursuant to a contract between the registered investment company and its custodian, and approved by the directors of the registered investment company.**

Under the Euroclear Program, lenders are not required to pay any service, placement or other fees in connection with any loan, but there is a spread between the fees payable by borrowers and receivable by lenders that is designed to compensate Morgan Guaranty for assuming the credit risk of the borrowers on the guaranty and to compensate the Euroclear Cooperative for making the Program available to the Participants. To the extent any compensation to the Euroclear Cooperative is in excess of the costs of operating the Program, it would be available for distribution back to the Participants as rebates on their fees.

Guideline 6. The registered investment company retains voting rights on the loaned securities. The Staff indicated that it would not object if voting rights passed with the lending of the securities, although this would not relieve the directors of a registered investment company of their fiduciary obligation to vote proxies and if the manager of the registered investment company has knowledge that a material event will occur affecting an investment on loan, the directors would be obligated to call such loan in time to vote the proxies.

Securities borrowed through the Euroclear Securities Lending and Borrowing Program can be transferred by the borrowers to third parties as if the securities had been purchased. If a registered investment company wishes to exercise its voting rights with respect to any lent securities, it must recall the securities before any relevant record date. As noted above, the time required to recall securities lent through the Euroclear Program should frequently be less, and should rarely be longer than one business day more, than the time required to recall securities through most U.S.-based programs. As further noted above, in the rare instances in which the recall period could be one business day longer than the related trade settlement period, the extra business day is a practical necessity in the Euroclear context given the reality of different time zones and operating hours around the globe. As a result, a registered investment company should generally be able to recall securities with sufficient time to vote proxies.

Guideline 7. If the fundamental policies of the registered investment company, or those which may not be changed without shareholder approval, do not permit lending of portfolio securities, shareholder approval of the change in

investment policy must be obtained prior to engaging in the practice.

The Euroclear Program is in the same position as any of the programs addressed in the prior no-action letters with respect to this guideline.

Guideline 8. Compensation received from borrowers for dividend and interest income on loaned securities may be treated as "other income" for tax purposes and affect the Subchapter M status of a registered investment company.

The Euroclear Program is in the same position as any of the programs addressed in the prior no-action letters with respect to this guideline.

Guideline 9. The registered investment company must make the following disclosures in its prospectus: that one of its policies is the lending of portfolio securities, that the voting rights may pass with the lending of securities; however, the directors will be obligated to call loans to vote proxies if a material event affecting the investment is to occur, that the lending of portfolio securities may adversely affect pass-through tax treatment afforded to regulated investment companies by Subchapter M of the Internal Revenue Code.

The Euroclear Program is in the same position as any of the programs addressed in the prior no-action letters with respect to this guideline.

Compliance with Section 17(a)(3)

Section 17(a)(3) of the 1940 Act prohibits any "affiliated person or promoter of or principal underwriter for a registered investment company . . . or any affiliated person of such person, promoter, or principal underwriter, acting as principal . . . to borrow money or other property from such registered investment company or from any company controlled by such registered investment company . . . except as permitted by section 21(b)." Section 21(b) provides an exemption for "any loan from a registered company to a company which owns all of the outstanding securities of such registered company, except directors' qualifying shares." Thus, Section 17(a)(3) generally prohibits a registered investment company from lending its securities to an affiliated person.

The Commission has granted exemptive relief from Section 17(a)(3), permitting certain registered investment companies to lend their securities to affiliated persons, subject to certain conditions. For example, in Investment Company Release No. 18299 (Sep. 9, 1991), the Commission amended a pre-existing exemption that permitted various registered investment companies to lend their securities to Shearson Lehman Brothers Inc. ("Shearson"), an affiliated person of such investment companies. See also Investment Company Release No. 14498 (May 2, 1985).

In order to ensure compliance with Section 17(a), no registered investment company as to which Morgan Guaranty or any of its affiliates is an "affiliated person or promoter of or principal underwriter" or an "affiliated person of such person, promoter, or principal underwriter", and no company controlled by such a registered investment company, is or will be permitted to lend securities belonging to it through the Euroclear Securities Lending and Borrowing Program, absent appropriate exemptive, no-action or other relief other than the relief requested hereby.

Conclusion

Based upon the foregoing, it is our view that securities lent by a registered investment company under the Euroclear Securities Lending and Borrowing Program are exempted from the restrictions of Section 17(f) under the 1940 Act as implemented by Rules 17f-2(b) and 17f-5. We would appreciate your confirming to us that the Staff will not recommend enforcement action by the Commission against a registered investment company which, in reliance on Rule 17f-2(c), lends securities through the Euroclear Program.

If you have any questions or need any additional information with respect to the matters set forth in this letter, please contact me at the number provided above.

Very truly yours,

Randall D. Guynn

APR 17 1996

PUBLIC

Our Ref. No. 95-513
Morgan Guaranty
Trust Company of
New York
File No. 132-3

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter dated November 17, 1995 requests assurance that we would not recommend enforcement action to the Commission under section 17(f) of the Investment Company Act of 1940 (the "1940 Act") or rules 17f-2 or 17f-5 thereunder if an investment company lends securities through the Euroclear Securities Lending and Borrowing Program ("the Euroclear Program"), and each loan is collateralized by the guaranty (the "Guaranty") of the Morgan Guaranty Trust Company of New York ("Morgan") as described in your letter.

I. The Program

Morgan's Brussels office ("Morgan Brussels") operates the Euroclear Program through the Euroclear System, a clearance and settlement system for internationally traded debt and equity securities.[1] Under the Euroclear Program, each issue of securities is lent and borrowed through a separate pool. A borrower is not matched with a specific lender.[2] You state that lenders in the Euroclear Program (i) receive specified fees as compensation for the use of the lent securities, (ii) receive any dividends, interest or other distributions paid on those securities, and (iii) are not required to pay any service, placement or other fees in connection with any loan.

The loans for which you request no-action relief are "open-ended," which means they do not have a specified expiration date,

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[1]You state that the Euroclear System has more than 2,700 participants, including most of the major banks, broker-dealers and other institutions engaged in cross-border securities transactions. Morgan Brussels also operates the Euroclear System.

[2]Section 17(a)(3) of the 1940 Act prohibits an affiliated person, promoter, or principal underwriter of an investment company, or an affiliated person of such person, from borrowing money or other property from that investment company. You state that Morgan and certain of its affiliates may participate as borrowers in the Euroclear Program. You represent, therefore, that to avoid violations of Section 17(a)(3), no investment company as to which Morgan or any of its affiliates is an affiliated person, or an affiliated person of an affiliated person, will lend securities through the Euroclear Program without first obtaining appropriate relief under the 1940 Act.

but must be repaid when recalled.[3] When a lender recalls its lent securities, Morgan Brussels will attempt to replace the lender with a substitute lender.[4] If Morgan Brussels does not find a substitute lender, it will send out a mandatory recall request to designated borrowers requiring them to return the securities within the applicable "recall period."[5] The recall period generally is the shorter of (i) the shortest customary settlement period for the securities on loan plus one business day, or (ii) any shorter period determined by Morgan Brussels given the borrower's ability to satisfy the recall request by entering into reverse repurchase agreements, subject in either case to a minimum recall period of three business days.[6] If the

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[3]The staff takes the position that, while the voting rights with respect to securities on loan may pass to the borrower, the board of directors of an investment company has a fiduciary obligation to recall a loan in time to vote proxies if it has knowledge that a vote concerning a material event regarding the securities will occur. State Street Bank and Trust Corp. (pub. avail. Dec. 27, 1971; May 22, 1972) ("State Street"). You state that open-ended loans under the Euroclear Program provide lenders with sufficient time to recall securities in order to vote proxies. The no-action relief provided herein does not extend to fixed-term loans (*i.e.*, loans that must be repaid on a specific date and that do not impose on the borrower an obligation to return recalled securities before that date).

[4]You state that Morgan Brussels historically has been able to find substitute lenders more than 99% of the time on a same-day or next-day basis for lenders that have recalled their securities. When Morgan Brussels finds a substitute lender, the original lender is released from its obligations and its securities are returned.

[5]The recall period commences when Morgan Brussels sends the mandatory recall request, which is required to occur no later than the next business day following the lender's recall request. Telephone conversation with Randall D. Guynn on March 5, 1996.

[6]The recall period is determined in this manner except in the case of ECU-denominated securities and Irish government securities, which have recall periods of six business days. You state that the customary settlement period for ECU-denominated securities varies depending upon the country of issuance, and that the customary settlement period for Irish government securities depends on whether they are traded domestically or internationally. You state that, in light of this variation, for practical reasons Morgan Brussels uses the longest customary settlement period plus one business day as the recall period for all loans of ECU-denominated and Irish government securities.

securities are not returned by the end of the recall period, the loan is considered to be in default.

II. The Guaranty

In the event of a default, the Guaranty, which will be administered by Morgan Brussels on behalf of Morgan,[7] will operate as follows. Morgan Brussels will, at the lender's option, either credit the lender's account with cash in the amount of the market value of the securities or attempt to purchase replacement securities. Specifically, the lender may, on the date that the recall period ends ("Repayment Date"), instruct Morgan Brussels to have its account credited with cash. If the lender does not request cash on the Repayment Date, Morgan Brussels will make a reasonable effort for two business days to purchase replacement securities for the lender. Then, if Morgan Brussels is unable to purchase replacement securities, the lender may again request and receive cash.[8] In any case in which the lender has requested and is entitled to receive cash, the lender's account, within two business days of the request, will be credited with cash in an amount equal to the market value of the securities as of the date Morgan Brussels receives the request plus any accrued interest and other distributions on the securities to the date the cash is credited to the lender's account.

You state that you have been informed by Belgian counsel that if Morgan does not honor the Guaranty, the lender would have the legal right under Belgian law to compel specific performance or obtain damages from Morgan, and Morgan would have no defenses against the lender in such an action.[9] In addition, Morgan may

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[7]You note that Morgan qualifies as a custodian under section 17(f).

[8]The lender also is entitled to have its account credited with cash if it requests cash during the two-day replacement period and Morgan Brussels has not yet begun to purchase replacement securities.

[9]You state that, although registered investment companies may participate in the Euroclear System as direct participants, virtually all participating investment companies do so indirectly through banks or other custodians that are themselves direct participants. An investment company that is not a direct participant in the Euroclear System may participate in the Euroclear Program in reliance on this letter only if the direct participant acting on its behalf is contractually or otherwise legally obligated to enforce the Guaranty on the investment company's behalf and to pass through the benefits of the Guaranty to the investment company as if the investment company itself

not modify or revoke the Guaranty without giving ten days prior written notice to participants in the Euroclear Program, thereby allowing lenders sufficient time to recall their securities.

III. Analysis

Section 17(f) of the 1940 Act and the rules thereunder set forth requirements with respect to the custody of the portfolio securities and similar investments of management investment companies. Rule 17f-2 permits management investment companies to act as custodians of their own securities if, among other requirements, the securities are deposited with a bank or other company supervised by Federal or State authorities. This requirement, however, does not apply to "securities on loan which are collateralized to the extent of their full market value." Rule 17f-5 permits management investment companies, under certain conditions, to place and maintain foreign securities and certain other assets with "eligible foreign custodians" as defined in that rule.[10]

The staff previously has taken no-action positions permitting investment companies to lend their securities in accordance with certain specified guidelines, particularly that the loan be fully collateralized by the borrower.[11] In prior letters, this collateral has taken the form of cash, government securities, and bank standby letters of credit.[12] The principal question raised by your letter is whether the Guaranty may serve as collateral for investment companies' securities lending through the Euroclear Program.

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were a direct participant. In order that investment companies lending securities through the Euroclear Program can be made aware of this and the other conditions of this letter, you state that Morgan Brussels will send a notice to all Euroclear Participants advising them in reasonable detail of the letter's existence and conditions and offering to provide a copy upon request.

[10]You state that the Euroclear System qualifies as an eligible foreign custodian under rule 17f-5. The Commission has proposed amendments to rule 17f-5 that would, among other matters, revise the definition of eligible foreign custodian. Investment Company Act Rel. No. 21259 (July 27, 1995).

[11]*See, e.g.*, State Street; Salomon Brothers (pub. avail. May 23, 1972).

[12]*See, e.g.*, State Street (cash); Lionel D. Edie Capital Fund (pub. avail. May 15, 1975) (U.S. government securities); The Adams Express Company (pub. avail. Oct. 20, 1979)("Adams Express")(bank standby letter of credit).

You assert that the Guaranty is the legal and functional equivalent of the irrevocable standby letter of credit that the staff has permitted in the past and, in certain respects, provides the lender with greater protection than a letter of credit. You state that, like a letter of credit, the Guaranty substitutes the guarantor's credit for that of the borrower, and that Morgan would have no defenses against the borrower under the facts you describe.[13] Further, under a letter of credit, the bank may have three business days from the time the lender provides the required documentation to credit the lender's account with cash,[14] while the Guaranty permits a lender to receive the cash value of the securities sooner than the third business day after the lender's request, without any documentation. In addition, a letter of credit provides for cash payment only, while a participant in the Euroclear Program has the option of receiving either cash or replacement securities.

While the Euroclear Program generally conforms to the other guidelines set forth in the earlier no-action letters,[15] it departs from those letters in that, in the past, the Division has required that borrowers agree to return the borrowed securities, upon request of the lender, within the normal settlement period for trading the securities.[16] The Euroclear Program, however, permits a period for the return of borrowed securities that may be two days longer than the customary settlement period. First, Morgan Brussels' attempt to find a substitute lender often results in a one-day delay in its issuing a recall notice to the borrower. Second, the recall period, which commences when the notice is sent, may set a Repayment Date of one day after the customary settlement period ends. You maintain, however, that as

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[13]As noted above, Morgan may participate as a borrower in the Euroclear Program. When it does, the Guaranty may fail to serve the intended credit enhancement function, as Morgan would be guaranteeing its own obligations. Therefore, you state that when Morgan borrows from a pool of lent securities, Morgan's borrowings from that pool will be collateralized by the guaranty of a separately incorporated and capitalized bank that qualifies as a bank custodian under section 17(f), or by the guaranty of a banking institution or trust company that qualifies as an eligible foreign custodian under rule 17f-5. This guaranty will be substantially on the same terms and conditions as the Guaranty provided by Morgan with respect to other securities loans under the Euroclear Program.

[14]*See* Adams Express.

[15]*See* State Street.

[16]*See* Salomon Brothers (pub. avail. May 4, 1975) (staff specifically rejected a six-day recall period).

a practical matter a lender typically faces little or no delay in the return of its securities, as Morgan Brussels historically has found substitute lenders more than 99% of the time within one day of a lender's request for return of the securities. You also assert that extending the recall period by one day beyond the settlement period is necessary because many of the Euroclear Program's participants are located in different time zones and, as a result, operate during widely varying hours. We agree that permitting the additional time is justified in light of the benefits to lenders of Morgan Brussels' finding a substitute lender (i.e., immediate return of the securities), the international nature of the Program, and because it would not appear to subject fund assets to any increased risk of loss or misappropriation.[17]

Therefore, based on the facts and representations set forth in your letter, we would not recommend enforcement action to the Commission under section 17(f) of the 1940 Act or the rules thereunder if an investment company lends securities through the Euroclear Program, and each loan is collateralized by the Guaranty.[18] You should note that different facts or circumstances might require a different conclusion.

Eric C. Freed

Eric C. Freed
Special Counsel

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[17]*See* Investment Company Act Rel. No. 21259, *supra* note 10, at §II.

[18]Similarly, we would not recommend enforcement action if, as described in your letter, a loan is collateralized by the guaranty of another bank and trust company to the extent Morgan is a borrower from a pool of securities. *See supra* note 13.