SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. IC–21259; International Series Release No. 831; File No. S7–23–95]

RIN 3235–AE98

Custody of Investment Company Assets Outside the United States

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule amendments and request for comment.

SUMMARY: The Commission is proposing amendments to the rule under the Investment Company Act of 1940 that governs the custody of investment company assets outside the United States. The amendments would revise the findings that currently must be made in establishing foreign custody arrangements to focus exclusively on the safekeeping of investment company assets. In addition, the amendments would provide investment companies with greater flexibility to address foreign custody arrangements by permitting a company's board of directors to delegate its responsibilities under the rule to evaluate these arrangements. The amendments also would expand the class of foreign banks and securities depositories that could serve as investment company custodians. The proposed amendments are intended to facilitate the use of foreign custody arrangements, consistent with the safekeeping of investment company assets.

DATES: Comments must be received on or before October 6, 1995.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6–9, Washington, D.C. 20549. All comment letters should refer to File No. S7–23–95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Elizabeth R. Krentzman, Assistant Chief, or Kenneth J. Berman, Assistant Director, (202) 942–0690, Office of Regulatory Policy, Division of Investment Management, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Commission today is requesting public comment on proposed amendments to rule 17f–5 (17 CFR 270.17f–5) under the Investment Company Act of 1940 (15 U.S.C. 80a) (the ''Act'').

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I. Executive Summary

The Commission is proposing amendments to rule 17f–5 to facilitate the use of foreign custody arrangements by registered management investment companies (''funds''). Among other things, the amendments would revise the findings that must be made in establishing foreign custody arrangements. Under the current rule, a fund's board of directors must find that the fund's arrangements are consistent with the best interests of the fund and its shareholders. This standard may be overbroad since it suggests, for example, that, in considering foreign custody arrangements, a fund's board needs to assess factors other than custodial risks. The amended rule would require findings that the fund's foreign custody arrangements will provide reasonable protection for fund assets. The proposed ''reasonable protection'' standard should facilitate evaluations of foreign custody arrangements by focusing exclusively on safekeeping considerations.

The amendments also would allow fund directors to play a more traditional oversight role with respect to foreign custody arrangements than that required under the current rule. Under the amendments, the board would be permitted to delegate its responsibility under the rule to evaluate foreign custody arrangements to the fund's investment adviser or officers or a U.S. or foreign bank. The amended rule would provide the board with the flexibility to assign different delegates responsibility for addressing different aspects of the fund's arrangements. The amended rule also would provide for general board oversight of a delegate's actions by requiring the delegate to provide the board with periodic reports concerning the fund's arrangements. The board would no longer be required to approve foreign custody arrangements annually.

In addition to updating and refining certain other provisions of rule 17f–5, the amendments would expand the class of foreign banks and depositories that could serve as fund custodians. Foreign banks would no longer have to meet specific capital requirements and foreign depositories would no longer have to operate the only system for the handling of securities in a country. The amended rule would require foreign custodians to be subject to foreign regulation. In addition, in connection with a custodian's selection, the amended rule would require a finding that the custodian will provide reasonable protection for the fund's assets based on all relevant factors, including the custodian's financial strength. This approach seeks to address safekeeping considerations without imposing capital and other requirements that may unnecessarily limit fund use of appropriate foreign custodians.

II. Background

Over the last ten years, the fund industry has become increasingly international in its investment perspective. At the end of 1984, shortly after rule 17f–5 was adopted, only 35 funds invested significant amounts of their assets in foreign securities.[1] By the end of 1994, the number of funds participating in foreign markets had increased almost twentyfold, with over 650 funds investing significant amounts of their assets outside the United States.[2]

[1] Investment Company Institute, The Growth Continues 1993 Perspective on Mutual Fund Activity 7 (Summer 1993); Lipper Analytical Services, Inc. (''Lipper''), Year Over Year Comparison of Growth by Objective of Closed-End Funds (1980–1990) (prepared for the Commission).

[2] Investment Company Institute, Trends in Mutual Fund Activity (Dec. 1994) (ICI News No. ICI–95–05); Lipper, Closed-End Fund Performance Analysis Service (Jan. 31, 1995) (as supplemented by the Commission staff to reflect closed-end funds that liquidated or converted to open-end status during the ten-year period ending December 31, 1994). Based on Commission filings, the Division of Investment Managements estimates that over 2,200

The availability of custodial arrangements in foreign markets where a fund invests is important. Maintaining securities outside of their primary market can add significant costs to investing in that market and may preclude foreign investment.[3]

Section 17(f) of the Act and the rules thereunder govern the safekeeping of fund assets.[4] The legislative history and requirements of section 17(f) indicate that Congress intended fund assets to be kept by financially secure entities that have sufficient safeguards against misappropriation.[5] Under section 17(f), only U.S. banks and their foreign branches, members of a U.S. securities exchange, funds themselves, and U.S. securities depositories may serve as fund custodians.[6] Before rule 17f–5 was adopted, therefore, funds seeking to maintain their assets outside the United States could use only foreign branches of U.S. banks as foreign custodians.[7]

Rule 17f–5 expanded the foreign custody arrangements available to funds.[8] Under the rule, the fund's board of directors must approve each country where the fund's assets will be maintained, each foreign bank or depository that will hold the assets, and the contract governing the arrangement.[9] The rule requires foreign custody contracts to contain certain provisions, and Notes to the rule enumerate factors that the board should consider in placing fund assets in foreign countries and with foreign custodians.[10] In addition, the rule requires the fund's board to monitor foreign custody arrangements and to approve the arrangements at least annually.[11]

Rule 17f–5 limits ''eligible foreign custodians'' to foreign banks and trust companies that either have more than $200 million in shareholders' equity or are majority-owned subsidiaries of U.S. banks or bank holding companies with more than $100 million in shareholders' equity.[12] Foreign depositories that hold fund assets must operate either the only system for a country's handling of securities or a transnational system for the central handling of securities.[13]

The Commission's Division of Investment Management (''Division'') has received extensive submissions urging amendment of rule 17f–5 from the Investment Company Institute (''ICI'') and a group of custodians that provide global custody services to funds (the ''Custodian Group'').[14] These commenters, as well as others, have indicated that rule 17f–5 places inappropriate burdens on fund directors.[15] Commenters have observed that the rule requires directors to ''micro-manage'' foreign custody arrangements, which is inconsistent with the oversight role directors generally perform.[16] Commenters also have indicated that directors usually lack the expertise to make foreign custody determinations, and that, in discharging their responsibilities under the rule, directors rely almost exclusively on the analysis and recommendations of third parties such as the fund's adviser and primary custodian.[17]

Commenters, including the ICI and the Custodian Group, also have indicated that the rule's definition of an eligible foreign custodian is too restrictive.[18] Since rule 17f–5 was adopted, foreign custodial arrangements have evolved significantly. Today, the safekeeping of foreign investments typically is effected through the fund's primary custodian, which uses a global custody network consisting of various foreign custodians with which the primary custodian has established relationships.[19] In addition, many countries have securities depositories, which offer ''paperless'' book-entry systems for the custody of fund assets.[20]

A number of exemptive orders and no-action letters have addressed the

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fund portfolios maintained some of their assets in foreign custody arrangements during the past year.

[3] Moving securities away from their primary market may entail additional costs in connection with hiring a servicing agent in the primary locality to collect and disseminate information with respect to the securities, transferring the securities to an eligible custodian and procuring insurance for possible loss in transit, and exchanging coupons for interest or dividends or for new shares in connection with a rights offering. Exemption for Custody of Securities by Foreign Banks and Foreign Securities Depositories, Investment Company Act Release No. 12354 (Apr. 5, 1982), 47 FR 16341, 16342 (hereinafter 1982 Proposing Release). Funds also may be prevented from, or delayed in, selling the securities if they are unable to make timely delivery to prospective purchasers in the primary market. *Id.* In addition, the best price for a foreign security typically may be obtained in its primary market. *Id.*

[4] 15 U.S.C. 80a–17(f).

[5] Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 264 (1940). Cf. 10 SEC Ann. Rep. 169 (1944) (discussing section 17(f) and its protections against theft and embezzlement by affiliated persons).

[6] Bank custodians must be subject to federal or state regulation and have at least $500,000 in aggregate capital, surplus, and undivided profits. Investment Company Act sections 2(a)(5), 15 U.S.C. 80a–2(a)(5) (defining bank), and 26(a)(1), 15 U.S.C. 80a–26(a)(1) (containing the $500,000 capital requirement). *See also* rule 17f–1, 17 CFR 270.17f–1 (custody by members of a U.S. securities exchange), rule 17f–2, 17 CFR 270.17f–2 (custody by funds themselves), and rule 17f–4, 17 CFR 270.17f–4 (custody by U.S. securities depositories). *See* generally Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Investment Company Act Release No. 20313 (May 24, 1994), 59 FR 28286 (proposing rule 17f–6, which would permit custody of fund assets by futures commission merchants and commodity clearing organizations).

[7] 1982 Proposing Release, *supra* note 3, at 16342 n.11. Before rule 17f–5 was adopted, several Commission orders under section 17(f) permitted funds to place their assets with certain foreign banks if the fund's U.S. custodian assumed responsibility for the arrangement. *See* Chase Manhattan Bank, Investment Company Act Release Nos. 12002 (Oct. 23, 1981), 46 FR 53567 (Notice of Application) and 12053 (Nov. 20, 1981), 24 SEC Docket 109 (Order).

[8] Exemption for Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 14132 (Sept. 7, 1984), 49 FR 36080 (hereinafter 1984 Adopting Release). Rule 17f–5 was proposed in 1982 and reproposed in 1984. *See* 1982 Proposing Release, *supra* note 3; Exemption for Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 13724 (Jan. 17, 1984), 49 FR 2904 (hereinafter 1984 Reproposing Release). In addition, certain technical amendments were made to the rule after its adoption. Custody of Investment Company Assets Outside of the United States, Investment Company Act Release Nos. 14548 (May 31, 1985), 50 FR 24540 (hereinafter 1985 Release Proposing Amendments), and 14711 (Sept. 11, 1985), 50 FR 37654 (hereinafter 1985 Release Adopting Amendments])

[9] Rule 17f–5(a)(1)(i)–(iii). *See also* ''Discussion—Assets Maintained in Foreign Custody'' below.

[10] Rule 17f–5(a)(1)(iii), Rule 17f–5, Notes 1 and 2.

[11] Rule 17f–5(a)(2) and (3).

[12] Rule 17f–5(c)(2)(i) and (ii). Non-subsidiary foreign bank and trust companies also must be subject to foreign regulation.

[13] Rule 17f–5(c)(2)(iii) and (iv).

[14] Letter from Matthew P. Fink, President, ICI, to Marianne K. Smythe, Division Director, SEC (Jan. 18, 1993) (hereinafter ICI Letter I); Letter from Catherine L. Heron, Vice President (Tax and Pension), ICI, to Barry P. Barbash, Division Director, SEC (Oct. 13, 1993) (hereinafter ICI Letter II); Letter from Stephen K. West, Sullivan & Cromwell, to Barry P. Barbash, Division Director, SEC (Sept. 29, 1994) (hereinafter ICI Letter III); Letter from Daniel L. Goelzer, Baker & Mackenzie (on behalf of Bankers Trust Company, Boston Safe Deposit and Trust Company, Brown Brothers Harriman & Co., Chase Manhattan Bank, Morgan Guaranty Trust Company of New York, Morgan Stanley Trust Company, and State Street Bank and Trust Company), to Barry P. Barbash, Division Director, SEC (Feb. 9, 1994) (hereinafter Custodian Letter I); Letter from Daniel L. Goelzer, Baker & Mackenzie, to Elizabeth R. Krentzman, Special Counsel, SEC (Oct. 20, 1994) (hereinafter Custodian Letter II); Letter from Daniel L. Goelzer, Baker & Mackenzie, to Barry P. Barbash, Division Director, SEC (Nov. 3, 1994) (hereinafter Custodian Letter III). These letters are located in the Commission's Public Reference Room under File No. S7–23–95.

[15] *See* Division of Investment Management, SEC, Protecting Investors: A Half Century of Investment Company Regulation 270 n.78 (1992) (hereinafter Protecting Investors report).

[16] *Id.*

[17] *Id.*

[18] *See, e.g.,* ICI Letter II, *supra* note 14; Custodian Letter I, *supra* note 14.

[19] *See* John Paul Lee & Richard Schwartz, Global Custody: A Guide for the Nineties (1990). Funds also use different custodian networks for different geographical regions. *See* Andrew Sollinger, *Breaking Away,* Institutional Investor 171 (Sept. 1991).

[20] *See* Group of Thirty, Clearance and Settlement Systems in the World's Securities Markets 7, 51–64 (Mar. 1989) (hereinafter Group of Thirty Report).

eligibility of certain foreign banks and depositories to serve as fund custodians.[21] Obtaining administrative relief with respect to a particular custodian, however, may involve significant amounts of time and expense, and may delay or impede investment in some foreign jurisdictions. Exemptive orders and no-action letters also may have the unintended effect of suggesting Commission approval with respect to safekeeping abilities of some custodians, particularly in the case of foreign depositories.

Based on the evolution of foreign markets and related custodial systems, the concerns raised by industry commenters, and the Commission's administrative experience, the Commission is proposing amendments to rule 17f–5. The amendments seek to facilitate the use of foreign custody arrangements, consistent with the safekeeping of fund assets.

III. Discussion

A. Standard for Evaluating Foreign Custody Arrangements

Rule 17f–5 currently requires fund boards of directors to find that the fund's foreign custody arrangements are consistent with the best interests of the fund and its shareholders. This finding must be made with respect to the custody of the fund's assets in a particular country, each foreign custodian that holds the assets, and the foreign custody contract.[22] The Commission believes that the ''best interest'' standard may be overly broad and difficult for directors to apply. The standard and certain Notes to the current rule, for example, suggest that, in considering foreign custody arrangements, a fund's board needs to assess factors other than custodial risks, such as the risk of expropriation.[23]

The Commission believes that the amended rule should require foreign custody arrangements to be evaluated based on the level of safekeeping they will afford fund assets. Thus, the amended rule would require findings that the fund's foreign custody arrangements will provide reasonable protection for fund assets. The proposed ''reasonable protection'' standard is intended to facilitate evaluations of foreign custody arrangements by focusing exclusively on the safekeeping of fund assets.

B. Delegation of Board Responsibilities

1. Appropriate Delegate for Foreign Custody Decisions

The amended rule would permit fund boards to play a role more consistent with their traditional oversight role in connection with a fund's foreign custody arrangements, by allowing the board to delegate its responsibilities under the rule to the fund's investment adviser or officers or a U.S. or foreign bank.[24] The fund's investment adviser or custodian are likely to be in a better position than the fund's board to evaluate the sorts of factors that would be involved in assessing whether a custodial arrangement will afford reasonable protection for fund assets. Under the amended rule, the board could use different delegates for different foreign custody responsibilities.[25] This approach seeks to provide the board with the flexibility to delegate components of foreign custody decisions to the entity it determines is in the best position to evaluate those aspects of the fund's arrangements.[26]

In selecting particular delegates for foreign custody decisions, the board, under the amended rule, would need to find that it is reasonable to rely on the delegate to perform the delegated responsibilities.[27] Factors typically involved in making this determination would include the expertise of the delegate and, if applicable, the delegate's intended use of third party experts in performing its responsibilities.[28] Other relevant factors may include, in the case of foreign delegates, the board's ability to monitor the delegate's performance and the fund's ability to obtain U.S. jurisdiction over the delegate if problems arise in the delegate's performance.

The amended rule would not require the board to approve the fund's foreign custodians or other foreign custody matters on an initial or annual basis.[29] The board also would not be required to pre-approve or ratify actions taken by the delegate, such as the selection of particular foreign custodians or changes in those arrangements.[30] Instead, the amended rule would require the delegate to provide the board with written reports notifying the board of the placement of the fund's assets in a particular country and with a particular custodian.[31] The delegate also would have to provide written reports of any material changes in the fund's arrangements.[32] These reports, which are intended to facilitate the board's oversight of the delegate's performance, would be provided to the board no later than the next regularly scheduled board

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[21] *See* ''Discussion—Eligible Foreign Custodians'' below.

[22] *See* rule 17f–5(a)(1)–(3).

[23] *See* 1984 Reproposing Release, *supra* note 8, at 59608 (in making the required best interest finding, the board should weigh the risks of maintaining the securities in or near a country against the benefits of the arrangement).

[24] The Commission previously considered permitting U.S. custodians to select particular foreign custodians. 1982 Proposing Release, *supra* note 3, at 16345–46; 1984 Reproposing Release, *supra* note 8, at 2910. *See also* Protecting Investors report, *supra* note 15, at 270–71 (recommending that the Commission consider revising rule 17f–5 to make the fund's adviser or primary domestic custodian responsible for foreign custody matters, subject to the board's general oversight; also recommending that the Commission consider requiring indemnification protections from the fund's domestic custodian).

[25] The adviser, for example, could evaluate the risks associated with the custody of the fund's assets in a particular jurisdiction and a U.S. custodian could evaluate the risks of using specific foreign custodians.

[26] Proposed rule 17f–5(b). U.S. bank delegates would have to be subject to federal or state regulation by virtue of the definition of bank in section 2(a)(5) of the Act. Through the definition of ''qualified foreign bank,'' proposed rule 17f–5(d)(6) would require foreign delegates to be regulated as either a foreign banking institution or trust company by the government of the country under whose laws it is organized or any agency thereof.

[27] Proposed rule 17f–5(b)(1).

[28] *See generally* Custodian Letter II, *supra* note 14, at 2 (indicating that U.S. custodians can provide information regarding the nature and operation of a foreign country's custody facilities); Gordon Altman Butowsky Weitzen Shalov & Wein, A Practical Guide to the Investment Company Act 30 (1993) (indicating that, under the current rule, the fund's custodian typically provides the board with information concerning foreign legal restrictions and the qualifications of the foreign custodians used by the fund); Glorianne Stromberg, Regulatory Strategies for the Mid-'90s; Recommendations for Regulating Investment Funds in Canada (prepared for the Canadian Securities Administrators) 242 (Jan. 1995) (suggesting it is unlikely that an individual investment company or its adviser will have the expertise or bargaining power to deal with numerous and varied foreign custodians throughout the world).

[29] *See* rule 17f–5(a)(3) (requiring the board to annually approve foreign custody arrangements). *See also* Revision of Certain Annual Review Requirements of Investment Company Boards of Directors, Investment Company Act Release No. 19719 (Sept. 17, 1993), 58 FR 49919 (rule amendments eliminating certain annual approval requirements).

[30] The amended rule, however, would not preclude a board and its delegate from agreeing that the board's guidance would be sought on a particular matter, such as changing custodians. *See* Custodian Letter II, *supra* note 14, at 16–17 (expressing concerns that, without the board's involvement, responsibility for changing custodians could increase a delegate's liability if, for example, the delegate does not make a custodian change and fund assets are lost as a result of the custodian's insolvency).

[31] Proposed rule 17f–5(b)(2).

[32] *Id.* A material change in the fund's arrangements could include a delegate's decision to remove the fund's assets from a particular jurisdiction or custodian. A material change also could include circumstances that may adversely affect a foreign custodian's financial or operational strength, such as a change in control resulting from the custodian's sale. If appropriate, the delegate's report could discuss the reasons for continuing to maintain the fund's assets in the country or with a particular custodian.

meeting following the delegate's actions.[33]

The Commission requests comment on the proposed approach and possible alternatives. The Commission requests specific comment on the proposed entities to which foreign custody responsibilities could be delegated. In particular, the Commission requests comment whether U.S. and foreign bank delegates should be required to meet specific capital standards. The Commission also requests comment whether custodian delegates should be limited to U.S. banks.[34] Alternatively, should the rule permit the board to use any party that, in the board's judgment, would be qualified to make foreign custody decisions?

The Commission also requests comment whether the amended rule should require the same delegate to evaluate all aspects of the fund's arrangements or tie certain responsibilities to particular delegates.[35] The ICI and the Custodian Group, for example, indicated that the fund's adviser should be the exclusive delegate for considering a county's custodial risks because of the relationship between decisions to invest in the country and maintain the fund's assets in that country.[36] They also suggested that U.S. bank custodians should be the only eligible delegates for selecting the fund's foreign custodians.[37] The ICI suggested that evaluating foreign custodian arrangements is within the expertise of the fund's U.S. custodian and not the fund's adviser.[38] The Custodian Group expressed concerns about advisers being in a position to make a U.S. custodian use a foreign custodian with which the U.S. custodian does not have a pre-existing relationship and whose practices and procedures do not meet the U.S. custodian's standards.[39]

Although these approaches may limit flexibility, they could eliminate potential questions between different delegates concerning their respective roles in foreign custody matters. They also could eliminate the need to attribute various foreign custody risks to the practices of a particular country or foreign custodian.[40]

The Commission also requests comment on the proposed requirements relating to the board's delegation. The Commission requests specific comment on requiring the board to determine that it is reasonable to rely on the delegate to perform the delegated responsibilities and whether another standard would be more appropriate. The Commission also requests comment on requiring delegates to provide the board with periodic reports concerning the fund's arrangements. In particular, does the proposed approach appropriately address the role of the board in foreign custody matters? Should, for example, the rule require the board to establish guidelines and procedures governing a delegate's responsibilities?[41] Should the rule mandate the standard of care to be used by delegates in making custodial decisions?[43]

Finally, the Commission requests comment generally on the relationship between the level of the delegate's role in selecting foreign custodians and the flexibility that a fund should have in using particular custodians. For example, current rule 17f–5 both limits the class of foreign banks that are eligible to hold fund assets (based on, among other things, their shareholder's equity) and requires the fund's board to select an appropriate custodian from that class based on several qualitative factors (such as the bank's reputation). As discussed below, the amended rule would not require foreign custodians to satisfy an objective financial standard.[44] The amended rule instead would require the board's delegate to select foreign custodians based on the qualitative determination that the custodian will provide reasonable protection for the fund's assets.[45]

The Commission requests comment on an alternative approach that would rely exclusively on objective standards to determine those custodians that would be eligible to hold fund assets. Under this approach, having determined that a potential custodian meets the rule's objective standards, a delegate would not be required to evaluate the appropriateness of the foreign custodian based on any qualitative determination. Nor would the delegate be required by the rule to provide the fund's board with specific reports concerning the fund's arrangements.[46] Commenters favoring this approach should recommend specific objective standards that would not unduly limit or preclude the use of qualified foreign custodians.[47] Commenters also should consider whether objective standards, by themselves, would protect fund assets or whether, consistent with the current rule, delegates should be required to consider additional qualitative factors.

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[33] Proposed rule 17f–5(b)(2). *See* ICI Letter I, *supra* note 14, at 6–7; Custodian Letter I, *supra* note 14, at 18 (recommending that delegates provide written year-end reports).

[34] Several exemptive orders relating to rule 17f–5 involve foreign banks and their foreign subsidiaries. *See, e.g.*, Barclays Bank PLC, Investment Company Act Release Nos. 20128 (Mar. 10, 1994), 59 FR 12390 (Notice of Application) and 20192 (Apr. 5, 1994), 56 SEC Docket 1117 (Order).

[35] Requiring the same delegate to evaluate all aspects of foreign custody arrangements could effectively eliminate the potential for U.S. custodians to serve as delegates, since the Custodian Group has suggested that U.S. custodians may be unwilling to evaluate the prevailing custodial risks of a particular country. *See infra* note 36 and accompanying text.

[36] ICI Letter I, *supra* note 14, at 4, n.5; ICI Letter III, *supra* note 14, at 1–3; Custodian Letter I, *supra* note 14, at 6–7; Custodian Letter II, *supra* note 14, at 2. *See also* Custodian Letter III, *supra* note 14, at 2. The Custodian Group indicated that, because decisions relating to a country's prevailing custodial risks may depend on the fund's investment strategies and willingness to accept certain risks, custodians are not in a position to make these assessments. Custodian Letter I, *supra* note 14, at 6–7; Custodian Letter II, *supra* note 14, at 2; Custodian Letter III, *supra* note 14, at 2. The Custodian Group also asserted that requiring U.S. custodians to evaluate prevailing custodial risks would transfer new liabilities to U.S. banks, which could raise bank regulatory concerns. *Id.* at 5–6.

As discussed *infra* notes 62–68 and accompanying text, the ICI and the Custodian Group viewed differently the responsibilities involved in determining whether to maintain custody of fund assets in a particular country.

[37] ICI Letter III, *supra* note 14, at 3 and at 1, 6 (Exhibit A); Custodian Letter I, *supra* note 14, at 8–9 and at 3–4, 7–8 (Exhibit A) (also recommending that boards be permitted to delegate to U.S. custodians the authority to negotiate and approve foreign custody contracts and to monitor the fund's arrangements).

[38] ICI Letter III, *supra* note 14, at 3.

[39] Custodian Letter I, *supra* note 14, at 8.

[40] Under the current rule, for example, the board is responsible for both the decision to place fund assets in a particular country and with a particular custodian. If a country's prevailing custodial risks are not evaluated by the board in deciding to maintain assets in a particular jurisdiction, these risks would be considered in selecting particular custodians in that jurisdiction. *See also infra* notes 49 and 71 and accompanying text.

[41] *See* ICI Letter III, *supra* note 14, at 1–3 (Exhibit A); Custodian Letter I, *supra* note 14, at 3–5 (Exhibit A) (recommending board-approved guidelines and procedures that include factors governing a delegate's selection of foreign custodians). *See also* rules 10f–3, 17a–7, and 17e–1 under the Act, 17 CFR 270.10f–3, –17a–7, –17e–1 (consistent with this approach).

[42] *See* ICI Letter III, *supra* note 14, at 5 (Exhibit A); Custodian Letter I, *supra* note 14, at 7 (Exhibit A) (recommending that delegates make certain representations to the board prior to using a foreign custodian).

[43] *See* ICI Letter III, *supra* note 14, at 3 and at 1, 6 (Exhibit A); Custodian Letter I, *supra* note 14, at 8–9 and at 3–4, 7–8 (Exhibit A) (recommending that, in selecting foreign custodians, U.S. bank delegates be required to act with the degree of care, prudence, and diligence of a reasonable professional custodian under applicable state law).

[44] *See* ''Eligible Foreign Custodians'' below.

[45] *See* ''Selecting Foreign Custodians'' below.

[46] This approach would be consistent with the provisions of section 17(f) governing the custody of fund assets with a domestic bank. *See supra* note 6.

[47] *See* ''Eligible Foreign Custodians'' below.

2. Custody in Foreign Countries

a. Prevailing Custodial Risks

Rule 17f–5 requires a fund's board to approve each country where the fund's assets will be maintained.[48] Because placing fund assets in a particular country may affect the safekeeping of those assets, the amended rule would continue to address the risks associated with custody of a fund's assets in a foreign country.[49]

The amended rule would require a finding that custody of the fund's assets in a particular country can be maintained in a manner that will provide reasonable protection for those assets.[50] Making the proposed determination would not require a finding that fund assets could never be lost in a foreign country.[51] Rather, the proposed determination would require the delegate to consider whether the fund's assets will be maintained in a manner that will provide reasonable *protection* based on all relevant factors and, in particular, the factors specified in the amended rule.[52]

The amended rule would require the delegate to evaluate, among other factors, the prevailing practices in a country for the safekeeping of the fund's assets.[53] Evaluating a country's custodial practices typically would involve, among other things, considering the manner in which securities are maintained (*e.g.*, whether securities are held in physical or uncertificated form), the physical protections available for certificated securities (*e.g.*, the use of vaults or other facilities), the method of keeping custodial records (*e.g.*, the use of computers, microfilm or paper records), custodial communication systems (*e.g.*, the use of electronic media, telex, or telephone), security and data protection practices (*e.g.*, alarm systems and the use of pass codes and back-up procedures for electronically stored information), and the protections provided by governmental or other regulatory oversight.[54] These considerations seek to address the systemic custodial risks of a particular country. Although evaluating a country's custodial practices would require knowledge of foreign custody arrangements, it would not require a finding concerning the protections provided by any specific foreign custodian.[55]

In evaluating the custodial risks of a particular country, the delegate would be required to assess any adverse effects foreign law may have on the safekeeping of fund assets.[56] The delegate specifically would have to consider whether foreign law would restrict (A) the access of the fund's accountants to the custodian's books and records and (B) the fund's ability to recover its assets in the event of a custodian's bankruptcy or a loss of assets in the custodian's control. These factors are derived from the Notes to the current rule.[57] The amended rule would broaden the current rule, however, by requiring consideration of all relevant foreign legal constraints, in addition to those governing the custodian's books, bankruptcy, and loss of assets.[58]

In addition, the amended rule would permit the delegate to consider any special arrangements that mitigate prevailing custodial risks.[59] Such arrangements would include, for example, insurance or guarantee agreements covering the loss of fund assets. Such arrangements also may include instituting special procedures that depart from prevailing practices and are designed to reduce custodial risks. A recent Division no-action position, for example, was based, in part, on the existence of certain contractual protections that would not otherwise have been given in the course of the country's prevailing custody practices.[60]

The Notes to the current rule instruct the fund's board to consider the likelihood of various adverse political events (*e.g.*, the expropriation or freezing of assets) and potential difficulties in converting the fund's cash and cash equivalents to U.S. dollars.[61] The amended rule would not address these risks. Although these risks may affect the safety and liquidity of fund assets, they appear to relate more to the investment risks of a particular country than the custodial risks of that country. Adverse political events and foreign exchange problems, for example, may threaten fund assets regardless of where the assets are held. The Commission believes that these risks should be considered in connection with the determination that a fund should *invest* in a particular country.

The ICI and the Custodian Group recommended different approaches to evaluating a country's prevailing custodial risks. The ICI recommended eliminating country-related risk determinations from the rule.[62] The ICI indicated that, for the most part, the risks of maintaining assets in a particular jurisdiction (*e.g.*, expropriation risks) are independent of the risks associated with using a specific

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[48] See rule 17f–5(a)(1)(i).

[49] *See* Custodian Letter I, *supra* note 14, at 6–7 (indicating that deciding to place assets in a particular country may mean accepting certain risks if custodial protections comparable to those of the United States are not available in the foreign jurisdiction).

The proposed approach also seeks to address circumstances where different delegates assess the custodial risks of a particular country and the risks of using a particular foreign custodian. If, for example, a country's prevailing custodial risks are not evaluated by a delegate in deciding to maintain assets in the country, a different delegate selecting the fund's foreign custodians could determine that the custody of the fund's assets in that country presents unacceptable risks, without regard to the protections provided by any specific custodian. Delegates making the respective country-wide and custodian risk assessments could, in effect, disagree over the appropriateness of maintaining fund assets in the country. Such disputes may have to be resolved by the board, which could undermine the purposes of delegation by re-involving the board in foreign custody decisions.

[50] Proposed rule 17f–5(a)(1). Consistent with the current rule, this finding would have to be made prior to placing the fund's assets in the country. The amended rule would not address the *investment* risks associated with investing in foreign securities, since these risks fall outside the scope of rule 17f–5.

[51] This approach would be consistent with the current rule.

[52] Throughout this release, references are made to a delegate's responsibilities, since the amendments contemplate that the board will use one or more delegates to establish and oversee the fund's foreign custody arrangements. If, however, the board decides to retain decision-making authority for foreign custody matters, these responsibilities would remain with the board. The amended rule uses the term *foreign custody manager* to recognize that a delegate or the board may assume responsibility for the fund's arrangements. *See* proposed rule 17–f(d)(1).

[53] Proposed rule 17f–5(a)(1)(i).

[54] The importance of each of these factors would depend on the particular jurisdiction and related securities market. For example, vault facilities and alarm systems may be less important in markets where securities are primarily held in book-entry form. Similarly, the need for electronic information systems may be more important in markets with a high volume of securities transactions than in markets where trading is less frequent. *See* Custodian Letter II, *supra* note 14, at 4–5.

[55] *See* ''Selecting Foreign Custodians'' below.

[56] Proposed rule 17f–5(a)(1)(ii).

[57] *See* rule 17f–5, Notes 1(a)–(c).

[58] In evaluating any adverse effects foreign law may have on the safekeeping of fund assets, consideration of U.S. legal standards may be relevant. In determining whether custody of fund assets in a particular country will provide reasonable protection for those assets, however, delegates would not be required to find that the protections provided by foreign law are equivalent to U.S. standards.

[59] Proposed rule 17f–5(a)(1)(iii).

[60] Templeton Russia Fund, Inc. (pub. avail. Apr. 18, 1995) (contracts between the fund's foreign custodian and certain registries).

[61] Rule 17f–5, Notes 1(d)–(e).

[62] ICI Letter III, *supra* note 14, at 3–7. The ICI's proposal would require the decision to place assets in a particular jurisdiction to have been made by the board or adviser as a condition precedent to selecting specific foreign custodians. *Id.* at 6–7. The ICI indicated that the board or adviser would consider the custodial risks of a particular jurisdiction in deciding whether to *invest* in the country. ICI Letter I, *supra* note 14, at 4, n.5; ICI Letter III, *supra* note 14, at 6–9.

foreign custodian.[63] The ICI indicated that, as a consequence, assessments of country-related risks are not appropriate considerations for a foreign custody rule.[64] The ICI also expressed concerns that requiring evaluations of a country's prevailing custodial risks would transfer to the country selection process the responsibility to determine whether one or more custodians in a country could provide reasonable protections for the fund's assets.[65]

The Custodian Group recommended that the rule require an evaluation of a country's prevailing custodial risks prior to placing assets in that jurisdiction.[66] As to the factors governing these assessments, the Custodian Group recommended that the Commission consider adding two new factors to the Notes to the current rule.[67] The Custodian Group's new factors would require the board's delegate to evaluate each securities depository in the country and to consider whether the financial systems in the country, including the methods for securities settlement and custody, are sufficient to provide reasonable protection for the fund's assets.[68]

The Commission requests comment on these two approaches. The Commission also requests comment on an alternative approach that would make evaluations of a country's prevailing custodial risks part of the custodian selection process. Such an approach would simplify the rule and should not raise any safekeeping concerns since the factors that relate to a country's prevailing custodial risks would be evaluated in connection with a custodian's selection.[69]

b. Compulsory Depositories

Certain countries have depositories the use of which is unavoidable for the custody of foreign securities purchased by a fund (a ''compulsory depository''). Because the custody of fund assets in a foreign country may necessitate using any compulsory depository in the country, the amended rule would make the selection of compulsory depositories part of the assessment of a country's prevailing custodial risks.[70] The amended rule would require a finding that using a compulsory depository will provide reasonable protection for the fund's assets based on factors specified in the amended rule governing the selection of foreign custodians.[71]

The amended rule would define a compulsory depository as a depository the use of which is mandatory (i) by law or regulation, (ii) because securities cannot be withdrawn from the depository, or (iii) because maintaining securities outside the depository is not consistent with prevailing custodial practices.[72] Part (iii) of the proposed definition is intended to recognize cases when a depository's use is effectively compulsory as a result of prevailing practices even though securities may be held outside of the depository.[73] Determining whether a depository's use is compulsory would depend on the facts and circumstances presented.[74] Factors relevant to making this determination may include whether virtually all securities are maintained in the depository, whether the depository's involvement is required to transfer securities ownership, and whether significant time and expense are associated with keeping securities outside the depository.[75]

The Commission requests comment on requiring compulsory depositories to be evaluated in connection with assessments of a country's prevailing custodial risks.[76] The Commission also requests comment on the proposed definition of compulsory depository.

3. Selecting Foreign Custodians[77]

The amended rule would require a finding that using a particular custodian will provide reasonable protection for the fund's assets.[78] Selecting foreign custodians would not involve reassessments of a country's prevailing custodial risks and the use of any compulsory depositories. Under the amended rule, these matters would be evaluated in determining whether the custody of the fund's assets in the country will provide reasonable protection for those assets.[79]

In selecting foreign custodians, the delegate would not be required to find that assets could never be lost while in the foreign custodian's possession. Instead, the amended rule would focus on the reasonableness of a custodian's protections based on all relevant factors and, in particular, those factors specified in the amended rule.[80] The proposed factors that would govern the selection of foreign custodians are

[63] ICI Letter III, *supra* note 14, at 3–7, 10. As discussed in the text above, the amended rule would not address political and foreign exchange considerations.

[64] ICI Letter III, *supra* note 14, at 6–7, 10.

[65] *Id.* at 3–8 (commenting on the Custodian Group's recommendations). *See supra* 49 and 55 notes and accompanying text (regarding the approach of the amended rule).

[66] Custodian Letter I, *supra* note 14, at 3–7.

[67] *Id.* at 7.

[68] *Id.*

[69] This approach, however, may have potential drawbacks in connection with boards selecting different delegates to evaluate different aspects of the fund's arrangements. *See supra* note 35 and *infra* note 70 and accompanying text.

[70] *See* Custodian Letter I, *supra* note 14, at 4–5, 6–7 and Custodian Letter II, *supra* note 14, at 11–12 (indicating that, once a fund invests in a country with a compulsory depository, the fund's custodian (or any foreign bank custodian in that country) has no choice but to use the compulsory depository). The current rule does not distinguish between compulsory depositories and other foreign custodians or associate the use of any specific foreign custodian with the decision to maintain assets in a particular country.

[71] Proposed rule 17f–5(a)(1) and (a)(1)(iv). *See also* proposed rule 17f–5(a)(2)(i)–(iii), discussed *infra* notes 80–91 and accompanying text. The Commission recognizes that, conceptually, the decision to use a compulsory depository appears to fall within the scope of the rule's provisions governing the selection of foreign custodians (discussed in the text below). The Commission also recognizes that a significant number of foreign depositories may be considered compulsory depositories. Consequently, requiring compulsory depositories to be evaluated in connection with a country's prevailing custodial risks could mean that the majority of depository decisions will not be made by the delegate selecting the fund's other foreign custodians.

[72] Proposed rule 17f–5(d)(4). *See also* proposed rule 17f–2(d)(3)(iv) (defining an eligible foreign custodian to include a compulsory depository). The proposed definition should be construed narrowly. If maintaining assets in a depository or with a foreign bank custodian are feasible alternatives, the Commission believes the decision to use a depository should be made in connection with the custodian selection process. See ''Selecting Foreign Custodians'' below.

[73] *See* ICI Letter III, *supra* note 14, at 10 (Exhibit A); Custodian Letter I, *supra* note 14, at 13 (Exhibit A) (suggesting that a depository should be considered to be compulsory if securities held outside the depository cannot be traded or transferred in accordance with routine clearance and settlement practices).

[74] When different delegates evaluate country-wide and foreign custodian risks and disagree on whether using a depository is compulsory, the depository's status may have to be determined by the board.

[75] *See* Custodian Letter II, *supra* note 14, at 14–15 (discussing these considerations).

[76] *See* ICI Letter III, *supra* note 14, at 10 (recommending that evaluations of compulsory depositories be part of the custodian selection process); Custodian Letter I, supra note 14, at 4–5, 6–7 (consistent with proposed approach).

[77] Any custodian selected by the delegate would have to be an ''eligible foreign custodian'' as defined in proposed rule 17f–5(d)(3). *See* ''Eligible Foreign Custodians'' below.

[78] Proposed rule 17f–5(a)(2). *See also* ICI Letter III, *supra* note 14, at 5 (Exhibit A); Custodian Letter I, *supra* note 14, at 7 (Exhibit A) (recommending that U.S. bank delegates be required to represent to the board that a foreign custodian's internal controls or established procedures are adequate to provide reasonable protection for fund assets).

The proposed approach would be consistent with that governing country-wide custodial risks evaluations. Like the current rule, the proposed finding of reasonable protection would have to be made prior to placing the fund's assets with the foreign custodian.

[79] Proposed rule 17f–5(a)(2). *See* ''Custody in Foreign Countries'' above.

[80] Proposed rule 17f–5(a)(2) (i) through (iii). As indicated in the text accompanying note 71 *supra*, proposed rule 17f–5(a)(1) would require delegates that evaluate the protection afforded fund assets held by a compulsory depository to consider the factors set forth in rule 17f–5(a)(2) (i) through (iii) governing the selection of foreign custodians.

derived from the Notes to the current rule.[81]

The Notes to rule 17f–5 address a foreign custodian's financial strength, its general reputation and standing in the country, and its ability to provide efficiently the custodial services required and the relative costs of those services.[82]

In addition to a custodian's financial strength,[83] the amended rule would address a custodian's reputation and standing generally, rather than in the country where the custodian is located.[84] A custodian's reputation and standing outside of its own country may be relevant, especially in the case of multi-national banks. By no longer tying consideration of a custodian's reputation and standing to the country where the custodian is located, the amended rule seeks to provide delegates with greater flexibility to evaluate a custodian's reputation based on the facts and circumstances relevant to the particular custodian. The amended provision also would require, in the case of a securities depository, consideration of the depository's operating history and number of participants.[85]

In addition, the amended provision would no longer address a custodian's efficiency and relative costs. Weighing a custodian's efficiency against the costs of its services does not appear to be particularly germane to the safety of fund assets in the hands of that custodian. Although these matters would not be addressed under the amended rule, the delegate may appropriately consider custodial efficiency and costs in selecting a foreign custodian.

The Notes to rule 17f–5 also state that the fund's board should consider whether a foreign custodian will provide a level of safeguards not materially different from those of the fund's U.S. custodian.[86] The Commission believes that foreign custodian arrangements, although different from U.S. arrangements, nonetheless may provide reasonable and effective safeguards for fund assets.[87] Accordingly, the amended rule would focus on whether a foreign custodian would provide reasonable protection for fund assets, and would specifically require the delegate to consider the custodian's practices, procedures, and internal controls in making this determination.[88]

The protections provided by custodians within a foreign country may vary widely. Thus, one custodian's practices and internal controls may provide reasonable protections, while those of other custodians may not. In addition, although the rule would not require parity between foreign and U.S. custodian arrangements, reference to U.S. standards may be relevant in determining whether a foreign custodian's practices and internal controls will reasonably protect fund assets.

Finally, the amended rule would require the delegate to assess the likelihood of U.S. jurisdiction over and enforcement of judgments against a foreign custodian.[89] The proposed requirement would broaden the Notes to the current rule, which address whether a foreign custodian has any branch offices in the United States.[90] Under the proposed approach, in addition to considering domestic branches, the delegate could take into account other jurisdictional and enforcement means, such as whether a foreign custodian has appointed an agent for service of process in the United States or consented to U.S. jurisdiction.[91]

The Commission requests comment on the proposed approach and the factors that delegates would be required to consider in selecting foreign custodians.

4. Foreign Custody Contracts

a. Proposed Approach

Rule 17f–5 currently requires the fund's foreign custody arrangements to be governed by a written contract that has been approved by the board.[92] The current rule also enumerates specific provisions that must be included in the contract. The contract generally must provide that: (A) The fund will be indemnified and its assets insured in the event of loss; (B) the fund's assets will not be subject to liens or other claims in favor of the foreign custodian or its creditors; (C) the fund's assets will be freely transferable without the payment of money; (D) records will be kept identifying the fund's assets as belonging to the fund; (E) the fund's independent public accountants will be given access to those records or confirmation of the contents of those records; and (F) the fund will receive periodic reports, including notification of any transfers to or from the fund's account.[93]

The amended rule would retain the requirement of a written foreign custody contract, but would not enumerate specific provisions that must be included in the contract.[94] In proposing this approach, the Commission does not intend to imply that the contract provisions required under the current rule are not important. Rather, the Commission believes that funds should be able to establish contractual arrangements that reflect the particular circumstances presented. Contract provisions other than those currently required may be important in any given foreign market or for a specific foreign custodian. In addition, certain practical problems and interpretive questions have arisen regarding the current contract requirements.[95] As custody practices change, similar issues may

[81] *See* rule 17f–5, Notes 2(a)–(d).

[82] Rule 17f–5, Note 2(a).

[83] In evaluating a custodian's financial strength, the delegate, for example, may consider capitalization, financial history, and any other lines of business undertaken by the custodian and the potential effects of such businesses on the custodian's financial condition and operations.

[84] Proposed rule 17f–5(a)(2)(i).

[85] These matters currently are addressed as a separate Note under rule 17f–5. Rule 17f–5, Note 2(d). Although certain matters (*i.e.*, operating history and number of participants) would specifically apply to depositories, all of the factors set forth in proposed rule 17f–5(a)(2) (i) through (iii) would have to be considered when selecting foreign depositories.

The Custodian Group indicated that information concerning certain depositories may be difficult or impossible to obtain. The ICI and the Custodian Group recommended that the rule address this problem by requiring consideration of a depository's operating history if such information is ''reasonably obtainable.'' ICI Letter III, *supra* note 14, at 2–3 (Exhibit A); Custodian Letter I, *supra* note 14, at 14–16 and at 4 (Exhibit A).

The extent (or absence) of information about a foreign depository may be relevant in determining whether the depository will provide reasonable protection for fund assets. For example, the lack of available information about a depository's operating history may militate against the depository's use. Consequently, the amended rule would not make an exception when information about a depository is not available.

[86] Rule 17f–5, Note 2(b).

[87] *See* Custodian Letter II, *supra* note 14, at 3–6.

[88] Proposed rule 17f–5(a)(2)(ii). *See* ICI Letter III, *supra* note 14, at 2 (Exhibit A); Custodian Letter I, *supra* note 14, at 9–11 and at 4 (Exhibit A) (recommending that the rule focus on the protections provided by foreign custodians rather than the equivalency of those protections to U.S. standards).

When different delegates evaluate country-wide and foreign custodian risks, the delegates may come to different determinations, which are attributable to the different assessments involved. *See* text accompanying note 55 *supra* (regarding evaluations of a country's prevailing custodial risks).

[89] Proposed rule 17f–5(a)(2)(iii).

[90] *See* rule 17f–5, Note 2(c).

[91] The Commission recognizes that U.S. jurisdiction may not be obtainable over certain foreign depositories. As with the other factors under the amended rule, an affirmative finding of U.S. jurisdiction would not be required. Rather, the absence of U.S. jurisdiction would have to be considered in making the overall determination that using the custodian will provide reasonable protection for fund assets.

[92] Rule 17f–5(a)(1)(iii).

[93] Rule 17f–5(a)(1)(iii)(A)–(F).

[94] Proposed rule 17f–5(a)(3).

[95] *See* ''Request for Comment on Specific Contract Provisions'' below.

arise in the future that could delay or preclude certain arrangements.

The amended rule would require a finding that the foreign custody contract will provide reasonable protection for the fund's assets based on all factors relevant to the safekeeping of such assets. Determining whether a contract provides such protection typically would involve consideration of the contract provisions required under the current rule as well as those customarily provided by U.S. custodians and other foreign custodians operating in the country.[96]

In addition, the Commission understands that funds often contract with their primary custodians for foreign custody services; the primary custodian, in turn, enters into separate contracts with the fund's foreign bank custodians. When the fund's contractual relationship with a foreign custodian is indirect, the delegate should consider the fund's rights vis-a-vis both the contracting intermediary custodian and the foreign custodian that holds the fund's assets. The delegate, for example, should consider whether the intermediary custodian has agreed in its contract with the fund to obtain indemnification or other contractual protections from the foreign custodian. The delegate also should consider, among other things, whether the fund would be able to assert claims directly against the foreign custodian in the event of loss.[97]

The Commission also understands that depository arrangements typically are not governed by contract.[98] In addition, a foreign depository's services often are not provided directly to the fund or its primary custodian.[99] Depository services typically are provided through foreign banks that have an established relationship with the depository.[100] The amended rule, like the current rule, would not require foreign depositories to be parties to the fund's foreign custody contract.[101] Instead, the delegate should consider the responsibilities of the bank custodian interacting with the depository, along with the rights of the fund in relation to both the intermediary custodian and depository.

The Commission requests comment on the proposed approach. The Commission requests specific comment whether the amended rule should require specific contract provisions. In particular, would the proposed approach facilitate the use of foreign custody arrangements or create difficulties in obtaining important contractual protections from foreign custodians? For example, codifying specific contract requirements may offer certain advantages to fund shareholders by removing these protections from the items that could be subject to negotiation. The Commission also requests comment whether the amended rule should include specific factors (such as those discussed above) that delegates would have to consider in evaluating the protections provided by a contract.[102]

b. Request for Comment on Specific Contract Provisions

The ICI and the Custodian Group recommended retaining the rule's current contract requirements, with certain modifications.[103] The Commission requests comment on the current provisions and the related recommendations of the ICI and the Custodian Group. In addition, the Custodian Group indicated that the rule's current contract requirements have become industry standards for custodial arrangements involving foreign banks.[104] The Commission requests specific comment whether this is the case.

The ICI and the Custodian Group recommended modifying the current requirement prohibiting liens on the fund's assets.[105] The ICI and the Custodian Group indicated that this requirement should not apply to cash, since, in most jurisdictions, cash may become subject to creditors' claims if a custodian becomes bankrupt.[106]

The ICI and the Custodian Group also recommended modifying the current recordkeeping requirement to specifically recognize the permissibility of ''omnibus accounts.'' [107] These accounts contain the assets of more than one custodial customer, and are established by intermediary custodians with foreign banks and securities depositories.[108] In an omnibus account structure, the intermediary, which is reflected on the foreign custodian's books as the record owner of the assets, is responsible for maintaining records that identify each of its customer's assets.[109]

The ICI and the Custodian Group disagreed on how the rule should address indemnification and insurance.[110] The ICI recommended

[96] The proposed approach would not require a finding that the foreign custody contract provides protections equivalent to U.S. safeguards or that the contract addresses every possible contingency for loss of the fund's assets. Rather, the amended rule would focus on whether the contract would provide reasonable protection for the fund's assets.

[97] *See, e.g.*, Citibank, N.A., Investment Company Act Release Nos. 18710 (May 15, 1992), 57 FR 21835 (Notice of Application) and 18782 (June 12, 1992), 51 SEC Docket 1533 (Order) (contract between the intermediary U.S. custodian and the foreign custodian gives the fund the right to enforce the agreement directly against the foreign custodian).

[98] See Custodian Letter II, *supra* note 14, at 6–8. The ICI and the Custodian Group recommended that any required contract provisions should not apply to depositories. ICI Letter III, *supra* note 14, at 3–5 (Exhibit A); Custodian Letter I, *supra* note 14, at 11–12. The ICI and the Custodian Group recommended requiring the rules or established practices of a depository to provide specific safeguards relating to the free transferability of the fund's assets, the keeping of adequate records, and periodic reporting and notification of asset transfers. ICI Letter III, *supra* note 14, at 3–5 (Exhibit A); Custodian Letter I, *supra* note 14, at 12.

[99] *See* Custodian Letter I, *supra* note 14, at 11–12.

[100] *Id.* (indicating that, from the fund's perspective, a depository typically will be a custodian for a foreign bank custodian, which is itself a subcustodian of the fund's U.S. custodian). *See* also Custodian Letter II, *supra* note 14, at 6–8.

[101] *See* Investment Company Institute 2–3 (pub. avail. Nov. 4, 1987) (hereinafter 1987 Division Letter).

[102] Including specific factors does not appear to be necessary since the Commission understands that foreign custody contracts incorporating important contractual protections are a matter of standard industry practice. *See, e.g.*, Custodian Letter I, discussed *infra* note 103.

[103] ICI Letter I, *supra* note 14, at 5 (indicating that it is appropriate for the rule to require certain essential contract provisions); Custodian Letter I, *supra* note 14, at 11. The ICI and the Custodian Group recommended that the contract requirements apply only to foreign bank custodians. See *supra note* (regarding the ICI and the Custodian Group's recommendations for depository arrangements).

[104] *See* Custodian Letter I, *supra* note 14, at 11

[105] ICI Letter III, *supra* note 14, at 12; Custodian Letter I, *supra* note 14, at 21–22. *See* rule 17f–5(a)(1)(iii)(B).

[106] ICI Letter III, *supra* note 14, at 12; Custodian Letter I, *supra* note 14, at 21–22.

[107] ICI Letter III, *supra* note 14, at 3–4 (Exhibit A); Custodian Letter I, *supra* note 14, at 22–23. See rule 17f–5(a)(1)(iii)(D).

[108] Custodian Letter I, *supra* note 14, at 22–23. The ICI and the Custodian Group also recommended specifically recognizing the role of U.S. intermediary custodians in connection with the current provisions relating to indemnification and insurance, access to the foreign custodian's books, and periodic reporting. ICI Letter III, supra note , at 3–4 (Exhibit A); Custodian Letter III, *supra* note 14, at 5–6 (Exhibit A). This approach may help clarify the rule's requirements, although it does not appear to be necessary.

[109] Although the recommended change may help clarify the rule's requirements, it is not necessary. The current rule does not prescribe a specific manner for keeping custody records. *See* also State Street Bank and Trust Company (pub. avail. Feb. 28, 1995) (regarding the permissibility of omnibus accounts).

[110] By its terms, rule 17f–5 requires foreign custody contracts to provide that the fund will be indemnified *and* its assets insured in the event of loss. Rule 17f–5(a)(1)(iii)(A). Consistent with a prior Division no-action position, the ICI and the Custodian Group recommended requiring either indemnification or insurance. ICI Letter III, *supra* note 14, at 5 (Exhibit A); Custodian Letter III, *supra* note 14, at 4 (Exhibit B). *See also* 1987 Division Letter, *supra* note 101, at 2–3. The ICI and the Custodian Group also recommended requiring fund assets to be protected for losses resulting from a foreign custodian's failure to use reasonable care. ICI Letter III, *supra* note 14, at 5 (Exhibit A);

Continued

that, instead of requiring indemnification or insurance as a contract provision, the rule require the fund's U.S. custodian (acting as the delegate responsible for the foreign custody contract) to represent that the fund's overall contractual arrangements provide indemnification or insurance protections.[111] The ICI indicated that, under its approach, indemnification or insurance protections could appear either in the fund's contract with its U.S. custodian or in the contract between the U.S. custodian and the foreign custodian.[112] The Custodian Group objected to the ICI's approach, arguing that it would make custodian delegates responsible for indemnifying or insuring depository arrangements.[113]

5. Monitoring Custody Arrangements and Withdrawing Assets From Custodians

The amended rule would require the delegate to monitor the continuing appropriateness of the custody of the fund's assets in a country, with a particular custodian, and under the foreign custody contract.[114] This requirement seeks to address the possibility that the fund's arrangements, although consistent with the amended rule's requirements when initially entered into, may later fail to provide reasonable protection for fund assets.[115] The proposed monitoring requirement would involve establishing a means of receiving sufficient and timely information to respond to material changes.[116] Determining appropriate monitoring procedures would depend on the facts and circumstances involved. For example, custodial practices in certain countries or used by certain custodians may require frequent monitoring, while other arrangements require significantly less oversight.[117]

If an arrangement no longer meets the requirements of the amended rule, the fund would have to withdraw its assets from the country or custodian as soon as reasonably practicable. The current rule requires a fund in these circumstances to withdraw its assets from a foreign custodian as soon as reasonably practical, but specifies that, in any event, assets withdrawals must be made within 180 days.[118] The amended rule would eliminate the 180 day provision and focus instead on the importance of taking prompt action based on the circumstances presented. For example, a fund that invests its assets primarily in a single country may require more time to withdraw those assets than a fund that has placed only a small percentage of its assets with a particular custodian or in a particular country.

The Commission requests comment on the proposed monitoring requirement. The Commission requests specific comment whether the amended rule should require asset withdrawals to be effected within a specific time period.[119] Commenters favoring this approach should indicate what the time period should be and whether a period of less than 180 days (*e.g.*, 90 days) would be appropriate. The Commission also requests comment whether, as an alternative or in addition to providing a specific grace period, the rule should require the use of interim arrangements, such as insurance or third-party indemnification agreements, to protect against possible loss of fund assets until alternative arrangements can be made.

C. Eligible Foreign Custodians

1. Banks and Trust Companies

a. Proposed Approach

The amended rule would define an ''eligible foreign custodian'' as foreign banks and trust companies that are subject to foreign bank or trust company regulation.[120] An eligible foreign custodian also would include majority-owned foreign subsidiaries of a qualified U.S. bank or a U.S. bank holding company.[121] The amended rule would not subject foreign bank and trust custodians to specific capital requirements.[122] The amended rule, however, would prohibit foreign bank and trust custodians from being affiliated persons of the fund or affiliated persons of such persons.[123]

Rule 17f–5 currently limits the class of eligible fund custodians to foreign banks and trust companies that have more than $200 million in shareholders' equity and majority-owned foreign subsidiaries of qualified U.S. banks or bank-holding companies that have more than $100 million in shareholders' equity.[124] Although this approach seeks to protect against the risk of loss from a custodian's insolvency,[125] the shareholders' equity requirement has become an inflexible standard that does not address matters, such as credit and market risks, that may affect an institution's financial health.[126]

Custodian Letter III, *supra* note 14, at 4 (Exhibit B). See 1987 Division Letter, *supra* note 14, at 2–3 (indicating that the rule requires indemnification or insurance to cover foreseeable risks of loss).

[111] ICI Letter I, *supra* note 14, at 5 (noting that indemnification provisions often are included in the fund's contract with its U.S. custodian); ICI Letter III, *supra* note 14, at 12 and at 4 (Exhibit A).

[112] ICI Letter III, *supra* note 14, at 12. This approach currently is permitted under rule 17f–5, which does not specify the party that must provide indemnification and insurance protections. *See* rule 17f–5(a)(1)(iii)(A).

[113] Custodian Letter III, *supra* note 14, at 4. The Custodian Group would not require indemnification or insurance with respect to depository arrangements. *Id*. *See also* Custodian Letter II, *supra* note 14, at 6–7 (indicating that depositories often establish compensation funds for losses attributable to the depository).

[114] Proposed rule 17f–5(a)(4). *See* rule 17f–5(a)(2) (requiring a system to monitor the fund's arrangements to ensure compliance with the conditions of the rule).

[115] The amended rule seeks to clarify the scope of the monitoring requirement by tying monitoring obligations to the reasonable protection findings required to be made in establishing foreign custody arrangements. *See* ICI Letter III, *supra* note 14, at 6 (Exhibit A); Custodian Letter I, *supra* note 14, at 17 (recommending that monitoring responsibilities relate to specific representations that would have to be made when custody arrangements are entered into).

[116] *See* 1984 Reproposing Release, *supra* note 8, at 2910 (consistent with the proposed approach). *See also* 1987 Division Letter, *supra* note 101, at 4 n.5 (indicating that, under the current rule, the board generally may rely on the fund's U.S. custodian or another third-party expert to oversee the fund's arrangements so long as the expert agrees to notify the board of any material changes, and that the board is not required to review periodic reports in the absence of a material change).

[117] The ICI and the Custodian Group recommended allowing delegates to satisfy their monitoring obligations by periodically, but no less frequently than annually, reviewing a foreign custodian's financial position and internal controls. ICI Letter III, *supra* note 14, at 6 (Exhibit A); Custodian Letter I, *supra* note 14, at 17 (also indicating that, in a formal sense, the board or a custodian delegate could not be expected to monitor continuously a foreign custodian's financial position and internal controls).

[118] Rule 17f–5(a)(4). *See generally* 1985 Release Proposing Amendments, *supra* note 8, at 24541 (proposing a 90-day grace period); 1985 Release Adopting Amendments, *supra* note 8, at 37655 (adopting a 180-day grace period to provide sufficient time for funds to negotiate alternative arrangements).

[119] *See* ICI Letter III, *supra* note 14, at 6 (Exhibit A); Custodian Letter I, *supra* note 14, at 8 (Exhibit A) (incorporating the 180-day grace period of the current rule).

[120] Proposed rule 17f–5(d)(3)(i).

[121] A ''qualified U.S. bank'' would be defined in proposed rule 17f–5(d)(5). Under current rule 17f–5, the definition of a qualified U.S. bank mirrors the definition of ''bank'' in section 2(a)(5), except that it requires certain banks and trust companies that receive deposits or exercise fiduciary powers and that are subject to state or federal regulation *to be organized under state or federal law*. *See* 15 U.S.C. 2(a)(5)(C) and rule 17f–5(c)(3)(iii). Proposed rule 17f–5(d)(5) would not change this definition.

[122] The Commission previously considered using this approach. *See* 1982 Proposing Release, *supra* note 3, at 16347.

[123] *See* section 2(a)(3), 15 U.S.C. 80a–2(a)(3) (defining affiliated person).

[124] Rule 17f–5(c)(2) (i) and (ii).

[125] *See* John Downes & Jordan Elliot Goodman, Dictionary of Finance and Investment Terms 377 (2d ed. 1987) (defining shareholders' equity as total assets minus total liabilities of a corporation). *Cf.* 1984 Reproposing Release, *supra* note 8, at 2907 (indicating that the rule's capital requirements seek to address disparities in the protections provided by various foreign regulatory systems).

[126] The shareholders' equity requirement has been the subject of several no-action letters and a number of exemptive orders. *See infra* notes 128, 142, and 144 and accompanying text.

Shareholders' equity also does not provide a uniform assessment of financial strength, since it may be calculated differently depending both on the country where the institution is organized and the institution's accounting practices.[127]

In addition, the shareholders' equity requirement may limit unnecessarily the class of eligible foreign custodians. Certain highly capitalized custodians, such as national banks that maintain substantial government-funded reserves to satisfy their liabilities, do not have shareholders' equity.[128] In addition, in certain emerging and smaller markets, very few or no foreign custodians have sufficient shareholders' equity to meet the $100 million and $200 million standards.[129]

In proposing to eliminate specific capital requirements, the Commission does not intend to imply that a custodian's financial strength is not important to the custodian's ability to serve a fund.[130] The amended rule would require the board's delegate to determine that foreign custodians will provide reasonable protection for the fund's assets based on, among other things, a custodian's financial strength.[131] This approach should sufficiently address the adequacy of a custodian's capital, without imposing specific capital requirements.

The Commission requests comment on the proposed approach. The Commission requests specific comment whether the current shareholders' equity requirement should be retained, with higher or lower standards.[132] For example, the ICI and the Custodian Group recommended lowering the current $100 million and $200 million standards to expand the class of eligible foreign custodians in emerging and smaller markets.[133] In particular, they recommended that a custodian with more than $25 million in shareholders' equity should be eligible to hold fund assets, if it is one of the five largest banks in the country.[134] The Custodian Group indicated that this approach should not present significant risks, given the limited amount of assets likely to be maintained in smaller markets and the other protections of the rule.[135]

The Commission also requests comment whether any additional entities, such as foreign broker-dealers, should be permitted to serve as custodians.[136] Commenters addressing this issue should consider the circumstances under which additional types of entities should be permitted to hold fund assets. For example, should these entities be subject to capital or other special requirements?[137]

Finally, the Commission requests comment on prohibiting affiliated foreign custody arrangements. Custody by fund affiliates raises special investor protection concerns. To guard against potential abuses resulting from control over fund assets by related persons, rule 17f–2 under the Act, the Commission rule applicable to funds that retain custody of their own assets, has been applied to affiliated custody arrangements.[138]

The Commission is aware of only one existing affiliated foreign custody arrangement, and believes that other such arrangements may be best addressed on a case-by-case basis.[139] The Commission recognizes, however, that affiliated arrangements may become more prevalent as global investing and custodian networks continue to grow and as the fund industry continues to consolidate.[140] The Commission, therefore, requests comment whether the proposed prohibition would be unduly restrictive and whether the prohibition should apply only to certain affiliated arrangements, such as when there is a control relationship between the fund's adviser and a foreign custodian.[141] The Commission also requests comment whether there are alternative safeguards that would address the investor protection concerns raised by these arrangements. For example, should fund boards establish and oversee affiliated arrangements without the discretion to delegate this responsibility?

b. Other Alternatives Considered

The Commission considered several other approaches to defining an eligible foreign custodian. These alternatives could be used in lieu of the current shareholders' equity requirement or in conjunction with reduced capital standards. The Commission requests comment on each approach.

The Commission considered using an approach that would focus on a bank or trust company's safekeeping abilities.[142]

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[127] The Commission previously sought to address this problem by proposing that shareholders' equity be calculated according to generally accepted accounting principles. 1985 Release Proposing Amendments, *supra* note 8. The Commission decided to postpone final action on this proposal due to concerns that compliance costs would be excessive. 1985 Release Adopting Amendments, *supra* note 8.

[128] *See* 1984 Adopting Release, *supra* note 8, at 36082. Custodians organized as private banks also may not have shareholders' equity. No-action letters, however, have found the capital of certain private banks to be the equivalent of shareholders' equity. *See* Pictet & Cie (pub. avail. Sept. 8, 1993) (private bank with partners' equity); Union Bank of Norway (pub. avail. Nov. 30, 1992) (private bank found to have the equivalent of paid-in capital and retained earnings).

[129] *See* Custodian Letter I, *supra* note 14, at 18–19.

[130] *See generally Sub-custodian Services Survey,* Euromoney 116 (Jan. 1994) (indicating that U.S. custodians view capitalization and credit rating as the most significant considerations in selecting foreign custodians).

[131] *See* ''Delegation of Board Responsibilities—Selecting Foreign Custodians'' above.

[132] *See* ICI Letter II, *supra* note 14, at 3 (suggesting that the Commission consider whether the current standards are unnecessarily high); Custodian Letter I, *supra* note 14, at 18 (indicating that the shareholders' equity requirement ''has served the Custodian community well in major, established markets'').

[133] ICI Letter III, *supra* note 14, at 7 (Exhibit A); Custodian Letter I, *supra* note 14, at 18–19. *See also* ''Other Alternatives Considered'' below (regarding the ICI's and the Custodian Group's other recommendations).

[134] ICI Letter III, *supra* note 14, at 7 (Exhibit A); Custodian Letter I, *supra* note 14, at 18–19. *See also* 1984 Adopting Release, *supra* note 8, at 36082 (rejecting the use of foreign bank custodians that constitute one of the five largest banks in a country when no bank in that country meets the shareholders' equity requirement).

[135] Custodian Letter I, *supra* note 14, at n.12. The Custodian Group also noted that smaller banks would not become eligible custodians in larger markets, since they would not be one of the five largest banks in the country. *Id.* at 19.

[136] When a foreign entity acts as both a bank and broker-dealer, it would meet the definition of an eligible foreign custodian if the division or part of the entity that has custody of fund assets is regulated under foreign law as a banking institution. *See generally* 1984 Reproposing Release, *supra* note 8, at 2907–08 (not allowing foreign broker-dealers to serve as custodians since funds had not expressed an interest in these arrangements). *See also* Canada Trustco Mortgage Company (pub. avail. Dec. 29, 1989) (loan company with wholly-owned trust subsidiary deemed to be an eligible foreign custodian).

[137] Broker-dealers, for example, could be required to be subject to foreign regulatory requirements relating to their financial responsibility and the segregation and handling of customer securities. *See, e.g.,* rule 206(4)–2(b) under the Investment Advisers Act of 1940, 17 CFR 275.206(4)–2(b). *See also* rule 17f–1 under the Act.

[138] *See, e.g.,* Pegasus Income and Capital Fund, Inc. (pub. avail. Dec. 1, 1977) (custody by U.S. adviser-bank). Rule 17f–2 appears to be unworkable in the foreign custody context because the rule requires, among other things, fund assets to be maintained in a bank that is subject to state or federal regulation; the fund's assets also must be subject to Commission inspection and verified by an independent public accountant. Rule 17f–2(b), (d), and (e). *See* 1984 Reproposing Release, *supra* note 8, at 2907–08.

The Division currently is reviewing rule 17f–2, and may recommend in the future that the Commission propose certain changes in the rule's requirements.

[139] Dean Witter World Wide Investment Trust (pub. avail. Mar. 14, 1988) (affiliation between the fund's sub-adviser and primary custodian deemed sufficiently remote so as not to require the protections of rule 17f–2).

[140] *See* John Waggoner, *Urge to Merge Hits Mutual Funds,* USA Today, Feb. 8, 1995, at 1B. *See also* Timothy L. O'Brien and Steven Lipin, *In the Latest Round of Banking Mergers, Even Big Institutions Become Targets,* Wall St. J., July 14, 1995, at A3.

[141] *See* section 2(a)(3)(C) of the Act.

[142] *See* Permanent Trustee Company Limited, Investment Company Act Release Nos. 17833 (Oct.

Continued

Under this approach, a bank or trust company would be an eligible foreign custodian if it had maintained custody of a substantial amount of assets (*e.g.*, $500 million) over a specified period of time (*e.g.*, the past five years) and had not incurred any material loss of custodial assets during that period. Commenters addressing this alternative should discuss the criteria that should be used to establish a custodian's safekeeping abilities and the feasibility of monitoring compliance with such criteria.[143]

The ICI and the Custodian Group recommended using an approach based on prior exemptive orders.[144] Under this alternative, a foreign bank or trust company would not have to satisfy a shareholders' equity requirement if (i) the bank or trust company is a subsidiary of the fund's primary custodian; (ii) the primary custodian meets certain capital requirements; and (iii) the primary custodian assumes financial responsibility for the bank or trust custodian's use.[145] The Commission requests commenters addressing this alternative to consider the appropriateness of allowing U.S. and foreign banks to serve as both assurance-providers and delegates for foreign custodian selection.[146] The Commission also requests commenters to consider whether assurance arrangements should be limited to parent custodians and their foreign subsidiaries.[147]

In addition, the ICI recommended that the Commission consider using an investment grade rating from a nationally recognized statistical rating agency as a means of determining a foreign bank's eligibility to serve as a fund custodian.[148] The ICI also recommended that the Commission consider using international capital standards, such as those approved by the Basle Committee on Banking Regulations and Supervisory Practices (the ''Basle Accord'').[149]

2. Non-Compulsory Depositories and Transnational Systems [150]

Under the amended rule, an eligible foreign custodian would include a securities depository or clearing agency that operates a system for the central handling of securities or equivalent book-entries that is regulated by a ''foreign financial regulatory authority,'' which would include a foreign government, an agency thereof, or a foreign self-regulatory organization.[151] An eligible foreign custodian also would include a depository or clearing agency that operates a transnational system for the central handling of securities or equivalent book-entries.[152]

Rule 17f–5 currently requires depositories and clearing agencies that are not transnational systems to operate the only system for the handling of securities in a country.[153] This requirement seeks to ensure a country's interest in establishing and maintaining a depository's integrity.[154] The Commission believes, however, that the current provision, which has been the subject of a number of no-action positions, is overly restrictive.[155] With the increased immobilization and dematerialization of securities, the Commission believes that rule 17f–5 should not constrain the use of depository arrangements.[156]

The amended rule would address a country's interest in a depository by requiring the depository to be subject to foreign regulation by the government, an agency thereof, or a self-regulatory organization. The amended rule also would require, among other things, consideration of the depository's operating history and number of participants and whether the depository will provide reasonable protection for the fund's assets.[157] This approach should sufficiently address a depository's custodial integrity, while giving funds the flexibility to use a depository that may not operate an exclusive book-entry system.

The Commission requests comment on the proposed approach. The Commission requests specific comment on requiring regulatory oversight of depository arrangements and on permitting such oversight to be conducted by self-regulatory organizations.[158] The Commission also

31, 1990), 55 FR 46749 (Notice of Application) and 17888 (Nov. 30, 1990), 47 SEC Docket 1627 (Order) (granting exemptive relief from the shareholders' equity requirement based on the applicant's established record as a custodian and certain other factors).

[143] In some foreign countries, for example, the amount of assets in a custodian's safekeeping may be considered proprietary information that would not be available to delegates.

[144] *See, e.g.*, Chase Manhattan Bank, Investment Company Act Release Nos. 18025 (Mar. 4, 1991), 56 FR 10451 (Notice of Application) and 18077 (Apr. 2, 1991), 48 SEC Docket 864 (Order).

[145] ICI Letter III, *supra* note 14, at 8–10 (Exhibit A); Custodian Letter I, *supra* note 14, at 20 and at 10–12 (Exhibit A) (the primary custodian would have to be either a U.S. bank with more than $100 million in shareholders' equity or a foreign bank or trust company with more than $200 million in shareholder's equity; in addition, the primary custodian would have to assume responsibility for any loss arising from the arrangement (including losses attributable to the foreign custodian's bankruptcy or insolvency) to the same extent as if the primary custodian had itself performed the custody services). *See also supra* note 24.

[146] For example, banks serving as both assurance-provider and the board's delegate may be inclined to disregard custodial problems in hopes of delaying or avoiding their indemnification responsibilities. On the other hand, banks serving in both capacities may be more vigilant in establishing and overseeing foreign custody arrangements, since they would be liable for losses associated with the foreign custodian's use.

[147] *See* State Street Bank and Trust Company, Investment Company Act Release Nos. 20519 (Aug. 31, 1994), 59 FR 46463 (Notice of Application) and 20583 (Sept. 27, 1994), 57 SEC Docket 2091 (Order) (custodian providing assurances was not the foreign custodian's parent). *See also* Bank van Haften Labouchere N.V., Investment Company Act Release Nos. 19073 (Nov. 2, 1992), 57 FR 53531 (Notice of Application) and 19135 (Dec. 1, 1992), 52 SEC Docket 2892 (Order) (assurances provided by a foreign company that was not an eligible foreign custodian since it was primarily engaged in the insurance business).

[148] ICI Letter II, *supra* 14, at 3. *See also* Nationally Recognized Statistical Rating Organizations, Securities Act Release No. 7085 (Aug. 31, 1994), 59 FR 46314 (requesting comment on the role of ratings generally in the federal securities laws).

[149] ICI Letter II, *supra* 14, at 3. In general, the Basle Accord seeks to establish minimum standards of capital adequacy for internationally active banks through a ratio that measures an institution's capital in relation to credit risk. *See* Basle Committee on Banking Regulations and Supervisory Practices, International Convergence of Capital Measurement and Capital Standards, Fed. Banking L. Rep. (CCH) ¶ 5403 at 3309 (amended Nov. 6, 1991).

[150] *See also* ''Custody in Foreign Countries—Compulsory Depositories'' above.

[151] Proposed rule 17f–5(d)(3)(ii) (using the definition of foreign financial regulatory authority in section 3(a)(52) of the Securities Act of 1934 [15 U.S.C. 78c(a)(52)). *See* 1984 Reproposing Release, *supra* note 8, at 2908 n.31 (noting that securities depositories may be denominated clearing agencies in some countries).

[152] Proposed rule 17f–5(d)(3)(iii). *See* rule 17f–5(c)(iv) (consistent with the proposed approach).

[153] Rule 17f–5(c)(2)(iii).

[154] *See* 1984 Reproposing Release, *supra* note 8, at 2908.

[155] *See, e.g.*, 1987 Division Letter, *supra note* 101, at 3 (taking a no-action position with respect to certain groups of depositories that are integrated and effectively function as one system within a country); Custody of B Shares Trading on the Shenzhen and Shanghai Securities Exchanges (pub. avail. Apr. 26, 1993) (no-action position with respect to depositories that operate the central system for a particular issue and class of securities). *See generally* Templeton Russia Fund, *supra* note 60 (addressing the unique custodial and settlement arrangements in Russia). *See also* ICI Letter III, *supra* note 14, at 10 (Exhibit A); Custodian Letter I, *supra* note 14, at 21 and at 12–13 (Exhibit A) (recommending expanding the class of eligible foreign depositories by codifying prior no-action positions).

[156] Securities are immobilized by storing stock certificates or other indicia of securities ownership with the depository. Securities are dematerialized by dispensing with physical evidence of securities ownership. Group of Thirty Report, *supra* note 20, at 55–56. *See also* Custodian Letter I, *supra* note 14, at 14 (indicating that depositories generally are subject to strict government regulation and provide a high level of safety for fund assets).

[157] *See* ''Delegation of Board Responsibilities—Selecting Foreign Custodians'' above.

[158] *See* 1984 Reproposing Release, *supra* note 8, at 2908 (not requiring depositories to be regulated by foreign governments or agencies thereof since several principal depositories would not meet the requirement).

requests comment whether transnational depositories should be required to be subject to similar or other requirements.[159]

D. Assets Maintained in Foreign Custody

Rule 17f–5 permits funds to use foreign custody arrangements for their foreign securities, cash, and cash equivalents.[160] Rule 17f–5 defines foreign securities to include those that are issued and sold primarily outside the United States by foreign and U.S. issuers.[161] By restricting the types of securities that may be maintained outside the United States, the rule seeks to establish a nexus between its scope and its purpose, *i.e.*, to give funds the flexibility to keep abroad assets that are purchased or intended to be sold abroad.[162] In addition, rule 17f–5 limits the cash and cash equivalents that funds may maintain outside the United States to amounts that are reasonably necessary to effect the fund's foreign securities transactions.[163]

The amended rule would not change these restrictions, although it would simplify the definition of foreign securities by eliminating references to specific types of issuers.[164] The Commission requests comment whether any other changes should be made. In particular, should the amended rule continue to restrict the types of securities and amounts of cash and cash equivalents that may be maintained outside the United States?

E. Canadian and Other Foreign Funds

Rule 17f–5 contains special provisions governing the foreign custody arrangements of registered Canadian funds.[165] To address jurisdictional concerns, these provisions are more restrictive than those applied to U.S. funds.[166] Rule 17f–5 allows Canadian funds to maintain their assets only in overseas branches of qualified U.S. banks.[167] The rule also places responsibility for the fund's foreign custody arrangements on the fund's board of directors.[168]

Canadian investment companies have not sought to register under the Act for some time, and very few Canadian funds currently offer their shares in the United States.[169] Accordingly, the amended rule would make limited changes in the foreign custody requirements applicable to Canadian funds. The amended rule would revise the current ''best interest'' standard for placing fund assets in a particular country and require instead a finding that such custody will provide reasonable protection for the fund's assets.[170] In addition, the amended rule would eliminate the current requirement that the board of a Canadian fund review and approve foreign custody arrangements at least annually. Under the amended rule, the board instead would be required to monitor the continuing appropriateness of the fund's arrangements.[171] If an arrangement no longer meets the rule's requirements, the fund would be required to withdraw its assets from the country or custodian as soon as reasonably practicable.[172]

The Commission requests comment on the proposed approach. The Commission requests specific comment whether the special provisions applicable to Canadian funds should be eliminated. Under this approach, a Canadian fund's foreign custody arrangements could be considered in connection with the fund's registration under the Act. In evaluating proposed arrangements, the Commission would be able to consider any jurisdictional concerns and the requirements of rule 17f–5 applicable to U.S. funds in effect at that time.

Alternatively, should the amended rule allow Canadian funds to use foreign custody arrangements on the same basis as their U.S. counterparts?[173] Commenters favoring this alternative should consider whether any special requirements should be imposed to address jurisdictional concerns. For example, should Canadian funds be required to consent to U.S. jurisdiction or should limits be placed on the amount of a Canadian fund's assets that could be maintained outside the United States?[174]

F. Disclosure of Custody Risks

The Notes to rule 17f–5 currently instruct the fund's board to consider disclosing in the fund's prospectus material risks, if any, associated with the fund's foreign custody arrangements.[175] The amended rule would not address disclosure issues. The Commission believes that these issues are more appropriately addressed by individual funds in considering their disclosure obligations under the Securities Act of 1933.[176]

G. Unit Investment Trusts

Under the Act, unit investment trusts (''UITs'') are required to maintain their assets in the custody of U.S. banks or their foreign branches.[177] UITs generally are not permitted to use the foreign

[159] The Commission understands that there are very few transnational systems, and is not aware of any problems associated with the current transnational provision.

[160] Rule 17f–5(a).

[161] Rule 17f–5(c)(1).

[162] *See* 1984 Reproposing Release, *supra* note 8, at 2907.

[163] Rule 17f–5(a).

[164] Proposed rule 17f–5(a) and (d)(2).

[165] *See* rule 17f–5(b). Section 7(d) of the Act prohibits foreign investment companies from publicly offering their securities in the United States unless the Commission issues an order permitting registration under the Act. 15 U.S.C. 80a–7(d). Rule 7d–1 sets forth conditions governing applications by Canadian funds that seek Commission orders pursuant to section 7(d). 17 CFR 270.7d–1. Among other conditions, rule 7d–1 provides that the assets of Canadian funds are to be held in the United States by a U.S. bank, except as provided under rule 17f–5. Rule 7d–1(b)(8)(v). Although rule 7d–1 by its terms only applies to Canadian funds, funds organized in other jurisdictions generally have agreed to comply with its conditions as a prerequisite to receiving a section 7(d) order. Protecting Investors report, *supra* note 15, at 193 n.23.

[166] *See* 1984 Reproposing Release, *supra* note 8, at 2906–07; 1984 Adopting Release, *supra* note 8, at 36082.

[167] *See* 1984 Adopting Release, *supra* note 8, at 36082 (indicating that, by restricting custody to *overseas* branches of U.S. banks, Canadian funds may not maintain their assets with Canadian branches of U.S. banks).

[168] *See* rule 17f–5(b)(1)–(3).

[169] Protecting Investors report, *supra* note 15, 193 n.23 (noting that, in 1992, only three Canadian funds were active).

[170] *See* ''Standard for Evaluating Foreign Custody Arrangements'' above.

[171] Proposed rule 17f–5(c)(2).

[172] Proposed rule 17f–5(c)(3). *See* ''Delegation of Board Responsibilities—Monitoring Custody Arrangements and Withdrawing Assets from Custodians'' above.

[173] The ICI and the Custodian Group recommended this approach. ICI Letter I, *supra* note 14, at 4 (also recommending that the foreign custody arrangements of any non-Canadian foreign funds continue to be evaluated on a case-by-case basis); Custodian Letter I, *supra* note 14, at 1 (Exhibit A).

[174] In 1991, a South African fund was allowed to rely on rule 17f–5 as if it were a U.S. fund. ASA Limited, Investment Company Release Nos. 17904 (Dec. 17, 1990) 55 FR 52925 (Notice of Application), and 17945 (Jan. 15, 1991), 47 SEC Docket 1535 (Order). Although the fund's custody arrangements were not restricted to foreign branches of U.S. banks, limits were placed on the amount of the fund's assets that could be held overseas. *Id.*

[175] Rule 17f–5, Note 3.

[176] *See, e.g.*, Forms N–1A, 17 CFR 239.15A (the registration form for open-end funds) and N–2, 17 CFR 274.11a–1 (the registration form for closed-end funds). Item 4(c) of Form N–1A and item 8.3.a of Form N–2 require disclosure in the prospectus of the principal risk factors associated with investing in the fund. Item 13(c) of Form N–1A and item 17.3 of Form N–2 require disclosure in the Statement of Additional Information (''SAI'') of the risks inherent in certain significant investment policies, such as investing in foreign securities. Guide 9 to Form N–2 instructs funds with more than 10% of their assets in foreign securities to discuss in the SAI the fund's foreign custody arrangements. *See generally* Templeton Russia Fund, *supra* note 60 (apprising fund investors of certain custodial risks in Russia).

[177] A UIT is a type of fund that issues redeemable securities representing an undivided interest in a portfolio of specified securities. 15 U.S.C. 80a–4(2). *See* Investment Company Act §§ 2(a)(5) (defining bank) and 26(a)(1) (requiring UIT custodians to have at least $500,000 in capital, surplus and undivided profits).

custodians available to funds under rule 17f–5.[178] The foreign custody arrangements of UITs may raise special concerns, since UITs do not have boards of directors to oversee the arrangements.[179]

The Commission requests comment on the appropriateness of a rule that would expand the foreign custody arrangements available to UITs.[180] The Commission requests specific comment on allowing UIT sponsors, custodian banks or other parties to establish and monitor foreign custody arrangements, without independent oversight. The Commission also requests comment whether special protections should attend UIT foreign custody arrangements by, for example, requiring the sponsor, custodian bank, or other party to assume financial responsibility for a foreign custodian's use.[181] Finally, the Commission requests comment whether foreign custody arrangements and the procedures for changing those arrangements should be required to be set forth in UIT trust indentures.

IV. Cost/Benefit Analysis

The amendments would substantially reduce burdens on fund directors and provide funds with greater flexibility to establish and use foreign custody arrangements, consistent with the protection of fund assets. To facilitate evaluations of foreign custody arrangements, the amendments would revise the findings that currently must be made in establishing these arrangements. The amended rule would require findings that foreign custody arrangements will provide reasonable protection for fund assets.

In addition, the amendments would allow fund boards to play a role more consistent with their traditional oversight role in connection with foreign custody arrangements, by permitting boards to delegate their responsibility under the rule to evaluate foreign custody matters. The amendments also would eliminate the current requirement that boards annually approve foreign custody arrangements.

The proposed delegation provisions may impose certain additional costs since delegates would be required to provide fund boards with written reports regarding certain aspects of the arrangements. These costs, however, are not expected to be significant, and are likely to be much less than the costs associated with providing fund boards with information pertaining to their annual review of foreign custody arrangements. In addition, because the reports would facilitate a board's oversight of the delegate's performance, any additional costs associated with the reports would be outweighed by the benefits provided to funds and their shareholders.

The amendments also would expand the class of foreign banks and securities depositories that could serve as fund custodians. Under the amendments, foreign custodians would no longer have to satisfy specific capital standards or other objective requirements. The amended rule instead would require delegates to select foreign custodians based on the custodian's ability to provide reasonable protection for fund assets. While addressing safekeeping considerations, this approach avoids imposing inflexible standards that may unnecessarily limit the use of foreign custodians. In addition, instead of requiring foreign custody contracts to contain specific provisions (as under the current rule), the amendments would require these contracts to reasonably protect fund assets.

V. Summary of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding amendments to rule 17f–5. The analysis notes that the amendments are designed to provide funds with greater flexibility in establishing and using foreign custody arrangements, consistent with the protection of their assets. Cost-benefit information reflected in the ''Cost/Benefit Analysis'' section of this Release also is reflected in the analysis. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Elizabeth R. Krentzman, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 10–6, Washington, DC 20549.

VI. Statutory Authority

The Commission is proposing to amend rule 17f-5 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 6(c), 37(a)].

Text of Proposed Rule Amendments

List of subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

2. By revising § 270.17f-5 to read as follows:

§ 270.17f-5 Custody of investment company assets outside the United States.

(a) A registered management investment company, incorporated or organized under the laws of the United States or of a state, may place and maintain in the care of an Eligible Foreign Custodian the company's Foreign Securities, cash and cash equivalents in amounts reasonably necessary to effect the company's Foreign Securities transactions, *provided that:*

(1) The Foreign Custody Manager shall have determined that custody of the company's assets in a particular country can be maintained in a manner that will provide reasonable protection for the company's assets and that custody of the company's assets with any Compulsory Depository in that country will provide reasonable protection for the company's assets, after considering, in each case, all factors relevant to the safekeeping of such assets, including:

(i) The prevailing practices in the country for the custody of the company's assets;

(ii) Whether the country's laws will affect adversely the safekeeping of the company's assets, such as by restricting:

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[178] Several exemptive orders permit UITs to maintain their assets in certain foreign transnational securities depositories. *See, e.g.*, Merrill Lynch, Pierce, Fenner & Smith, Investment Company Act Release Nos. 15739 (May 14, 1987), 52 FR 19006 (Notice), and 15813 (June 16, 1987), 38 SEC Docket 891 (Order).

[179] UITs do not have corporate-type management structures. Typically, UITs are created by a sponsor or ''depositor'' that accumulates a portfolio of securities and deposits them with a U.S. bank or ''trustee'' under the terms of a trust indenture. A UIT's portfolio generally is unmanaged; thus, UITs do not have investment advisers. A UIT's operations are subject to the terms of the trust indenture, which specifies the ongoing responsibilities of the trustee, the depositor and other third-party service providers. *See generally* Form N–7 for Registration of UITs Under the Securities Act of 1933 and Investment Company Act of 1940, Securities Act Release No. 33–6580 (May 14, 1985), 50 FR 21282.

[180] *See* Letter of Pierre de Saint Phalle, Davis Polk & Wardwell, to Diane C. Blizzard, Assistant Director, SEC (Mar. 14, 1995) (recommending a rule for UIT foreign custody arrangements) (File No. S7–23–95). In addition, certain UITs have sought exemptive relief to use foreign custody arrangements available to management funds. *See* United States Trust Company of New York (*filed July 28, 1992*); Merrill Lynch, Pierce, Fenner & Smith, Inc. (*filed Oct. 27, 1993*) (both seeking exemptive relief from section 26(a)(2)(D) of the Act).

[181] Such financial assurances, for example, could cover the loss of UIT assets attributable to the foreign custodian's failure to exercise reasonable care or bankruptcy or insolvency.

(A) The access of the company's independent public accountants to a custodian's books and records; and

(B) The company's ability to recover its assets in the event of a custodian's bankruptcy or the loss of assets in a custodian's control;

(iii) Whether special arrangements that mitigate the risks of maintaining the company's assets in the country would be used; and

(iv) With respect to any Compulsory Depository, the factors specified in paragraph (a)(2) of this section.

(2) Subject to the decision to place assets in the country and to use any Compulsory Depository in that country under paragraph (a)(1) of this section, the Foreign Custody Manager shall have determined that the foreign custodian will provide reasonable protection for the company's assets, after considering all factors relevant to the safekeeping of such assets, including:

(i) The custodian's financial strength, its general reputation and standing and, additionally, in the case of a securities depository, the depository's operating history and number of participants;

(ii) The custodian's practices, procedures, and internal controls; and

(iii) Whether the company will have jurisdiction over and be able to enforce judgments against the custodian, such as by virtue of the existence of any offices of the custodian in the United States or the custodian's consent to service of process in the United States.

(3) The company's foreign custody arrangements shall be governed by a written contract that the Foreign Custody Manager has determined will provide reasonable protection for the fund's assets, after considering all factors relevant to the safekeeping of such assets.

(4) The Foreign Custody Manager shall have established a system to monitor the appropriateness of maintaining the company's assets in a particular country and using any Compulsory Depository in that country under paragraph (a)(1) of this section, maintaining the company's assets with a particular custodian under paragraph (a)(2) of this section, and the contract governing the company's arrangements under paragraph (a)(3) of this section. If an arrangement no longer meets the requirements of this section, the company shall withdraw its assets from the country or foreign custodian, as the case may be, as soon as reasonably practicable.

(b) The company's board of directors may delegate to the company's investment adviser or officers or to a U.S. bank or to a Qualified Foreign Bank the responsibilities set forth in paragraphs (a)(1), (a)(2), (a)(3), or (a)(4) of this section, *provided that:*

(1) The board shall have determined that it is reasonable to rely on the delegate to perform the delegated responsibilities;

(2) The board shall require the delegate to provide written reports notifying the board of the placement of the company's assets in a country and with a particular custodian (including any Compulsory Depository) and of any material change in the company's arrangements, with such reports to be provided to the board no later than the next regularly scheduled board meeting following such event.

(c) Any management investment company, incorporated or organized under the laws of Canada and registered under the Act pursuant to the conditions of § 270.7d-1, may place and maintain its Foreign Securities, cash and cash equivalents in the care of an overseas branch of a Qualified U.S. Bank, *provided that:*

(1) Prior to placing any assets with such overseas branch, the company's board of directors shall have determined that custody of the assets in the particular country will provide reasonable protection for those assets;

(2) The company's board of directors shall have established a system to monitor such foreign custody arrangements for their continuing appropriateness under this section and to ensure that the amount of cash and cash equivalents maintained in the care of such overseas branch is limited to an amount reasonably necessary to effect the company's Foreign Securities transactions; and

(3) If an arrangement no longer meets the requirements of this section, the company shall withdraw its assets from the country or such overseas branch, as the case may be, as soon as reasonably practicable.

(d) For purposes of this section:

(1) *Foreign Custody Manager* means the company's board of directors or any person serving as the board's delegate under paragraph (b) of this section.

(2) *Foreign Securities* mean securities issued and sold primarily outside the United States.

(3) *Eligible Foreign Custodian* means an entity that is incorporated or organized under the laws of a country other than the United States and that is:

(i) A banking institution or trust company that is regulated as such by the country's government or an agency thereof or a majority-owned direct or indirect subsidiary of a Qualified U.S. Bank or bank-holding company, *provided* that such foreign custodian is not an affiliated person of the company or an affiliated person of such person;

(ii) A securities depository or clearing agency that operates a system for the central handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority as defined under section 3(a)(52) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(52));

(iii) A securities depository or clearing agency that operates a transnational system for the central handling of securities or equivalent book-entries in the country; or

(iv) A Compulsory Depository.

(4) *Compulsory Depository* means an eligible foreign custodian under paragraph (d)(2)(ii) of this section, the use of which is mandatory:

(i) By law or regulation;

(ii) Because securities cannot be withdrawn from the depository; or

(iii) Because maintaining securities outside the depository is not consistent with prevailing custodial practices.

(5) *Qualified U.S. Bank* means an entity that has an aggregate of capital, surplus, and undivided profits of a specified minimum amount, which shall not be less than $500,000, and that is:

(i) A banking institution organized under the laws of the United States;

(ii) A member bank of the Federal Reserve System;

(iii) Any other banking institution or trust company organized under the laws of any state or of the United States, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this section: or

(iv) a receiver, conservator, or other liquidating agent of any institution or firm included in paragraphs (d)(5) (i), (ii), or (iii) of this section.

(6) *Qualified Foreign Bank* means 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.

Dated: July 27, 1995.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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