

eligibility of certain foreign banks and depositories to serve as fund custodians.<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup>

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.<sup>24</sup> 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.<sup>25</sup> 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.<sup>26</sup>

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.<sup>27</sup> 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.<sup>28</sup> 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.<sup>29</sup> 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.<sup>30</sup> 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.<sup>31</sup> The delegate also would have to provide written reports of any material changes in the fund's arrangements.<sup>32</sup> 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

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).

<sup>29</sup> 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).

<sup>30</sup> 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).

<sup>31</sup> Proposed rule 17f-5(b)(2).

<sup>32</sup> *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.

<sup>21</sup> See "Discussion—Eligible Foreign Custodians" below.

<sup>22</sup> See rule 17f-5(a)(1)-(3).

<sup>23</sup> 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).

<sup>24</sup> 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).

<sup>25</sup> 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.

<sup>26</sup> 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.

<sup>27</sup> Proposed rule 17f-5(b)(1).

<sup>28</sup> See generally Custodian Letter II, *supra* note 14, at 2 (indicating that U.S. custodians can provide