

## 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.<sup>48</sup> 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.<sup>49</sup>

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.<sup>50</sup> Making the proposed determination would not require a finding that fund assets could never be lost in a foreign country.<sup>51</sup> 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.<sup>52</sup>

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.<sup>53</sup> 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.<sup>54</sup> 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.<sup>55</sup>

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.<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup>

In addition, the amended rule would permit the delegate to consider any special arrangements that mitigate prevailing custodial risks.<sup>59</sup> 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.<sup>60</sup>

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.<sup>61</sup> 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.<sup>62</sup> 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

<sup>48</sup> See rule 17f-5(a)(1)(i).

<sup>49</sup> 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.

<sup>50</sup> 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.

<sup>51</sup> This approach would be consistent with the current rule.

<sup>52</sup> 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 17f-5(d)(1).

<sup>53</sup> Proposed rule 17f-5(a)(1)(i).

<sup>54</sup> 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.

<sup>55</sup> See "Selecting Foreign Custodians" below.

<sup>56</sup> Proposed rule 17f-5(a)(1)(ii).

<sup>57</sup> See rule 17f-5, Notes 1(a)-(c).

<sup>58</sup> 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.

<sup>59</sup> Proposed rule 17f-5(a)(1)(iii).

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

<sup>61</sup> Rule 17f-5, Notes 1(d)-(e).

<sup>62</sup> 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.