

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depository as a depository the use of which is mandatory (i) by law or regulation, (ii) because securities cannot be withdrawn from the depository, or (iii) because maintaining securities outside the depository is not consistent with prevailing custodial practices.⁷² Part (iii) of the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 Custodians⁷⁷

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

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.

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.