

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.