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.