Shareholders' equity also does not provide a uniform assessment of financial strength, since it may be calculated differently depending both on the country where the institution is organized and the institution's accounting practices.[127]

In addition, the shareholders' equity requirement may limit unnecessarily the class of eligible foreign custodians. Certain highly capitalized custodians, such as national banks that maintain substantial government-funded reserves to satisfy their liabilities, do not have shareholders' equity.[128] In addition, in certain emerging and smaller markets, very few or no foreign custodians have sufficient shareholders' equity to meet the $100 million and $200 million standards.[129]

In proposing to eliminate specific capital requirements, the Commission does not intend to imply that a custodian's financial strength is not important to the custodian's ability to serve a fund.[130] The amended rule would require the board's delegate to determine that foreign custodians will provide reasonable protection for the fund's assets based on, among other things, a custodian's financial strength.[131] This approach should sufficiently address the adequacy of a custodian's capital, without imposing specific capital requirements.

The Commission requests comment on the proposed approach. The Commission requests specific comment whether the current shareholders' equity requirement should be retained, with higher or lower standards.[132] For example, the ICI and the Custodian Group recommended lowering the current $100 million and $200 million standards to expand the class of eligible foreign custodians in emerging and smaller markets.[133] In particular, they recommended that a custodian with more than $25 million in shareholders' equity should be eligible to hold fund assets, if it is one of the five largest banks in the country.[134] The Custodian Group indicated that this approach should not present significant risks, given the limited amount of assets likely to be maintained in smaller markets and the other protections of the rule.[135]

The Commission also requests comment whether any additional entities, such as foreign broker-dealers, should be permitted to serve as custodians.[136] Commenters addressing this issue should consider the circumstances under which additional types of entities should be permitted to hold fund assets. For example, should these entities be subject to capital or other special requirements?[137]

Finally, the Commission requests comment on prohibiting affiliated foreign custody arrangements. Custody by fund affiliates raises special investor protection concerns. To guard against potential abuses resulting from control over fund assets by related persons, rule 17f–2 under the Act, the Commission rule applicable to funds that retain custody of their own assets, has been applied to affiliated custody arrangements.[138]

The Commission is aware of only one existing affiliated foreign custody arrangement, and believes that other such arrangements may be best addressed on a case-by-case basis.[139] The Commission recognizes, however, that affiliated arrangements may become more prevalent as global investing and custodian networks continue to grow and as the fund industry continues to consolidate.[140] The Commission, therefore, requests comment whether the proposed prohibition would be unduly restrictive and whether the prohibition should apply only to certain affiliated arrangements, such as when there is a control relationship between the fund's adviser and a foreign custodian.[141] The Commission also requests comment whether there are alternative safeguards that would address the investor protection concerns raised by these arrangements. For example, should fund boards establish and oversee affiliated arrangements without the discretion to delegate this responsibility?

b. Other Alternatives Considered

The Commission considered several other approaches to defining an eligible foreign custodian. These alternatives could be used in lieu of the current shareholders' equity requirement or in conjunction with reduced capital standards. The Commission requests comment on each approach.

The Commission considered using an approach that would focus on a bank or trust company's safekeeping abilities.[142]

---

[127] The Commission previously sought to address this problem by proposing that shareholders' equity be calculated according to generally accepted accounting principles. 1985 Release Proposing Amendments, *supra* note 8. The Commission decided to postpone final action on this proposal due to concerns that compliance costs would be excessive. 1985 Release Adopting Amendments, *supra* note 8.

[128] *See* 1984 Adopting Release, *supra* note 8, at 36082. Custodians organized as private banks also may not have shareholders' equity. No-action letters, however, have found the capital of certain private banks to be the equivalent of shareholders' equity. *See* Pictet & Cie (pub. avail. Sept. 8, 1993) (private bank with partners' equity); Union Bank of Norway (pub. avail. Nov. 30, 1992) (private bank found to have the equivalent of paid-in capital and retained earnings).

[129] *See* Custodian Letter I, *supra* note 14, at 18–19.

[130] *See generally Sub-custodian Services Survey,* Euromoney 116 (Jan. 1994) (indicating that U.S. custodians view capitalization and credit rating as the most significant considerations in selecting foreign custodians).

[131] *See* ''Delegation of Board Responsibilities—Selecting Foreign Custodians'' above.

[132] *See* ICI Letter II, *supra* note 14, at 3 (suggesting that the Commission consider whether the current standards are unnecessarily high); Custodian Letter I, *supra* note 14, at 18 (indicating that the shareholders' equity requirement ''has served the Custodian community well in major, established markets'').

[133] ICI Letter III, *supra* note 14, at 7 (Exhibit A); Custodian Letter I, *supra* note 14, at 18–19. *See also* ''Other Alternatives Considered'' below (regarding the ICI's and the Custodian Group's other recommendations).

[134] ICI Letter III, *supra* note 14, at 7 (Exhibit A); Custodian Letter I, *supra* note 14, at 18–19. *See also* 1984 Adopting Release, *supra* note 8, at 36082 (rejecting the use of foreign bank custodians that constitute one of the five largest banks in a country when no bank in that country meets the shareholders' equity requirement).

[135] Custodian Letter I, *supra* note 14, at n.12. The Custodian Group also noted that smaller banks would not become eligible custodians in larger markets, since they would not be one of the five largest banks in the country. *Id.* at 19.

[136] When a foreign entity acts as both a bank and broker-dealer, it would meet the definition of an eligible foreign custodian if the division or part of the entity that has custody of fund assets is regulated under foreign law as a banking institution. *See generally* 1984 Reproposing Release, *supra* note 8, at 2907–08 (not allowing foreign broker-dealers to serve as custodians since funds had not expressed an interest in these arrangements). *See also* Canada Trustco Mortgage Company (pub. avail. Dec. 29, 1989) (loan company with wholly-owned trust subsidiary deemed to be an eligible foreign custodian).

[137] Broker-dealers, for example, could be required to be subject to foreign regulatory requirements relating to their financial responsibility and the segregation and handling of customer securities. *See, e.g.,* rule 206(4)–2(b) under the Investment Advisers Act of 1940, 17 CFR 275.206(4)–2(b). *See also* rule 17f–1 under the Act.

[138] *See, e.g.,* Pegasus Income and Capital Fund, Inc. (pub. avail. Dec. 1, 1977) (custody by U.S. adviser-bank). Rule 17f–2 appears to be unworkable in the foreign custody context because the rule requires, among other things, fund assets to be maintained in a bank that is subject to state or federal regulation; the fund's assets also must be subject to Commission inspection and verified by an independent public accountant. Rule 17f–2(b), (d), and (e). *See* 1984 Reproposing Release, *supra* note 8, at 2907–08.

The Division currently is reviewing rule 17f–2, and may recommend in the future that the Commission propose certain changes in the rule's requirements.

[139] Dean Witter World Wide Investment Trust (pub. avail. Mar. 14, 1988) (affiliation between the fund's sub-adviser and primary custodian deemed sufficiently remote so as not to require the protections of rule 17f–2).

[140] *See* John Waggoner, *Urge to Merge Hits Mutual Funds,* USA Today, Feb. 8, 1995, at 1B. *See also* Timothy L. O'Brien and Steven Lipin, *In the Latest Round of Banking Mergers, Even Big Institutions Become Targets,* Wall St. J., July 14, 1995, at A3.

[141] *See* section 2(a)(3)(C) of the Act.

[142] *See* Permanent Trustee Company Limited, Investment Company Act Release Nos. 17833 (Oct.

Continued