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SECTION
RULE 17f-5
PUBLIC AVAILABILITY July 10, 1997

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

July 10, 1997

VIA FACSIMILE AND AIR MAIL

Dr. Evgeni Zografski
Managing Director
Macedonian Stock Exchange
20 Mito Hadzivasilev Str.
P.O. Box 852
91000 Skopje
MACEDONIA

Dear Dr. Zografski:

Thank you for your letter (undated), which we received on June 25, 1997. You ask whether the current and future custodial and clearing system in Macedonia qualify as eligible foreign custodians under Rule 17f-5 under the Investment Company Act of 1940 (the "Investment Company Act"). You also ask whether the staff of the U.S. Securities and Exchange Commission (the "SEC") must investigate the Macedonian Stock Exchange (the "MSE") before it can issue a no-action response.

You state that two institutions operate the clearance and settlement system in Macedonia, the MSE and the Payment Operational Service (known as "ZPP"). You state that ZPP is responsible for the settlement of both money and securities transfers on the MSE. You explain that the transfer of securities is made directly with ZPP, which operates on behalf of the MSE as a "central register" for all securities officially listed on the primary and secondary markets. You state that shares held by this central register generally are in certificated form, although shareholders may decide to have their holdings dematerialized. You also state that under the current law, all companies listed on the MSE must transfer their share registers to the central register. Companies that are not listed may voluntarily transfer their share registers to the central register. Under a new law, all joint stock companies will be required to keep their share registries with the central register that will be established in Macedonia.

Section 17(f) of the Investment Company Act sets forth the custodial requirements for U.S.-registered management investment companies ("funds"). Rule 17f-5 thereunder permits funds to maintain their assets outside the United States provided that the assets are held by

"eligible foreign custodians" that meet certain requirements that are specified in the rule. Until recently, a foreign securities depository or clearing agency that wanted to qualify as an eligible foreign custodian was required to operate (i) the central system for handling, or (ii) a transnational system for the central handling, of securities or equivalent book-entries in that country.[1] On May 12, 1997, the Commission amended Rule 17f-5.[2] Among other things, the amended rule no longer requires that a foreign securities depository or clearing agency operate "*the* central system for handling securities or equivalent book-entries." It is now sufficient if the securities depository or clearing agency operates "*a* system for the central handling of securities or equivalent book-entries," provided that the depository is regulated by a "foreign financial regulatory authority."[3]

As was the case before the recent amendments, Rule 17f-5 is self-operative and does not require a foreign institution that satisfies the definition of "eligible foreign custodian" to obtain the prior approval of the SEC before serving as an eligible foreign custodian for U.S.-registered funds. Further, if an institution meets the definition, and no legal issue is presented, the SEC staff, as a matter of policy, will not issue an approval or no-action letter. Custody arrangements

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[1] Former Rule 17f-5(c)(2)((iii) and (iv). Section 3(a)(23)(A) of the Securities Exchange Act of 1934 defines "clearing agency" generally as an intermediary that makes payments or deliveries in connection with transactions in securities. The term includes any entity, such as a securities depository, that (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series of an issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities without physical delivery of securities certificates.

Rule 17f-4 under the Investment Company Act defines a "securities depository" as a "system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of securities." Rule 17f-5(c)(2)(iii) refers to both securities depositories and clearing agencies because a foreign securities depository may be known as a "clearing agency" in certain countries.

[2] The amendments became effective on June 16, 1997.

[3] Amended Rule 17f-5(a)(1)(ii). "Foreign financial regulatory authority" is generally any foreign securities authority or governmental body, or self-regulatory organization or membership organization, empowered to administer or enforce laws regulating fiduciaries, trusts, commercial lending, insurance, trading in financial instruments and commodity futures contracts, or other financial activities. See Section 2(a)(50) of the Investment Company Act.

with foreign institutions that do not meet the requirements of Rule 17f-5 are evaluated on a case-by-case basis. Thus, if ZPP operates a system for the central handling of securities or equivalent book-entries in Macedonia, and is regulated by a Macedonian "financial regulatory authority," ZPP would be an "eligible foreign custodian" for purposes of Rule 17f-5, and would not need the approval of the SEC to provide custodial services to U.S. funds. We suggest that the MSE consult an attorney familiar with the U.S. federal securities laws to determine whether ZPP satisfies the eligible foreign custodian requirements under amended Rule 17f-5.

With respect to your second question, the staff does not conduct an on-site investigation prior to, or in connection with, issuing a no-action letter. The staff determines whether or not to issue a no-action letter based on the facts and representations contained in written submissions. The staff may ask questions, by telephone or correspondence, and may also request that these submissions be supplemented in writing.

I am sending with this letter a copy of the SEC release adopting amended Rule 17f-5. You will find the text of the amended rule at the end of the release. If you have any further questions, please contact me at (202) 942-0660 or [FAX] (202) 942-9659.

Sincerely,

Edward J. Rubenstein
Senior Counsel

cc: Anthony Randazzo, Regional Director, Financial Services Volunteer Corps
Attachment (with airmail copies only)

Macedonian Stock Exchange

Mr. John V. O'Hanlon
Assistant Chief Counsel
US Securities and Exchange Commission
Washington DC, 20549

Dear Mr. O'Hanlon:

On the basis of our on-going consultations with the Financial Services Volunteer Corps (FSVC), which has been advising us on the procedures regarding the issuance of a No-Action letter from the US SEC, I would like to formally request clarification of our status as a foreign custodian as specified by the regulation 17f-5 of the US SEC.

Specifically, we would like to know if the Macedonian Stock Exchange will need to be investigated by the US SEC pursuant to the issuance a No Action letter, or if the custodial and clearing functions currently in place, as well as future ones as planned in our new Securities Law, satisfy the requirements specified in 17f-5 for an eligible foreign custodian.

I have attached a description of our current custodial and clearing system, which is based on a contractual agreement with ZPP (our central payments system) for your review, as well as excerpts from our Securities Law which outlines the framework for the creation of a new clearing and depository house for Macedonia.

Please indicate in your response if it will be necessary for the US SEC to investigate our current and future systems toward the issuance of a No Action letter, or if these satisfy the necessary requirements for an eligible foreign custodian.

Sincerely,

Managing Director

Dr. Evgeni Zografski

cc: Mr. Ned Rubenstein (US SEC)

Attached: (1) letter describing current custodial-clearing system
(5) pages from current Securities Law showing provisions for creation of new Clearing-Depository House in Macedonia

Attachment 1

I will try to clarify the basis of the current concept of clearance and settlement system in Macedonia. Also, I would like to remind you that this system was set up from the very beginning of the official opening of the MSE in March, 1996. The provisions in the new Law on issuance and trading securities will impose some changes, but we are in the middle of a legally prescribed "period of adjustment" to the new legislation so we are going to explain only the present system (according to the new law a Clearing and Depo House as a joint stock company will be established.)

Two institutions are involved in operating the clearance and settlement - MSE and Payment Operational Service (or ZPP according to the Macedonian abbreviation.)

MSE has signed contract with ZPP by which ZPP is responsible to do the settlement of both the money transfer and transfer of securities traded on the MSE. Actually, clearing and settlement is handled by the MSE through designated account with the ZPP. Settlement of shares for now, is T+5 and for bonds T+1.

During the settlement period of 5 days, MSE Certification Office confirms the identity off shares being traded, brokers who did the trade, quantity, and price executed. At T+5 the MSE sends data to ZPP who checks all documents once again, checks the accounts opened at ZPP of all brokers involved on that particular settlement day, and if everything is correct carries out the money and securities transfer. The settlement of transactions is on the net basis.

The transfer of the securities is made directly with ZPP which operates on behalf of the MSE as a Central Register for all securities officially listed on the first and second markets. The Central Register is in certificated form, although shareholders may decide to have their holdings dematerialized. It is a condition of listing requirements that listed companies transfer their share register to the Central Register.

For those companies that are not listed, transfer of their share register to the Central register is voluntarily in this very moment (according to the new Law all joint stock companies are obliged to keep share register in the Central Register that will be established in Macedonia).

2.3 Settlement of transactions and keeping certificates in group depository

Article 135

A clearing-depository house may be founded for the purpose of clearing and settlement of transactions with long-term securities and keeping certificates in a group central depository (in both materialized and dematerialized form).

The clearing-depository house is founded as a joint-stock company.

Founders of a clearing-depository house may be participants on the Exchange, the Republic of Macedonia and the National Bank of the Republic of Macedonia.

Article 136

The clearing-depository house may provide services to authorized participants on the Exchange.

Article 137

A clearing-depository house may issue only ordinary, registered shares of the same type.

Each of the founding shareholders may directly or indirectly hold up to 10 % of the capital of the clearing-depository house.

Shares of a clearing-depository house are not listed on the Exchange.

Article 138

The Commission grants a license for work of a clearing-depository house.

The Commission shall grant the license of para 1 above only if it is satisfied that the clearing-depository house meets following requirements:

- that it is qualified for quick and current settlement of liabilities under locked trades;
- that it provides safety in the keeping of securities;
- that it has established rules for membership such that enables membership for all participants on the market approved by the Securities and Exchange Commission;
- that it protects the interests of investors and the public; and
- that it be equipped in terms of staff, technology and organization for the purpose of proper conduct of its business.

Any more detailed conditions for issuing an approval for establishment and operation of a clearing-depository house are set by the Securities and Exchange Commission.

Article 139

Employees in a clearing-depository house who have access to information related to securities handled by the clearing-depository house may not be members of bodies or perform activities on behalf of brokerage firms, i.e. banks.

Article 140

The clearing-depository house shall set the clearing procedures in co-operation with the Exchange.

Article 141

For its clearing and settlement services to companies, the clearing-depository house shall charge a provision set by the clearing-depository house itself.

The provision of para 1 above is subject to approval by the Commission.

Article 142

An authorized participant failing to meet liabilities from transactions with securities or violates the general acts on the basis of which the clearing-depository house operates, shall be temporarily or permanently banned from the clearing and settlement procedure, following a consent of the Commission.

Article 143

Authorized participants shall meet their financial liabilities through segregated accounts with the payment operational service institution.

Article 144

The payment operational service institution facilitates the transfer of funds for settlement of transactions in long-term securities, in accordance with instructions from the clearing-depository house.

The payment operational service institution reports to the clearing-depository house and the authorized participant on the financial position on the account of the latter.

Article 145

Authorized participants shall provide sufficient funds on their segregated accounts for settlement of all concluded transactions.

Article 146

The clearing-depository house shall establish a Reserve Fund.

The Reserve Fund shall be contributed to by authorized participants.

Funds from the Reserve Fund shall be used by the clearing-depository house to settle transactions of an authorized participant on whose segregated account there are no sufficient funds to cover for its liabilities.

The manner and amount of contributions to the Reserve Fund by each authorized participant are set by the clearing-depository house.

Article 147

An authorized participant whose liabilities have been settled with funds from the Reserve Fund shall pay back into the Fund the amount used for the purpose of settling his liabilities, plus a commission for use of finances from the Fund.

The amount of the commission for use of finances from the Fund and the dead-line for payment of such commission are set by the clearing-depository house.

Article 148

The clearing-depository house shall keep securities of all authorized participants and other companies under an outside and easily recognized mark, separately from its own securities and the securities of other authorized participants and companies.

Under exception of para 1 above, the clearing-depository house may establish a group depository for keeping in safe custody securities of the same type and interchangeable securities.

Article 149

The clearing-depository house may not lend securities entrusted to it for safe custody.

Article 150

The clearing-depository house shall have the obligation to keep securities in safe custody with an appropriate care of a depository and shall undertake all steps necessary to secure and help implement rights of authorized participants emerging from the deposited securities.

If not stated otherwise in the agreement for depositing securities between companies and the clearing-depository house, the latter shall have an obligation to charge on behalf of the authorized participant all matured interests, principal and other rights emerging from the deposited securities.

The clearing-depository house shall without delay place at the disposal of the authorized participant all the funds which it has received on behalf of such a participant.

Article 151

The clearing-depository house may keep securities with another depository but shall have the same responsibility for such securities as if it kept them with itself.

Article 152

The clearing-depository house shall not be held responsible for securities deposited for keeping in safe custody with another depository upon a written request by the authorized participant itself.

Article 153

The clearing-depository house shall maintain securities and keep record of the securities of each authorized participant separately.

Article 154

The clearing-depository house shall maintain records of:

- authorized participants whose securities are deposited with the clearing-depository house;
- types, nominal values, quantity and other data relevant for the deposited securities;
- executed rights emerging from securities; and
- changes in the balance of the deposited securities.

Article 155

Transfer of securities deposited with a clearing-depository house shall be carried out through reflecting the changes in ownership onto the accounts of deposited securities of authorized participants.

The clearing-depository house shall provide a balance on the securities account equal to the balance on the account for deposited securities of each individual authorized participant.

Article 156

The authorized participant shall leave sufficient quantity of securities with the clearing-depository house, in order to facilitate the transfer of securities on the basis of concluded transactions on the Exchange.

Article 157

In the event that the balance on the account of an authorized participant is not sufficient for transfer of securities traded on the Exchange, the clearing-depository house shall notify the authorized participant and the Exchange without delay, if the securities in question are listed securities.

Article 158

The clearing-depository house shall, at least once a month, report to the Commission of the balance on the account for deposited securities and other relevant data that it is due to record under this Law.

Article 159

The surveillance over the work of the clearing-depository house shall be conducted by the Commission.

Article 160

While conducting surveillance over the work of the clearing-depository house, the Commission may ask for:

- reports and information on transactions;
- reports of and any additional information about a completed audit;
- changes to any acts regulating the operation of the clearing-depository house.

Article 161

If the surveillance over the work of the clearing-depository house reveals any violation of regulations for trading in securities, the Commission may undertake the following measures:

- partially or completely prohibit certain activities of employees of the clearing-depository house with special authorities;
- temporarily or permanently prohibit any activities, in accordance with this Law.

Article 162

In the event of revealed irregularities, the cost of inspection shall be born by the clearing-depository house.

ACTION: Final rule.

SUMMARY: The Export Administration Regulations (EAR) provide that the Bureau of Export Administration (BXA) may inform exporters, individually or through amendment to the EAR, that a license is required for exports or reexports to certain entities. The EAR contains a list of such entities. This rule adds Bharat Electronics LTD, (aka Baharat Electronics, Ltd.) located in India, to the entity list, and requires a license for exports or reexports of all items subject to the EAR.

EFFECTIVE DATE: This rule is effective May 16, 1997.

FOR FURTHER INFORMATION CONTACT: Eileen M. Albanese, Office of Exporter Services, Bureau of Export Administration, Telephone: (202) 482–0436.

SUPPLEMENTARY INFORMATION:

Background

General Prohibition Five (§ 736.2(b)(5) of the EAR) prohibits exports to certain end-users or end-uses without a license. In the form of Supplement No. 4 to part 744, BXA maintains an "Entity List" to provide notice informing the public of certain entities subject to such licensing requirements.

Although the Export Administration Act (EAA) expired on August 20, 1994, the President invoked the International Emergency Economic Powers Act and continued in effect, to the extent permitted by law, the provisions of the EAA and the EAR in Executive Order 12924 of August 19, 1994.

Rulemaking Requirements

1. This final rule has been determined to be not significant for purposes of Executive Order 12866.

2. Notwithstanding any other provision of law, this rule involves a collection of information subject to the Paperwork Reduction Act of 1980 (44 U.S.C. 3501 *et seq.*). This collection has been approved by the Office of Management and Budget under control number 0694–0088.

3. This rule does not contain policies with Federalism implications sufficient to warrant preparation of a Federalism assessment under Executive Order 12612.

4. The provisions of the Administrative Procedure Act (5 U.S.C. 553) requiring notice of proposed rulemaking, the opportunity for public participation, and a delay in effective date, are inapplicable because this regulation involves a military and foreign affairs function of the United States (5 U.S.C. 553(a)(1)). Further, no other law requires that a notice of proposed rulemaking and an opportunity for public comment be given for this final rule. Because a notice of proposed rulemaking and an opportunity for public comment are not required to be given for this rule under 5 U.S.C. 553 or by any other law, the requirements of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) are not applicable.

Therefore, this regulation is issued in final form. Although there is no formal comment period, public comments on this regulation are welcome on a continuing basis. Comments should be submitted to Sharron Cook, Regulatory Policy Division, Bureau of Export Administration, Department of Commerce, P.O. Box 273, Washington, DC 20044.

List of Subjects in 15 CFR Part 744

Exports, Foreign trade, Reporting and recordkeeping requirements.

Accordingly, part 744 of the Export Administration Regulations (15 CFR parts 730–774) is amended, as follows:

1. The authority citation for 15 CFR part 744 continues to read as follows:

Authority: 50 U.S.C. app. 2401 *et seq.*; 50 U.S.C. 1701 *et seq.*; 22 U.S.C. 3201 *et seq.*; 42 U.S.C. 2139a; E.O. 12058, 43 FR 20947, 3 CFR, 1978 Comp., p. 179; E.O. 12851, 58 FR 33181, 3 CFR, 1993 Comp., p. 608; E.O. 12924, 59 FR 43437, 3 CFR, 1994 Comp., p. 917; E.O. 12938, 59 FR 59099, 3 CFR, 1994 Comp., p. 950; Notice of August 15, 1995 (60 FR 42767, August 17, 1995); and Notice of August 14, 1996 (61 FR 42527).

PART 744—[AMENDED]

2. Supplement No. 4 to part 744 is amended by adding, in alphabetical order, the following entity:

"Bharat Electronics LTD, (aka Baharat Electronics, Ltd.) located in India, for all items subject to the EAR".

Dated: May 12, 1997.

Iain S. Baird,

Acting Assistant Secretary for Export Administration.

[FR Doc. 97–12805 Filed 5–15–97; 8:45 am]

BILLING CODE 3510–33–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 270

[Release Nos. IC–22658; IS–1080; File No. S7–23–95]

RIN 3235–AE98

Custody of Investment Company Assets Outside the United States

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to the rule under the Investment Company Act of 1940 that governs the custody of investment company assets outside the United States. The amendments provide investment companies with greater flexibility in managing their foreign custody arrangements consistent with the safekeeping of investment company assets. The amendments also expand the class of foreign banks and securities depositories that may serve as investment company custodians.

EFFECTIVE DATE: The amendments will become effective June 16, 1997.

FOR FURTHER INFORMATION CONTACT: Robin S. Gross, Staff Attorney, or Nadya B. Roytblat, Assistant Chief, Office of Regulatory Policy, at (202) 942–0690, Securities and Exchange Commission, Division of Investment Management, 450 Fifth Street, N.W., Mail Stop 10–2, Washington, D.C. 20549. Requests for formal interpretive advice should be directed to the Office of Chief Counsel at (202) 942–0659, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Mail Stop 10–6, Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") today is adopting amendments to rule 17f–5 (17 CFR 270.17f–5) under the Investment Company Act of 1940 (15 U.S.C. 80a) (the "Investment Company Act" or "Act").

Table of Contents

I. Executive Summary

The Commission is amending rule 17f–5 under the Investment Company Act to provide registered management investment companies ("funds") greater flexibility in managing their foreign custody arrangements. The amendments expand the class of foreign banks and securities depositories that may serve as custodians of fund assets by eliminating capital requirements that have precluded funds from using otherwise suitable custodians without first obtaining administrative relief from the Commission. The amended rule requires instead that the selection of a foreign custodian be based on whether the fund's assets will be subject to reasonable care if maintained by that custodian, after considering all factors relevant to the safekeeping of fund assets, including the custodian's financial strength, its practices and procedures, and internal controls.

The amendments eliminate the consideration of "prevailing country risks," *i.e.*, risks associated with investment in a particular country rather than placing assets with a particular custodian. The Commission has concluded that prevailing country risks are investment risks appropriately considered by a fund's board or investment adviser when deciding whether the fund should invest in a particular country, rather than custodial risks to be addressed in rule 17f–5.

The amendments also permit fund directors to play a more traditional oversight role with respect to the custody of fund assets overseas. Directors may delegate their duties to select a foreign custodian and monitor a fund's foreign custody arrangements to the fund's investment adviser, officers, or a U.S. or foreign bank, and are no longer required to approve foreign custody arrangements annually.

II. Introduction and Background

A growing number of funds invest their assets overseas.[1] Investing in foreign markets may present a fund with significant operational issues, one of which is the availability of appropriate custodians for fund assets. Maintaining securities outside of their primary market can add significant costs to investing in that market and may preclude foreign investment.[2] The availability of custodial arrangements in foreign markets where a fund invests, therefore, is very important.

Section 17(f) of the Act generally permits a fund to maintain its assets only in the custody of a U.S. bank and its foreign branches, a member of a U.S. securities exchange, the fund itself, or a U.S. securities depository.[3] Before rule 17f–5 was adopted, funds seeking to maintain their assets outside the United States could use only foreign branches of U.S. banks as their foreign custodians.[4]

In 1984 the Commission adopted rule 17f–5, which expanded the foreign custody arrangements available to funds.[5] The rule permits funds to maintain their assets overseas, subject to detailed findings by the fund's board of directors with respect to the decision to place fund assets in a particular country and with respect to each foreign custody arrangement.[6] Fund assets may be placed in the custody of an "eligible foreign custodian": (i) A foreign bank or trust company ("foreign bank") that has more than $200 million in shareholders' equity; (ii) a majority-owned subsidiary of a U.S. bank or bank holding company ("U.S. bank subsidiary") that has more than $100 million in shareholders' equity; or (iii) a foreign securities depository that operates either the central system for the handling of securities in that country or a transnational system for the central handling of securities.[7] Finally, the fund's foreign custody arrangements must be governed by a written contract that must be approved by the fund's board of directors and contain certain specified provisions.[8]

By 1995 the Commission had become concerned that the rule's provisions unnecessarily restricted foreign custody arrangements. In addition, the Commission became concerned that the rule placed unnecessary burdens on fund directors that detracted from the amount of time they could devote to the many other important duties they are assigned under the Act.[9] In July 1995, the Commission proposed amendments to rule 17f–5 in response to these concerns. To make the rule's requirements for board involvement in custody matters more consistent with the board's traditional oversight role, the proposed amendments would have permitted fund boards to delegate their

[1] Based on available data, the Commission staff estimates that at the end of February 1997, approximately 1,666 portfolios with assets of nearly $411 billion have investment objectives that contemplated significant foreign investments. *See also* Karen Damato, *Mutual Funds Drew $24 Billion During January*, Wall St. J., Feb. 13, 1997, at C1 (discussing recent increased investor interest in funds that invest overseas).

[2] Moving securities away from their primary market may entail additional costs in connection with hiring a servicing agent in the primary locality to collect and disseminate information with respect to the securities, transferring the securities to an eligible custodian and procuring insurance for possible loss in transit, and exchanging coupons for interest or dividends or for new shares in connection with a rights offering. *See* Exemption for Custody of Securities by Foreign Banks and Foreign Securities Depositories, Investment Company Act Release No. 12354 (Apr. 5, 1982) (47 FR 16341, 16342 (April 16, 1982)) (hereinafter 1982 Proposing Release). Funds also may be prevented from, or delayed in, selling the securities if they are unable to make timely delivery to prospective purchasers in the primary market. *Id.* In addition, the best price for a foreign security typically may be obtained in its primary market. *Id.*

[3] 15 U.S.C. 80a–17(f). Bank custodians must be subject to federal or state regulation and have at least $500,000 in aggregate capital, surplus, and undivided profits. Investment Company Act sections 2(a)(5) (15 U.S.C. 80a–2(a)(5)) (defining bank), and 26(a)(1) (15 U.S.C. 80a–26(a)(1)) (containing the $500,000 capital requirement). *See also* rule 17f–1 (17 CFR 270.17f–1) (custody by members of a U.S. securities exchange), rule 17f–2 (17 CFR 270.17f–2) (custody by funds themselves), rule 17f–4 (17 CFR 270.17f–4) (custody by U.S. securities depositories), and rule 17f–6 (17 CFR 270.17f–6) (custody by futures commission merchants and commodity clearing organizations).

[4] *See* 1982 Proposing Release, *supra* note 2, at n.7 and accompanying text.

[5] Exemption for Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 14132 (Sept. 7, 1984) (49 FR 36080 (Sept. 14, 1984)) (release adopting rule 17f–5) (hereinafter 1984 Adopting Release). For an administrative history of rule 17f–5, *see* Custody of Investment Company Assets Outside the United States, Investment Company Act Release No. 21259 (July 27, 1995) (60 FR 39592 (Aug. 2, 1995)) (hereinafter Proposing Release) at n.8.

[6] The fund's board of directors must determine that the custody arrangements are consistent with the best interests of the fund and its shareholders (the "best interests determination"). Rule 17f–5(a)(1)(i) through (iii). Notes to the current rule enumerate certain factors that the fund's board should consider in making the best interests determination. The rule also requires the board to monitor the fund's foreign custody arrangements and to approve each arrangement at least annually. Rule 17f–5(a)(2), (3).

[7] Rule 17f–5(c)(2) (i) through (iv).

[8] Rule 17f–5(a)(1)(iii) (A) through (F).

[9] *See* Proposing Release, *supra* note 5, at nn.15–17 and accompanying text.

responsibilities to approve and monitor foreign custody arrangements. To better reflect modern commercial custody practices, the proposed amendments would have revised the standard to be used in evaluating a fund's foreign custody arrangements to one that focuses on whether the custodial arrangement afforded "reasonable protection" for fund assets.[10] The proposed amendments also would have expanded the class of foreign banks, U.S. bank subsidiaries and securities depositories that could serve as fund custodians, and eliminated the requirement that the fund's foreign custody contract contain certain specified provisions.

The Commission received letters from 28 commenters. The commenters generally supported the proposed amendments, particularly those provisions that would have permitted a fund's board to delegate its responsibilities to select and monitor foreign custodians to the fund's investment adviser, officers, or a U.S. or foreign bank. The Commission is adopting the proposed amendments with several modifications that reflect, in part, the commenters' suggestions. The Commission believes that the amendments, as adopted, will provide significant additional flexibility for funds without reducing the level of investor protection afforded by the current rule.

III. Discussion

A. Decision to Place Fund Assets in a Country

1. Background

Maintaining fund assets outside the United States involves risks that relate to the particular custodian (*e.g.*, the risk that the custodian selected will not exercise the appropriate level of care with regard to fund assets, or that the custodian may not have the financial strength, practices, and procedures in place to safeguard the fund's assets).[11] In addition, maintenance of fund assets overseas exposes the fund to systemic risks that may affect the ability of any custodian to safeguard fund assets in that country ("prevailing country risks"). For example, a country's inefficient settlement practices constitute a risk of investing in that country, regardless of the level of care that can be provided by a particular custodian. Both of these types of risks have been addressed by rule 17f–5, and were to be addressed by the proposed amendments.[12]

The Proposing Release requested comment whether the rule should continue to address prevailing country risks.[13] A number of commenters suggested that it should not. These commenters asserted that prevailing country risks are inherently investment risks because they are an inextricable part of the fund's decision to invest in foreign securities. These commenters therefore urged the Commission to treat the decision to place fund assets in a country as a decision to be made by the fund's board or its investment adviser in the context of deciding to invest in that country, and as separate from the establishment of particular foreign custody arrangements under rule 17f–5.

2. The Amended Rule

These comments have caused the Commission to reconsider the proposed approach. Once a decision has been made to invest in a country, prevailing country risks cannot be avoided, except by maintaining assets outside of the country—an alternative that is often not possible or practicable. For that reason, prevailing country risks would seem inherently a part of the investment risks associated with the decision to invest in a particular country and should be considered by a fund's board or investment adviser before the fund invests in a foreign country. Inclusion of prevailing country risks in rule 17f–5, therefore, would appear inconsistent with the nature of those risks.

The Commission also is concerned that restrictions on a fund's approach to prevailing country risks may have the effect of denying funds and their shareholders overseas investment opportunities, particularly in developing markets. Such a result is inconsistent with the overall approach of the Investment Company Act, which generally does not limit a fund's ability to assume investment risks.[14] Moreover, such a result is not mandated by section 17(f), the legislative history of which suggests that the section was intended primarily to prevent misappropriation of fund assets by persons having access to assets of the fund.[15]

Based upon these considerations, the Commission has decided not to address prevailing country risks in rule 17f–5. Rather, the Commission believes that such risks should be carefully considered by a fund's board or its investment adviser before the fund invests in a foreign country, and, if material, disclosed to fund investors.[16] Accordingly, the amended rule focuses exclusively on the selection and monitoring of an eligible foreign custodian.

The amendments are not intended and should not be construed, however, to diminish the importance of considering the financial infrastructure of a foreign country when deciding to invest in that country. For example, the country's settlement systems and practices can have a significant effect on the liquidity and investment characteristics of fund assets.[17] The

[10] The factors that the rule specifies should be considered in this regard would have been revised to focus on safekeeping rather than investment risks (particularly the factors relating to the decision to place fund assets in a country).

[11] These issues also may be present when a fund's assets are maintained in the United States. Section 17(f), however, by limiting domestic custody arrangements to U.S. banks and certain other arrangements subject to Commission regulation, provides some assurance that custody arrangements will have appropriate safeguards. *See supra* note 3 and accompanying text.

[12] Rule 17f–5 currently requires a fund's board of directors to determine that maintaining the fund's assets in a particular country is consistent with the best interests of the fund and its shareholders. Rule 17f–5(a)(1)(i). Note 1 to the rule requires the board, in making this determination, to consider the effects of applicable foreign law on the safekeeping of fund assets; the likelihood of expropriation, nationalization, freezing, or confiscation of the fund's assets; and any reasonably foreseeable difficulties in repatriating the fund's assets kept overseas.

The proposed amendments would have narrowed the scope of the prevailing country risks determination to factors that have a closer nexus to safekeeping considerations. A fund's board of directors or its delegate would have been required to determine that custody of the fund's assets in a particular country could be maintained in a manner that provided reasonable protection for the fund's assets after considering all factors relevant to the safekeeping of such assets including: (i) The prevailing practices in the country for the custody of the fund's assets; (ii) whether the country's laws will affect adversely the safekeeping of the fund's assets, such as by restricting the access of the fund's independent public accountants to a custodian's books and records, or by affecting the fund's ability to recover its assets in the event of a custodian's bankruptcy or the loss of assets in a custodian's control; and (iii) whether special arrangements that mitigate the risks of maintaining the fund's assets in the country would be used.

[13] Proposing Release, *supra* note 5, at nn. 62–65 and accompanying text.

[14] *But see, e.g.*, rule 2a–7 under the Investment Company Act (17 CFR 270.2a–7) (establishing various limitations on permissible investments for money market funds).

[15] *See* Proposing Release, *supra* note, at n.5; *Thomas Harman*, Eligible Foreign Custodians and the Investment Company Act of 1940, 46 Bus. Law 1377 (1991).

[16] Funds' disclosure obligations are governed by other provisions of the securities laws. *See, e.g.*, Item 4(c) of Form N–1A (17 CFR 239.15A) (the registration form for open-end funds), and Item 8.3 of Form N–2 (17 CFR 274.11a–1) (the registration form for closed-end funds). These Items require disclosure in the fund's prospectus of the principal risk factors associated with investing in the fund. *See also* Proposing Release, *supra* note, at nn.175, 176 and accompanying text.

[17] A country's settlement systems, for example, may not require that payment for securities purchased by a fund be made only upon delivery of those securities, or that securities sold by a fund be delivered only upon receipt of payment for the

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amendments similarly are not intended to diminish the contribution that the fund's global custodian may make in deciding to place fund assets in a foreign country.[18] Commenters representing funds and custodians agreed that global custodians are a "primary source of information concerning the financial systems and practices of foreign markets."[19] The Commission, therefore, expects that fund boards and investment advisers, in making foreign investment decisions, will continue to seek and rely on information and opinions provided by the fund's custodian when the custodian has experience with regard to foreign custody services.[20]

B. Delegation of Board Responsibilities

The Commission proposed amending the rule to permit a fund's board to delegate its responsibilities to select, contract with, and monitor foreign custodians to the fund's investment adviser, officers or a U.S. or foreign bank. This approach was intended to permit fund boards to play a more traditional oversight role in connection with a fund's foreign custody arrangements.[21] This approach also sought to recognize that in discharging their responsibilities under the rule, directors rely heavily on the analysis and recommendations of the fund's investment adviser, legal counsel and global custodian.[22] Most commenters strongly supported the proposed amendments permitting delegation of board responsibilities and they are adopted substantially as proposed.[23]

1. Selecting Delegates

Under the proposed amendments, the board would have been required to find that it is reasonable to rely on the delegate to perform the delegated responsibilities related to the fund's foreign custody arrangements. Most commenters that addressed this aspect of the proposal supported the proposed standard, but suggested that the Commission discuss the factors to be considered in determining whether reliance on a delegate is reasonable.

The Commission is adopting the proposed reasonable reliance standard.[24] As stated in the Proposing Release, factors typically involved in making this determination include the expertise of the delegate and, if applicable, the delegate's intended use of third party experts in performing its responsibilities.[25] Other relevant factors may include, for example, the board's ability to monitor the delegate's performance or, in the case of a delegate that is a foreign bank, the fund's ability to obtain jurisdiction over the delegate in the U.S. should problems arise in the delegate's performance of its duties.[26] The delegate's financial strength also is relevant in analyzing its ability to perform its responsibilities and indemnify the fund if the delegate fails to adhere to the requisite standard of care.[27]

Certain commenters suggested that the board's responsibilities under the rule be delegable solely to the fund's custodian bank as the entity most qualified to provide such services. The Commission continues to believe that the board should have the flexibility to

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securities ("delivery vs. payment procedures"). Delivery vs. payment procedures can afford significant protections from losses if the other party to a transaction defaults on its obligations. *See, e.g.*, Group of Thirty, Clearance and Settlement Systems in the World's Securities Markets 11 (Mar. 1989). The fact that a foreign market's settlement practices do not incorporate these procedures should be carefully considered by the fund's board or investment adviser in deciding to invest in the country.

A country's settlement systems and practices also may present problems in accounting for fund assets (*e.g.*, establishing whether the fund owns the securities or has received dividends or other entitlements). *See, e.g.*, Buttonwood International Group, *Emerging Markets on the Net: India-Securities Infrastructure a Big Problem for Investors*, at http://www.buttonwood.com/p-i/1996es/india.html (discussing, among other things, difficulties resulting from the process of registering changes in ownership of securities).

[18] *See, e.g.*, John Paul Lee & Richard Schwartz, Global Custody: A Guide for the Nineties (1990) (noting that today the safekeeping of a fund's foreign investments typically is effected through the fund's primary or "global" custodian, which uses a world-wide network of custodians with which it has established relationships); Gordon Altman Butowsky Weitzen Shalov & Wein, a Practical Guide to the Investment Company Act 30 (1993) (indicating that the fund's custodian typically provides the board with information concerning foreign legal restrictions and the qualifications of foreign custodians).

[19] Letter from Baker & McKenzie to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Nov. 3, 1995), File No. S7–23–95, at 7–8; *see also* Letter from the Investment Company Institute to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Oct. 5, 1995), File No. S7–23–95, at 9. Custodian commenters suggested that their role in this regard may expand under the amended rule and emphasized that funds and their global custodians "are partners, not adversaries, in seeking to ensure that fund assets held outside the United States are properly safeguarded." Letters from Baker & McKenzie to Jonathan G. Katz, Secretary, Securities and Exchange Commission (June 7, 1996 and Sept. 10, 1996), File No. S7–23–95, at 3 and 2, respectively.

[20] The Commission always has recognized the extent to which fund boards rely on third party experts in addressing prevailing country risks. *See* 1984 Adopting Release, *supra* note 5, at n.12 and accompanying text. The failure of a fund's board to obtain information from reliable sources concerning the financial systems and practices of foreign markets in which the fund makes significant investments may in certain instances violate the directors' duty of care under applicable corporate and fiduciary law. *See, e.g.*, Task Force on the Fund Director's Guidebook, Federal Regulation of Securities Committee, Section of Business Law, American Bar Association, "Fund Director's Guidebook," 52 Bus. Law. 229, 237 (1996) ("Compliance with the duty of care under state law is based on diligence applied to the ordinary and extraordinary needs of the fund, including * * * obtaining and reviewing information on which to base decisions, and making appropriate inquiries under particular circumstances.") The Commission does not believe that the amendments will discourage fund boards and investment advisers from seeking the type of information they need to fulfill their responsibilities. *Cf.* Letter from State Street Bank to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Nov. 3, 1995), File No. S7–23–95, at 11 (suggesting that "competitive forces" may place incentives on custodian banks to assume greater responsibility for decisions to place fund assets in foreign countries). The amendments do not affect in any way the extent to which a custodian's opinions and reports may be relied upon by the fund's board or the investment adviser, or the custodian's legal liability to the fund with respect to any such opinions or reports.

[21] *See* Proposing Release, *supra* note 5, at nn.24–26 and accompanying text.

[22] *See supra* notes 18–20 and accompanying text. *See also;* Glorianne Stromberg, Regulatory Strategies for the Mid-'90s; Recommendations for Regulating Investment Funds in Canada (prepared for the Canadian Securities Administrators) 242 (Jan. 1995) (suggesting it is unlikely that an individual fund or its investment adviser will have the expertise or bargaining power to deal with numerous and varied foreign custodians throughout the world).

[23] While commenters generally supported delegation, a number of commenters suggested that custodian banks should not serve as delegates for the decision to place fund assets in a country. It is not necessary to address this issue in the amended rule, however, because the decision to place fund assets in the country is outside the scope of the amended rule. *See supra* Section III.A. of this Release.

[24] Amended rule 17f–5(b)(1) (17 CFR 270.17f–5(b)(1)).

[25] *See* Proposing Release, *supra* note 5, at n.28 and accompanying text.

[26] If the delegate is a foreign bank, it must be a "qualified foreign bank" (*i.e.*, regulated as either a banking institution or trust company by the government of the country under whose laws it is organized or any agency thereof). *See* amended rule 17f–5(d)(6) (17 CFR 270.17f–5(d)(6)). U.S. bank delegates must be subject to federal or state regulation by virtue of the definition of bank in section 2(a)(5) of the Act (15 USC 80a–2(a)(5)).

[27] The amendments, as proposed, would have required a U.S. bank delegate to have an aggregate of capital, surplus and undivided profits ("CSP") of $500,000—the aggregate CSP required for a U.S. bank to serve as a custodian for fund assets. *See* section 17(f)(1) of the Act (15 U.S.C. 80a–17(f)(1)) (requiring bank custodians to meet the qualifications prescribed by section 26(a) of the Act (15 U.S.C. 80a–26(a)) for the trustees of unit investment trusts). The Proposing Release requested comment whether foreign bank delegates should meet specific capital standards. Commenters were divided on this point. One commenter supported a minimum capital requirement for foreign bank delegates to avoid the inequity of subjecting only U.S. banks to minimum capital requirements. Other commenters suggested that, since the financial strength of a foreign custodian would be a factor in deciding to use it as a custodian for fund assets, the aggregate CSP requirement, or other minimum financial standards for delegates, were unnecessary. Consistent with the approach of focusing on financial strength, rather than specified minimum capital (as discussed in Section III.D.1 of this Release), the amended rule does not require a U.S. bank delegate to have a specified CSP.

delegate foreign custody decisions to the entity it determines is in the best position to evaluate the particular delegated aspects of the fund's foreign custody arrangements.[28] For example, under the delegation provisions of the amended rule, one delegate may assume responsibility for evaluating bank custodians, while another may be responsible for evaluating depositories.

The Commission notes that the terms of the delegation must be agreed upon by the board and the delegate. The potential delegate must agree to assume the delegated responsibilities and the delegate and the fund's board may agree to guidelines and procedures under which the delegate will exercise its responsibilities. If a foreign country, for example, has a depository that, as a practical matter, must be used if the fund is going to place assets in that country ("compulsory depository"), the fund's board may conclude that the investment adviser would be the appropriate delegate for evaluating the compulsory depository.[29]

2. Delegate's Standard of Care

The Proposing Release requested comment whether the rule should provide a standard of care to be used by a delegate in making custodial decisions. Several commenters suggested that the rule should provide guidance in this regard. These commenters expressed the view that if the Commission did not clarify this aspect of the amendments, the delegation provisions would be unworkable because potential delegates would be unwilling to risk being held liable for losses despite exercising reasonable care.

The amended rule requires a delegate to exercise reasonable care in performing the delegated duties.[30] The rule makes clear that reasonable care, in this context, requires the delegate to exercise the care, prudence and diligence that a person having the responsibility for the safekeeping of fund assets would exercise.[31] This provision is designed to ensure that delegates adhere to a threshold standard of care. Fund boards and their delegates may agree that the delegate should adhere to a higher standard of care.

3. Board Oversight; Delegate Reporting

The Commission is amending the rule, as proposed, to no longer require the board to review or approve the fund's foreign custody arrangements annually. The amended rule does require the delegate to provide the board with written reports notifying it of the placement of the fund's assets with a particular custodian.[32] The delegate also must provide written reports to the board concerning any material change in the fund's foreign custody arrangements ("material change reports").[33] These reports are intended to facilitate the board's oversight of the delegate's performance. Commenters generally agreed that delegate reporting is desirable.

The proposed amendments would have required the reports to be provided no later than the next regularly scheduled board meeting following the event necessitating the report. One commenter expressed concerns about the application of this requirement to fund boards that do not have regularly scheduled meetings. The amended rule requires material change reports to be provided at such times as the fund's board deems reasonable and appropriate based on the circumstances of the fund's foreign custody arrangements.[34] This provision should provide fund boards with the flexibility to tailor the reporting requirements to the fund's particular circumstances. Consistent with the provision, a fund's board could, for example, require the reports at the next regularly scheduled board meeting, as originally proposed. The board also may require the reports more or less frequently (*e.g.*, within 30, 60 or 90 days of the event or annually) as the board determines is reasonable and appropriate.

C. Selecting, Contracting With, and Monitoring a Foreign Custodian

1. Selecting a Foreign Custodian

a. General Standard

Rule 17f–5 currently requires a fund's board to find that the fund's foreign custody arrangements are consistent with the best interests of the fund and its shareholders.[35] Consistent with the goal of requiring foreign custody arrangements to be evaluated based on the level of safekeeping they will afford fund assets, the Commission proposed amending the rule to require a finding that the fund's foreign custody arrangement will provide "reasonable protection" for fund assets. The proposed reasonable protection standard was intended to facilitate evaluation of foreign custody arrangements by focusing exclusively on the safekeeping of fund assets.

Several commenters viewed the proposed reasonable protection standard as a results-oriented standard that could effectively render the entity making the determination a guarantor against any loss of fund assets in foreign custody. A number of commenters recommended that the rule require instead that the selection of a fund's foreign custodian be based on a determination that the custodian will provide "reasonable care" for the fund's assets in its custody ("reasonable care standard"). The commenters suggested that this standard of care would be more consistent with the way in which custodians traditionally have carried out their responsibilities.[36] Commenters also noted that a reasonable protection

[28] Similarly, a fund's board could select as delegate the entity having the greatest expertise with a geographic region. *See* Andrew Sollinger, *Breaking Away*, Institutional Investor 171 (Sept. 1991) (noting that U.S. custodians may use different subcustodian networks for different geographic regions).

[29] The amendments, as proposed, would have expressly addressed compulsory depositories, and would have required the evaluation of a compulsory depository to be made in the context of the decision to place fund assets in that country. This approach was designed to address the expectation that, because of the depository's compulsory nature, the fund's custodian would decline to assume the responsibility for evaluating it. The Commission recognized, however, that conceptually the decision to use a compulsory depository appeared to fall within the scope of the rule's provisions governing the selection of particular custodians. The rule, as proposed to be amended, would have required the fund's board or its delegate to make the same findings with respect to a compulsory depository as those required for the selection of any other type of foreign custodian. *See* Proposing Release, *supra* note 5, at n.71. Because the amended rule does not address the decision to place fund assets in a country, the Commission has concluded that it is not necessary for the rule to distinguish between compulsory depositories and other types of foreign custodians.

[30] Amended rule 17f–5(b)(3) (17 CFR 270.17f–5(b)(3)).

[31] A substantially similar standard of care was suggested by fund and custodian commenters. *See also infra* note 36, (discussing a custodian's standard of care under Article 8 of the Uniform Commercial Code ("U.C.C.")).

[32] Amended rule 17f–5(b)(2) (17 CFR 270.17f–5(b)(2)).

[33] *Id.* A material change in the fund's arrangements would include, for example, a delegate's decision to remove the fund's assets from a particular custodian. A material change also could include events that may adversely affect a foreign custodian's financial or operational strength, such as a change in control resulting from a sale of the custodian's operations. If appropriate, the material change report would discuss the reasons for continuing to maintain the fund's assets with a particular custodian.

[34] Amended rule 17f–5(b)(2) (17 CFR 270.17f–5(b)(2)).

[35] Rule 17f–5(a)(2).

[36] For example, the newly revised Article 8 of the U.C.C. (which has been adopted in 29 states, as of December 1996), addresses the duty of care to be exercised by a custodian (or other "securities intermediary"). Section 8–504 provides that in the absence of an agreement, the custodian should exercise "due care in accordance with reasonable commercial standards." (Section 8–509 recognizes that regulatory law may impose a higher standard.) Note 4 to Section 8–504 observes that "(the duty of care includes both care in the intermediaries' own operations and care in the selection of other intermediaries through whom the intermediary holds the assets in question."

standard would suggest that the level of custodial protection that is deemed "reasonable" would vary from fund to fund.

In proposing the reasonable protection standard, the Commission emphasized that the delegate would not be required to find that fund assets could never be lost while in the foreign custodian's possession. Instead, the focus would have been on the reasonableness of a custodian's protections for the fund's assets, based on all relevant factors and, in particular, those factors that would have been specified in the rule.[37] Thus, the proposed standard was not intended to be substantially different than the reasonable care standard suggested by the commenters. Nonetheless, recognizing the benefits of using terminology currently used and commonly understood by participants in fund custodial arrangements, the Commission has decided to adopt a "reasonable care" standard as suggested by commenters. The use of this terminology also underscores the objective nature of the standard for determining whether a fund's custodial arrangements in a particular country satisfy a "reasonableness" standard.

The amended rule requires the fund's board or its delegate (the "Foreign Custody Manager") to determine that the fund's assets will be subject to reasonable care if maintained with the foreign custodian.[38] This determination would be based on standards applicable to custodians in the relevant market.[39] In making this determination, the Foreign Custody Manager must consider all factors relevant to the safekeeping of fund assets, including the custodian's practices, procedures and internal controls, its financial strength, reputation and standing, and whether the fund will be able to obtain jurisdiction over and enforce judgments against the custodian.[40] The Commission notes that the reasonable care standard is merely a threshold standard, and that fund boards and their delegates have the flexibility to agree that the delegate will select foreign custodians that will exercise a higher degree of care with respect to fund assets.

b. Specified Factors

The amended rule requires the Foreign Custody Manager to consider all factors relevant to the safekeeping of fund assets. The rule identifies several specific factors that the Foreign Custody Manager must consider when selecting a foreign custodian.

i. Practices, Procedures and Internal Controls

The amended rule states that the foreign custodian's practices, procedures, and internal controls are among the factors that must be considered in deciding whether the fund's assets will be subject to reasonable care.[41] As noted in the Proposing Release, the protections provided by custodians within a foreign country can vary widely.[42] The amended rule specifies certain additional factors that should be considered in assessing the custodian's internal controls: The physical protections the custodian makes available for certificated securities (*e.g.*, the use of vaults or other facilities), the custodian's method of keeping custodial records (*e.g.*, the use of computers, microfilm or paper records), as well as security and data protection practices (*e.g.*, alarm systems and the use of pass codes and back-up procedures for electronically stored information). The proposed amendments would have treated these factors as related to the decision to place fund assets in a country.[43] Commenters suggested, and the Commission agrees, that these factors also should be considered in selecting a particular foreign custodian.[44]

ii. Financial Strength and Reputation

The amended rule requires the Foreign Custody Manager to consider whether the foreign custodian has the requisite financial strength to provide reasonable care for fund assets.[45] Particular emphasis should be placed on evaluating the custodian's financial strength, since the amended rule no longer requires the foreign custodian to have a specified minimum shareholders' equity.[46] As noted in the Proposing Release, in considering financial strength, the Foreign Custody Manager should assess the adequacy of the custodian's capital with a view of protecting the fund against the risk of loss from a custodian's insolvency.[47]

In addition, consideration must be given to the custodian's reputation and standing generally. The amended rule does not limit the Foreign Custody Manager to considering the foreign custodian's reputation in the country where the custodian is located. This approach seeks to provide greater flexibility to evaluate a custodian's reputation based on the facts and circumstances relevant to the particular custodian (such as the custodial services it provides in other jurisdictions).[48]

iii. Jurisdiction

The amended rule also requires the Foreign Custody Manager to assess the likelihood of U.S. jurisdiction over and enforcement of judgments against a foreign custodian.[49] This provision is designed to allow the Foreign Custody Manager to consider various factors, including whether a foreign custodian has branch offices in the United States. The Foreign Custody Manager should evaluate other jurisdictional and enforcement means such as whether the foreign custodian has appointed an agent for service of process in the United States or has consented to jurisdiction in this country. The Commission recognizes that U.S. jurisdiction may not be obtainable over certain foreign depositories and other custodians, and an affirmative finding of U.S. jurisdiction would not be required. Rather, the existence or absence of U.S. jurisdiction would have to be considered in making the overall

[37] *See* Proposing Release, *supra* note 5, at n.80 and accompanying text.

[38] Amended rule 17f–5(c)(1) (17 CFR 270 17f–5(c)(1)).

[39] *Id.* As noted in the Proposing Release, *supra* note 5, at nn.88–89 and accompanying text, while reference to U.S. standards may be relevant in determining whether the fund's assets will be maintained with reasonable care, the rule does not require parity between foreign and U.S. custodial arrangements.

[40] Amended rule 17f–5(c)(1) (i) through (iv) (17 CFR 270.17f–5(c)(1) (i) through (iv)).

[41] Amended rule 17f–5(c)(1)(i) (17 CFR 270.17f–5(c)(1)(i)).

[42] *See* Proposing Release, *supra* note 5, at nn.88–89 and accompanying text. For example, if delivery vs. payment procedures are not part of the settlement practices of a particular foreign market, some custodians in that market might provide safeguards that address the lack of such procedures, while others might not. *See, e.g.*, Department of the Treasury, Office of Comptroller of the Currency, *Emerging Market Country Products and Trading Activities* 20 (Dec. 1995) (discussing alternatives to delivery vs. payment procedures). Such differences among custodians should be considered in determining whether a particular custodian will provide reasonable care for fund assets. *See supra* note 17 (discussing the delivery vs. payment procedures).

[43] *See* Proposing Release, *supra* note 5, at n.54 and accompanying text.

[44] *See* Letter from Chase Manhattan Bank to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Oct. 6, 1995), File No. S7–23–95, at n.4 (noting that the use of vaults and computers, for example, is important with respect to any particular foreign custodian).

[45] Amended rule 17f–5(c)(1)(ii) (17 CFR 270.17f–5(c)(1)(ii)).

[46] *See infra*, Section III.D.1 of this Release.

[47] *See* Proposing Release, *supra* note , at nn.125–131 and accompanying text.

[48] Amended rule 17f–5(c)(1)(iii) (17 CFR 270.17f–5(c)(1)(iii)). The amended rule no longer addresses a custodian's efficiency and relative costs.

[49] Amended rule 17f–5(c)(1)(iv) (17 CFR 270.17f–5(c)(1)((iv)).

determination that the custodian will provide reasonable care for fund assets.

2. Foreign Custody Contract

Rule 17f–5 currently requires a fund's foreign custody arrangements to be governed by a written contract that the fund's board determines is in the best interests of the fund and which contains specified provisions.[50] The proposed amendments would have eliminated the requirement that specific provisions be included in the contract but would have required the Foreign Custody Manager to determine that the contract would provide reasonable protection for fund assets. Although a small number of commenters supported the proposed approach, commenters generally favored retaining the contract requirements in the rule as benefitting funds and their shareholders. The commenters asserted, among other things, that the rule's requirements have resulted in international standards for foreign custody agreements that have served to protect investors.

In light of these comments, the Commission has concluded that the amended rule should continue to require foreign custody arrangements to be governed by a written contract. Consistent with the new standard for evaluating foreign custody arrangements, the amended rule requires that the Foreign Custody Manager determine that the contract will provide reasonable care for fund assets.[51] The amended rule also retains the specific contract requirements.[52] In addition, the amended rule permits the contract to contain alternative provisions in lieu of those specified in the rule. The Foreign Custody Manager must determine that the alternative provisions, in their entirety, will provide the same or a greater level of care and protection for fund assets as the specified provisions, in their entirety.[53] This change should provide funds and their custodians with the flexibility to take advantage of innovations that are consistent with investor protection. Finally, as discussed below, the specified contract requirements have been modified to reflect commenters' suggestions and staff interpretive positions.

a. Indemnification and Insurance

Rule 17f–5 currently requires the foreign custody contract to provide that the fund will be adequately indemnified *and* its assets adequately insured in the event of loss.[54] This provision has been interpreted as permitting the contract to provide for indemnification (but not insurance) if the indemnification arrangements would adequately protect the fund.[55] In response to the commenters' suggestions, the Commission has clarified the provision in rule 17f–5 to reflect this interpretation.[56] The amended rule specifies that the contract must provide for indemnification or insurance arrangements (or any combination of the foregoing) such that the fund will be adequately protected against the risk of loss of assets held in accordance with the contract.[57]

b. Liens

Rule 17f–5 currently requires the foreign custody contract to provide that the fund's assets will not be subject to any right, charge, security interest, lien or claim of any kind in favor of the foreign custodian or its creditors except a claim of payment for the safe custody or administration of the fund's assets.[58] Commenters suggested that in many jurisdictions, cash deposits may become subject to creditors' claims if a custodian becomes bankrupt. The rule as amended addresses this issue by providing that the prohibition against liens does not apply to cash deposits that may become subject to creditors' claims or rights arising under bankruptcy, insolvency, or other similar laws.[59] If a fund places assets with a custodian in a jurisdiction in which the deposits can become subject to a lien, the Foreign Custody Manager should take this factor into account in determining whether the foreign custodian has the requisite financial strength to provide reasonable care for fund assets, and in establishing monitoring procedures with respect to the custodial arrangement.[60] The Foreign Custody Manager, for example, should consider adopting procedures for assuring that the amount maintained in deposit accounts that could be subject to liens is kept to a minimum or explore reasonable alternatives to cash deposits.

c. Omnibus Accounts

In an "omnibus account" structure, the assets of more than one custodial customer are contained in an account that has been established, typically by and in the name of an intermediary custodian, with a foreign bank or securities depository. Rule 17f–5 currently requires the foreign custody contract to provide that adequate records will be maintained identifying the assets in foreign custody as belonging to the fund.[61] Although the Commission staff has taken the position that the current rule does not prescribe a specific manner for keeping custodial records, and therefore does not prohibit omnibus accounts,[62] several commenters recommended amending the rule to specifically recognize the permissibility of omnibus accounts.

The amended rule provides that the custodian's records may either identify the assets as belonging to the fund or as being held by a third party for the benefit of the fund.[63] The amended rule therefore recognizes that in an omnibus account structure, the securities depository's books may show that the custodian is the owner of the fund's assets. The amended rule makes clear, however, that the fund's interest in the account should be reflected on the books of the custodian.[64]

d. Depository Arrangements

The Commission understands that foreign depository arrangements typically are governed not by contract, but pursuant to rules or practices of the depository.[65] To accommodate the use

[50] Rule 17f–5(a)(1)(iii). 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. Rule 17f–5(a)(1)(iii)(A) through (F).

[51] Reasonable care, in this context, would be determined by reference to the same standards used in selecting the foreign custodian.

[52] Amended rule 17f–5(c)(2)(i) (17 CFR 270.17f–5(c)(2)(i)).

[53] Amended rule 17f–5(c)(2)(ii) (17 CFR 270.17f–5(c)(2)(ii)).

[54] Rule 17f–5(a)(1)(iii)(A).

[55] *See* Investment Company Institute (Nov. 4, 1987).

[56] Amended rule 17f–5(c)(2)(i)(A) (17 CFR 270.17f–5(c)(2)(i)(A)).

[57] *See* Investment Company Institute, *supra* note 55.

[58] Rule 17f–5(a)(1)(iii)(B).

[59] Amended rule 17f–5(c)(2)(i)(B) (17 CFR 270.17f–5(c)(2)(i)(B)).

[60] *See infra* Section III.C.3 of this Release.

[61] Rule 17f–5(a)(1)(iii)(D).

[62] *See* State Street Bank & Trust Company (Feb. 28, 1995).

[63] Amended rule 17f–5(c)(2)(i)(D) (17 CFR 270.17f–5(c)(2)(i)(D)).

[64] *Id.* A conforming change has been made to paragraph (c)(2)(i)(F) of the rule, which requires that the fund receive notice of any transfers of fund assets to or from the custodian. This notice provision requires notice of transfers to or from third party accounts. Amended rule 17f–5(c)(2)(i)(F) (17 CFR 270.17f–5(c)(2)(i)(F)).

[65] Typically, the contractual arrangement pursuant to which fund assets are held in a foreign depository involves an eligible foreign bank that is itself a subcustodian of the fund's U.S. custodian. Rule 17f–5 currently does not require the foreign depository to be party to the fund's foreign custody

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of these depositories, the Commission is amending rule 17f–5 to clarify that the provisions required to be in the custody contract may be reflected in the rules or established practices or procedures of the depository, or in any combination of the foregoing.[66]

3. Monitoring Custody Arrangements and Withdrawing Fund Assets

Rule 17f–5 currently contains detailed provisions concerning board oversight and monitoring of foreign custodial arrangements.[67] The amended rule replaces these provisions with a requirement that the Foreign Custody Manager establish a system to monitor the appropriateness of maintaining the fund's assets with a particular custodian and the fund's foreign custody contract.[68] Commenters supported these amendments.

If a foreign custody arrangement no longer meets the requirements of the amended rule, the fund must withdraw its assets from the custodian as soon as reasonably practicable.[69] Rule 17f–5's monitoring requirement is intended to result in the Foreign Custody Manager receiving sufficient and timely information to permit it to respond to material changes in the fund's foreign custody arrangement. The amended rule focuses on the importance of taking prompt action based on the circumstances presented. For example, a fund that places substantially all of its assets with one custodian 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 in a particular country.

D. Eligible Foreign Custodians

1. Foreign Banks and Trust Companies

Rule 17f–5 currently limits the class of "eligible foreign custodians" to foreign banks and trust companies that have more than $200 million in shareholders' equity and U.S. bank subsidiaries that have more than $100 million in shareholders' equity.[70] The Commission proposed eliminating these requirements in favor of a more flexible standard that allows the Foreign Custody Manager to take into account all factors that affect the foreign custodian's financial strength and its ability to provide custodial services, including credit and market risks.[71] Commenters strongly supported these amendments.

Under the amended rule, any foreign bank or trust company that is subject to foreign bank or trust company regulation, as well as any U.S. bank subsidiary, may be an eligible foreign custodian.[72] As discussed above, a custodian's financial strength is an important factor to be considered in selecting a foreign custodian. The amended rule requires the Foreign Custody Manager to evaluate the financial strength of a foreign custodian in determining whether the fund's assets will be subject to reasonable care if maintained with that custodian.[73]

2. Affiliated Foreign Custodians

Rule 17f–5 currently does not address affiliated foreign custody arrangements. Under the proposed amendments, eligible foreign banks and trust companies would have been prohibited from being affiliated persons of the fund or affiliated persons of such persons. The Commission proposed this approach because rule 17f–2 under the Investment Company Act, the rule that governs funds' self-custody arrangements and has been interpreted by the Commission staff to apply to affiliated custody arrangements, appeared to be unworkable in the foreign custody context.[74]

Commenters generally disagreed with the proposed prohibition, arguing that it would be particularly troublesome in certain markets where there is a limited number of eligible custodians. In response to these comments, and upon further consideration of the issue, the Commission is not including the proposed prohibition on foreign affiliated custody arrangements in rule 17f–5 as amended. The Commission will consider the issues raised by foreign affiliated custody arrangements when it considers comprehensive amendments to rule 17f–2.

The Commission understands, however, that a number of market participants currently use arrangements involving an unaffiliated primary custodian of the fund and a foreign sub-custodian that is affiliated with the fund.[75] The Commission is of the view that such an arrangement, provided it is structured with appropriate oversight and controls by the unaffiliated intermediary (*i.e.*, the primary custodian), may adequately address the concerns of self-custody. The risks of misappropriation of fund assets are mitigated when the custody arrangement is entered into by, and operated through, an unaffiliated intermediary custodian and is subject to adequate independent scrutiny.

The Commission believes that this generally would be the case when the fund's assets are held by the foreign sub-custodian in an omnibus account in the name of the primary custodian, so as to preclude specific identification of fund assets by the affiliated sub-custodian. In addition, adequate involvement by an unaffiliated custodian would require that the sub-custodian be permitted to settle transactions involving fund assets solely on receipt of instructions from the primary custodian (which, in turn, receives its instructions from the fund).[76] The primary custodian also should closely monitor the fund's account to assure that unauthorized transactions have not occurred, and the fund's auditors should review and test the monitoring and control safeguards for fund assets.

3. Securities Depositories

Rule 17f–5 currently includes among eligible foreign custodians a foreign securities depository or clearing agency that operates the only system for the central handling of securities or equivalent book-entries in a country (the "only system requirement").[77] The only system requirement was designed to ensure a country's interest in establishing and maintaining a depository's integrity. Because the requirement has been unnecessarily restrictive, the Commission proposed to eliminate it.[78] Commenters uniformly supported the proposed change.

The amended rule requires a securities depository or clearing agency that acts as a system for the central

contract. *See* Proposing Release, *supra* note 5, at nn. 98–100 and accompanying text.

[66] Amended rule 17f–5(c)(2) (17 CFR 270.17f–5(c)(2)).

[67] Rule 17f–5(a) (2) through (4).

[68] Amended rule 17f–5(c)(3)(i) (17 CFR 270.17f–5(c)(3)(i)).

[69] Amended rule 17f–5(c)(3)(ii) (17 CFR 270.17f–5(c)(3)(ii)). Current rule 17f–5(a)(4) requires fund assets to be withdrawn within 180 days under these circumstances.

[70] Rule 17f–5(c)(2)(i), (ii).

[71] *See* Proposing Release, *supra* note 5, at nn.124–126 and accompanying text.

[72] Amended rule 17f–5(a)(1) (17 CFR 270.17f–5(a)(1)).

[73] *See supra* Section III.C.1.b.ii of this Release.

[74] *See* Proposing Release, *supra* note 5, at n.138; Pegasus Income and Capital Fund, Inc. (Dec. 31, 1977) (to guard against potential abuses resulting from control over fund assets by related persons, rule 17f–2 (17 CFR 270.17f–2) has been applied to affiliated custody arrangements). Rule 17f–2 requires, among other things, that fund assets 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), (e) (17 CFR 270.17f–2(b), (d), (e)).

[75] *See supra* note 18 and accompanying text (discussing primary custodians).

[76] The affiliated sub-custodian should not share personnel with other affiliates of the fund (*e.g.*, the fund's investment adviser) to assure the integrity of the safeguards for fund assets.

[77] Rule 17f–5(c)(2)(iii).

[78] *See* Proposing Release, *supra* note 5, at nn.155–156 and accompanying text.

handling of securities or equivalent book-entries to be regulated by a foreign financial regulatory authority.[79] The Commission believes that foreign regulation of a depository demonstrates a country's interest in the depository's safety, thus achieving the Commission's objective.

E. Assets Maintained in Foreign Custody

Rule 17f–5 currently permits a fund to use foreign custody arrangements for its foreign securities, cash, and cash equivalents.[80] Rule 17f–5 defines foreign securities to include those that are issued and sold primarily outside the United States by foreign and U.S. issuers.[81] By restricting the types of securities that may be maintained outside the United States, the rule seeks to establish a nexus between its scope and its purpose (*i.e.*, to give funds the flexibility to keep abroad assets that are purchased or intended to be sold abroad). In addition, rule 17f–5 currently limits the cash and cash equivalents that a fund may maintain outside the United States to amounts that are reasonably necessary to effect the fund's foreign securities transactions.[82]

The Proposing Release requested comment whether the rule should continue to restrict the types of securities and amounts of cash and cash equivalents that a fund may maintain outside the United States. One commenter suggested that this provision may not permit a fund to maintain investments in other assets, such as foreign currencies, for which the primary market is outside of the United States. To better reflect these types of investment practices, the amended rule permits a fund to maintain in foreign custody any investment (including foreign currencies) for which the primary market is outside the United States.[83]

F. Canadian Funds

Rule 17f–5 currently contains special provisions governing the foreign custody arrangements of Canadian funds registered in the United States.[84] To address jurisdictional concerns underlying section 7(d) of the Act, these provisions are more restrictive than those applied to U.S. funds and allow Canadian funds to maintain their assets only in overseas branches of U.S. banks.[85] Because Canadian funds have not sought to register under the Act for some time, and very few Canadian funds currently offer their shares in the United States, the proposed amendments would have made limited conforming changes in the foreign custody requirements applicable to Canadian funds.

The Commission received one comment letter addressing Canadian funds. The commenter suggested that Canadian funds be permitted to use foreign custody arrangements on the same basis as their U.S. counterparts. The amended rule generally reflects this approach. As under the current rule, however, a Canadian fund's assets must be kept in the custody of an overseas branch of a U.S. bank. In addition, if the Canadian fund's board delegates its responsibilities under the rule, the only permissible delegates are the fund's officers, investment adviser or a U.S. bank.[86]

IV. Effective Date; Compliance Dates

The amendments to rule 17f–5 become effective thirty days after publication in the **Federal Register**. Funds that wish to rely on the amended rule prior to the effective date of the amendments may do so. Funds that have established foreign custody arrangements in accordance with rule 17f–5 prior to the effective date of these amendments ("existing foreign custody arrangements") must bring these arrangements into compliance with the amended rule (*i.e.*, have the fund's board make the findings required by the amended rule or appoint a delegate to do so) within one year of the effective date of these amendments. The one year period is designed to give funds the flexibility to bring an existing foreign custody arrangement into compliance with the amended rule either when that arrangement would have been subject to the fund board's annual review, as was required by the rule before these amendments, or at any board meeting within the one year period.

V. Cost/Benefit Analysis and Effects on Competition, Efficiency and Capital Formation

The amendments to rule 17f–5 seek to give funds greater flexibility in their foreign custody arrangements consistent with investor protection. The amended rule permits a fund's board to delegate its responsibilities to select and monitor a fund's foreign custody arrangements and no longer requires the board to approve these arrangements annually. The amended rule does require delegates to provide fund boards with written reports regarding certain aspects of the foreign custody arrangements. This requirement is designed to facilitate board oversight and protect fund shareholders. The potential costs associated with this requirement are not expected to be significant, and are likely to be much less than the costs associated with the current requirement of providing fund boards with information pertaining to their annual review of foreign custody arrangements.

The amendments also expand the class of foreign banks and securities depositories that may serve as custodians of fund assets overseas. These amendments give funds greater flexibility in selecting foreign custodians and eliminate the need for funds to request administrative relief for certain foreign custody arrangements.

Section 2(c) of the Investment Company Act provides that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[87] The Commission has considered the amendments to rule 17f–5 in light of these standards. The Commission believes that the amendments are consistent with the public interest and will promote efficiency and competition because the amendments (i) permit fund directors to

[79] Amended rule 17f–5(a)(1)(ii) (17 CFR 270.17f–5(a)(1)(ii)). Rule 17f–5 currently also includes among eligible foreign custodians a security depository or clearing agency, incorporated or organized under the laws of a country other than the United States, that "operates" a transnational system for the central handling of securities or equivalent book-entries. The amended rule refers to securities depositories or clearing agencies that "act as" such transnational systems. Amended rule 17f–5(a)(1)(iii) (17 CFR 270.17f–5(a)(1)(iii). This change is intended to recognize that in some instances the service provider that operates or administers the transnational system may be organized under the laws of the United States (*e.g.*, as a foreign branch of a U.S. bank).

[80] Rule 17f–5(a).

[81] Rule 17f–5(c)(1).

[82] Rule 17f–5(a).

[83] Amended rule 17f–5(c) (17 CFR 270.17f–5(c)). As a result of this change, the rule no longer refers to "foreign securities" (which had been defined as securities "issued and sold primarily outside of the United States"). The "primary market" formulation is designed to encompass foreign securities as well as other types of investments.

[84] Rule 174f–5(b)

[85] Section 7(d) of the Investment Company Act (15 U.S.C. 80a–7(d)) prohibits foreign investment companies from publicly offering their securities in the United States unless the Commission issues an order permitting registration under the Act. Rule 7d–1 under the Investment Company Act (17 CFR 270.7d–1) sets forth conditions governing applications by Canadian funds that seek Commission orders pursuant to section 7(d). Among other conditions, rule 7d–1 provides that the assets of Canadian funds are to be held in the United States by a U.S. bank, except as provided under rule 17f–5. Rule 7d–1(b)(8)(v) (17 CFR 270.7d–1(b)(8)(v)).

[86] Amended rule 17f–5(d) (1), (2) (17 CFR 270.17f–5(d) (1), (2)).

[87] 15 U.S.C. 80a—2(c).

play a more traditional oversight role with respect to the custody of fund assets overseas, (ii) better focus the scope of the rule on safekeeping considerations, and (iii) expand the class of eligible foreign banks and securities depositories that may serve as custodians of fund assets. The Commission also believes that the amendments will have no adverse effect on capital formation.

VI. Summary of Final Regulatory Flexibility Analysis

A summary of the Initial Regulatory Flexibility Analysis, which was prepared in accordance with 5 U.S.C. 603, was published in Investment Company Act Release No. 21259. No comments were received on that Analysis. The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA") in accordance with 5 U.S.C. 604. The FRFA states that the objective of the amendments is to give funds greater flexibility in their foreign custody arrangements by permitting fund boards to delegate their responsibilities to select and monitor foreign custodians, and by expanding the class of eligible foreign custodians. The FRFA provides that approximately 194 funds and 242 investment advisers that are small entities may be effected by the amendments. The FRFA explains that the amendments seek to reduce burdens on all funds, including those that are small entities, and that the amended rule's compliance requirements are necessary for the safekeeping of fund assets and investor protection. Finally, the FRFA states that in adopting the amendments the Commission considered (a) the establishment of differing compliance requirements that take into account the resources available to small entities; (b) simplification of the rule's requirements for small entities; (c) the use of performance rather than design standards; and (d) an exemption from the rule for small entities. The FRFA states that the Commission concluded that different requirements for small entities are not necessary and would be inconsistent with investor protection, and that the amended rule incorporates performance standards to the extent practicable. Cost-benefit information reflected in the "Cost/Benefit Analysis" section of this Release also is reflected in the FRFA. A copy of the FRFA may be obtained by contacting Robin S. Gross, Mail Stop 10–2, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC. 20549.

VII. Paperwork Reduction Act

The amendments to rule 17f–5, among other things (i) permit a fund's board of directors to delegate its responsibilities under the rule upon a finding that it is reasonable to rely on the delegate to perform the delegated responsibilities, and (ii) require the delegate to notify the board of the placement of the fund's assets with a particular foreign custodian and of any material change in the fund's foreign custody arrangements. These provisions constitute a "collection of information" requirement within the meaning of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501), because making the finding and providing the notices are necessary to be able to rely on the amended rule for foreign custody arrangements. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

Accordingly, the Commission submitted the proposed amendments to the Office of Management and Budget ("OMB") pursuant to 44 U.S.C. 3507 and received approval of the amendments" "collection of information" requirements (OMB control number 3235–0269). As discussed in section III.A. of this Release, the Commission has determined not to adopt the proposed amendment requiring a fund's board to make a finding that placing fund assets in a particular country would provide reasonable protection for fund assets. The Commission believes that this is not a material change for purposes of collection of information requirements and will not have any impact on the Commission's estimate of total burden hours. The amended rule does not require that the collection of information be made public or kept confidential by the parties; to the extent that the Commission obtains access to the collection of information through its inspection program, the information generally would not be available to third parties.

VIII. Statutory Authority

The Commission is amending rule 17f–5 pursuant to the authority set forth in sections 6(c) and 38(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–6(c), 80a–37(a)).

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Rule

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 270—RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

1. The authority citation for part 270 continues to read, in part, as follows:

Authority: 15 U.S.C. 80a–1 *et seq.*, 80a–37, 80a–39 unless otherwise noted;

* * * * *

2. Section 270.17f–5 is revised to read as follows:

§ 270.17f–5. Custody of investment company assets outside the United States.

(a) *Definitions.* For purposes of this section:

(1) *Eligible Foreign Custodian* means an entity that is incorporated or organized under the laws of a country other than the United States and that is:

(i) A Qualified Foreign Bank or a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company;

(ii) A securities depository or clearing agency that acts as a system for the central handling of securities or equivalent book-entries in the country that is regulated by a foreign financial regulatory authority as defined under section 2(a)(50) of the Act (15 U.S.C. 80a–2(a)(50)); or

(iii) A securities depository or clearing agency that acts as a transnational system for the central handling of securities or equivalent book-entries.

(2) *Foreign Custody Manager* means a Fund's or a Registered Canadian Fund's board of directors or any person serving as the board's delegate under paragraphs (b) or (d) of this section.

(3) *Fund* means a management investment company registered under the Act (15 U.S.C. 80a) and incorporated or organized under the laws of the United States or of a state.

(4) *Qualified Foreign Bank* means a banking institution or trust company, incorporated or organized under the laws of a country other than the United States, that is regulated as such by the country's government or an agency of the country's government.

(5) *Registered Canadian Fund* means a management investment company incorporated or organized under the laws of Canada and registered under the Act pursuant to the conditions of § 270.7d–1.

(6) *Securities Depository* means a system for the central handling of securities as defined in § 270.17f–4(a).

(7) *U.S. Bank* means an entity that is:

(i) A banking institution organized under the laws of the United States;

(ii) A member bank of the Federal Reserve System;

(iii) Any other banking institution or trust company organized under the laws of any state or of the United States, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this section, or

(iv) A receiver, conservator, or other liquidating agent of any institution or firm included in paragraphs (a)(7)(i), (ii), or (iii) of this section.

(b) *Delegation.* A Fund's board of directors may delegate to the Fund's investment adviser or officers or to a U.S. Bank or to a Qualified Foreign Bank the responsibilities set forth in paragraphs (c)(1), (c)(2), or (c)(3) of this section, *provided that:*

(1) The board determines that it is reasonable to rely on the delegate to perform the delegated responsibilities;

(2) The board requires the delegate to provide written reports notifying the board of the placement of the Fund's assets with a particular custodian and of any material change in the Fund's arrangements, with the reports to be provided to the board at such times as the board deems reasonable and appropriate based on the circumstances of the Fund's foreign custody arrangements; and

(3) The delegate agrees to exercise reasonable care, prudence and diligence such as a person having responsibility for the safekeeping of Fund assets would exercise, or to adhere to a higher standard of care, in performing the delegated responsibilities.

(c) *Selecting an Eligible Foreign Custodian.* A Fund may place and maintain in the care of an Eligible Foreign Custodian any investments (including foreign currencies) for which the primary market is outside the United States, and such cash and cash equivalents as are reasonably necessary to effect the Fund's transactions in such investments, *provided that:*

(1) The Foreign Custody Manager determines that the Fund's assets will be subject to reasonable care, based on the standards applicable to custodians in the relevant market, if maintained with the custodian, after considering all factors relevant to the safekeeping of such assets, including, without limitation:

(i) The custodian's practices, procedures, and internal controls, including, but not limited to, the physical protections available for certificated securities (if applicable), the method of keeping custodial records, and the security and data protection practices;

(ii) Whether the custodian has the requisite financial strength to provide reasonable care for Fund assets;

(iii) The custodian's general reputation and standing and, in the case of a Securities Depository, the depository's operating history and number of participants; and

(iv) Whether the Fund will have jurisdiction over and be able to enforce judgments against the custodian, such as by virtue of the existence of any offices of the custodian in the United States or the custodian's consent to service of process in the United States.

(2) Contract. The Fund's foreign custody arrangements must be governed by a written contract (or, in the case of a Securities Depository, by such a contract, by the rules or established practices or procedures of the depository, or by any combination of the foregoing) that the Foreign Custody Manager has determined will provide reasonable care for Fund assets based on the standards specified in paragraph (c)(1) of this section.

(i) Such contract shall include provisions that provide:

(A) For indemnification or insurance arrangements (or any combination of the foregoing) such that the Fund will be adequately protected against the risk of loss of assets held in accordance with such contract;

(B) That the Fund's assets will not be subject to any right, charge, security interest, lien or claim of any kind in favor of the custodian or its creditors except a claim of payment for their safe custody or administration or, in the case of cash deposits, liens or rights in favor of creditors of the custodian arising under bankruptcy, insolvency, or similar laws;

(C) That beneficial ownership for the Fund's assets will be freely transferable without the payment of money or value other than for safe custody or administration;

(D) That adequate records will be maintained identifying the assets as belonging to the Fund or as being held by a third party for the benefit of the Fund;

(E) That the Fund's independent public accountants will be given access to those records or confirmation of the contents of those records; and

(F) That the Fund will receive periodic reports with respect to the safekeeping of the Fund's assets, including, but not limited to, notification of any transfer to or from the Fund's account or a third party account containing assets held for the benefit of the Fund.

(ii) Such contract may contain, in lieu of any or all of the provisions specified in paragraph (c)(2)(i) of this section, such other provisions that the Foreign Custody Manager determines will provide, in their entirety, the same or a greater level of care and protection for Fund assets as the specified provisions, in their entirety.

(3)(i) Monitoring the Foreign Custody Arrangements. The Foreign Custody Manager must have established a system to monitor the appropriateness of maintaining the Fund's assets with a particular custodian under paragraph (c)(1) of this section, and the contract governing the Fund's arrangements under paragraph (c)(2) of this section.

(ii) If an arrangement no longer meets the requirements of this section, the Fund must withdraw its assets from the custodian as soon as reasonably practicable.

(d) *Registered Canadian Funds.* Any Registered Canadian Fund may place and maintain outside the United States any investments (including foreign currencies) for which the primary market is outside the United States, and such cash and cash equivalents as are reasonably necessary to effect the Fund's transactions in such investments, in accordance with the requirements of this section, *provided that:*

(1) The assets are placed in the care of an overseas branch of a U.S. Bank that has aggregate capital, surplus, and undivided profits of a specified amount, which must not be less than $500,000; and

(2) The Foreign Custody Manager is the Fund's board of directors, its investment adviser or officers, or a U.S. Bank.

May 12, 1997.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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EQUAL EMPLOYMENT OPPORTUNITY COMMISSION

29 CFR Part 1601

Increased Fine for Notice Posting Violations

AGENCY: Equal Employment Opportunity Commission.