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2825 8992

**BY HAND & BY FAX (No. 2869 6794)**

Salumi Chan  
Legislative Council Secretarian  
3/F Citibank Tower  
3 Garden Road, Central

Dear Sirs

**Mandatory Provident Fund Schemes (General) Regulation (the "General Regulation")**

We are writing on behalf of the group of custodians/trustees (the "**Group**") named at the end of this letter.

We refer to the Legislative Council Brief relating to the Mandatory Provident Fund Schemes Ordinance (Chapter 486) prepared by the Financial Services Bureau dated 24 March 2000 (File ref:FSB CR G6/9/39C), which we have had the opportunity to consider briefly. We understand that this Legislative Council Brief, together with the Mandatory Provident Schemes (General) (Amendment) Regulation 2000 (the "**Amendment Regulation**") annexed thereto at Annex B, is being submitted to the Legislative Council's Vetting Committee for approval on 12 April 2000.

A number of the amendments proposed by the Amendment Regulation address or, according to the Legislative Council Brief, are aimed at addressing certain (but not all) areas of concern in relation to the General Regulation that were raised by the Group with the Mandatory Provident Fund Schemes Authority (the "**Authority**") and the Financial Services Bureau ("**FSB**").

Unfortunately, the Group has not been invited to participate in any consultation process in relation to the proposed Amendment Regulation, although certain representatives of the Group had been lead to believe that the Group would be given this opportunity. Certainly, some comfort has been taken by the Group from the fact that the FSB in its Legislative Council Brief have accepted the Group's submissions that certain provisions of the General Regulation are "problematic".

Although we have only had very limited time to consider the proposed Amendment Regulation, we are writing to summarise the Group's position on the Amendment Regulation. We have limited the Group's issues to four main points which remain of considerable concern. We have also provided suggested drafting language for you to consider.

1. ***Permitted encumbrances (under Section 65 of the General Regulation and paragraph 3 of Schedule 3 to the General Regulation)***

We note the proposed amendments (contained in Section 12 of the Amendment Regulation) to Section 65 of the General Regulation. However, there remain several fundamental flaws, as follows:

- (i) We note that a new paragraph (c) will be added to Section 65(2) which permits encumbrances created for certain purposes by "a central securities depository or a delegate of a custodian". It does not, however, permit encumbrances created in favour of "the custodian" for the custodian's own safe custody or administration of scheme assets. What is the basis for excluding the custodian in this way?

*We therefore believe that the words "a custodian" should be added to paragraph (c) between the words "scheme assets by" and "a" on the third line.*

- (ii) Under Sections 65(2)(a) and (b) of the General Regulation (which are not affected by the Amendment Regulation), an encumbrance created over scheme assets in favour of the lender to secure a scheme's permitted borrowings (at the time of the borrowing) should not become void (under Section 65(3) of the General Regulation) simply because the borrowing is not repaid within 90 or 7 days (as the case may be). This is unfairly prejudicial to the lender. The lender may typically have no control in respect of the timing of repayment of the borrowing and could potentially lose its security, unless of course it enforces that security within the prescribed time frame. In our view, this scenario is not in the best interests of the scheme or scheme members.

*Accordingly, paragraphs (a)(iii) and (b)(iii) of Section 65(2) should be deleted in their entirety. To achieve this, a new paragraph (a) and (b) should be added to Section 12 of the Amendment Regulation as follows:*

*"(a) by repealing paragraph (a)(iii) and (b)(iv) in their entirety.*

*(b) by repealing "borrowing; and" from the end of paragraph (a)(ii) and substituting "borrowings. ""*

The period of permitted borrowing for the purposes of the borrowing restrictions contained in paragraph 4 of Schedule 1 would remain. Accordingly, the trustee and the investment manager would still be required to ensure that any borrowings did not exceed 90 or 7 days (as the case may be).

- (iii) For the purposes of Section 65(2)(b)(iv) of the General Regulation, by virtue of paragraph B2.3 of the Authority's Code on MPF Investment Funds (Second Edition, December 1999) (we attach a copy of your case of reference), it is the opinion of the investment manager as to whether a borrowing would be necessary to settle a transaction relating to the acquisition of securities which is relevant. The validity of a lender's (which in most cases will be the custodian) encumbrance over scheme assets to secure a settlement loan is therefore entirely dependent on the "independent" investment manager's (under the General Regulation the investment manager must be independent of the trustee and custodian) belief. Custodians are typically not informed of the reasons for their customers transactions. Custodians should not therefore be exposed to risks over which they have no control. It is common practice for custodians to provide credit facilities to settle customer transactions. Such settlement loans are provided routinely to overcome, for example, time zone difficulties and to address cash shortfalls resulting from failed trades. The availability for such settlement loans are therefore generally considered to be in the interests of the customer, and without which a customer's dealings could be restricted.

Custodians are in most cases unlikely to provide such facilities on a totally unsecured basis (whether or not it is secured depends on the third party investment manager's belief at the relevant time, of which the custodian is unlikely to have knowledge).

*Accordingly, paragraph (b)(iv) should be deleted in its entirety. To achieve this, a new paragraph (c) and (d) could be added to Section 12 of the Amendment Regulation as follows:*

- "(c) by repealing paragraph (b)(iv) in its entirety;*
- (d) by repealing "borrowings; and" from the end of paragraph (b)(ii) and substituting "Borrowings". "*

The points raised above apply equally to paragraph 2 of Schedule 3, and accordingly Section 23(c) of the Amendment Regulation.

## **2. *The trustees/custodian's indemnity (under paragraph 5 of Schedule 3 to the General Regulation)***

First, it is not market practice for custodians to provide indemnities to their customers (although typically, when excluding their liability to a customer custodians would not exclude their liability for fraud, dishonesty and negligence). There is a fundamental distinction in accepting liability for fraud, dishonesty and negligence and providing an indemnity in respect of losses suffered as a result of fraud, dishonesty and negligence.

Secondly, custodians would in nearly all (if not all) cases seek to exclude their liability for indirect, consequential and special losses. Under paragraph 5 of Schedule 3, custodians are in fact required to provide an indemnity for "indirect" losses.

Of course, each custodian seeks to exclude its (and accepts) liability in a slightly different way but the above principles apply across the industry Group.

Thirdly, we note (and appreciate) that Section 23 of the Amendment Regulation gives the Authority the power to waive (subject to such conditions as it sees fit) the requirements for an indemnity, but to do so the Authority must be of the opinion that the indemnity provisions either:

- cause undue hardship;
- are incapable of or precluded from being complied with by virtue of a law in a place outside Hong Kong; or
- are not in the interests of relevant scheme members.

The Group has not yet seen the Authority's proposed guidelines for waiving some or all of the relevant requirements of Schedule 3. In relation to the custodian's indemnity, the Group has concerns that the Authority might have difficulty in reaching an opinion that the removal of the indemnity causes "undue hardship" (the other cases in this instance are probably not applicable). (In this respect, please see our comments at paragraph 3 below). In that case, the Authority may feel that it is not able to grant the necessary waivers to this requirement for an indemnity. If that is the case, then the problems identified by the FSB with this paragraph of Schedule 3 (identified at Section 6 of the Legislative Council Brief (under "Section 5")) will not have been addressed.

The reality is that the giving of an indemnity for indirect losses is commercially unacceptable to the Group and is not in line with market practice.

*The Group would therefore welcome the deletion of the words "or indirectly" appearing in parenthesis in the first line of paragraph 5(a), and ideally the addition of the words "provided that the agreement shall not require the custodian to indemnify the scheme for any indirect, consequential or special losses". The changes required to be made to the Section 23(d) of the Amendment Regulation to achieve this are to add the following words to the end:*

*"and by repealing "or indirectly" in the parenthesis"*

**3. *The circumstances in which the Authority may waive certain of the content requirements of a custodial agreement/trustee's undertaking (as set out in Schedule 3 to the General Regulation)***

Preferably, the Group would like to see the Authority having discretion to be able to waive or modify all of the provisions of Schedule 3. The application of Schedule 3 generally to sub-custodian agreements, for example, adds no additional protection to scheme members, but may increase the costs chargeable to the scheme.

In any event, and entirely consistent with Section 64(1)(b) of the General Regulation and paragraph 1(a) of Schedule 3, we believe that the Authority should have the power to waive any of the relevant requirements of Schedule 3 if the Authority is of the opinion that the requirement is contrary to market practice.

If the Vetting Committee is minded to extend the Authority's waiver discretion to all of the provisions of Schedule 3 then the words "This Schedule is subject to the provision of Section 11" could be added to the beginning of Section 11, and paragraphs (a), (b), and (d) could be deleted from Section 23 of the Amendment Regulation.

*Accordingly, the Group would like to see paragraph (f) of Section 13 of the Amendment Regulation read as follows:*

*"11. [This Schedule is subject to the provision of this Section 11.] The Authority may, subject to such conditions as the Authority thinks fit, by notice in writing (published in such manner as the Authority thinks fit) waive or modify [any and all of the provisions of Schedule 3] where the Authority is of the opinion that those provisions:-*

- (i) cause undue hardship; or*
- (ii) are incapable of or precluded from being complied with by virtue of a law in a place outside Hong Kong; or*
- (iii) are not in the interests of relevant scheme members; or*
- (iv) are contrary to market practice currently prevailing in the place where the custodian or any delegate of the custodian is situated."*

The introduction of the new paragraph (iv) above is important and helpful.

**4. *The treatment of all scheme assets as trust property (under paragraph 1(b) of Schedule 3 to the General Regulation).***

There remain two fundamental flaws with paragraph 1(b) of Schedule 3, as follows:

- (i) Section 23(f) of the Amendment Regulation (and the Legislative Council Brief) recognise that in many jurisdictions the concept of trust is not part of their legal system (in the same way as it is, for example, in Hong Kong).

However, Section 23(f) of the Amendment Regulation applies only to the sub-custodian agreement. Accordingly, under the proposed amendment the custodian is still required to agree with the trustee (or in the deed of undertaking to the Authority) that:

- all scheme assets will be administered as trust property of the scheme (this is acceptable to the Group); and

- where the scheme assets are held in a foreign jurisdiction which does not have a trust law similar to that existing in Hong Kong, those scheme assets will nevertheless be held (by the sub-custodian) "as if such a law were in force in that place and were trust property under that law". It is very difficult to see how a custodian could be expected to give this level of contractual assurance, which the FSB seem to recognise but have not reflected fully.

*Accordingly, it seems that either the Authority should be given the power to waive paragraph 1(b) for custodian agreements/trustee's deed of undertaking under section 69(1) or (2) as well as sub-custodian agreements under section 72; or the second part of paragraph (b) should be deleted altogether. To achieve this, the addition of the following to the Amendment Regulation would be welcome:*

- *in Section 23(f): "by deleting "(a) the provisions of section 1(b) of this Schedule in the case of an agreement referred to in section 72 of this Regulation; or (b)" and repealing "section 2 or 5" and substituting "section 1(b), 2 or 5". "*
- *at the end of Section 32(a): "and by repealing "or, if those assets are located in a place where no law of trusts is in force, to be administered and dealt with as if such a law were in force in that place and as if those assets were trust property under that law. ""*
- (i) No distinction is made in paragraph 1(b) of Schedule 3 between "scheme assets" which are securities and those which are cash. The practical (and legal) reality is that custodians which are also authorised institutions will hold cash as banker and not as trust property. The banker's relationship with its customer will be one of debtor/creditor. This distinction needs to be reflected in paragraph 1(b).

*Accordingly, the Group would welcome the following amendments to Section 23(a) of the Amendment Regulation, before "subject to":*

*"other than scheme assets comprising cash held by a custodian which is an authorised institution or an approved overseas bank and"*

If you have any questions on the content of this letter please do not hesitate to contact Mark Shipman (tel: 2825 8992) at Clifford Chance.

Representatives of the Group would also be very happy to attend Wednesday's meeting of the Vetting Committee to discuss the Group's concerns in some more detail if this would be helpful.

Yours faithfully

## **Clifford Chance**

*list of the names of the Group*

The Bank of Bermuda Limited & Bermuda Trust (Far East) Limited

The Chase Manhattan Bank

Brown Brothers Harriman (Hong Kong) Limited

Butterfield Trust (Hong Kong) Limited

Citibank N.A.

Deutsche Bank

HSBC International Trustee Limited

State Street Bank and Trust Company

The Northern Trust Company of Hong Kong Limited

Standard Chartered Bank

The Bank of New York

## Chapter B2: Investment Requirements

### General Requirement

- B2.1 A constituent fund may maintain an internal portfolio by investing in permissible investments in accordance with sections 2-5 and 7-16 of Schedule 1 to the Regulation, or may invest in one or more APIFs.

### *Financial Futures and Option Contracts*

- B2.2 In the case of a constituent fund acquiring financial futures and option contracts for purposes other than hedging, the approved trustee and the investment manager must have the relevant experience in administering and managing futures and options funds recognized by the SFC.

### *Borrowing of Money*

- B2.3 No borrowing of money for a constituent fund is allowed otherwise than in accordance with section 4 of Schedule 1 to the Regulation. Temporary borrowing can be made for the purposes of settling a transaction to acquire securities or other investments only if at the time the decision to enter into the transaction was made, it was unlikely that the borrowing would be necessary. It means that, as a matter of course, borrowing to settle a transaction to acquire securities or other investments, or entering into transactions with the intention of borrowing to cover settlement is not allowed. At the time an acquisition transaction is entered into, the constituent fund should have sufficient cash on hand or, in the reasonable opinion of the investment manager, cash will be available from the disposition of other securities or investments in time to settle the acquisition transaction.

### *Bank Deposits*

- B2.4 For the purposes of section 11 of Schedule 1 to the Regulation, "deposit" has the same meaning as in section 2 of the Banking Ordinance (Cap. 155) and also includes a certificate of deposit issued by an authorized financial institution. That definition may include deposits that are at negative interest, at no interest or