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20 April 2000

*By fax: 2869 6794*

Miss Salumi Chan  
Clerk to Subcommittee  
Legislative Council  
Legislative Council Building  
8 Jackson Road  
Central  
Hong Kong

Dear Salumi,

**Mandatory Provident Fund Schemes  
(General) Regulation (“Regulation”)**

I refer to Mr Shipman’s letter to you on the captioned subject dated 11 April 2000.

Our comments to the issues raised in the letter are set out in the following paragraphs.

**Item 1(i)**

The purpose of proposing to permit encumbrances created in favour of subcustodians is to enable the custodians to tap into their existing network of subcustodians without having to re-negotiate a new subcustodial agreement with each of them, which might be difficult, time-consuming and costly. However, each custodial agreement in relation to MPF schemes will

necessarily be a new contract incorporating the conditions prescribed in Schedule 3 to the Regulation. Moreover, the parties to the custodial agreement, i.e., the trustee and the custodian, are required to have a presence in Hong Kong. In the remote case of any non-payment of custodian fees or charges, the custodian can quite easily resolve such cases with the trustee face-to-face. It is therefore considered that no amendment in this regard needs to be introduced.

**Item 1(ii)&(iii)**

The policy is that MPF schemes should not borrow because, to do so, scheme investments would be leveraged thus creating unnecessary risks. For that reason, sections 65(2)(a) and (b) seek to limit borrowing to circumstances where it is needed temporarily (until part of scheme assets is sold to repay the loan) to enable accrued benefits to be paid or to complete the acquisition of scheme assets.

Such settlement loans are usually provided by the custodian (or subcustodian) and are secured by a lien or other encumbrance over the scheme assets acquired. By that lien, in the event that the loan is not repaid, the custodian (or subcustodian) will be entitled to hold the scheme assets. Our view is that a similar lien would also arise impliedly by operation of law in common law jurisdictions.

Sections 65(2)(a) and (b) depend upon the intent of the borrowing. Our view is that if a loan was taken for a period of only 90 days or 7 working days (as the case may be) but, through no fault of the custodian (or subcustodian) was not repaid within that time, the loan and the encumbrance would not be invalidated. Provided that a secured loan was created for the purposes specified in those paragraphs, if the loan was extended beyond 90 days or 7 working days (as the case may be) for reasons beyond the control of the custodian (or subcustodian), neither sections 65(1) nor 65(3) would come into operation.

We stress that sections 65(2)(a) and (b) looks at the purpose of the loan and not the ultimate outcome. Section 3 of Schedule 3 is virtually identical to sections 65(2)(a) and (b).

It would be relatively simple for the custodian (or subcustodian) to be made aware of the purpose of the loan by the trustee issuing an instruction that, unless a contrary intention is expressed, the purpose of all borrowings is to pay benefits or settle transactions relating to the acquisition of scheme assets.

### **Items 2 and 3**

Section 5 of Schedule 3 requires that a custodian (or subcustodian) indemnify the scheme “for any losses incurred (directly or indirectly) by scheme members” in consequence of fraud, dishonesty or negligence on the part of the custodian or subcustodian or their employees.

Mr Shipman’s client’s concern is that the coverage of indirect losses places an intolerable risk on them insofar as they would be liable for unforeseeable losses. It is also suggested that the MPFA should rely on prevailing market practice. The Administration does not accept this view.

When the content of the custodial agreement was first proposed, it was the intention of the legislators to maintain certain control over the terms of the custodial agreement. Since custodians (and subcustodians) are the main parties holding scheme assets, it is necessary to ensure that proper contractual agreement with the custodians (and subcustodians) would be in place so as to ensure that scheme members’ interests would be well protected.

As reflected in paragraph 6 in the LegCo Brief, the concern of the group of custodians/trustees was well noted by the Administration. The proposed amendment allows flexibility to the MPFA to relax some of the alleged problematic clauses in Schedule 3 to the Regulation on a case-by-case basis having due regard to factors including undue hardship, operation of laws in a place outside Hong Kong and interests of relevant scheme members. We believe that this approach can, to a large extent, alleviate the Group’s concern without compromising the scheme members’ interest.

### **Item 4**

We note the concerns expressed but we do not see section 1(b) of Schedule 3 operating in the manner suggested in Mr Shipman’s letter. Section 1(b) does not require the assets held in a jurisdiction where there is no trust law to be held on trust.

Our understanding is that in Hong Kong a custodian's accounts and records would record that scheme assets were held for the XYZ scheme or by XYZ (i.e. the trustee) and were not the custodian's assets. A Hong Kong sub-custodian's accounts and records would record that scheme assets were held for a specified custodian. That is how scheme assets are dealt with and administered in a jurisdiction where there is trust law. We consider that scheme assets held in a non-trust jurisdiction could in most circumstances be "administered and dealt with as if such law was in force in that place and were trust property under that law" in a similar manner.

Nevertheless, for the sake of clarification, the MPFA is seeking discretion to waive or modify section 1(b) in circumstances where it is impossible to so deal with and administer assets in a foreign jurisdiction.

A custodian (or subcustodian) may hold cash on deposit with the custodian (or subcustodian) provided that, in doing so, the custodian (or subcustodian) recognizes that the deposit is held for the trustee (or custodian) on trust. No amendment is therefore considered required in this regard.

Yours sincerely,

( Miss Patricia So )  
for Secretary for Financial Services