April 21, 2000

VIA FACSIMILE AND AIR COURIER

Salumi Chan
Clerk to Subcommittee
Subcommittee on Mandatory Provident Fund Schemes Ordinance
3/F Citibank Tower
3 Garden Road, Central
Hong Kong Special Administrative Region
of the People's Republic of China

Re: Mandatory Provident Fund Schemes (General) Regulation

Dear Ms. Chan:

This letter is submitted on behalf of the Association of Global Custodians ("Association") to address the custody-related provisions of the Mandatory Provident Fund Schemes (General) Regulation ("Regulation") and the changes to the Regulation proposed in the Legislative Council Brief entitled "Mandatory Provident Fund Schemes Ordinance (Chapter 486)" (March 24, 2000) ("Brief"). The Association is an informal coalition of nine U.S. banks that act as global custodians or sub-custodians for the assets of major institutional investors.[1]

1/ The members of the Association are:

The Bank of New York
Boston Safe Deposit and Trust Company
Brown Brothers Harriman & Co.
The Chase Manhattan Bank
Citibank, N.A.
Deutsche Bank/Bankers Trust Company

Interest of the Association

Members of the Association intend to act as global custodian for accounts that hold assets of Mandatory Provident Fund Schemes ("Schemes"). The custody provisions of the Regulation are therefore of considerable interest and importance to the Association. On December 8, 1999, the Association submitted a letter ("December 8 Letter") concerning the impact of the Regulation on Scheme global custody to Raymond Tam, Executive Director (Service Supervision), Mandatory Provident Fund Schemes Authority ("Authority"). A copy of that letter is attached hereto.

As noted in the December 8 Letter, the Association is deeply concerned that compliance with certain provisions of the Regulation would be legally or practically impossible. Further, the Regulation would impose severe burdens on global custodians without materially increasing the safety of Scheme assets. The impact of these obstacles to global custody would be to limit the access of Schemes to the services of many of the largest and most sophisticated global custodian banks, increase costs for Schemes that invest in securities that trade outside of Hong Kong, and, in some cases, to preclude Schemes from investing in particular markets. We strongly believe that these consequences would not be in the best interests of Schemes or their members.[2]

Investors Bank & Trust Company
The Northern Trust Company
State Street Bank and Trust Company

The members of the Association are among the largest providers of global custody services in the world. One of the objectives of the Association is to encourage regulatory and legal policies that promote the efficient and effective provision of global custody services and the removal of barriers to transnational custody and investment. The Association seeks to accomplish these goals by, among other activities, participation in governmental and self-regulatory organization proceedings and communication and discussion with regulatory officials.

2/ Our December 8 Letter (pages 3-6) describes the manner in which the cross-border assets of institutional investors are held in custody. We believe that this overview of the features

Comments on the Proposals in the Brief

The Brief describes certain proposed changes to the Regulation. While some of these changes would address issues raised in our December 8 Letter, most of the concerns we raised would not be ameliorated. We would respectfully urge that the Subcommittee review the December 8 Letter and make the further changes needed to address the matters discussed therein.[3]

We do not wish to burden the Subcommittee by repeating in this letter all of the points that are set forth in our December 8 Letter. This letter is therefore limited to highlighting briefly four issues that we have previously raised and that are affected by the changes to the Regulation proposed in the Brief. In other respects, we would direct the Subcommittee's attention to our prior letter.

A. Limitations on Custodian Eligibility

As pointed out in the December 8 Letter, the Regulation imposes eligibility requirements on custodians that would prohibit a Scheme from employing as its custodian the great majority of the multi-national banks that provide global custody services. See December 8 Letter at page 6. Limiting the ability of the banks that specialize in global custody to compete for the business of Schemes would not, in our view, be in the best interest of Schemes and their members.

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and benefits of global custody would be of use to the members of the Subcommittee in evaluating our comments.

3/ We have also reviewed the April 11, 2000 letter submitted to the Subcommittee by the Hong Kong Custody/Trustee Group formed to address issues under the Regulation. We fully share and support all of the points raised by the Custody/Trustee Group (some of whose members are the Hong Kong offices or affiliates of members of the Association). However, as discussed above and in the attachment, we have numerous additional concerns that would not be resolved by the changes proposed in the Custody/Trustee Group's April 11 letter.

The Brief proposes to address this problem by the insertion of the words "or corporation" after the word "company" at various places in Section 68. Apparently, it is intended that the word "corporation" will encompass entities that are organized outside of Hong Kong and that are not registered under the Companies Ordinance. This change would not alleviate the issue we raised in our December 8 Letter because Subsection 68(6) would apparently continue to provide that a "person is not eligible to be a custodian of scheme assets unless the person has a sufficient presence and control in Hong Kong." Section 68(8) defines "sufficient presence and control in Hong Kong" to require, among other things, that "the chief executive officer of the person ordinarily resides in Hong Kong." Obviously, this will preclude virtually all banks that are not based in Hong Kong from serving as Scheme custodians.

B. Limitations on Subcustodian Eligibility

The Regulation also imposes eligibility requirements on subcustodians that are inconsistent with those of other advanced jurisdictions. See December 8 Letter at pages 7-9. The proposed revisions to Section 71 would not solve the problems we have raised in this regard.

At present, Section 71 requires that all delegates be eligible to act as custodians. The Brief proposes to expand Section 71 by also including as eligible "delegates" of a custodian (e.g., subcustodians) --

- "an approved overseas bank or overseas trust company," and

- an overseas bank or overseas trust company that is "a wholly-owned subsidiary of an approved overseas bank or approved overseas trust company."

We do not believe that this proposed change would permit the use of most existing subcustodians, since it does not appear that any change has been proposed to the requirements in Sections 3 and 5. These provisions require that a subcustodian organized outside of Hong Kong must submit an application to the Authority.

As noted in our prior letter, few banks that are not doing business in Hong Kong would be likely to submit to an approval process administered by Hong Kong regulatory bodies.

C. Routine Security Interests

The provisions of Section 65, and the parallel requirements of Item 3 of Schedule 3, would preclude encumbrances against Scheme assets, except in narrowly defined and limited circumstances. As discussed in the December 8 Letter, these limitations would invalidate certain types of liens that are common in custody agreements, would discourage custodians from extending settlement loans to Schemes, and are, as a practical matter, likely to cause many subcustodians to simply refuse to hold Scheme assets. See December 8 Letter at pages 13-15.

The amendments proposed in the Brief partially address the concerns we raised.[4] We urge that the Subcommittee review the discussion of contractual limitations on liens and of settlement liens in our December 8 Letter. Further changes are needed to conform the Regulation to standard industry practice and to the rules of other jurisdictions.

D. Schedule 3 and the Proposed Waiver Process

4/ Amended Section 65(2)(e) would permit liens created by operation of law; a parallel change to Item 3 of Schedule 3 has also been proposed. These changes would address the issue discussed under the heading "Statutory Liens" on page 14 of the December 8 Letter.

Amended Section 65(2)(c) would permit liens for the safe custody or administration of assets "by a central depository or a delegate of a custodian;" a parallel change to Item 3 of Schedule 3 has also been proposed. These changes would partly address the issue discussed under the heading "Liens for Unpaid Custody Fees" on pages 14-15 of the December 8 Letter. However, as discussed on page 2 of the April 11, 2000 Hong Kong Custodian/Trustee Group letter, Section 65(2)(c) should be further revised to permit liens for safe custody and administration charges imposed by both custodians and subcustodians, not only be subcustodians.

In our December 8 Letter, we raised concerns regarding various provisions of Schedule 3 that, when read in conjunction with Section 72, impose requirements on subcustody agreements that, in many cases, would be difficult or impossible to satisfy. In particular, we noted the problems arising from --

- Item 1(b) (requiring that the subcustody agreement provide that Scheme assets will be dealt with as trust property, or if there is no law of trust, as if such a law were in force);

- Item 2 (requiring that Scheme assets be "recorded separately from all other assets of the custodian and trustee, including any assets held by the custodian or trustee for the benefit of * * * any other person"); and

- Item 5 (requiring that the subcustody agreement provide that the subcustodian will "indemnify" the custodian for "any losses incurred" as a result of fraudulent, dishonest, or negligent act by the subcustodian's employees).

The amendments in the Brief do not directly address any of these problems. Instead, a new Item 11 would be added to Schedule 3. Item 11 would permit the Authority to waive or modify the requirements of Items 1(b), 2, and 5 where the Authority believes that the requirements in question would "cause undue hardship," are "incapable of or precluded from being complied with by virtue of a law in place outside Hong Kong," or are "not in the interest of relevant scheme members."

The Association does not believe that, as presently drafted, the waiver approach is adequate. The most fundamental problem is that the matters addressed in Items 1(b), 2, and 5 are critical to many subcustody arrangements. The Regulation should not deal with these topics in a manner that is patently unworkable for most custodians and subcustodians, with relief from this unworkability relegated to a discretionary waiver process, the application and administration of which are uncertain. Items 1(b), 2 and 5 should be revised, not merely made subject to the possibility of waiver.

If there is nonetheless to be a waiver mechanism, we recommend that it be revised in several important respects --

- The waiver process should contemplate general or "block" waivers. The Authority should be empowered to grant waivers that would, for example, apply to all subcustodians of a particular custodian, to all subcustodians holding Scheme assets in a particular jurisdiction, or to all Scheme assets held be a particular subcustodian. It would be burdensome and highly inefficient to require that global custodians apply for separate waivers with respect to each subcustodian holding Scheme assets. In the case of a Scheme with extensive overseas investments, this could necessitate scores of waiver applications.

- The waiver criteria should be broadened. In addition to subparagraphs (i)-(iii) of proposed Item 11, the Authority should be empowered to grant waivers where it concludes that particular provisions of Schedule 1:

  (iv) are not customary practice of professional custodians operating in the place where the scheme assets are held; or

  (v) are not necessary for the reasonable protection of scheme assets.

- The requirements subject to waiver should also be broadened. Item 11 should be expanded to permit the Authority to waive or modify <u>any</u> provision of Schedule 3 if it is satisfied that one of the waiver criteria is met.

* * *

We appreciate the opportunity to comment to the Subcommittee on the Regulation and the Brief. We share the concerns of the Subcommittee and the Authority for the safety of Scheme assets, and our comments are not intended to suggest in any way that

safety be compromised. However, in formulating cross-border custody regulations, it is essential to recognize that global custody is a service that, by its nature, is performed simultaneously in many markets. If a particular regulator imposes requirements that are inconsistent with those of other financially sophisticated and highly regulated jurisdictions, the effect is likely to be counter-productive. It is simply not possible for global custodians to establish different procedures for assets that are governed by regulatory regimes that do not conform to industry norms. It is likewise unrealistic to expect that responsible multi-national banks will ignore the plain language of such regulations or will "interpret" that language in a way that makes the rules workable. Therefore, assets that are subject to such regimes will be denied the opportunity to use the services of the most experienced and active major global custody banks. We strongly believe that this is not in the best interests of those with a financial interest in such assets.

Because of the limited time available to us prior to the Subcommittee's April 26 meeting, we have not included in this letter specific language that would address the problems we have raised. If such language would be of assistance, of if the members of the Subcommittee have questions concerning this letter or would like to discuss the issues described herein and in our December 8 Letter, please contact the undersigned by telephone at 202/452-7013 or by e-mail at daniel.l.goelzer@bakernet.com.

Sincerely,

Daniel L. Goelzer

cc: Raymond Tam
Executive Director (Service Supervision)
Mandatory Provident Fund Schemes Authority

Mark Shipman

Clifford Chance -- Hong Kong

Attachment -- Letter, dated December 8, 1999, to Raymond Tam, Executive Director (Service Supervision) Mandatory Provident Fund Schemes Authority, Re: Provisions of the Mandatory Provident Fund Schemes (General) Regulation Governing Custody of Scheme Assets

December 8, 1999

VIA AIR COURIER

Raymond Tam
Executive Director (Service Supervision)
Mandatory Provident Fund Schemes Authority
21/F & 22/F, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

Re: Provisions of the Mandatory Provident Fund Schemes (General) Regulation Governing Custody of Scheme Assets

Dear Mr. Tam:

This letter is submitted on behalf of the Association of Global Custodians ("Association"), an informal association of nine U.S. banks that act as global custodians or sub-custodians for the assets of major institutional investors.[1] Members of the

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1/ The members of the Association are:

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The members of the Association are among the largest providers of global custody services in the world. One of the objectives of the Association is to encourage regulatory and legal policies that promote the efficient and effective provision

Association intend to act as global custodian for accounts that hold assets of Mandatory Provident Fund Schemes ("Schemes") subject to the jurisdiction of the Mandatory Provident Fund Schemes Authority ("Authority"). The Mandatory Provident Fund Schemes (General) Regulation ("Regulation") is therefore of considerable interest and importance to the Association. The Association has serious concerns regarding the provisions of the Regulation that govern the custody of Scheme assets. We are writing to bring those concerns to your attention and to offer to work with you and your colleagues in resolving them.

In our view, compliance with certain of the provisions of the Regulation would be legally or practically impossible, while other provisions would impose severe burdens on global custodians without materially increasing the safety of Scheme assets. We are particularly concerned that:

- The Regulation would restrict Scheme access to many of the world's largest and most experienced global custody providers and could disrupt long-established relationships between global custodians and their subcustodians.

- The Regulation seeks to impose requirements on custodians and subcustodians that they are not in a position to discharge and that are inconsistent with traditional custodian responsibilities.

- The Regulation casts doubt on whether the customary and beneficial industry practice of omnibus accounting can be employed with respect to Scheme assets.

- The provisions of the Regulation governing liens will unfairly place custodians in the position of policing the borrowing activities of Scheme trustees. In addition, these provisions place custodians and subcustodians in the untenable position of purporting, by contract, to abrogate third-party liens.

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of global custody services and the removal of barriers to transnational custody and investment. The Association seeks to accomplish these goals by, among other activities, participation in governmental and self-regulatory organization proceedings and communication and discussion with regulatory officials.

- The lien provisions will, as a practical matter, preclude custodians from looking to assets held in custody for security with respect to routine credit extensions to permit settlement.

- The Regulation prohibits liens with respect to a custodian's charges for safekeeping and administration. Such liens are generally permitted under the custody rules of other advanced jurisdictions.

- The Regulation imposes liabilities in the form of broad indemnities that are inconsistent with industry practice and are unlikely to be acceptable to most global custodians and their subcustodians.

- The Regulation attempts to impose trust law concepts on custody relationships in jurisdictions where the law of trusts does not exist. This approach is unrealistic and likely to breed confusion and uncertainty.

The balance of this letter describes our concerns in greater detail. This discussion is not intended to be exhaustive. We have also reviewed the comments submitted to the Authority by the Hong Kong Custody/Trustee Group formed to address issues under the Regulation. Although we do not comment in this letter on all the points raised by the Custody/Trustee Group, we fully share its concerns.

Modern Global Custody Practice

In order to place the Association's comments in context, it is useful briefly to review the manner in which the cross-border assets of institutional investors are held in custody.

At the outset, it is important to recognize that custodians are service providers whose obligations are defined by the contract between the custodian and its client. The custodian's basic responsibility is to safeguard the client's assets and to follow scrupulously the client's instructions with respect to those assets. Custodians do not exercise discretion or judgment on behalf of their clients. Therefore, custodians are not privy to a client's investment strategy, to the motivations for instructions given to the custodian, or to the contractual or legal obligations that govern the decisions of the client or its investment manager.

Typically, an institution that invests outside of its home market enters into a custody agreement with a multi-national bank that specializes in providing global custody services. These global custodians, in turn, maintain custody networks. That is, in each jurisdiction in which a global custodian offers custody services, it enters into a subcustody agreement with a local bank or trust company.[2] The local subcustodians hold securities that trade in the jurisdiction (and related cash balances) on behalf of the customers of the global custodian.

The global custodian does not establish separate subcustody arrangements, or enter into a separate subcustody contract, for each customer. On the contrary, the relationship between a global custodian and a particular subcustodian is governed by a single contract by which the global custodian establishes the standards and procedures required of the subcustodian. An institutional investor's decision to use a particular global custodian is in effect a decision to use all the subcustodians in that global custodian's network.

2/ In some cases, the subcustodian may be an affiliate of the global custodian. Less frequently, the global custodian may operate a branch in a particular jurisdiction in which it offers custody.

The selection and monitoring of subcustodians is one of the key services provided by global custodians. If an institutional investor were required to locate, contract with, and supervise, individual subcustodians in each market in which it wished to invest, the costs would be prohibitive. In addition, the impact on asset safety would be negative, since most institutional investors lack specialized expertise in custody. In contrast, global custodians have rigorous and specialized procedures for the selection of the subcustodians comprising their networks. Employees of the global custodian periodically visit the local subcustodians to inspect their facilities and operations. Global custodians insist, for business and competitive reasons, on a high standard of subcustodian performance, as measured by reasonable care relative to the practices of the local market.

The global custodian generally maintains a single "omnibus" account with each of its local subcustodians.[3] In an omnibus account, all the securities held in custody in a given jurisdiction on behalf of the global custodian are combined in one account on the books of the local subcustodian. This account identifies the assets in the omnibus account as held on behalf of the global custodian.[4] The securities in an omnibus account may be beneficially owned by numerous clients of the global custodian, domiciled in a variety of jurisdictions.

In the great majority of countries, the business of custody no longer entails the physical possession of certificates. Instead, publicly-traded securities must, as a practical or legal

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3/ In some instances (generally where required to do so by local law or regulation in the market in which the asset is held), the global custodian creates a separate account with particular subcustodians for each of its clients. Such an account might be carried on the books of the subcustodian as "Global Custodian Bank for the account of XYZ Investor" or in similar form. This practice imposes significant additional costs, which must, of course, ultimately be borne by the client in the form of its custody fees.

4/ Such an account might be carried on the books of the subcustodian as "Global Custodian Bank for the Account of its Customers." For tax or other reasons, more than one omnibus account may exist in some cases.

matter, be held in an account at the central depository associated with the local securities market.[5] The global custodian's local subcustodian must therefore maintain an account at the central depository for the securities of the global custodian's clients.[6] Foreign depositories normally do not permit participants to open multiple custody accounts. Accordingly, all the securities held in custody by the local subcustodian often must be commingled in a single depository account. That account therefore may hold securities of both the global custodian's clients and of other custody clients of the local subcustodian.[7]

5/ Central securities depositories are typically governmental or quasi-governmental entities. Often, they are instrumentalities of the central bank or of the local stock exchange. The rules and practices of the central securities depository are usually subject to local regulatory control, and are not therefore negotiable by individual depository participants.

6/ Since depositories frequently permit only local financial institutions to be participants, investors have no option except to place their securities in the custody of such an institution. Investors that insist on record ownership in their own name would, at best, render their securities illiquid and would in many cases be unable to invest in the local market.

7/ As the foregoing illustrates, in most countries, "custody" of publicly traded securities does not involve the physical possession and safekeeping of a certificate. Instead, physical certificates, if they exist at all, are immobilized in the central securities depository. Transfers of securities between depository participants are accomplished by book entry on the records of the depository. Moreover, in an increasing number of countries, securities have been dematerialized. Dematerialized securities exist only as book entries on the records of the issuer's transfer agent or of the depository. In these cases, since physical share certificates do not exist at all, "custody" of the security does not involve physical safekeeping.

Comments on the Custody Provisions of the Regulation

With this background in mind, we have reviewed the custody provisions of the Regulation. Set forth below are comments regarding the key areas of concern.

A. Limitations on Custodian Eligibility

The Regulation would apparently prohibit Schemes from employing as their custodian the great majority of the multi-national banks that specialize in providing global custody services. For example, Section 68(6) provides that a "person is not eligible to be a custodian of scheme assets unless the person has a sufficient presence and control in Hong Kong." Section 68(8) defines "sufficient presence and control in Hong Kong" to require, among other things, that "the chief executive officer of the person ordinarily resides in Hong Kong." Obviously, this will preclude virtually all banks that are not based in Hong Kong from serving as Scheme custodians. We question whether restricting the universe of eligible custodians in this fashion is in the best interest of Schemes.

B. Disruption of Subcustody Networks

One of the most troublesome aspects of the Regulation is that it seems to assume that it is customary -- or at least feasible -- for a global custodian to make a special selection of a subcustodian and to negotiate a unique subcustody agreement in order to accommodate Scheme assets. In fact, this would be extremely costly and onerous, and could disrupt long-established relationships between global custodians and their subcustodians. Given the nature of some of the Authority's requirements, it may well be impossible for global custodians to obtain the agreement of their subcustodians to the necessary amendments to existing subcustody contracts. The effect of the Regulation may, therefore be to deprive Schemes of two of the major benefits of global custody -- the ability to access and rely upon the global custodian's subcustody network and avoidance of the costs and risks of jurisdiction-by-jurisdiction subcustodian selection.

1. Eligibility Requirements For Subcustodians

The Regulation imposes eligibility requirements on subcustodians that are confusing and apparently inconsistent with those of other advanced jurisdictions. For example --

- The manner in which the eligibility requirements in Section 68 are intended to apply to banks and trust companies that are not organized under Hong Kong law is unclear. Section 2 of the Regulation defines "custodian" to include "any person to whom any custodian has delegated the custodian's function" and "any other person who is authorized by the custodian to have custody of [Scheme] assets. Thus, it appears that subcustodians (and possibly their nominees) are deemed to be custodians for purposes of the Regulation. Section 68 sets forth the eligibility requirements for custodians.[8] In the case of a bank or trust company organized outside of Hong Kong, eligibility would require the institution to submit an application to the Authority.[9] However, in many

8/ Section 68(7) exempts subcustodians from the "sufficient presence and control in Hong Kong" requirement discussed above, provided that the assets held by the subcustodian "were acquired outside Hong Kong."

9/ See, e.g., Sections 3 and 5 of the Regulation.

jurisdictions, the local banks that specialize in providing subcustody to foreign institutional investors are not active in other markets, such as Hong Kong. Few banks that are not doing business in Hong Kong would be likely to submit to an approval process administered by the Authority or by other Hong Kong regulatory bodies.

- Subsection 68(10) provides that a person is not eligible to be a custodian unless that person "and all delegates of the person are independent of each investment manager appointed in respect of the scheme and of all delegates of the investment manager." For a Scheme with assets in numerous jurisdictions, it would be impractical to assure that all subcustodians are independent of the Scheme's investment manager and of all its sub-advisors. Also, changes in affiliations are not uncommon. These could cause previously eligible subcustodians to become ineligible, with attendant disruption in custody relationships.

- Sections 68, and the definition of "custodian" in Section 2, read together, seem to prohibit a bank that does not operate in Hong Kong from serving as a subcustodian of Scheme assets unless the bank has the equivalent of US$200 million in "paid up capital."[10] This requirement will preclude Schemes from investing in some jurisdictions, since there will be no available

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10/ It appears that this US$200 million requirement may be based on the 1984 version of Rule 17f-5 under the U.S. Investment Company Act of 1940. The U.S. Securities and Exchange Commission abolished that requirement in 1997. In lieu thereof, Rule 17f-5(c)(1) now requires a finding that assets held by a foreign bank will be subject to "reasonable care" based on the standards of the local market. The Association supported this change. The quality of the service offered by local custodians is, in our experience, more closely correlated with the caliber of the sub-custodian’s personnel and the nature of the procedures and controls it employs than to the magnitude of its shareholders equity.

subcustodian meeting these requirements;[11] it will greatly limit the custodian's choice of subcustodians in many other jurisdictions.

- In addition, Section 68 requires a "custodian" to satisfy a "minimum credit rating" standard to be set by the Authority, based on a rating determined "by an approved credit rating agency." Since holding Scheme assets will not be a predominant part of the business of most subcustodians, few are likely to submit to the cost and burden of obtaining a rating from an Authority-approved rating agency.

11/ The experience of the members of the Association suggests that, in smaller or emerging markets, the US$200 million requirement excludes most -- or, in some cases, all -- potential local subcustodian banks. We recommend that, like the U.S. Securities and Exchange Commission, the Authority dispense with any equity requirement. Alternatively, subcustodian eligibility should be contingent on a shareholders equity requirement of $50 million. A $50 million requirement should be more than adequate to protect Scheme beneficiaries, while at the same time permitting greater latitude in selecting the local banks best able to provide reliable service.

To the extent that particular members of established global custodian networks do not meet these requirements, Schemes will simply be unable to lawfully access custody facilities in that jurisdiction through their global custodian's network. It would rarely be economical for a global custodian to establish a new subcustody relationship solely for the benefit of Schemes. Similarly, as noted above, the cost to a Scheme of negotiating (or paying a global custodian to negotiate) separate custody arrangements in numerous jurisdictions is likely to be prohibitive.

We recommend that the Authority model its subcustodian eligibility requirements on those of the U.S. Securities and Exchange Commission. Under this approach, a subcustodian would be required to be a banking institution or trust company, organized or incorporated under the laws of a jurisdiction other than Hong Kong, that is regulated as such by that jurisdiction's government or an agency of that government.[12]

2. Subcustody Agreements

Section 72 requires that subcustody agreements (i.e., agreements by which the custodian delegates functions to another person) must meet the requirements of Schedule 3 of the Regulation. However, in many respects, the requirements of Schedule 3 would be difficult or impossible for custodians to impose upon their subcustodians. For example --

- Item 1(b) requires that the subcustody agreement provide that Scheme assets will be dealt with as trust property, or if there is no law of trust, as if such a law were in force. Subcustodians in civil law jurisdictions are unlikely to agree to handle assets "as if" they were subject to a body of law that does not exist in their

12/ See Rule 17f-5(a)(1) and (4).

jurisdiction and with which they may have no familiarity. See Section G, below. [13]

- Item 4 requires that the subcustody agreement provide that any encumbrance "created or granted" over Scheme assets that is inconsistent with Schedule 3 is void. Subcustodians are unlikely to execute an agreement that is contrary to their local law, where that law establishes liens in favor of third parties. See Section E, below.

- Item 5 (read in conjunction with Section 72) requires that the subcustody agreement provide that the subcustodian will "indemnify" the custodian for "any losses incurred (directly or indirectly)" as a result of fraudulent, dishonest, or negligent act by the subcustodian's employees. The potential magnitude of consequential losses is not quantifiable. Therefore, subcustodians (like primary custodians) do not normally provide such indemnification and instead require that their liability be limited to the value of the securities held in custody. A subcustodian would have no reason to agree to accept exposure to open-ended liability, let alone an indemnity, merely in order to include Scheme assets among the assets it holds on behalf of the global custodian. See Section F, below.

- Item 7(b) (read in conjunction with Section 72) requires that the subcustody agreement provide that the subcustodian must furnish the custodian with audited financial statements within 60 days of the end of its fiscal year. Few subcustodians could enter into such an agreement in good faith, since few could comply. In many jurisdictions, it would be uncommon for audited financial statements to be available until 120 days, or longer, after the end of a bank's fiscal year.[14] Further, no

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13/ Even where trust law does exist, many subcustodians would be unwilling to transform a non-fiduciary function (i.e., custody) into a fiduciary function.

14/ In the United States, public companies are required to file audited financial statements within 90 days of the end of the fiscal year; in other jurisdictions, still longer periods are

> useful purpose is served by requiring custodians to provide Scheme clients with subcustodian financial statements. The monitoring of subcustodian financial strength is one of the functions performed by a global custodian; clients seldom have the expertise or the desire to perform this function themselves.

More broadly, any requirement that imposes specific terms on subcustody agreements is likely to require the re-negotiation of all the global custodian's agreements with its network members. As previously discussed this would be a major, costly, and time-consuming undertaking. It is doubtful that it would be economically feasible to undertake this re-negotiation process, except in jurisdictions in which there were a very substantial amount of Scheme assets. Even where re-negotiation were to be undertaken, many subcustodians will no doubt demand higher fees for complying with non-standard terms -- and some would likely refuse to agree to certain of the Authority's required terms under any circumstances. These costs will, of course, be passed on to Schemes.

We do not believe it is feasible or necessary for the Authority to attempt to dictate the terms of subcustody agreements applicable to subcustodians in scores of markets around the world. In the case of subcustody contracts, we recommend that the Authority limit its requirements to Item 1(a) of Schedule 3: "The agreement must require the Scheme assets to be recorded and controlled in such manner as may be customary and prudent in the circumstances."

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common. The Authority should require that custodians and subcustodians furnish their financial statements and auditors reports at the same time as these documents are required to be made public in the custodian or subcustodian's home jurisdiction.

C. Imposition of Custodian "Whistleblower" Requirements

Section 75 of the Regulation would require custodians (and, apparently, subcustodians) to report to the Authority various kinds of putative violations of Hong Kong law. For example, under Section 75(1)(c), if, in the custodian's opinion, a payment were made from the funds of the Scheme that was "materially prejudicial to the interests of scheme members" or in violation of certain provisions of the Regulation, the custodian would be required to "report the matter immediately to the Authority by written notice."[15]

As discussed above, the custodian's obligation is to follow its client's instructions. It has no discretion with respect to, or information upon which to evaluate, the merits of those instructions. The notion that custodians should be obligated to form an opinion on the wisdom of client transactions and to report those which appear to be "prejudicial" to a regulatory body is wholly inconsistent with the custodian's role. Custodians are not equipped to perform this function.

D. Impact on Customary Industry Omnibus Accounting

As explained above, omnibus accounts are common industry practice. However, Item 2 of Schedule 3 casts doubt on whether omnibus accounting can be employed with respect to Scheme assets. Item 2 of Schedule requires that Scheme assets be "recorded separately from all other assets of the custodian and trustee, including any assets held by the custodian or trustee for the benefit of * * * any other person." This provision could be construed to prohibit the use of omnibus accounts.

15/ This reporting obligation would also be triggered if the custodian formed an opinion that the trustee was pursuing certain "forbidden investment practices" (Section 75(1)(e)); if the custodian became aware that the trustee was violating various regulatory requirements (Section 75(1)(a) and (f)); or if the custodian concluded that Scheme assets were being misappropriated (Section 75(1)(b)) or commingled (Section 75(1)(d)) with other assets of the trustee.

It is difficult to conceive of any regulatory purpose that would be served by precluding Scheme assets from being held in omnibus accounts. Indeed, other advanced jurisdictions expressly permit omnibus accounting.[16] We recommend that Schedule 3 be amended to permit omnibus accounting.

E. Impact on Routine Security Interests

Item 3 of Schedule 3 provides that the custody agreement must require that Scheme assets will not be made subject to any encumbrance, except under certain narrow circumstances relating to the period, purpose, and amount of the borrowing secured by the encumbrance. Section 65 of the MPFS Regulation contains a similar requirement. Item 3(b) permits, under limited conditions, secured borrowings for the purpose of settling a transaction relating to the acquisition of Scheme assets. Item 4 of Schedule 3 provides any encumbrance that is inconsistent with Schedule 3 is void. These provisions have several serious flaws.

1. Contractual Limits on Liens

Item 3(a) seeks to make the Scheme's custodian contractually responsible for the propriety of any encumbrance imposed on Scheme assets. This requirement is apparently premised on the erroneous assumption that a custodian can and should control the borrowing practices of its clients. In fact, Item 3(a) would expose custodians to risks over which they have no control.

As discussed above, custodians are typically not informed of the reasons for their client's transactions. The extent of, and reasons for, encumbrances are the responsibility of the Scheme's trustee, not of its custodian. Except in the case of settlement loans, lending is not a normal incident of the relationship between a custodian and its custody client. In contrast, the Scheme trustee makes the decision to borrow, is aware of its motivations and expectation at the time of a particular loan, and enters into the lending relationships that result in the

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16/ See, e.g., Rule 17f-5(c)(2)(i)(D) under the U.S. Investment Company Act of 1940. The U.S. Securities and Exchange Commission has expressly stated that omnibus accounting is permissible. See Investment Company Release No. 22658 at notes 61 through 64 and accompanying text (May 12, 1997).

encumbrances with which Item 3(a) is concerned. If the Authority wishes to limit the extent and purpose of encumbrances, it should do so by regulations applicable to Scheme trustees, not to custodians.

2. Statutory Liens

In many jurisdictions, certain encumbrances for the benefit of third persons arise by operation of law. Obviously, the custodian has no control over such encumbrances, and it is unfair to require the custodian to agree by contract that such a lien is void. It is also futile, since the beneficiary of the lien would not be a party to the custody agreement. Item 4 should therefore be limited to encumbrances created by, or waiveable by, the custodian or subcustodian.

3. Liens for Advances to Settle Trades

Item 3(b) imposes strict limits on liens to secure borrowings to finance the acquisition of Scheme assets. Among other things, these conditions include that "the period of the borrowing does not exceed 7 working days" and that "at the time the decision to enter into the transaction was made, it was unlikely that the borrowing would be necessary."

It is common for custodians to advance funds to settle customer transactions and to take a security interest in custody assets to secure the borrowing. Such advances are to the advantage of the custodian's client, since, in most cases, the client would be unable to settle its transaction absent the advance, and the underlying trade would fail. By imposing non-standard conditions on the length and validity of liens of this type, the Authority will discourage custodians from affording this benefit to Schemes. The requirement that the need to borrow be "unlikely" at the time of the transaction is particularly objectionable. A custodian is not a party to a client's investment decisions, and, when called upon to extend credit to avoid the client's default, would have no way of knowing whether this condition was met. Moreover, since advances to fund settlement are accepted industry practice, it might be difficult to characterize such borrowing as "unlikely."

4. Liens for Unpaid Custody Fees

Liens for custody fees are also common, and arise by law in many jurisdictions. Custody is a service performed for the benefit of the Scheme, and ultimately of its beneficiaries. Custodians, like other service providers, should be able to recover their fees and the expenses incident to providing this service. The assets in custody are a legitimate source of such recovery. Item 3 should be amended to permit such liens. [17]

F. Impact on Custodian Liabilities

Item 5 of Schedule 3 requires that the custody agreement provide that the custodian will indemnify the Scheme for certain "losses incurred (directly or indirectly) * * *."[18] Pursuant to Section 72, subcustody agreements are required to provide that subcustodians will similarly indemnify custodians.

The intent of the inclusion of the word "indirectly" is unclear; we recommend that it be deleted. Typically, the contract between the global custodian and its client provides that the global custodian will be liable for losses resulting

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17/ Both liens for advances to settle trades and liens for custody fees are commonly permitted under other regulatory regimes. See, e.g., Rule 17f-5(c)(2)(i)(B) under the Investment Company Act of 1940. Rule 17f-5 requires that custody contracts prohibit assets from being subjected to any right, charge, security interest, lien, or claim of any kind in favor of the custodian "except a claim of payment for their safe custody or administration." This provision permits liens with respect to both out-of-pocket expenses and custody fees. See also Section 6.4(3)(a) of National Instrument 81-102 promulgated by the Canadian Securities Administrators (prohibiting custody agreements from creating any security interest in portfolio assets "except for a good faith claim for payment of the fees and expenses of the custodian or sub-custodian for acting in that capacity").

18/ Covered losses are those that are "attributable to fraudulent, dishonest or negligent acts or omissions committed by the custodian or its employees" and those that are "attributable to fraudulent, dishonest or negligent acts or omissions committed by delegates of the custodian to the same extent as if the custodian had committed those acts or omissions itself."

from its own failure or that of its subcustodians to exercise reasonable care. This liability would, as in any contract-based claim, be limited to the value of the asset lost, and would not extend to consequential damages. The amount of consequential damages that might be alleged to have resulted from a given loss of deposited assets could not be predicted in advance. Accordingly, it is unlikely that custody services would be made available to a client who insisted on the right to recover consequential damages.[19]

G. Treatment of Scheme Assets as Trust Property

Item 1(b) of Schedule 3 of the Regulation requires that assets be "dealt with as trust property" or, where there is no law of trusts, "as if such a law were in force." This requirement raises two problems.

First, the meaning of Item 1(b) as applied to cash is unclear. A cash balance would normally be held in a deposit account at each subcustodian bank in order to fund transactions, as the proceeds of securities sales or dividend payments, and for similar reasons. The depositor has only a contractual right to the return of deposited cash. However, if the subcustodian must treat Scheme cash as if the subcustodian were a trustee, it may be necessary for the subcustodian to segregate the Scheme's cash. This would require either that cash be held in the form of currency (e.g., in a safe deposit box) or in a deposit account at another bank. These alternatives could have a negative effect on the availability of the cash and on custodian recordkeeping.

Second, as Item 1(b) recognizes, in many jurisdictions the concept of a trust is not part of the legal system. We believe that a requirement that assets be administered "as if such a law were in force in that place" is unrealistic and would impose

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19/ We also believe that the use of the word "indemnify" is inappropriate. Custodian banks do not typically give indemnification, in part because indemnification may be read to imply liability regardless of fault. As noted above, this is not an accurate characterization of a custodian's obligations in the event of a loss. In addition, indemnification liability could be construed to extend to losses that are not reasonably foreseeable and to include indirect or consequential losses.

unreasonable obligations on custodians and subcustodians in jurisdictions that do not recognize trusts. Such a requirement is likely to lead to uncertainty and dispute concerning how a law that by hypothesis does not exist would have been construed, had it existed.

The Regulation should recognize the reality that cash is held by subcustodians as a deposit. To accomplish this, Item 1(b) should, at minimum, be amended to permit cash to be held in deposit accounts and to permit other assets to be held in accordance with local market practice in each jurisdiction. Alternatively, Item 1(b) should be deleted.

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We are mindful of the Authority's responsibilities to assure that Scheme assets are properly protected. In determining how best to promote these goals, it is critical that the Authority, like other regulators, recognize that global custody is, by its nature, a service that is performed across borders and in many different markets with differing legal regimes and banking practices. If the various regulatory bodies with jurisdiction over custody impose conflicting or inconsistent requirements, it will become difficult or impossible for global custodians to continue to offer the low-cost and efficient service that today facilitates cross-border institutional investment.

We also recognize that several of the issues we have raised stem from statutory language that would apparently require legislative revision. We would be pleased to work with the Authority in formulating or reviewing such legislation and in devising interim interpretive relief that will permit Schemes to continue to enjoy the benefits of global custody while legislative changes are under consideration.

We appreciate the opportunity to comment on the Authority’s regulations. In our view, the Association's members and the Authority have a common interest in the safe and efficient custody of Scheme assets. If you have questions concerning this letter or would like to discuss the issues we have raised, please contact the undersigned at 202/452-7013.

Sincerely,

Daniel L. Goelzer