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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

1/ The members of the Association are:

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

the 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.

- 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.

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in governmental and self-regulatory organization proceedings and communication and discussion with regulatory officials.

- 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.

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

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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.

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

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 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

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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.

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.

global custodian's clients and of other custody clients of the local subcustodian.[7]

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.

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.

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

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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 subcustodian meeting these requirements;[11] it will

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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.

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.

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.

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]

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.

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

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 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.

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.

- 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 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

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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 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.

be recorded and controlled in such manner as may be customary and prudent in the circumstances."

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 encumbrances with which Item 3(a) is concerned. If the Authority wishes to limit the extent and purpose of encumbrances, it should

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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).

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 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

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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."

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 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

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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.

accordance with local market practice in each jurisdiction. Alternatively, Item 1(b) should be deleted.

* * *

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

Daniel L. Goelzer