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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.<sup>1</sup>

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

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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.<sup>2</sup>

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

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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.<sup>3</sup>

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.

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

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<sup>3/</sup> 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.

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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

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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.<sup>4</sup> 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

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

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<sup>4</sup>/ 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.

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- 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 by 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.

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- 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 any 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.

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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, or 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