THE ASSOCIATION OF GLOBAL CUSTODIANS

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May 23, 2002

BY AIR COURIER AND E-MAIL

Christoph Crüwell
Secretariat
Committee of European Securities Regulators
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75082 Paris Cedex 02
France

Elias Kazarian
European Central Bank
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

RE: Joint Work of the European System of Central Banks and the Committee of European Securities Regulators in the Field of Clearing and Settlement

Dear Messrs. Crüwell and Kazarian:

The Association of Global Custodians (the "Association")[1] appreciates the opportunity to respond to the request of the Committee of European Securities Regulators and the European System of Central Banks (together "the Group") for

1/ The Association of Global Custodians is an informal association of nine banks that are major providers of cross-border custody services to institutional investors. The members of the Association are The Bank of New York, Brown Brothers Harriman, Citibank, N.A., Deutsche Bank Trust Company Americas, Investors Bank & Trust Company, JPMorgan Chase Bank, Mellon Trust/Boston Safe Deposit & Trust Company, Northern Trust Company, and State Street Bank and Trust Company.

comments on the Group's March 15, 2002 joint paper ("Joint Consultation Paper") on clearing and settlement. The Association welcomes the determination of the European Union to address the continued fragmentation of the European financial markets resulting from disparate legal frameworks, dissimilar clearing and settlement systems, and varying rights of access to those systems. Initiatives such as the project the Group has undertaken are key to enhancing the efficiency and integration of the European capital markets and to strengthening Europe's role in the international financial system.

The Association's comments on the specific issues raised in the Joint Consultation Paper are set forth below. The major themes of our comments are highlighted in boldface type and underscored.

Issue 2.1: Nature of the recommendations

> What should be the legal nature of the recommendations and/or standards to be issued by the Group? Are there issues for which a European legal instrument is deemed appropriate? Are there recommendations and standards that should be adopted by national law?

The Association believes that the Group's recommendations will only be effective if implemented by the adoption of a legal framework that has the force of law in each member state. The Group's recommendations and standards should be comprehensive and unambiguous. In order to accomplish this goal, fundamental legislative and regulatory reform will be necessary, although the option to implement change through new market practices should be preserved in those cases where it would be more expeditious to proceed in that fashion.

The European financial markets suffer from an absence of a uniform legal framework addressing core issues, such as supervision, share ownership rights, insolvency, and taxation. Europe also lacks consistent application of those common standards that do exist. In the past, industry organizations such as the Group of Thirty and the International Securities Services Association have succeeded in obtaining impressive support from the financial community and regulators for a set of broad standards, and such initiatives should be encouraged. Likewise, the Association supports the broad-based work of the Hague Conference on Private International Law and the joint efforts of the Committee on Payments and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions. However, the European financial markets face issues that are far more complex than can be cured by a non-binding or a piece-meal approach. For this reason, the Group's

recommendations and standards will need to have the direct force of law in each member state. This will require the use of regulations rather than directives. Variances in the manner in which the member states have historically implemented, or not implemented, directives have been an obstacle to EU securities market integration.

Issue 2.2: Addressee

> Who is the appropriate addressee of the possible standards or recommendations to be drawn up by the Group: the regulators, the systems, the operators or the users? In such cases where standards and/or recommendations are addressed neither to regulators nor to legislators, what are the appropriate incentives for their implementation and compliance?

In general, the Group's recommendations and standards should be addressed to legislators and regulators. The Group's recommendations and standards must, in the Group's own words, "overcom[e] the significant heterogeneity with the legislative frameworks of European countries." The creation of a harmonised legal framework can only occur by the action of those bodies with the power to make law. It would be futile to attempt to use non-binding recommendations or standards to achieve change in the intractable areas identified in the Joint Consultation Paper.[2]

While we believe that the end product of much of the Group's work must be changes in the law, the Association recognizes that successful integration and harmonization of the European clearance and settlement environment will also depend on harnessing commercial and competitive forces. The Group should strive to identify those changes that can be effected at a market practice level. Change that is accomplished by the alignment of market forces and regulatory goals is more efficient than change that is dependent on the legislative process.

Issue 2.3: Scope

> Do you agree that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects and is not limited to any

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2/ Similarly, removal of many of the barriers to efficient cross-border clearance and settlement identified by the Giovannini Group would require changes in the law. See The Giovanni Group, Cross-Border Clearing and Settlement Arrangements in the European Union at 44-59 (Brussels, November 2001).

particular type of service provider? More specifically, do you agree that central securities depositories (CSDs), international central securities depositories (ICSDs), CCPs, custodians and registrars are included? Do you think that some standards should apply on a differentiated basis to these parties given that the scope of their business is not directly comparable? Should standards apply to other parties? If so, which standards and to which parties? With regard to custody and safekeeping services, what are the advantages or disadvantages of a distinction being drawn between custody services, on the one hand, and clearing and settlement on the other? Do particular considerations apply where custody and safekeeping services are provided by credit institutions or investment services firms? With regard to the securities covered, do you agree that sovereign and private debt, equity and other securities, as well as depository certificates, receipts, derivatives, etc., are included, or where would differentiation be necessary? Should some standards/recommendations be specifically addressed to cross-border transactions? If so, which ones?

The scope of the Group's work should include all entities that are involved in the trade settlement process, and in the "chain of custody," including CSDs, ICSDs, central counterparties ("CCPs"), custodians, and registrars. However, the applicable standards must be carefully differentiated depending on the entity type in question. Differences in the legal status, structure, and supervision of CSDs, ICSDs, CCPs, custodians, and registrars reflect fundamental differences in the roles of each. For example --

- CSDs typically provide, either on a mandatory or optional basis, market infrastructure services with respect to specific eligible securities. Such services may include clearing and settlement, acting as central registrar, and book-entry transfer of ownership. In the case of sovereign debt, the CSD may be a governmental entity.

- ICSDs originally served as central depository facilities for "stateless" instruments that lacked a home country market. Today, however, the securities for which ICSDs play this role is a small and declining fraction of the total number of number of instruments ICSDs handle. In effect, ICSDs have begun to act as global custodians with respect to the majority of the assets they hold, and, like traditional bank global custodians, are establishing multi-jurisdictional global custody networks. Because of this changing role, we believe it is particularly

important that ICSDs be regulated based on the functions they perform, not based on the label under which they act.

- CCPs, in contrast, have a limited and specific market function. CCPs are intended to minimize counterparty risk and provide greater efficiencies in the use of capital. By their nature, CCPs are either appendages of a particular exchange or group of exchanges, or are components of the settlement mechanism for those markets.

- Traditional bank custodians are also part of the market infrastructure. Custodians typically hold, maintain, and service a wide range of customer assets, including both cash and securities, some of which may be depository-eligible and some of which may be held directly by the custodian. These services may be provided with respect to a single market or a number of markets, and may extend to accounting, corporate actions, proxy voting, and similar functions. Typically, clients use global custodians to provide centralization of their recordkeeping and accounting and to avoid the need to organize and manage interfaces with securities systems in many markets and for many instruments. The most fundamental difference between bank custodians and CSDs is that, unlike many CSDs, bank custodians are not de facto or de jure monopolies, either with respect to particular markets or with respect to particular instruments. Bank custodians are selected at the discretion of their clients and can survive only if they are able to offer clients a competitively attractive service.

As these brief points suggest, bank custodians have traditionally filled different roles and provided different services than have depositories and CCPs. Depositories have traditionally acted as components or agents of particular markets, while custodians have acted as agents of investors. It is critical that the Group tailor its recommendations to these differing functions; recommendations that seek to impose uniform requirements across entities that perform different functions under different economic and regulatory regimes will be unworkable.

Preserving the differences between bank custodians and depositories is important to controlling and assigning risk. There are two reasons why a blurring of the lines between utilities or "market agents" and investor agents increases risk. First, as ICSDs (and even some CSDs) seek to have a foot in each camp, they are taking advantage of their regulatory status as market utilities to offer

commercial services without necessarily being subject to the full panoply of legal, regulatory, and supervision requirements that apply to commercial custodians. If those requirements serve investor protection purposes, they should apply to all providers of custody service. If they serve no purpose, they should be abolished. Regulating traditional providers and deregulating those that have evolved from single market or international depositories is illogical and unfair. Further, it re-exposes market participants to the risks that regulation was designed to ameliorate.

Second, permitting CSDs and ICSDs to offer cross-border services increases risk because these entities tend to shift risk to their participants, who are also their commercial competitors. Custodians that hold assets through ICSDs bear a disproportionate amount of risk because ICSDs (and some CSDs) use their market position to disclaim this risk. These entities typically offer the services on a take-it-or-leave-it basis, and are rarely subject to the competitive checks that preclude other providers from transferring the risks of their business to those with whom they deal.

The Group's recommendations must accommodate the expectations and practices of institutions that invest globally. This requires equal focus on the role in the European market integration process of market participants that act as agents and of those that act as principals. Ultimately, the success of any market reform must be measured by its effect on the investor, particularly institutional investors. Institutional investors typically believe that their interests are best protected when there is a separation of functions between the execution of trades, the management of investments, and recordkeeping and custody of assets. We believe there is little doubt that institutional investors will continue to insist on operating in all of the markets to which they commit capital -- whether in Europe, the US, or elsewhere -- through agents, such as independent investment managers and custodians. Market infrastructure must accommodate this expectation. The role of agents is not simply one of providing "value added" services. Rather, agents constitute the key link between the market place and the institutional investor.

The Group's recommendations and standards should address "cross-border" transactions, both within the boundaries of the European Union and between the EU and other markets. The Association does not believe that it would be effective to create one framework for transactions occurring within the European Union and another for transactions that cross the borders of the EU. The harmonization of the intra-European framework should lay the groundwork for more efficient resolution of intercontinental securities market issues.

Issue 2.4: Objectives

A priori, the objectives of central banks and securities regulators in the field of securities clearing and settlement systems could be summarized as follows: 1) risk mitigation, including investor protection, for both the system and the users; 2) efficiency, including for cross-border activities; 3) creation of a level playing field between participants and service providers, irrespective of their legal status or their geographical location; 4) promotion of integration of the EU securities markets infrastructure. Do you agree? Do you consider that these objectives are sufficient?

The Association agrees that these four goals are appropriate objectives of clearing and settlement integration.[3] However, accomplishing these objectives is a long term undertaking, and a fifth objective should be pursued while that effort is underway: **The Group should also take steps to encourage interoperability among entities within the European Union (and beyond)**.

Interoperability is a first step to realizing the efficiencies and benefits of integration of the EU securities markets infrastructure. Interoperability can be achieved through efficient regulation that encourages, rather than discourages, innovation, and allows market participants to be legally structured in a way that does not interfere with co-operative initiatives. Interoperability also involves the promotion of compatible technology standards and interaction between competing parties, potentially allowing settlement systems access through a single network connection.

Issue 2.5: Access conditions

Are you aware of access conditions to specific service providers, which could be considered discriminatory? If so, where do the main problems lie? Do you consider that the present rules do/do not establish a level playing field in this respect? Do they relate to the access criteria of the system or to other conditions such as operational features? If so, which ones?

3/ We note that objective 2) refers to "cross-border activities" with respect to the objective of achieving efficiency in clearance and settlement systems. The reason for the express inclusion of cross-border activities only in 2) is unclear. The Association believes that the concept of cross-border activity should be implicit in all of the Joint Consultation paper objectives.

Open access to clearing and settlement services should be a fundamental principle of the Group's work. The Association believes that access rights must be based on objective and disclosed standards that are nondiscriminatory. Refusal of access to potential users should be justifiable only on the basis of clear, objective, and publicly-available criteria, applied uniformly to all existing and potential participants, so as not to interfere with competition. Common standards of this nature would reduce systemic settlement risk.

In addressing the issue of open access, consideration should be given to both formal barriers and more subtle forms of discrimination. In some instances, for example, geographical or operational variations operate to the detriment of some potential participants. Time zone differences may result in a disconnect between movements of cash or securities in cross border transactions that clearly favor one entity's participants over those participants of another. In other situations, inefficiencies may be preserved to the disadvantage of certain participant groups. The Group should be sensitive to these types of de facto unequal access.

Issue 2.6: Risks and weaknesses

What are the most relevant factors to risks and weaknesses in terms of clearing and settlement of domestic and cross-border transactions (i.e. legal, settlement, custody and operational risks)?

As far as legal risks are concerned, what kind of problems can different legal approaches create? When looking in particular at cross-border transactions, how does the existence of different jurisdictions and the involvement of several actors such as local agents, global custodians, foreign CSDs or ICSDs in the process of cross-border clearing and settlement affect the nature and magnitude of these risks? What would be the most appropriate manner of addressing these issues?

As far as custody activities are concerned, do you agree that the segregation of assets and the reconciliation of positions are the most crucial issues to be addressed?

As far as settlement risk is concerned, do you agree that the definition and timing of finality (including the need for intraday settlement finality), delivery versus payment, access to central bank money as settlement assets for systemically important systems and conditions of use of central bank money versus

commercial bank money are the most crucial issues to be addressed with regard to clearing and settlement of domestic transactions? What specific impact could these issues have on clearing and settlement of cross-border transactions?

Finally, as far as operational risks are concerned, what are the main factors to be considered?

Participants in the clearing and settlement system must reasonably be able to determine – in advance and with certainty – the law applicable to their transactions; their rights under that law to securities, cash, and collateral; and mechanisms available for enforcing those rights. Legal predictability would substantially reduce the risk of loss that may result from unanticipated entitlement or liability gaps between different legal jurisdictions. We believe that the absence of uniform standards across the European Union addressing systemic operational, legal, and financial risk contributes to sub-optimal shareholder and market-user protection.

The involvement of multiple entities in the clearing and settlement process is not a source of added risk; the participation of agents reduces risk in the cross-border environment. Agent participants, such as local agent banks, global custodians, and other intermediaries, play a key role in trade processing control and settlement authorization. These agents identify and manage risk points under the execution of mandates from their clients, the investors. In performing that role, agents contribute significantly to the overall safety of the system. Therefore, the roles of the different participants should be preserved to avoid excessive concentration of risk.

Segregation of client assets from agent assets is critical to asset safety, as is reconciliation of positions.[4] Client securities are separately identified on the books and records of the global custodian. Similarly, at the subcustodian level, securities held for the global custodian's clients are segregated on the books of the subcustodian from other assets which the subcustodian holds for other depositors or for its own account. As a result of these practices, client securities are not included on either the custodian's or the subcustodian's balance sheet and are not available to creditors in the event of insolvency. CSDs and ICSDs typically determine whether the participant may have one or more omnibus accounts for all client assets, or subaccounting to reflect underlying

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4/ Reconciliation is increasingly an automated function. Automation is essential to ensuring high levels of accuracy at reasonable cost.

client holdings. Virtually all ICSDs and CSDs permit or require members to segregate their own assets from client assets[5].

The Group has correctly identified the key elements of settlement risk in both cross-border and domestic transactions. DVP and settlement finality must occur in the context of a well-organized system that provides risk controls. A settlement system that handles both cash and securities is more likely to meet strict DVP, although a system which utilizes a separate cash agent for settlement would not necessarily preclude DVP. Ultimately, the objectives of a settlement system must include safety and soundness, true DVP settlement, proper controls, and settlement finality. While settlement in central bank money may be more certain, commercial bank money settlements would be equally acceptable in a robust banking system where markets are moving toward a true DVP environment.

Operational risk is dependent on the capacity of the system to handle foreseeable transaction volumes efficiently and accurately. As trading volume continues to increase, it is important that system capacity be substantial enough to comfortably accommodate such traffic. Beyond raw technological capabilities, organizational policies and procedures should be geared heavily towards a risk management framework, and towards robust stress testing of the systems, including contingency and continuity planning.

Issue 2.7: Settlement cycles

> What are the arguments for and against harmonised and/or shorter settlement cycles? It appears, for instance, that while a very short cycle could increase settlement default rates, a longer cycle could increase uncertainty and settlement risk. Is there a need to adopt different settlement cycles for different securities, such as for equities and government debt instruments, etc?

Shortening settlement cycles would have substantial benefits, provided that market participants have adequate systems in place to support shortened timeframes. While shorter settlement cycles may temporarily increase fail rates, those

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5/ Where there is a choice of account structures, factors that influence the choice may include a need to have separate per-client accounts or omnibus accounts based on tax domicile. In addition, aspects of the interaction with brokers may make it safer to choose or avoid use of individual accounts.

rates are likely to drop as market participants adapt to the new timeframes. Any residual, persistent causes of fails can then be identified and addressed systemically. Further, the exposure of market participants and investors to risk associated with outstanding trades in the event of a market disaster is less in a shorter settlement cycle environment. The dangers of an over-ambitious implementation schedule, however, are clear and potentially expensive in terms of cost and market confidence. It is also important, particularly in the cross-border environment, to coordinate acceleration of securities settlement timeframes with foreign exchange transaction timeframes.

Issue 2.8: Structural issues

> The structure of the securities clearing and settlement industry in Europe has been hotly debated recently. An integrated market can be achieved via a number of routes, with concentration, interoperability and open access being the most obvious alternatives. What are the arguments, if any, for a public policy intervention relating to (i) centralised or decentralised structures for infrastructure and service providers; and (ii) the governance structure of infrastructure and service providers? Are custodians, CCPs, CSDs and ICSDs to be considered as commercial firms, driven by regular competition, or should they (or some categories of these entities) be considered as utilities whether or not they operate within a monopoly environment? Does the same reasoning apply to the provider of trading services?

Many of the questions raised in this section are addressed in prior responses. The Association is, of course, aware of the contrasting approaches of the "horizontal" and the "vertical" schools of thought. In the short term, such differences will continue to exist, and custodians must therefore be prepared to deal with a variety of approaches.

To the extent utilities are created to centralize specific market functions, such utilities should be user-owned and governed. In general, we do not believe that the markets or the user community have fully understood the ramifications of "for-profit" market utilities. Such entities would, by definition, be responsive primarily to shareholder pressures, rather than to the needs of users and investors. This is not to say that a user-owned utility cannot or should not act aggressively or ambitiously in service expansion. However, the returns that would be of paramount importance to

user-owners would be measured in terms of quality and costs of service, not levels of dividends paid on share ownership interests.[6]

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Finally, we note that the Group is considering the possible adaptation of the CPSS/IOSCO "Recommendations for Securities Settlement Systems" to the European environment. The work of CPSS/IOSCO has been instrumental in identifying and shaping core principles for the securities market. However, we believe that the Group should also take into consideration the results of other initiatives in this area. Those initiatives include the "Recommendations 2000" published by the International Securities Services Association, and the expected report of the Group of Thirty. These groups address securities settlement systems from a variety of perspectives, and both have had the advantage of broad industry input, including by many members of the Association. In the case of the Group of Thirty, of course, there was also very significant regulatory participation.

The Association appreciates the opportunity to comment on the issues raised in the Joint Consultation Paper. If you have any questions concerning this letter, please contact the undersigned at 202/452-7013.

Sincerely,

Daniel L. Goelzer
Counsel to the Association

6/ In contrast, bank custodians, as discussed above, are not utilities. Custodians are private, non-monopoly service providers that compete for clients by providing service levels that investors require. Unlike market utilities, bank custodians do not seek to serve the needs of all participants in the market.