

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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29 July 2011

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### **Re: CPSS-IOSCO Consultative Report – Principles for Financial Market Infrastructures**

Dear Sirs:

We write on behalf of the members of the Association of Global Custodians<sup>1</sup> to set out members' views concerning the March 2011 Consultative Report ("Consultation") -- Principles for Financial Market Infrastructures ("FMI's"), issued by the Bank for International Settlements' Committee on Payment and Settlement Systems and the International Organization of Securities Commissioners ("CPSS-IOSCO"). The Association appreciates the opportunity to comment on the Consultation.

The Association fully supports the Consultation's objective of fostering financial stability in post market infrastructure, and members view the bulk of the Consultation's Principles as furthering this objective. Members' comments here address points made in the Consultation relating to Central Securities Depositories ("CSDs") and Securities Settlement Systems ("SSSs"), as these FMIs are particularly relevant to the business of global custodians. Given that some Association members have submitted their own comments concerning the Consultation, or will do so soon, this letter is limited to high-level observations on select points of particular concern to global custodians.

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<sup>1</sup> The Association is an informal group of 11 member banks that provide securities safekeeping and asset-servicing functions to cross-border institutional investors worldwide. Members provide custody-related services to most types of institutional investors, including investment funds, pension funds, and insurance companies. Members participate in all CSDs around the globe either directly or through subcustodians and as such have considerable interest in safe, effective and efficient CSD operations.

## THE ASSOCIATION OF GLOBAL CUSTODIANS

CPSS-IOSCO FMI Consultation -- AGC Comments

29 July 2011

Page 2

### General Note

Members view the Consultation as dealing with two main subjects of interest to custodians. One concerns the risk profile of CSDs and their activities. On this subject, members believe that certain requirements (in particular those in Principles 4 and 8) should be strengthened. The second concerns the supervisory and regulatory role that appears to be imposed on CSDs (in particular in segments of Principles 18 and 19). Members believe that these principles and requirements relating to CSD supervision of participants should be adjusted to ensure that the fundamental role of a CSD as an essential industry service utility remains undiluted.

### Comments on Specific Principles

#### Principle 4: CSD/SSS Credit Risk

Members believe that this principle, as it relates to CSDs and SSSs, should be strengthened to emphasize the need to minimize the credit risk to which a CSD or SSS is exposed. The Consultation text in paragraph 3.4.2 implies that CSDs and SSSs can make use of a deferred net settlement design or a guaranteed settlement model to facilitate this goal. Members believe, however, that the Principles should also note systemic risk-reducing options such as the introduction of Real-Time Gross Settlement, where there are clear risk benefits and supporting cost-benefit analyses.

As a more fundamental issue, the Association recommends that the Consultation do more to address the potential systemic risk involved when CSDs engage in commercial activities beyond their core infrastructure function. In members' view, this source of systemic risk should not be underestimated; the overriding principle in CSD regulatory regimes should be to ensure that CSDs, as systemically important market infrastructure, do not underwrite risks which could jeopardize their ability to provide core services, whether in a routine setting or in stressed market conditions. Indeed, members believe *the main objective of CSD regulation should be to ensure the safety and soundness of the post-trading environment*. Members believe that the Consultation downplays that emphasis, including by encouraging CSDs to undertake broader participant-supervision responsibilities.

#### Principle 8: Settlement Finality

Members believe it important that CSDs, SSSs and large-value payment systems, provide for intra-day finality so as to minimize risk and increase efficiency.

## THE ASSOCIATION OF GLOBAL CUSTODIANS

CPSS-IOSCO FMI Consultation -- AGC Comments

29 July 2011

Page 3

Provisional settlement creates credit and liquidity pressures as well as systemic risk that should not be considered acceptable in today's global markets. Accordingly, members suggest that the current text of this Principle be strengthened to emphasize intra-day finality as an overarching goal.

### Principle 11: Central Securities Depositories

Members fully support the phrasing of this principle, including as detailed in the key considerations. Members wish to note, however, the potential for confusion in respect of "participant customer accounts" as found in 3.11.5 - Segregation of assets. Given the potential for misunderstanding based on the current draft of that section, members identify below some key points that the Association would encourage CPSS-IOSCO to consider incorporating into the principles.

First, the principle of segregation of client assets from proprietary assets is fundamental to sound safekeeping. This means that a CSD should segregate its own proprietary assets from the assets of its participants (and their clients); and a CSD participant should – in the books of the CSD – segregate its own proprietary assets from the assets of its clients, and the CSD should allow for such segregation.

Second, members believe that a CSD should facilitate any further segregation – in the books of the CSD - that a CSD participant may choose to effect. However, a CSD should not impose such further segregation. If a CSD were to impose obligations to segregate further -- for example, segregation by final beneficiary in the books of the CSD -- this would prove to be immensely burdensome, if not infeasible, for investors, notably foreign investors, and would lead to conflicts with the "fair and open participation/access" requirements of Principle 18. Moreover, even if such final beneficiary segregation arguably reduces local legal risk, legislative steps should be taken to improve the relevant legal framework in lieu of imposing impractical and onerous segregation requirements at the CSD level.

### Principle 18: Access and Participation Requirements

Association members fully support the text of Principle 18 as drafted. However, aspects of sections 3.18.5 and 3.18.6 imply that a CSD's participation requirements should be determined not simply by considerations of safety and efficiency to the FMI and to its participants, but also by reference to broader "system and financial market" goals. Those goals and the related requirements are largely unspecified, which may well create undesirable uncertainty in application. In addition, the text in those sections

may suggest that CSDs should take on a role -- again not sharply delimited -- as regulator and/or supervisor of their participants. The Association encourages revisions to this text; any participant "monitoring and oversight" by a CSD should fit the scope of existing CSD risk-management regimes.

More specific comments in respect of this Principle are as follows:

(i) The third sentence in paragraph 3.18.5 states: "Where participants act for other entities (indirect participants or users) it may be appropriate for the FMI to impose additional requirements to ensure that they have the capacity to do so". The scope and nature of suggested requirements is not clear. Under one reading, the Consultation may suggest that FMIs should impose client-servicing requirements and standards on their participants. Members do not believe that this is the role of a CSD -- and more generally of any FMI -- and we encourage revision to this text.

(ii) Paragraph 3.18.6 specifies that CSD participation requirements should not "discriminate unduly" against particular classes of participants. Members suggest a narrower construction that would limit differential treatment among CSD applicants in admission decisions or among CSD participants in use of CSD services to reasonable treatment that is based on risk considerations or safekeeping dictates.

#### Principle 19: Tiered participation arrangements

Members believe this principle requires careful review. As it currently reads, it suggests that CSDs take on a supervisory, if not quasi-management, role with respect to their participants' client relationships and intermediation activities, including among other tasks, gathering information about participants' clients, specifying rules relating to the relationship between a participant and its clients, and monitoring compliance with those rules. Members suggest that the text be revised to tightly focus and carefully limit CSD "risk-management" responsibilities in relation to participants' clients or in respect of relations between participants and clients.

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The Association appreciates the opportunity to set out members' views on the foregoing select matters of interest and concern to global custodians. If you have

THE ASSOCIATION OF GLOBAL CUSTODIANS

CPSS-IOSCO FMI Consultation -- AGC Comments

29 July 2011

Page 5

questions or would like additional information, please contact the undersigned as an initial matter.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Dan W. Schneider", followed by a long horizontal flourish.

Dan W. Schneider  
Baker & McKenzie LLP  
Counsel to the Association