THE ASSOCIATION OF GLOBAL CUSTODIANS

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July 2, 2002

BY MESSENGER

Jonathan G. Katz
Secretary,
Office of the Secretary, Mail Stop 6-9
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

RE: File No. SR-DTC-2002-06/Securities Exchange Act Release No. 34-46028 (June 4, 2002) – Proposed Rule Change by the Depository Trust Company Relating to the Use of the Federal Reserve Banks' Net Settlement System by Settling Banks

Dear Mr. Katz:

This letter is submitted on behalf of the Association of Global Custodians[1] in response to the request for public comment in the above-captioned release ("Release"). The Release contains a proposed Depository Trust Company ("DTC) rule change that would require all DTC bank participants that settle for themselves or for other participants ("Settling Banks") to enter into a "Settlement Arrangement" pursuant to which their net debit balances would be settled through the Federal Reserve's National Settlement Service ("NSS"). Since eight of the nine members of the Association are

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1/ The Association of Global Custodians ("Association") is an informal association of nine banks that are major providers of custody services to registered investment companies. The members of the Association are listed above.

Mellon Trust and The Northern Trust Company have declined to participate in this letter.

Settling Banks, this proposed rule change is of considerable interest and importance to the Association.

For the reasons set forth below, the Association urges that the Commission institute proceedings pursuant to Section 19(b)(2)(B) to disapprove this proposal. In our view, the concept of mandatory NSS participation raises numerous questions that are not addressed in the Release or in DTC's supporting filing. In particular, we are concerned that, by forcing all Settling Banks into an NSS settlement arrangement, the proposal could expose the major commercial banks in the United States to a new source of risk. That risk would be most pronounced in the event of a market emergency -- precisely the time at which the stability of the banking system, and the capacity of major banks to control and manage their exposures, would be most critical. Further, it is at best unclear whether and how the proposal would contribute to the reliability of DTC settlement. To the extent that the proposal is intended to address the possibility that Settling Banks may, on rare occasions, be unable to initiate wire transfers, there may be other, less draconian ways of accomplishing DTC's objectives.

We do not, of course, mean to express any criticism of NSS or of the terms under which it operates. Indeed, several members of the Association are participants in NSS. We would, however, suggest that voluntary participation is a far different matter than is participation that is, as DTC has proposed, a mandatory pre-condition to acting as a Settling Bank. Today, the use of NSS is optional; prospective participants can weigh the risks and costs against the benefits in deciding whether to join, and existing participants are free to withdraw. For the reasons discussed in this letter, we do not believe that the Commission should use its approval authority under Section 19(b)(2) to deprive Settling Banks of the ability to individually make (and to periodically reassess) these choices.

NSS and DTC's Proposal

NSS is a service offered by the Federal Reserve under which a group of entities that have accounts with a Reserve Bank may enter into an arrangement by which the participants (or "Settlers") designate a "Settlement Agent" to act on their behalf in settling balances due to or from the participants as a result of their clearing activities.[2]

2/ The conditions under which the Federal Reserve Banks offer settlement services are described in a Fed. publication entitled Operating Circular 12 (March 29, 1999), a copy of which is Exhibit 2 of DTC's Form 19b-4. Terms that appear in quotation marks in the text above are defined in Paragraph 1.2 of Operating Circular 12.

The participants authorize the Settlement Agent to submit a "Settlement File" to the "Processing Reserve Bank." The Settlement File shows the debits and credits of each participant -- that is, the amount that each participant owes, or is owed by, other participants to the Settlement Arrangement. The Processing Reserve Bank reviews the Settlement File and, if the file passes this review, causes each participant's Reserve Bank account to be debited or credited in accordance with the Settlement File.

The Federal Reserve Banks require the parties to a Settlement Arrangement to indemnify and hold harmless the Federal Reserve Banks for any loss they might incur as a result of providing settlement services under such an arrangement. Paragraph 6.4 of Operating Circular 12 sets forth the procedure under which a claim under this indemnity would be paid. In essence, a Reserve Bank would make a claim against the participants in the Settlement Arrangement that gave rise to the loss. If this claim were not paid within 15 days, a proportionate share of the claim would be charged to each participant's Federal Reserve Bank account. If some participants' accounts were insufficient to satisfy their share of the claim, the unpaid amount would be reallocated to the remaining participants. If the reallocation exceeded the Fed. accounts of any of the remaining participants, the shortfall would again be reallocated in successive rounds until the Federal Reserve Bank was made whole (or until the Federal Reserve accounts of all participants were exhausted). Thus, Paragraph 6.4 provides for "cascading" liability under which a default by one participant could result in the remaining participants incurring charges in excess of their proportionate share of the original loss.

DTC's rule proposal would make Settling Bank participation in NSS mandatory. DTC is the Settlement Agent under the Settlement Arrangement to which all Settling Banks would have to become parties. The proposal therefore would allow DTC direct access to each Settling Bank's Federal Reserve Bank account to settle end-of-day net debit balances. At present, Settling Banks may settle their debit balances either by wiring funds to DTC or by participating in NSS. DTC invited settling banks to join NSS voluntarily in 2000, but the majority of settling banks have chosen not to do so. The Release asserts that the need for mandatory participation in NSS "became more obvious than ever" during the week of September 11, 2001, and that participation in NSS will reduce risk.

Views of the Association

The Association believes that participation in NSS could create new risks and potential exposures substantially beyond those which Settling Banks and their institutional customers face today as a result of DTC's current end-of-day payment

process. With little detailed explanation, DTC seeks to rely on the events of September 11 to justify mandatory NSS use. To the contrary, the members of the Association believe that it is precisely on the occasion of devastating crisis events that Settling Banks need to retain strict control over their Federal Reserve accounts.

The Association's primary concerns include the following:

1. Settling bank participants will lose control over access to their Federal Reserve accounts.

As a matter of principle, we believe that commercial banks should not be forced surrender control over access to their assets, including their Federal Reserve Bank accounts, except where the bank regulatory authority with jurisdiction over the institution concludes that shared access is appropriate. We question whether, as a matter of policy, the federal securities laws should be employed to compel banks -- especially those with a long and unblemished history of honoring their DTC settlement commitments -- to share control of their Federal Reserve Bank accounts with DTC as a condition to continuing as a DTC participant.

Principle aside, loss of a Settling Bank's control over debts to its Federal Reserve Account could also have adverse practical consequences. For banks with substantial intra-day cash flows, the timing of debits and wires out may be significant. NSS participation would deprive Settling Banks of control over the timing of their DTC debit. Further, although DTC has stated that it would seek acknowledgment of a debit balance amount before charging a Settling Bank's account at the Federal Reserve, there is no apparent mechanism to prevent a debit which is unacknowledged, erroneous, disputed, or simply unauthorized. Stated differently, once a Settling Bank executes the NSS arrangement agreement, it relinquishes the ability to prevent debits to its account.

2. The Release contains no discussion of the controls applicable to DTC's access to Settling Bank Federal Reserve accounts or of the procedures for resolving disputes and errors.

Our concerns regarding the proposed mandatory granting of DTC access to Settling Bank Fed. accounts are exacerbated by the lack of any discussion in the Release of DTC's controls and procedures. It is unclear what controls DTC would, or has, put in place to guard against unacknowledged, erroneous, disputed or unauthorized debits to Settling Bank Federal Reserve accounts. Similarly, there is no apparent procedure to respond to disputes regarding such events. The Release and

related Rule 19b-4 filing contain no information concerning how and on what schedule a Settling Bank could cause DTC to restore funds to a participant's account in the event of an error, particularly if the beneficiary of the error became insolvent. If Settling Banks are to be compelled to appoint DTC as their Settlement Agent as part of an NSS arrangement, we believe that, at minimum, the Commission should condition its approval of such a rule on a detailed understanding of the controls that DTC will employ to protect the assets of Settling Banks and of the procedures that will be followed in the event of a dispute concerning the manner in which DTC has exercised its authority.

3. The potential consequences of the cascading indemnity clause in Paragraph 6.4 of Operating Circular 12 are unclear and may include exposure of Settling Banks to additional, unquantifiable, risk.

As noted above, participation in NSS requires a Settling Bank to sign an agreement with the Fed. embodying the terms of Operating Circular 12, including the cascading indemnity clause. The risks associated with this indemnity liability are not a feature of Settling Bank participation in DTC at present. The implications of this provision should be fully explored before action is taken on DTC's proposal.

The situations in which a Settling Bank might have liability under the cascading indemnity requirement, and the potential magnitude of such liability, particularly in the face of a devastating market crisis, are unclear.[3] The Commission should not force Settling Banks to agree to such liability as a condition to continuing to participate in DTC without a full explanation of the circumstances in which such liability might arise; how, if at all, it might be limited; and the potential impact on the banking system in the event that the cascading indemnity were invoked at a time when the banking system was under financial strain as a result of some catastrophic event.[4]

3/ The level of risk associated with the indemnity element of an NSS arrangement is a function of the creditworthiness of the other participants in the arrangement. However, the Release provides no information concerning whether existing participants will be afforded any say in -- or even advised concerning -- the admission of new Settling Banks. Without transparency in the Settling Bank admission process, it will be difficult for participants to evaluate or manage their NSS risk exposure.

4/ In The Release also states that DTC, as Settlement Agent, would have "certain responsibilities regarding the allocation among Settling Banks using NSS of a claim for an indemnity by a FRB" and that DTC would "attempt to apply the same loss

4. The relative costs and benefits (if any) of mandatory NSS participation have not been explained or analyzed.

DTC justifies this proposal on the ground that, by eliminating the need for bank wires, use of NSS will reduce the risk that "completion of DTC settlement will be delayed." The Release refers specifically to September 11, 2001 and implies that reliance on NSS will facilitate settlement when extraordinary events preclude Settling Banks from initiating wires. While the Association supports efforts to promote the reliability of DTC settlement, it is, we believe, questionable whether mandatory NSS participation will further that goal.

Under the present system, Settling Banks that have not elected to participate in NSS (i.e., the majority of Settling Banks) settle their DTC net debits by wiring funds to DTC. In this type of decentralized system, the failure of one Settling Bank to initiate its wire has no impact on the timeliness of DTC's receipt of funds from other Settling Banks. In contrast, under an NSS arrangement, the entire Settlement File is apparently cancelled if a single participant lacks the funds in its Federal Reserve account to cover its debit.[5] While DTC may be able to obtain the necessary funds from the defaulting

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allocation procedures" as appear in its rules. DTC's undertaking to "attempt to apply" its allocation procedures would afford little comfort in an environment in which a significant Fed. indemnity liability was allocated, especially if the same event as had caused that liability simultaneously imposed other strains on Settling Bank liquidity. In short, participants could be exposed to very considerable risks that they do not currently face, that are unquantifiable, and over which they would have no control.

5/ The Processing Federal Reserve Bank may (and presumably would) "reject a Settler's debit Balance if the Settler has failed, been suspended, been closed, or the like; or in the opinion of the Reserve Bank holding the Settler's Master Account, the Settler does not or will not at the end of the day have in its Master Account a balance of actually and finally collected funds sufficient to cover its debit Balance." Paragraph 5.3, Operating Circular 12. When a debit Balance is rejected, various attempts are made to obtain funds from the Settler in question. See Paragraphs 5.5(a), (b)(1), and (b)(2). However, if sufficient funds cannot be obtained pursuant to Paragraphs 5.5(b)(1) or 5.5(b)(2), the only remaining alternative is for the Settlement Agent to "instruct the Processing Reserve Bank to cancel settlement of the original Settlement File." This means that none of the Settling Banks' accounts will be debited in accordance with that file.

bank by other means, or may be able to submit a new Settlement File excluding that bank, the effect is to delay receipt of funds from any Settling Bank because of the inability of one Settling Bank to cover its debit.

Opinions could perhaps vary as to whether, on balance, mandatory participation in NSS would promote or retard settlement, especially in crisis situations in which some banks are in fact unable to make payment. However, the Release and the underlying Form 19b-4 filing provide little analysis of this issue. Similarly, no effort has been made to consider alternatives[6] or to balance the perceived benefits of compulsory NSS participation against the costs and risks that such participation could impose on Settling Banks. The Commission should require that such an analysis be performed and exposed for comment.[7]

6/ If the rationale for the proposal is to address the unusual situation in which a Settling Bank is unable, because of some extraordinary event, to initiate a wire, there may be ways of addressing the problem short of mandating that all Settling Banks participate in NSS. The possibility could, for example, be explored of requesting that non-NSS participants authorize DTC, or some third party, to initiate a wire on their behalf in emergency situations, based on a fax instruction from the Settling Bank. Obviously, however, even an emergency procedure of this nature would have to be subject to well-defined controls.

7/ While less critical than the other issues discussed in this letter, we are also concerned with the scope of Paragraph 6.7 of Operating Circular 12. Under that provision, each Settler and its Settling Agent must agree to provide to the Reserve Bank "information regarding the transactions giving rise to Balances." Apparently, the Reserve Bank could request this information for any reason, including reasons having no relation to the purpose and operation of the Settlement Arrangement, and could, in turn, share such information with the Board of Governors of the Federal Reserve System (and possibly with other federal or state agencies). While we recognize that client identifying information may be excluded, we believe that this provision could raise issues under some contracts with Settling Bank clients. We also question whether it is appropriate for the Commission to condition Settling Bank participation in DTC on this type of confidentiality waiver.

Conclusion

The Association does not believe that DTC has adequately justified the need for the drastic step of requiring Settling Banks to relinquish sole control over their accounts at the Federal Reserve. The Commission should institute proceedings pursuant to Section 19(b)(2)(B) of the Act in order that the issues outlined above can be more fully explored and a public record developed concerning the proposal.[8]

* * *

The Association appreciates the opportunity to comment on this proposed DTC rule change. If you have any questions concerning this matter, please contact me at 202/452-7013.

Sincerely,

Daniel L. Goelzer
Counsel to the Association

cc: Richard B. Nesson
Managing Director
The Depository Trust Company

8/ Various members of the Association have discussed the implications of NSS membership with representatives of the Fed. and DTC. While we remain opposed to mandatory NSS participation, we appreciate the willingness of both institutions to devote time to considering our concerns and responding to our questions.