

THE ASSOCIATION OF GLOBAL CUSTODIANS

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October 31, 2003

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Dear Messrs Godeffroy and Wymeersch:

On October 1, 2003, the Association of Global Custodians (the "Association") submitted a comment letter (the Association's "First Letter") in response to the request for comments regarding documents entitled, "Standards for securities clearing and settlement in the European Union" (the "Standards Report") and "The scope of application of the ESCB-CESR standards" (the "Scope Statement"), prepared by the European System of Central Banks and the Committee of European Securities Regulators (together, "ESCB-CESR"), dated August 1, 2003. This letter supplements the First Letter and also includes as an attachment the Association's comments on each of the 19 proposed standards addressed in the Standards Report ("Standards").

As noted in the First Letter, the Association is an informal group of ten banks with extensive European branches and affiliates that provide global custody services to cross-border institutional investors, including pension funds and investment companies. In view of the extensive role Association members play in safekeeping and related banking activity for investors in European markets, and given that the Standards -- if adopted -- would materially impact Association members (as well as the balance between participants in the market), the

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Association is submitting these additional comments and concerns regarding the Standards Report.

The First Letter conveyed members' concerns regarding the application of the Standards to *custodians*, particularly the Standards' focus on *sizable custodians*. The First Letter explained why the Association believes the Scope Statement and the Standards Report inappropriately equate custodians with infrastructure utilities, such as Central Securities Depositories ("CSDs") and International Central Securities Depositories ("ICSDs"), and incorrectly suggest that custodians present the same systemic settlement risks as do infrastructure utilities. In addition, the First Letter described the shortcomings in treating certain custodians as operators of "systemically important systems" whether based on their size or otherwise. Finally, the First Letter urged ESCB-CESR to include representatives of custodians in the group of experts on which ESCB-CESR relies for policy guidance and formulation, so that an industry segment that is going to be materially impacted by the Standards has the same opportunity to shape proposed standards as is afforded other segments. We would hope it would be ESCB-CESR's desire to ensure a balance of interests in the expert process.

Since submission of the First Letter, members have met with ESCB-CESR representatives and attended the ESCB-CESR Open Hearing on October 2, 2003 ("Open Hearing") in Paris. As a result of these meetings, Association members wish to make the following general points, which are based in part on statements and assumptions reflected in the Standards Report, as well as observations and comments made during the discussions at the Open Hearing.

First, we wish to affirm our understanding that the Standards on transparency, open access, efficiency and governance, which make particular sense for infrastructure entities, are *not now* intended by ESCB-CESR to be applied to commercial entities like custodian banks. We base our understanding concerning this change in the intended scope of these Standards on discussions that occurred during the Open Hearing in Paris.

Second, Association members believe that the responsibility lies with regulatory authorities to identify specific risks that are unaddressed within the current regulatory regime before imposing new requirements that do not take into account, and that potentially may conflict with, existing comprehensive regulations. However, in reviewing the Standards Report, we did not find an assessment of specific risks posed by bank custodian activities or an explanation of why such risks are not currently addressed by the elaborate regulation applicable to bank custodians. We would hope that, before regulatory authorities apply the Standards, appropriate assessments and explanations would be undertaken.

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Third, because of some confusion regarding the functions of CSDs and ICSDs on one hand, and the functions of custodians on the other, the Standards would apply requirements designed for the CSD and ICSD functions to the custody function, regardless of what that function entails. We encourage ESCB-CESR to be very clear about the particular functions they are trying to capture, and to apply appropriate requirements to the relevant functions. In this regard, we note that CPSS-IOSCO specifically did not include custodians within the ambit of their recommendations, and was very specific about the functions that might cause custodians to be included. We further note that custodians, as banks, make credit and collateral determinations based on established risk-management disciplines and client-monitoring controls, and that activity is required to be supported by substantial risk-adjusted capital. Custodians thus exercise regulated judgment in deciding when and to whom credit should be extended, in what amounts, and when collateral or other forms of assurance are needed. In contrast to the approach reflected in the CPSS-IOSCO recommendations, ESCB-CESR seems to be casting a very broad net, applying standards fit for utilities to already highly-regulated, non-utility institutions in an effort to address a perceived but unspecified risk within custodian functions.

General Comments

A. In general, custodians are regulated, examined and supervised by bank regulators as credit institutions and safekeeping entities. The existing regulatory scheme applicable to banks requires banks to maintain adequate risk-based capital, employ professional risk management controls covering all steps in the custody/settlement operation, undergo frequent audits and examinations by professional auditors and regulatory examiners, and regularly assess client creditworthiness and manage client performance behavior. Additional regulation that may be appropriate for depositories as the infrastructure components of the EU clearance and settlement system is neither necessary nor appropriate for highly-regulated custodian banks.

Members of the Association are thoroughly regulated -- both directly under U.S. banking and fiduciary laws, and indirectly under laws applicable to institutional investors, including pension funds and investment companies.¹ European affiliates of members of the Association generally are subject to comparably extensive and penetrating regulation and supervision under

¹ See, e.g., the Comptroller's Handbook, Custody Services, Jan. 2002, issued by the United States Comptroller of the Currency, Administrator of National Banks; for reference, see the citations to myriad U.S. laws and regulations applicable to bank custody and related services set out in the Examination Procedures and Appendix sections thereto.

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the laws applicable to licensed EU banking institutions,² and in some EU jurisdictions, for example the United Kingdom, they may also be subject to regulation to varying degrees as “investment firms”. The Banking Consolidation Directive (2000/12/EC) deals with the authorization of credit institutions, including the requirement that credit institutions must obtain appropriate authorization and be subject to supervision by competent banking authorities before commencing credit activities. Among the activities covered by the scope of the Directive are “safekeeping and administration of securities” and “safe custody services.” In addition, the Capital Adequacy Directive (93/6/EC) establishes principles for imposing supplemental obligations on banks to maintain appropriate levels of risk-based capital in support of their authorized banking activities.

Thus, effectively, the regulatory regimes applicable to custodian banks include components that currently address the various risks associated with safekeeping and agency settlement activities by custodian banks. The Association therefore sees no basis for new or additional regulation of custodian banks when they engage in securities custody and related banking activities, whether the custodian is large or small.

B. Custodian banks, generally, are credit institutions and, as such, are authorized and competent to provide credit in connection with their safekeeping and related banking activities. In addition, custodian bank credit decisions and activities are subject to effective regulation and oversight (see discussion above). While considerations concerning collateralization requirements for infrastructure utilities appear to fall within the scope of the work of ESCB-CESR, it is not clear whether the ESCB-CESR Standards should -- or may -- include matters involving the regulation of credit and credit activities of duly-authorized credit institutions.

As banks, custodians make credit and collateral determinations based on established risk-management disciplines and client-monitoring controls, and that activity -- like all aspects of banking activity -- must be supported by substantial risk-adjusted capital. In that regulated business context, custodians exercise regulated judgment in deciding when and to whom credit should be extended, in what amounts, and when collateral or other forms of assurance are needed.

² For example, most Association members have FSA-regulated affiliates.

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As addressed in detail in our attached comments,³ this business and the regulatory setting in which bank custodians carry out their credit-related activities contrasts with the perspective and assumptions about these activities reflected in the Standards Report. In the Standards Report, ESCB-CESR asserts that sizeable custodians, as “systems,” should not run credit risks and should fully collateralize all their credit exposures.⁴ However, custodian banks traditionally do provide credit to investors and manage exposures as an integral component of delivering custody and related banking services. In so doing, custodians exercise regulated discretion and apply various controls, including collateralization, in connection with each credit decision. However, collateralization is only one method banks use to manage each increment of credit risk presented by client activity, and collateralization is not universally appropriate for all custody circumstances or all of a custodian’s investor clients.⁵

Where there are collateral requirements today in the current EU settlement environment, they are satisfactory and the applicable processes and arrangements are well-defined and effective. Participation in multiple securities depositories across the EU necessarily entails intra-day credit risk. That risk is managed by each depository’s participation and operating requirements as they apply to each of its direct participants. The risk that a local custodian may in turn have relative to any of its clients (including a global custodian client) is already managed through normal credit evaluation processes and controls, subject to regulation and supervision under applicable regulations. In a similar way, a global custodian manages this potential credit risk with its respective clients on an individual basis, but still subject to similar protections, controls and supervision. We therefore see no risk-based reason for ESCB-CESR to attempt to

³ See Association comment on Standard 9, attached.

⁴ See Standards Report at paragraph 109.

⁵ Moreover, many types of institutional investors are subject to legal restrictions on pledge of assets, and for those investors, new collateral requirements could be unworkable. In this connection, we note, the Standards recommend that the use of loss-sharing arrangements and guarantee funds across “participants” be required of “operators of systems,” including sizeable custodians. (See Standards Report at paragraphs 107 and 110.) Investors that employ custodians would not acquiesce in a custodian’s use of this sort of pooled or mutualized risk management device, however. Institutional investors appoint custodian banks as their agents to achieve safe segregation of assets, and any form of required mutualization of risk across investors that use a given custodian or a collective sharing of losses by all investors using a given bank’s custody services would be infeasible and for many clients would be impermissible legally.

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subject custodians -- sizeable or otherwise -- to new collateralization requirements or to attempt to impose new standards and obligations on banks in respect of credit determinations.⁶

To the extent the Standards address credit activities and decisions of custodians, the Association suggests that ESCB-CESR work with bank regulatory officials who oversee credit activities and controls of banks before finalizing those Standards. Although the scope of work of ESCB-CESR in developing standards and recommendations for the regulation of infrastructure utilities in the clearance and settlement network seems fairly clear, it is not clear that the scope should -- or may -- extend to matters involving the regulation of credit activities of credit institutions as such. The scope of the Banking Consolidation Directive, *supra*, would seem to confer jurisdiction over such subject matter to banking authorities.

C. The proposal to regulate sizable custodians as depositories raises important competitive implications and competition policy issues affecting the future structure and costs of the EU settlement system. These issues should be addressed by appropriate EU competition policy authorities, perhaps in consultation with ESCB-CESR.

While the Standards Release indicates that issues of competition do not fall within the ESCB-CESR mandate,⁷ the Association believes that the equating in the Standards of sizeable custodians with infrastructure utilities raises significant issues affecting competition and the role of competition policy in the evolution of market structure and regulation in the EU settlement system context. We therefore believe that considerations of issues involving competition can not be avoided and must be addressed in connection with developing regulatory principles for the evolving market. ESCB-CESR would need to seek, and in our view should seek, the consultative assistance of authorities responsible for that subject matter. In this regard, we note that the report of the European Parliament on clearing and settlement, issued under Rapporteur

⁶ In this connection, as discussed in our comment on Standard 1, attached, the Association fully supports efforts by appropriate authorities within the EU to unify and clarify the laws applicable to security interests in personal property, including investment securities. Harmonization would greatly increase confidence and predictability and would facilitate expanded use of appropriate contractual liens. Indeed, ESCB-CESR should consider whether a statutory lien should be created allowing settlement systems as a matter of law to use the securities that are in the process of settlement as collateral for that settlement transaction.

⁷ See Standards Report at 3.

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Generoso Andria, noted that competition policy in the EU applies to all regulatory and legislative undertakings, including clearing and settlement.⁸

D. The Standards propose to regulate sizeable custodians as depositories. If particular banking activities of custodians raise particular issues of interest to ESCB-CESR, whether systemic or otherwise, those issues should be suitably focused for separate review.

In the First Letter, we noted the possibility that the ESCB-CESR's effort to encompass sizeable custodians in the scope of certain of the Standards might be based on the activities of some primarily European-based agent banks in arranging settlements of client transactions internally -- on the books and through the facilities of the bank -- rather than through central depository facilities. We noted that such book-based transfers and "internalized" settlements occur rarely on the books of *global* custodians. Indeed, for global custodians, such transfers typically would only occur where a single client instructs the global custodian to transfer securities from one of its portfolios held by the global custodian to another portfolio also held by the global custodian. This is the equivalent of a client transferring cash from one of his accounts to another account at the same financial institution. These types of transfer events are infrequent and in any case are very ministerial.

"Internalized" *settlement* should not be viewed as similar to "internalized" *trading*, given the differing implications of these activities on the end investor. In the case of "internalized" trading, such activity may raise concerns about price, transparency and customer choice. However, this is not the case for "internalized" settlement where the price of such settlements is transparent to the client, and the settlement "location" is determined by the clients and not by the custodian in whose books the transaction will be settled.

E. The systemic risks associated with the operation of centralized settlement facilities is different in kind and degree from the type of risk associated with the typical settlement-related activities of custodian banks. These differences in risk profiles underscore the continuing need to recognize the implications of functional differences and to tailor regulations and risk-management requirements to the respective functional roles

⁸ See Report on the communication from the Commission to the Council and the European Parliament entitled "Clearing and settlement in the European Union. Main policy issues and future challenges," Committee on Economic and Monetary Affairs (December 4, 2003) (the "Andria Report") at Preamble # O.

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accordingly. This process would necessarily include taking into account existing regulations and controls.

CSDs, as infrastructure utilities, bear responsibility for measuring, controlling and managing aggregate settlements for the entire community of participating intermediaries.⁹ CSDs also bear responsibility for managing and controlling risks across links with other depository utilities. The responsibilities of these infrastructure utilities pose various systemic risks to all participant intermediaries, and these risks increase in dimension as depositories expand their linkages or enhance their range of services to include extending credit as commercial banks.

ESCB-CESR is prudent to recommend that these infrastructure utilities need to employ rigorous risk management tools and must collateralize the risk exposure that settlement or operational defaults at depositories present to the markets, financial institutions, and investors. Many of the CSDs in the EU are not licensed as banking institutions, and in general CSDs in the EU are not regulated in the same way as authorized banking institutions and therefore may not have credit authorizations or the benefit of direct regulatory oversight by credit regulators. Imposing collateralization and capital requirements on CSDs therefore seem appropriate regulatory responses.

In contrast, global custodians facilitate settlements for each of their investor clients either directly, by participating in central depositories, or indirectly, through use of participating local custodians.¹⁰ Through such arrangements custodians facilitate the delivery of investor securities against the receipt of cash (for sales), or the payment of investor cash against the receipt of securities (for purchases). Custodians facilitate the settlement process for investor clients only on an agency basis, and only when the custodian's client has posted the necessary securities or cash or has made satisfactory financing arrangements with its agents. In managing these activities, custodians apply the controls and experience noted above as regulated institutions.

⁹ See the Andria Report. That report concludes, at page 11, that "core" settlement services of "infrastructure" CSDs and ICSDs "should be managed as public utility services, the reason being that these services are public services. These 'core' services should be provided within special utility entities * * *."

¹⁰ Typically, where a global custodian uses a local custodian for access to the settlement facilities in a particular jurisdiction, the local custodian is the direct depository participant providing safekeeping services to the global custodian and, indirectly, the global custodian's clients within that market. The local custodian typically also provides familiarity with country-specific customs and rules pertaining to the local market.

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Accordingly, the typical settlement activities of custodian banks, as agent for their clients, do not present uncontrolled, unmanaged, or unsupervised credit risk or settlement risk to the depository or other depository participants.

Typical risk management tools used by a global custodian when appointing a local custodian would include a full credit and due diligence review, a review of local regulations regarding enforceability of contractual arrangements under local law, the ring fencing of clients assets, the use of appropriate account structures at the local custodian and at the local CSD, as well as a review of the business continuity arrangements of the local custodian.

Recently, in Denmark and Japan, local custodians that, based solely on their size, would fit the ESCB-CESR notion of “systemically important” systems experienced major systems failures. However, these incidents did not affect the ability of the market as a whole to continue operating. Transfers of title -- which could not happen in the case of a system failure at a CSD -- continued to take place (with inherent delays) based on manual procedures (faxes, physical delivery of statements, etc.), allowing the markets to continue to operate unimpaired.

In terms of type and scope of settlement operations, these differences between infrastructure depositories as compared to custodian banks are fundamental. In order to be effective, regulation must recognize these differences. Such differential regulation is currently recognized in regulatory regimes in EU jurisdictions. For example, infrastructure providers in the United Kingdom, such as CRESTCo, are subject to a separate regulatory regime particularly suited to their central market position, and this regime is different from the one applicable to intermediaries. While the Association supports ESCB-CESR’s effort to establish high standards for managing risk and ensuring efficiency in the clearance and settlement infrastructure, in our view, as noted above, global custodian banks do not operate clearing and settlement *systems*, and are at present fully regulated, examined, and supervised *in respect of their activities and risks as safekeeping entities and credit institutions serving investor clients*.

Conclusion

The Association appreciates the opportunity to provide its comments and express its concerns regarding the Standards and the Standards Report. The Association’s views regarding Standards 1 through 19, including a brief statement of the Association’s general position on each

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Standard, are attached hereto. We would be pleased to supplement these comments on request. Questions may be directed to the Association through the undersigned.

Sincerely yours,

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Attachment - Comment of the Association of Global Custodians on the 19 Proposed Standards ("Standards") Set Forth in the "Standards for securities clearing and settlement in the European Union."

cc (via e-mail only) - Elias Kazarian, ECB
Wim Moeliker, CESR
Joint ESCB and CESR Secretariat

Comments of the Association of Global Custodians (“Association”) on the 19 Proposed Standards (“Standards”) Set Forth in the “Standards for securities clearing and settlement in the European Union.”

Specific Standards

Standard 1: Legal framework

Securities clearing and settlement systems and links between them should have a well-founded, clear and transparent legal basis in the relevant jurisdictions.

The Association supports efforts by law-makers and regulators to clarify the laws that apply to securities clearing and settlement processes and systems, including the links established among the component infrastructure CSDs, ICSDs, and CCPs, and to make their application understood and uniform.¹ However, the Association does not support the application of this Standard to global custodians.

Participants in the clearing and settlement system must reasonably be able to determine the law applicable to their transactions; their rights to securities, cash and collateral under that law; and the mechanisms available to them for enforcing those rights. Liability gaps and inconsistent rules that exist in the various, heterogeneous European jurisdictions must be eliminated or otherwise addressed through sound and uniform legal standards.

Association members believe that the creation of a harmonized legal framework can only occur through the action of those bodies with the power to make law. EU lawmakers will have to unify key laws to ensure legal predictability and consistency of process. Similarly, we believe that the EU must adopt a uniform approach to cross-border security interests and uniform recognition of a secured party's rights in securities collateral.

Paragraph 31 - We further agree that this Standard should include adherence to Directive 98/26/EC on settlement finality by, and designation thereunder for, all CSDs and CCPs governed by the law of a European Economic Area (“EEA”) Member State. Irrevocable settlement is fundamental to the safety and soundness of all clearing and settlement systems.

¹ Throughout this document, as appropriate, references to CSDs are intended to include ICSDs.

CSDs and CCPs operate market-servicing systems, accessed by professional intermediaries, based on a set of uniformly-applied and non-negotiable set of rules and operating terms and conditions. Such infrastructure utilities commonly operate as quasi-governmental entities under some form of governmental oversight, and intermediaries, including custodians, are required to use these entities directly or indirectly to settle most securities transactions in the markets the entities service. Even if services are poor or costly, intermediaries and investors have no choice. It would follow then, that such entities' general terms of service should be transparent and subject to direct user input. In contrast, custodians are private commercial enterprises. Their service agreements with clients are heavily negotiated and commonly tailored to meet the particular service needs of particular clients. The terms and conditions of custodian service are subject to the natural commercial pressure created by competition for clients, and clients can choose among various service providers. While intermediaries, including custodians, participate in the core infrastructure utilities, infrastructure utilities do not "participate in" commercial custodians. Accordingly, public policy considerations that do not apply to global custodians do apply to CSDs and CCPs as infrastructure utilities.

Consequently, we do not agree that this Standard should encompass or be addressed to custodians as if they play a public facility infrastructure role. As a result, we disagree with the implications of Key Element 2 of this Standard that custodians' contracts with clients should be made public or that any client's service agreement with its custodian should be "accessible" to anyone other than the client. Custodian service agreements are privately negotiated contracts, and as such should be respected as proprietary and confidential. Nor do we agree with the implications of Explanatory Memorandum Paragraph 29 that the 15 points of transparency identified therein should apply to custodians, custodian service agreements, or the processes by which custodians negotiate the terms of service with individual clients. We hold these views as to all custodians, whether "sizeable" or not.

Standard 2: Trade confirmation and settlement matching.

Trades between direct market participants should be confirmed without delay after trade execution, and no later than trade date (T + 0). Where confirmation of trades by indirect market participants (such as institutional investors) is required, it should occur as soon as possible after trade execution and no later than T + 0. For settlement cycles that extend beyond T + 0, settlement instructions should be matched as soon as possible and no later than the day before the specified settlement date.

The Association agrees that trade confirmation should occur without delay after trade execution and settlement matching should occur at least the day before the contractual settlement date.

Adherence to the proposed principles will decrease the incidence of delayed settlement, thereby decreasing the costs and risks associated with unsettled trades. However, although many EU trading platforms already enable trade confirmation directly after execution, in our experience there are two primary barriers that must be overcome before trade confirmation/settlement processes achieve full compliance to those principles: insufficient technology and time zone differences.

While progress has been made in adopting universal messaging standards and communication protocols, market participants can only take advantage of this progress through an investment in technology that enables speedier communication of confirmation and settlement information. Without the correct straight-through-processing-enabling technology -- coupled with the expertise to use it -- delayed communication will continue to inject delays in confirmation/settlement processes.

With respect to time zone differences, indirect market participants based outside of Europe may have difficulty in completing the confirmation process on T + 0. This is particularly true for trades executed late in the European trading day. Additionally, remote exchange membership can have a negative impact on confirmation. Indirect participants should not be disadvantaged by T + 0. They should, however, be required to have operations in place to deal with related issues such as the differences in time zone.

The Association agrees that a T + 0 confirmation and settlement pre-matching convention will achieve important safety and efficiency benefits. However, the evolution of operations activity under this Standard toward an "enforceable" EU market-wide practice necessarily depends on the evolution of straight-through processing ("STP"), matching utilities and related technologies, as well as market participants' willingness and ability to utilize them.

Standard 3: Settlement Cycles

Rolling settlement should be adopted in all securities markets. Final settlement should occur no later than T+3. The benefits and costs of an EU-wide settlement cycle shorter than T+3 should be evaluated.

The Association agrees with this Standard as it would apply to all securities markets and believes that a shortened settlement cycle,

harmonized across EU markets, would be an asset to achieving safety and soundness in clearing and settlement in the EU.

Paragraph 44 - We agree that a shortened settlement cycle may reduce certain risks associated with a longer period between the trade date and settlement of a transaction. As a result of developments in information and communications, an infrastructure that supports general rolling settlement on a T+3 basis has largely evolved, particularly among major market participants.

The Association believes, however, that the movement from a T+3 to a T+1 settlement environment has the potential to reduce the tolerance of the settlement system for correction of errors identified by pre-matching. In addition, in making such a change, participants would have to consider the processing of the very large number of trades that at some point in the settlement cycle are not subject to STP. It is therefore quite conceivable that shortening the settlement cycle could temporarily result in a higher number of failed trades until parties adapt to the new timeframes, and until the market implements better STP to handle the shortened settlement cycle. Finally, consideration should be given to the ongoing problems inherent in settling foreign exchange transactions in a T + 1 (or T + 0) environment

Paragraphs 45, 46, and 47 - We agree that a shortening of the settlement cycle should be considered in light of the particularities of different markets and classes of securities. For example, currently T+1 settlement is very largely confined to central bank/government securities markets. The particular facility of a central bank to coordinate payment and delivery in a single integrated system differentiates these situations from the general run of securities markets. Caution should be exercised in extrapolating the capacity of market participants to process T+1 or T+0 settlements on the basis of these distinctive examples.

Paragraphs 48 and 49 - We agree that harmonization of settlement cycles must take into consideration the varied schedules across EU markets. To achieve this end, a cost benefit analysis should be undertaken by, or should involve, market participants with respect to harmonizing settlement cycles. That said, the industry would benefit from clear guidance as to cost-benefit analyses that are required. We believe that CESR-ESCB should work with market participants to develop such analyses and then to assess the costs and benefits of the changes to the industry across the EU.

Paragraph 50 - The Association supports the proposed study of T+3 implementation with close attention to failure rates and associated risk. The Association believes that the cause of failures to settle due to systemic weaknesses should be identified and addressed separately. In addition, fines or other penalties should be assessed against repeated and avoidable failures that indicate an unsound operation in

a market participant and should not be levied for occasional failures that occur unavoidably in generally sound operations. Finally, we would note that many markets already have remedial procedures, imposed directly by rules of exchange or based on principles of contract, for failure to settle a trade. These existing typical remedies should be catalogued and evaluated to determine whether further strictures should be introduced through settlement procedures.

Standard 4: Central Counterparties (CCPs)

The benefits and costs of a CCP should be evaluated. Where such a mechanism is introduced, the CCP should rigorously control the risks it assumes.

The Association supports this Standard and agrees that the benefits and costs of the creation of a single CCP should be considered and evaluated across EU markets.

The Association agrees that there are a number of advantages to a CCP arrangement including a reduced number of counterparties, efficiencies in clearance and settlement and facilitation of netting arrangements. However, the costs associated with creating and operating such an entity may not justify its existence in all markets. We note that certain current market arrangements may provide similar benefits as those provided by a CCP without the costs associated with the creation of such an entity. These existing arrangements should be reviewed closely with an eye towards their potential risk, costs and benefits as compared to the creation and operation of a CCP.

Paragraph 53 - With respect to netting, we believe that a CCP's netting practices must be described expressly and with precision - whether for settlement netting, balance sheet netting, close-out netting or multilateral netting.

Paragraph 58 - If a CCP's netting arrangement includes novation, we believe that the existence of such should be clearly identified to participants in the CCP. Where novation is used, it needs to be defined and well understood -- e.g., when it happens, how it happens, whether it can be reversed or revoked, and if so, why.

Paragraph 59 - The Association believes that a CCP's collateral management practice must be transparent and supported by robust risk controls (e.g., clear calculations and valuation methodologies, applicable haircuts, daily mark-to-market, stress testing, enforceable and clear rights of ownership and set-off). A diverse range of instruments should be accepted as collateral, including assets that can be held off-shore. In addition, the location of the collateral should be expressly known (e.g., held in a central depository or clearing bank).

Paragraphs 58 - 63 - Risk management controls are essential to the successful operation of a CCP. The risk reduction strategies addressed in this Standard (e.g., access criteria, member and position monitoring, valuation and adjustment of margin requirements, default arrangements and sufficient and liquid financial resources to cover risk assumed by the CCP) are appropriate to ensure the safety and soundness of a CCP's operations, and as a result, the markets it serves.

How these strategies are applied in practice will necessarily affect the risks associated with use of a particular CCP. For example, membership requirements should balance credit quality of a participant against the risks posed by the participants' dealing activity through the CCP. Because the terms and conditions of membership are necessarily imprecise instruments in assuring actual performance of a participant, member and position monitoring are important supplemental controls.

Standard 5: Securities lending

Securities lending and borrowing (or repurchase agreements and other economically equivalent transactions) should be encouraged as a method for expediting the settlement of securities. Barriers that inhibit the practice of lending securities for this purpose should be removed. The arrangements for securities lending should be sound, safe and efficient.

The Association supports the basic points set forth in Standard 5 relating to securities lending as it applies to CSDs and CCPs. The Association does not support the application of this Standard to global custodians.

Paragraphs 65 and 66 - Securities lending and borrowing are critical components to expedited settlement of securities. CSDs and ICSDs should be encouraged to make efficient centralized securities lending and borrowing facilities openly available to direct and indirect participants, and law-makers and regulators should work in coordinated fashion across the EU to eliminate barriers to the use of securities lending arrangements and facilities. In particular, cross-border lending arrangements should be respected and facilitated by a uniform body of law that recognizes the superior rights of secured parties to securities loan agreements, including in instances in which one of the parties to the transaction becomes insolvent. Specifically, each party to a securities loan transaction should have a high degree of certainty that it can promptly foreclose on, and liquidate, collateral in the event of the counterparty's (or its agent's) insolvency. In addition, adequate risk management measures should be employed by parties to securities loans, particularly by centralized lending entities when acting as principal to these transactions. Finally, CSDs and ICSDs offering lending programs should, at a minimum, be held to the same standards as banking institutions offering those services, including appropriate capital.

Paragraphs 73 and 74 - Custodians act in a lending capacity only at the specific direction of their clients pursuant to negotiated agreements. A securities lending agreement between a custodian and a particular client or counterparty includes bilateral terms that safeguard against risk of loss in the event of default under the lending arrangement (e.g., collateralization and minimum credit requirements). In addition, custody arrangements entail the use of a number of risk management controls, and these controls typically apply in the context of custodians' bilateral securities lending activity. As a result, while the Association agrees that effective risk management efforts should be required with respect to centralized and bilateral lending arrangements, we believe that risk management controls customarily employed by, or required of, custodians as bank institutions are appropriate and sufficient for custodians' securities lending activities. We thus see no basis for subjecting custodians to additional regulation in their securities lending activities, and private commercial custodians should not be equated for purposes of this Standard with the quasi-governmental infrastructure utilities.

Standard 6: Central securities depositories (CSDs)

Securities should be immobilized or dematerialized and transferred by book entry in CSDs to the greatest extent possible. To safeguard the integrity of securities issues and the interest of investors, the CSD should ensure that the issue, holding and transfer of securities are conducted in an adequate and proper manner.

In order to minimize systemic risks, CSDs should avoid taking risks to the greatest practicable extent.

The Association supports the application of Standard 6 to CSDs, as well as to registrars insofar as they perform issuance functions, including management of the issue, and transfers through book-entry.

The Association supports and encourages strengthened efforts to immobilize securities and effect transfers of ownership interests by book-entry through CSDs as a paramount policy objective. However, we encourage regulators to keep in view that the safety, soundness and integrity of the markets and securities settlement activities depend critically on CSDs and their facilities and operations. Market participants (and their customers) must be assured that appropriate safeguards will be maintained in the operation and continuity of such CSDs.

Standard 7: Delivery versus payment (DVP)

Principal risk should be eliminated by linking securities transfers to funds transfers in a way that achieves actual delivery versus payment.

The Association supports application of this Standard to CSDs, but does not agree that it should apply to global custodians.

The Association supports steps pursuant to this Standard as applied to CSDs that would promote the use of DVP settlement and that would cause cash settlement finality to be tied closely in time with securities settlement finality. Linking the processes for payments and the processes for delivery of securities and transfer of title in ways that reduce financial exposure and timing risk for participants and investors is an important systemic objective. Efforts should be undertaken toward these ends both within European market transactions and cross-border transactions as well.

Standard 8: Timing of settlement finality

Intraday settlement finality should be provided through real-time or multiple-batch processing in order to reduce risks and allow effective settlement across systems.

The Association supports efforts to promote settlement finality, including by requiring suitable arrangements among CSDs and ICSDs and harmonization of laws across Europe. The Association does not support the application of this Standard to global custodians.

Settlement finality, with accompanying legal certainty as to finality, should be assured for intra-market transactions as well as for transactions that involve cross-links and inter-market transfers. CSDs and ICSDs should be required to define in their rules the timing of finality on transactions settled through their systems, such that transfers of securities and cash become irrevocable and unconditional at identified times during each trading day. Such arrangements facilitate needed interoperability.

The Association believes that this Standard and its objectives do not and should not apply to the commercial context in which custodians provide services to clients. Unlike CSDs and ICSDs, global custodians do not provide settlement services as infrastructure utilities. Custodian banks as intermediaries record settlement, whereas infrastructure utilities, such as ICSDs and CSDs perform settlement. Paragraphs in this Standard refer to "rules of the system" and system "participants". Those references are not applicable to custodians. These are concepts borne from public policy requirements applicable to public utility-type entities that occupy exclusive market positions. Global custodians are not utility-type entities and as such do not have "rules" applicable to

“participants.” Instead, their service agreements with clients are negotiated with particularity client-by-client.

Standard 9: Risk controls in systemically important systems

Entities that operate systemically important systems need to put in place rigorous risk control measures in order to ensure that the probability of failing to provide timely settlement is negligible. Systemically important systems that extend explicit credit to participants should employ robust risk mitigation measures and, whenever practicable, full collateralisation should be applied. Incomplete collateralisation must be complemented by additional risk mitigation measures such as minimum credit quality of the borrower, credit exposure limits and, on the part of the operator, an adequate minimum capital base and adequate internal risk control measures.

Operators of net settlement systems should institute risk controls that, at a minimum, ensure timely settlement in the event that the participant with the largest payment obligation is unable to settle.

The Association agrees with the general premise of this Standard as it originally applied under the CPSS-IOSCO Recommendations – to market infrastructures such as CSDs and CCPs only. The Association does not support the application of this Standard to global custodians.

Although the original CPSS-IOSCO Recommendations acknowledged that certain CSDs may extend credit, the second Giovannini Report stated that credit extension is not a necessary feature of settlement operations for a CSD² and that concentration risk is reduced if banking services are provided by a multitude of banks in a competitive environment. This Standard appropriately references the importance of risk controls in reducing systemic risk posed by central infrastructure utilities. The Standards should include additional regulatory guidance as to the conditions and limitations appropriate to credit activities of such utilities and how the specific risks posed by their credit activities should be managed.

Even though custodians may from time to time facilitate a high proportion of settlements or a high percentage of settlement values, custodian banks are already regulated under relevant laws of their jurisdiction as to their capital, credit activities, and continuity of business arrangements. In this regard, credit risk management methods approved for banks and broker-dealers should be permitted to remain as they are, even

² Second Report on EU Clearing and Settlement Arrangements, The Giovannini Group, April 2003, Page 29.

though different from those that may be imposed on market infrastructures. Adequate prudential regulation already exists to govern banks and broker dealers with respect to credit extended to their customers, and it is debatable whether they should be supplemented or replaced.

Paragraphs 109 and 110 - With respect to collateralization, a regulatory framework, should make allowance for the use of different risk management methods as appropriate to a given entity's business model and risk management capabilities. Collateralization does not eliminate risk; it provides an alternative to credit risk but gives rise to market risk and legal risk. The exclusive use of only one method of risk management is in itself riskier for the market than the use of diverse (and functionally appropriate) methods of managing risk.

Banks which have the expertise to assess credit, have sufficient capital, and are in any case qualified to participate in ESCB credit operations, should be able to determine, client-by-client, whether collateralization is required for any particular client based on its own credit assessment. To require market intermediaries that are credit institutions to collateralize all credit utilization regardless of the creditor's ability to assess its client's credit worthiness would impose unnecessary costs and burdens.

If the collateralization requirements of Standard 9 are applied to sizeable custodian banks as if they are "operators of systemically important systems", it would encourage market participants to use smaller banks not designated as "systemically important" in order to avoid the cost of posting required collateral. This anomaly would be even more dramatic in markets where the CSD does not extend credit and collateral is only required for "systemically important" custodians. In these markets, the migration of credit extension towards smaller financial institutions with a limited capital base would have the opposite effect from what Standard 9 intends to achieve.

Paragraph 107 - The Association is opposed to the ability of market participants to unwind transactions. A prohibition on unwinding could reduce the stress on market liquidity, but its replacement by mandatory loss-sharing arrangements and guarantee funds may introduce an economically inequitable solution and "moral hazard" problems. There are alternative risk management methods to make the overall settlement network more resilient, such as ensuring that credit is to be provided by a large number of financial institutions, or ensuring that finality is achieved in one settlement system before a position is transferred to another (as provided for in Standard 19). In addition, if this aspect of the Standard is intended to encompass sizeable custodians, we note that custodians' clients do not employ custodians on a basis that involves loss-sharing with other clients.

Paragraph 109 - This paragraph contains the statement that “operators of settlement systems must also ensure that their activities not related to settlement do not endanger the ability of the institution to provide settlement services”. This requirement could be interpreted by regulators applying the Standard to mean that settlement services must be provided via a special purpose vehicle. This vehicle might be required to have a separate organizational structure and business focus from those of its parent entity so that its settlement service could not be “endangered”.

Global custodians are not “operators of settlement systems” and as such the measures and implied regulatory conditions discussed in Paragraph 109 should not apply to them. To the extent that such measures might be applied to custodians and interpreted to require the establishment of special purpose vehicles, custodians may exit the market if they find it excessively expensive in relation to providers having large scale economies or those not burdened by the special requirement. This exodus would needlessly result in a more concentrated market for intermediary services and reduced competition.

Standard 10: Cash settlement assets

Assets used to settle payment obligations arising from securities transactions should carry little or no credit or liquidity risk. If central bank money is not used, steps must be taken to protect the participants in the system from potential losses and liquidity pressures arising from the failure of the cash settlement agent whose assets are used for that purpose.

The Association supports the application of this Standard to CSDs and agrees that CSDs should always offer their members who are eligible for a central bank account the option to use the central bank as the cash settlement agent. The Association does not support the application of this Standard to global custodians.

Paragraphs 113 and 114 - Where CSD members who do not have central bank cash accounts need to use a settlement bank as a service provider, the arrangements between the CSD member and the settlement bank should be a matter of commercial contract based on credit assessment by both parties regarding their potential exposure to each other. Each party should be allowed to manage their exposure in a manner appropriate to their business model and to price the commercial contract commensurate with the level of risk. Imposing a unilateral requirement to collateralize exposure as specified in Standard 9 will result in economic distortions as differences in credit quality are not recognized.

Paragraphs 116 and 117 - The Standard requires a CSD or custodian to take steps to protect clients from potential losses and liquidity pressures arising from the failure of the cash settlement agent selected by a CSD in situations where the CSD does not settle in central bank money. The Association believes it is not reasonable for custodians to bear this responsibility as they are not responsible for either the CSD's choice of cash settlement agent or its decision not to settle in central bank money. As a result, the Association believes the protection sought by this Standard should be provided through prudential regulation of the cash settlement agent and the CSD's decisions.

Standard 11: Operational reliability

Sources of operational risk arising in the clearing and settlement process should be identified, monitored and regularly assessed. This risk should be minimized through the development of appropriate systems and effective controls and procedures. Systems and related functions should be i) reliable and secure ii) based on sound technical solutions, iii) developed and maintained in accordance with proven procedures iv) have adequate, scalable capacity and v) have appropriate business continuity and disaster recovery arrangements that allow for timely recovery of operations and the completion of the settlement process.

The Association agrees that proper management of operational risk is important to the sound functioning of a capital market and supports the application of this Standard to CSDs and CCPs. The Association does not support the application of this Standard to global custodians.

Paragraphs 121, 126, 127 and 128 - We support the requirement that infrastructure entities involved in clearing and settlement should identify, monitor, assess and minimize sources of operational risk in clearing and settlement activities. Enhanced communication and periodic audits are all necessary to achieving a reduction in operation risk. Specific policies for implementing this Standard should be clearly defined and frequently tested and updated. Custodians are already subject to regulation in respect of operational risk management.

Paragraph 133 - The Association agrees that the Standard should apply to CSDs and CCPs, but does not support application of this Standard to global custodians. As outsourcing is becoming a common industry practice - and to the extent clearing and settlement-related activity is being outsourced - the Association believes that such arrangements should continue to be subject to contractually negotiated terms between the outsourcing entity and the provider of the outsourced services. While it is not clear what type of outsourcing arrangements are contemplated by this Standard, the Association generally believes that the requirement that the arrangement be approved

in advance by relevant competent authorities - that is, those authorities in the jurisdictions of the outsourcing entity and the provider of the services - undermines an entity's ability to effectively and efficiently establish outsourcing arrangements.

Standard 12: Protection of customers' securities

Entities holding securities in custody should employ accounting practices and safekeeping procedures that fully protect customers' securities. It is essential that customers' securities be protected against the claims of the creditors of all entities involved in the custody chain.

The Association supports this Standard.

We agree that safekeeping client assets from third-party liens and general obligations of the entity holding securities in custody, including in the event of the custodian's bankruptcy, is an important requirement for sound custody arrangements. In keeping with this view we support the key premise of this Standard, that is, the separation of proprietary and client assets by entities holding securities in custody. Association members believe, however, that the ESCB-CESR should consider recommending the uniform creation of a statutory lien allowing settlement systems as a matter of law to use the securities that are in the process of settlement as collateral for that settlement transaction.

Paragraph 138 - Under current custodian arrangements, client securities are not included on either the custodian's or the local custodian's balance sheet and are not available to creditors in the event of insolvency. In addition, virtually all CSDs and ICSDs permit or require members to segregate their own assets from client assets. The Association supports a Standard that requires such arrangements.

Standard 13: Governance

Governance arrangements for entities providing securities clearing and settlement services should be designed to fulfill public interest requirements and to promote the objectives of owners and users.

The Association supports this Standard as it applies to CSDs and CCPs. However the Association does not support the application of this Standard to global custodians.

Paragraph 147 - This Standard should not be applied to commercial custodians, including custodians that are deemed to have a dominant position in any European service market. For the reasons identified in the Association's First Letter, we believe

that the criteria for identifying a "dominant" intermediary are prone to ambiguity and misinterpretation and that, in any case, custodians should not be treated as tantamount to market-servicing utilities. Unlike the core infrastructure utilities, custodians are not public service cooperatives. They operate in a highly competitive service environment as regulated commercial organizations, and they meet the regulatory and shareholder governance requirements established for commercial entities in the locations in which they are organized and do business. There is no analysis or data in the Standards Report that would suggest that the competitive framework of the services markets in which custodians do business does not generate a competitive array of custody services or competitive fees. In all these respects, custodians, including sizeable custodians, are client-responsive. Accordingly, the Association believes that custodian banks provide adequate and appropriate information to clients and regulators based on existing strict regulatory requirements and competitive pressures.

Paragraph 149 - With respect to references to a "system run for profit", CSDs, and CCPs are infrastructure utilities that are created to centralize specific financial market processes and functions. Such utilities should be subject to meaningful user input into the utility's services and fees, with user ability to govern the utility's activity and service initiatives. Governance arrangements for such public service entities should be designed to fulfill public interest requirements and to promote the interests of users.

Standard 14: Access

CSDs and CCPs and custodians with a dominant position in a particular market should have objective and publicly disclosed criteria for participation that permit fair and open access. Rules and requirements that restrict access should be aimed exclusively at controlling risk.

The Association supports this Standard as it applies to CSDs and CCPs but does not support the application of this Standard to global custodians.

Paragraph 152 - The Association supports this Standard as it applies to infrastructure utilities, such as CSDs and CCPs. The Association further believes that intermediary access to the European settlement system operated by such utilities should be non-discriminatory with refusal of access to potential users based on clear, objective and publicly-available criteria applied uniformly to all existing and potential participants. However, the Association also believes that all custodians, including those with a significant number of clients, perform a fundamentally different functional role in settlement activities from the role played by infrastructure utilities, and the activities and functions of custodians are effectively regulated under existing bank regulatory regimes.

This Standard therefore should not apply - nor indeed can it apply - to commercial bank custodians or other commercial intermediaries regardless of their size in the market.

CSDs and CCPs are infrastructure utilities. In that regard, public policy requires that criteria for participation be openly available to market participants, and access to infrastructure facilities be fair and open to all eligible and suitably qualified intermediaries. In contrast, custodians, as commercial intermediaries, are not infrastructure utilities and lack the market position and central role afforded CSDs and CCPs. Indeed, the market for intermediary services is subject to often intense competition. The decision to provide services to customers and the terms of service are subject to each potential customer's specific and individual needs and the business policy of each custodian. Institutional investors have a choice among many custodians. Accordingly, terms of access and terms of service cannot be subject to regulation under this Standard as if custodians were infrastructure utilities.

Standard 15: Efficiency

While maintaining safe and secure operations, securities clearing and settlement systems should be cost-effective in meeting the requirements of users, including interoperability at both the national and the European level.

The Association supports this Standard as it would apply to CSDs and CCPs, and believes it accurately highlights the need for reduced operating costs for infrastructure utilities across the securities and clearing settlement system. The Association does not support the application of this Standard to global custodians.

Paragraph 167 - We agree that efficiency must be achieved at both the domestic and cross-border levels for the successful integration of securities infrastructure in Europe. Regardless of location, market participants should be able to rely on an efficient infrastructure in settling cross-border transactions. The Association believes that the resulting European infrastructure should be flexible for adaptation and use by participants worldwide. However, developing an optimal interoperability environment to achieve cost-effective clearance and settlement across European markets presents extensive challenges, as outlined in our comments under Standard 19.

Standard 16: Communication procedures, messaging standards and straight through processing

Entities providing securities clearing and settlement services and participants in their systems should use or accommodate the relevant international communication procedures and messaging and reference data standards in order to facilitate efficient clearing and settlement across-system. This will promote straight-through processing (STP) across the entire securities transaction flow.

Service providers should move towards STP in order to help to achieve timely, safe and cost-effective securities processing, including confirmation, matching, netting, settlement and custody.

The Association supports this Standard.

Paragraph 171 - In concept the Association accepts and supports the need for increased standardization of messaging, higher levels of settlement efficiency, and reduction in the level of manual intervention resulting in increased STP. The recent changes introduced as a result of ISO15022 messaging supports this standard, but the Association believes that the securities market participants groups should continue to work further towards standardization at all levels within the EU. This stance would allow local regulatory reporting requirements to be standardized at the same time.

Standard 17: Transparency

CSDs, CCPs and custodians with a dominant position in a particular market should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with securities clearing and settlement services.

The Association supports this Standard as applied to CSDs and CCPs, but believes that transparency with regard to global custodians is more appropriately achieved through direct interaction between the custodians and the relevant institutions or individuals seeking to utilize their services, rather than through a set of public disclosure requirements.

Paragraphs 183 and 184 - The Association agrees that sufficient transparency for CSDs and CCPs in the securities clearing and settlement environment allows market participants that use the essential facilities of such infrastructure utilities to consider and address relevant risk factors, and make informed decisions about whether and how to

access such utilities.³ In particular, the establishment of common standards of transparency for infrastructure utilities is a significant step towards creating harmonization. While appropriate types of transparency are necessary and should be encouraged for all entities in the chain of custody (specifically CSDs and CCPs), applicable standards must be carefully and appropriately differentiated to reflect the unique functional roles of each entity type. The intermediary roles played by global custodian banks and local custodian banks should be recognized as clearly distinct from the special roles of CSDs and CCPs as infrastructure utilities.

Given the functional and structural nature of CSDs and CCPs, the Association fully supports efforts that standardize the provision of information concerning CSDs and CCPs to the marketplace so that participants in these utilities have sufficient opportunity to evaluate associated risks and costs.

Custodian banks must meet the transparency standards and public disclosure requirements established in the domicile of their corporate operation and in the markets in which they choose to operate directly or via a network of agents. They must also meet flexible, competitive transparency standards for their clients based on the clients' various expectations. Disclosure with respect to a custodian's tailored servicing solutions and fees thus is more appropriately delivered in direct interaction with the relevant institutions or individuals seeking to utilize their services, rather than through a set of public disclosure requirements, driven by public policy concerns, that are appropriate to public utilities.

The Association believes that transparency principles should not blur the distinct roles and responsibilities of infrastructure utilities with those of custodian banks. The informational needs of participants using essential infrastructure utilities are significantly different from the informational needs of institutional or individual clients seeking to assess their individualized banking relationships with a global custodian or local custodian.

Standard 18: Regulation, supervision and oversight

Entities providing securities clearing and settlement services should be subject to transparent, consistent and effective regulation, supervision and oversight. Central banks and securities regulators/supervisors/overseers should co-operate with each other and with other relevant authorities, both nationally and across borders (in particular within the European Union), in a transparent manner.

³ See "Recommendations for Securities Settlement Systems," CPSS/IOSCO Consultative Report (January 2001).

The Association agrees with this Standard to the extent that such regulation, supervision and oversight is tailored to take into account existing regulatory mechanisms and principles and the significant differences between infrastructure utilities and intermediaries such as global custodians.

The Association would emphasize that, in applying the Standards, regulators should recognize that different constituencies have well-defined and different roles, and that these constituencies face different contractual contexts, and differences in the dynamics of risk management, accountability, basis of remuneration, and exposure to competition. Regulations must take fully into account the differences between ICSDs, CSDs and global custodians in terms of functional business objectives, client profile, legal status, structure, and supervisory regimes, in order to correctly identify risks and address them with policy precision.

As part of this effort, regulators should examine the special role of ICSDs as infrastructure utilities -- a role distinct from that of intermediaries. Specifically, custodians assume significant direct responsibilities to their investor clients, in order to protect client assets and interests and provide services responsive to each client's particular needs. Custodians also provide value-adding services to these clients. ICSDs and CSDs, on the other hand, function as wholesale clearing and settlement utilities transferring assets on their books between the accounts of market participants. Consistent with this, the limited commitments and one-size-fits-all participation rules that correctly befit the wholesale ICSD and CSD space, bear no comparison with the highly customized expectations and arrangements that investor clients have with their custodians.

In this regard, custodians are banks and, as such, are already subject to consistent and highly sophisticated regulation, supervision, and oversight by regulatory agencies in the jurisdictions of their formation. As custodians, banks must also comply with local laws and supervisory authorities in markets where they provide direct custody services, to ensure lawful performance of their responsibilities to their investor clients.

Paragraphs 193 and 198 - Select paragraphs of this Standard review the complex mission entailed in governing effectively across the multi-jurisdictional environment that is likely to prevail for some time in Europe. We believe that the European community needs to adopt a legal framework that would harmonize laws across the community.

Paragraph 196 - Although the discussion in this Standard alludes to a desirable centralized infrastructure, it mentions a number of devices intended to overcome the existing legal and regulatory heterogeneity, including such notions as "lead supervisor"

in the country of the principal legal domicile of a particular system or entity. We are uncertain whether there could be broad regulatory efficiency in solutions of this nature in a multi-jurisdictional setting. Indeed, in this Standard these formulations are accompanied by statements that "other alternative agreements might also be "adequate", but those alternatives unfortunately are not identified or developed.

We believe that the needed consolidation and rationalization of Europe's current legal, regulatory and facilities constructs will only occur once national barriers are removed or compatibility across all markets is created. We also believe that regulators, working together toward that objective, should immediately mobilize to focus on leveraging the many points of regulatory convergence that do already exist across the member countries.

Standard 19: Risks in cross-system links

CSDs that establish links to settle cross-system trades should design and operate such links to effectively reduce the risks associated with cross-system settlements.

The Association believes that this Standard is uniquely applicable to infrastructure utilities and as a result, global custodians, whether sizeable or otherwise, should not be included in the scope of this Standard.

Inter-ICSD and CSD linkage is the inevitable component of an approach to improving the settlement infrastructure that is predicated on interoperability. The expected benefit and overarching objective of interoperability -- for all parties, including investors -- is to eliminate processing flow interruptions resulting from the co-existence of multiple and distinctly operating utilities either within one market, or across markets and borders.

At the level of investors and their agents, this means that a participant in any ICSD or CSD that has an agreement to interoperate with another ICSD or CSD, enjoys access to that other ICSD or CSD in a transparent manner, substantially as if it were itself a participant in that other ICSD or CSD. To make that transparency valuable, interoperability should create a single conduit that enables participants in one utility to transact with participants in another without incurring more risks than when remaining within the confines of a single system. Interoperability thus leverages distributed processing in order to create a single platform effect among utilities, under multilaterally agreed uniform conditions.

Creating the interoperability environment that conforms to these performance expectations presents significant challenges in terms of development effort, costs, and

time -- not to mention the need for a fully effective agreement on standards and policies among interoperating entities, and the obligation of each participating ICSD or CSD to attain the required high level of technical capabilities, including contingency planning requisites established by regulation.

The only way to achieve this degree of performance is to develop a powerful electronic facility to which all entities are connected and which centrally and continuously polices the transaction messaging traffic in its totality, but does not perform transaction processing proper, which is left to each participating entity. We believe that the process of developing such a facility is very likely to divert resources and attention from the desirable, optimal end-state of a true integration into a single CSD; interoperability inevitably reduces incentives to progress toward the optimal solution. In any case, the efforts, costs, and contingency deployment needed to achieve either option are likely to be at best identical, but they are probably higher for interoperability since the latter would perpetuate redundant processes and overhead, and would entail collective investment in building, owning, and running the facility. Even interoperability that takes this more efficient form would still only create an appearance of efficiency because the key ingredient -- transaction processing on a single platform -- would remain unavailable. In contrast to interoperability taking this form, it could entail a network of entities that exchange settlement-related messages bilaterally as they emerge from settlement processes performed at each ICSD or CSD in the network. Of necessity, this form of interoperability requires a sequential process from which risk cannot be eliminated. In such a process, the links that perform last in the chain run the risk of being left "hanging" with transactions that will not be recyclable at other ICSDs or CSDs in the chain, until the next settlement day. Harmonized operating hours among ICSDs and CSDs would not resolve such concerns since thorough recycling would always require at least one ICSD or CSD to wait for another; yet all the linked entities would be expected to have closed their books at the same time.

The most advanced example today of this form of limited interoperability is the Bridge between Euroclear and Clearstream, which includes multiple successive exchanges of settlement information, with a view to reducing the risk of "hanging" trades to the minimum, yet without eliminating it completely. Notably, this Bridge, which most closely meets the conditions of Standard 19, involves only two entities operating in the finite international fixed income market. To replicate this model with its current degree of risk containment on the broader European scene would involve many more entities operating in all classes of investment vehicles in the international capital markets, handling settlement volumes that are multiples of those flowing between Euroclear and Clearstream.

If this is the form of interoperability envisioned in Standard 19, then we believe the following conditions should be required to be fulfilled by any two or more ICSDs or CSDs intending to interoperate in this manner:

- Mutual cash and securities accounts that reflect the true daily statement of liabilities of each system vis à vis the other(s);
- Daily settlement of net cash obligations in all currencies; ICSDs and CSDs should not extend credit to each other except for technical inability to execute same-day payments in particular currencies; size and duration of unsettled obligations monitored by supervisory agencies; availability of guarantee and indemnification devices addressed at local and EU levels;
- Arms-length and commercially reasonable agreements and appropriate regulation relative to the servicing of securities held by each system for the other(s), and other conditions applicable to the reality that each system acts as de facto subcustodian for the other(s), with the option for each system to redirect positions from time to time to other subcustodians of their choosing;
- Detailed contractual operating procedures governing all functional aspects of the links, including timings, exchange of reports, statements, etc.;
- Form of agreement (which could be made uniform across Europe) governing the links, with choice of jurisdiction – and/or accountability to participants and European supervisory authorities at the highest echelon;
- Full disclosure to ICSD and CSD participants of contractual and operating conditions of the links, and incorporation of these conditions into contractual agreements between ICSD and CSDs and their participants;
- Constant provision of audit trails.

In an environment where there are multiple settlement infrastructures, links between ICSDs and CSDs should also be ensured to provide intermediaries with a choice. Certainly, restrictions impairing choice of trading location should be lifted, since such choices have relevance to investment performance and strategies. Preserving choice of settlement location, however, while important, imposes a duty to manage inventories of securities dynamically across multiple locations, and fosters the development of more or less complex interoperability devices that may be, in any case, out of step with the reality of the benefits: large systems capabilities would have to be developed, and these would be short-lived if the desired end-state is to be a single settlement entity. For these and various reasons, we believe that integration and

interoperability efforts should be expended so as to facilitate early achievement of the single-entity end-state.

In the discrete clearing agency line of business, banks also compete with their peers in acquiring clients, including other intermediaries such as brokers, which are the counterparts to investors. Transactions for these client intermediaries are executed and settled through the operation of agency services offered by the banks under commercial conditions (including the extension of credit) that these banks define and perform at their risk, under the supervision of relevant regulatory authorities. Given the competitive nature of this line of business, agent banks do not seek -- and should not be expected -- to link with their competitors in the fashion contemplated for the infrastructure utilities -- ICSDs and CSDs -- in Standard 19.

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