THE ASSOCIATION OF GLOBAL CUSTODIANS

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STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:
BAKER & MCKENZIE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006

TELEPHONE: 202/452-7000
FACSIMILE: 202/452-7074

WWW.THEAGC.COM

July 11, 2003

VIA E-MAIL AND AIR COURIER

Mr. Klaus-Heiner Lehne
Member of European Parliament
Committee on Legal Affairs and the Internal Market Secretariat
Batiment Altiero Spinelli
10E103
60, rue Wiertz
B-1047 Brussels
Belgium

Mr. Peter W. Skinner
Member of European Parliament
Committee on Economic and Monetary Affairs Secretariat
rue Wiertz
B-1047 Brussels
Belgium

Re: Draft European Union Transparency Directive

Dear Messrs. Lehne and Skinner:

I am writing on behalf of the Association of Global Custodians ("Association"), an informal group of ten banks based in North America that are major providers of global custody services to cross-border institutional investors.[1] The members of the Association, through their own European branches or affiliates, or through their use of agent banks in Europe acting as subcustodians, safekeep very substantial positions in the securities of European companies for their institutional investor clients. Accordingly,

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[1] The members of the Association are listed above.

the Association has a direct interest in the proposed EU directive that is intended to amend directive 2001/34/EC (March 26, 2003) to enhance transparency in share ownership information and to establish share position reporting requirements for security holders in Europe ("Draft Directive").[2]

For reasons set out in this letter, the Association believes that any share position reporting requirements included in the Draft Directive should be imposed on those persons owning shares beneficially -- i.e., investors -- and not on intermediary custodians. Although we read the provisions of the Draft Directive as imposing reporting duties on investors, statements in the Explanatory Memorandum to the Draft Directive could be misconstrued to include custodians in the reporting obligations. We urge the European Parliament and the European Council to clarify the objective of the Draft Directive in this respect, and confirm that custodians are to be excluded from share position reporting obligations in any legislation adopted by EU member states based on the Draft Directive.

Background

We understand that the Draft Directive is intended to enhance the public availability of information regarding issuers whose shares are traded on regulated markets within the European Union. The availability of such information will increase transparency in EU securities markets and facilitate improved integration and consistency among markets. The Commission of the European Communities ("Commission"), through the Draft Directive, proposes to achieve this transparency by, among other things, establishing a framework under which security holders report to European issuers -- and the issuers report to the public -- information regarding significant changes in the size of security holder share positions. The Draft Directive seeks to facilitate that disclosure by requiring security holders to report to issuers whenever their share ownership position crosses one of several percentage thresholds. To that end, the Draft Directive contains a new definition of the term "security holder" as well as new provisions that attempt to impose share position reporting duties on those security holders that are entitled to exercise voting rights in the shares.

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[2] Proposal for a Directive of the European Parliament and of the Council on the Harmonisation of Transparency Requirements with regard to Information about Issuers Whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC (March 26, 2003).

Comments on the Text of the Draft Directive

Definition of "security holder;" security holder reporting

Article 9.1 of the Draft Directive calls on EU member states to ensure that issuers receive notification from a security holder when "the security holder, or any natural person or legal entity entitled to exercise voting rights on behalf [of] the security holder, acquires or disposes of voting rights or capital of the issuer * * *."[3]

Article 2.1 (e) of the Draft Directive defines the term "security holder" as any person who:

> "directly or through intermediaries, acquires or disposes of:
>
> (i) securities of the issuer in its own name and on its own account;
>
> (ii) securities of the issuer in its own name, but on behalf of another natural person or legal entity, except where such securities are acquired for the sole purpose of clearing and settling transactions within a short period * * *."[4]

There has been discussion within the custody community regarding the potential applicability to global custodians of the reporting requirements set out in the Draft Directive. Specifically, industry participants are concerned that custodians may be included in the definition of "security holder" and covered by the reporting requirement for security holders that exercise voting rights. These questions arise in view of the ambiguities that surface from a reading of the new provisions coupled with Section 5.2.2.1, Article 2(1) On (e) and Section 5.4.2, Article 10 Determination of the voting rights in the Explanatory Memorandum to the Draft Directive.[5]

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[3] Chapter III, Section I, Article 9.1.

[4] Chapter I, Article 2.1.e.

[5] Section 5.2.2.1, Article 2(1) On (e), of the Explanatory Memorandum states that:

> [t]he second subparagraph [of the definition of security holder] builds on Article 92(a) of Directive 2001/34/EC and *covers the case of custodian*

Applicability to Custodians

The Association believes that the definition of "security holder" and the reporting provisions in the Draft Directive must be read to exclude custodians (notwithstanding the ambiguities in the Explanatory Memorandum) for the following reasons:

- A necessary element in the definition of a security holder in Article 2.1 is that it "acquires or disposes of" securities. Custodians do not acquire or dispose of securities; rather, custodians facilitate settlement and safe keep securities on behalf of their clients. Custodians do not have the authority and/or discretion to acquire or dispose of securities, but only have authority to facilitate such activity incident to settlement of clients' transactions.

- The reference in the definition of security holder to acquisitions or disposals "directly or through intermediaries" suggests that the "intermediaries" themselves, including custodians, are to be excluded from the definition.

- Article 9.1 contemplates that a "natural person or legal entity" other than the security holder may be "entitled to exercise voting rights on behalf of the security holder," but even in such a situation it remains the security holder who must notify the issuer if it exceeds certain voting or capital ownership thresholds. In any event, custodians should not normally be deemed to be "entitled to exercise voting rights" for clients. In practice, custodians send issuers the voting instructions they receive from their various clients, and each client exercises its right to vote its interest as it sees fit. Thus, custodians do not exercise voting discretion but instead only act on clients' voting

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> *banks* and investment funds holding securities in their own name, but on behalf of their clients. [Emphasis added.]

Section 5.4.2, Article 10 Determination of the voting rights, of the Explanatory Memorandum states that:

> [w]hereas the holdings of an individual security holder might not necessarily meet the thresholds provided for, the situation may considerably differ with regard to custodian banks, investment funds, proxies and others who may exercise voting rights on behalf of numerous security holders.

instructions – they do not decide for their clients how to vote, even if they facilitate the technical casting of the vote by whatever means market practice may require.

- Paragraph 4.5.1 of the Explanatory Memorandum focuses on "investors" as the persons whose influence on company affairs is relevant to the transparency objective. The explanation in the Memorandum is clearly geared to these entities, rather than intermediaries holding shares in the chain of custody.[6]

- The same Paragraph 4.5.1 does not give any indication that a radical change in approach to reporting responsibilities is intended. On the contrary, many EU member states have already independently adopted laws under existing directives and along the lines of what is now being proposed (and these laws do not impose share position reporting requirements on custodians). The explanation confirms that the Draft Directive is intended merely to bring the remaining member states into line.[7]

Practical and Policy Reasons to Exclude Custodians from Reporting Requirements

In addition, the Association believes that share position reporting by custodians would not advance, but in fact would frustrate, the goals of the Draft Directive -- that is, the public identification of the underlying owners of securities with sizeable positions and power to affect company policies. In particular, the Association notes the following:

- It is a common, and very real, industry practice for investors to hold assets with a number of custodians. However, reporting by any particular custodian can only be based on the client share position information reflected in the custodian's own records. A custodian would have no way to include in its reporting the positions of a client in a given issuer where those positions are also held through other custodians. Thus, a client that holds interests in the same issuer through accounts with several

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6 "This [reporting] system would reflect not only the actual influence an investor on securities markets may take in a publicly traded company, but more generally its major interest in the company performance, business strategy and earnings." Explanatory Memorandum at paragraph 4.5.1.

7 "Already seven Member States apply such a more securities market directed transparency regime at national level.* * * The Commission proposal would align the situation amongst Member States * * *." Id.

custodians could cross one of the reporting thresholds in fact without having a position at any single custodian that triggers reporting.

- Custodian reports would not necessarily reflect the actual crossing of a threshold by a particular beneficial owner, and the issuer would have no way of knowing which reports did reflect a threshold crossing and which reports did not. This would occur where a custodian's aggregate share position held on behalf of several clients crosses a threshold although no single client's position does. It could also occur where the custodian's client is itself a custodian. A report in that circumstance indicating that a threshold has been crossed could merely reflect the fact that several underlying beneficial owner clients of the custodian's client had independently if concurrently made small increases (or reductions) in their positions. By the same token, a significant purchase by one client that might otherwise trigger a reporting threshold could be offset by a significant sale by another client.

- Reporting would be burdensome for custodians, and costly for their clients. Compliance could require each custodian to monitor, on a daily basis, all of its clients' holdings in covered European securities, and to report when there has been a change in any of the noted thresholds. These costs would inevitably have to be passed down to investors in the European markets.

- Similarly, to our knowledge, there is no current, publicly-available list of European companies whose securities would be subject to the reporting requirements set out in the Draft Directive, let alone any list which identifies outstanding numbers of issued shares against which threshold levels could be measured. Without access to an up-to-date document containing such information, it would be extremely difficult, if not impossible, for custodians to determine -- within any useful timeframe -- reportable client holdings in the subject securities.

In sum, requiring reports at the custodian level would not provide issuers or public investors with meaningful information about influential security holders or voting control blocks -- quite the contrary. The information reported by custodians would thus serve merely to confuse issuers and the public, because only the beneficial owner is in a position to provide complete and meaningful information as to its overall interest in any given security.[8] This is the approach which regulators around the world, including

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[8] Indeed, the text of the Draft Directive creates uncertainty with respect to which "security holder" bears responsibility for the required report. This uncertainty could result in confusion with respect to reports filed by custodians, as well as

Europe, have long recognized. A short-lived exception in France serves as a most pertinent and real example of the dangers of any other approach.

"Disastrous" Precedent

In July 2002, the Association addressed a similar threshold reporting issue with respect to French law N.2001-420, dated May 15, 2001, and Decree 2002-803 concerning the registration of intermediaries that hold shares of French companies on behalf of beneficial owners domiciled outside of France.[9] In its letter to the Conseil des Marchés Financiers ("CMF") in France, the Association observed, among other things, that provisions related to the reporting of ownership holdings should not apply to registered intermediaries (i.e., custodian banks and other agents/nominees that lack voting discretion) because such reporting would not provide meaningful information and would be difficult for intermediaries to comply with. A copy of the Association's letter is attached.

The Association Nationale des Sociétés par Actions -- the French association of public issuers, which had originally supported the provisions -- itself called for the repeal of the law, describing its effects as "disastrous" and the resulting market confusion caused by the required reports as "very detrimental." In addition, even French subcustodians indicated their discomfort with the new law and noted that the new law would also cause them extensive compliance issues if they were expected to comply with the reporting requirements contained therein.

Subsequent to its letter to the CMF, the Association gained the assistance of a member of the French Senat in seeking repeal of the provisions that imposed reporting duties on intermediaries. As a result, the registered intermediary reporting requirements

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redundancies in reporting, as more than one defined "security holder" may file reports with respect to the same positions -- although the fact that they are filing reports covering the same positions would not necessarily be apparent on the face of the reports.

[9] Letter, dated July 16, 2002, from Daniel L. Goelzer, to Bruno Gizard, Secrétaire Général Adjoint, and Wayne H. Smith, Charge de Mission, Direction des Operations Financieres, Conseil des Marchés Financiers, Re: New Registered Intermediary Law.

in France are expected to be repealed during the next review by the Assemblée Nationale later this month.

Conclusion

We urge those involved in the review and the reading of the Draft Directive to consider the foregoing points as well as the observations included in the attached correspondence, to ensure that custodians are unambiguously excluded from the definition of "security holder" and from share position reporting requirements for purposes of the Draft Directive.

If you wish to discuss this matter, or have any questions concerning these comments, please contact the undersigned at 312/861-2620.

Sincerely,

Dan W. Schneider, Esq. /MKB

Dan W. Schneider, Esq.
Baker & McKenzie
Counsel to the Association

Attachment: Letter, dated July 16, 2002, from Daniel L. Goelzer, to Bruno Gizard, Secrétaire Général Adjoint, and Wayne H. Smith, Charge de Mission, Direction des Operations Financieres, Conseil des Marchés Financiers, Re: New Registered Intermediary Law.

cc: Mr. Berton
Head of the Secretariat for the Committee on Economic and Monetary Affairs
Committee on Economic and Monetary Affairs
European Parliament

Mr. Schiffauer
Head of the Secretariat for the Committee on Legal Affairs and the Internal Market
Committee on Legal Affairs and the Internal Market
European Parliament

Mr. Jürgen Tiedje
European Commission

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& TRUST COMPANY
THE NORTHERN TRUST COMPANY
STATE STREET BANK AND TRUST COMPANY

COUNSEL TO THE ASSOCIATION:
BAKER & MCKENZIE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006

TELEPHONE: 202/452-7013
FACSIMILE: 202/452-7074

July 16, 2002

VIA FACSIMILE AND AIR COURIER

Bruno Gizard
Secrétaire Général Adjoint

Wayne H. Smith
Charge de Mission
Direction des Operations Financieres

Conseil des Marchés Financiers
31, rue Saint-Augustin 75002 Paris
France

Re: New Registered Intermediary Law

Messrs. Gizard and Smith:

I am writing on behalf of the Association of Global Custodians ("Association"), an informal group of nine U.S. banks that are major providers of global custody services to institutional investors.[1] The members of the Association hold, through French banks acting as subcustodians, very substantial positions in the securities of French companies for their institutional investor clients. Accordingly, the Association has a strong interest in the administration and interpretation of the recently-adopted law (Law N 2001-420, dated May 15, 2001 and Decree #2002-803) concerning the registration of

[1] The Association of Global Custodians ("Association") is an informal association of nine banks that are major providers of cross-border custody services to institutional investors. The members of the Association are listed above.

intermediaries that hold shares of French companies on behalf of beneficial owners that are domiciled outside of France. The purpose of this letter is to outline our concerns regarding the new law.

Background

We understand that Article L.228-1 of the Commercial Code provides that, when the beneficial owner of securities is not a resident of France, ownership may be recorded/registered in the name of an intermediary on behalf of the foreign beneficial owner. This may be accomplished either through registration of the securities in the name of the intermediary or by the holding of the foreign investor's securities in an omnibus account maintained with a French bank in the name of the intermediary. The objective of this new law is to improve transparency in the control of French companies, while reinforcing shareholders' rights by facilitating their participation in General Meetings. By improving French issuer access to the beneficial owners of securities, the law seeks to increase participation in such meetings and to lessen the problems associated with obtaining a quorum.

To accomplish these goals, the new law requires the registration of intermediaries that hold French securities on behalf of foreign investors and imposes certain responsibilities on such registered intermediaries. Articles L.228-2 and L.228-3 require a registered intermediary, on request from the issuer, to disclose the identity of the beneficial owners. Apparently, Article L.233-7 of the Commercial Code also requires that, for each French company whose securities are held by the registered intermediary, the registered intermediary must report to the company and to the Conseil des Marches Financiers ("CMF") the crossing of the following ownership thresholds: 5%, 10%, 20%, one-third, 50% and two-thirds of the share capital or of the voting rights of the company. Under French law, the company may additionally establish further thresholds subject to these same reporting obligations. Under Article L.228-3-3, sanctions for failure to comply with the law include the suspension of voting rights and the postponement of dividend payments. The deadline for an entity to file the required declaration that it is a registered intermediary is August 5, 2002.

Since this law was first published, there has been considerable discussion and uncertainty within the custody industry and issuer community regarding the role of the registered intermediary. Among other things, there are differences of opinion regarding

the scope of the reporting obligations of registered intermediaries and whether French banks acting as subcustodians can serve as registered intermediaries. We understand that the major French sub-custodian banks will meet with you on July 17 to discuss these issues.

Registered Intermediaries Should not be Required to Report Threshold Crossings

The Association believes that registered intermediaries should not be required to make substantial shareholding reports (i.e., to report when aggregated client positions in a particular company cross one of the reporting thresholds). Such reporting would not assist in the effort to identify the underlying owners of securities or the levels of their ownership. Reporting would, however, be burdensome for intermediaries. The reporting requirements should continue to focus on beneficial owners and issuers, not on intermediaries.

Requiring that a registered intermediary report on the crossing of thresholds would not provide meaningful information to issuers because such reporting could only be based on the information reflected in the registered intermediary's records. For example, a registered intermediary would have no way of including in its reporting the positions of a client that are held through other registered intermediaries. Thus, a client that holds interests in the same issuer through accounts with several intermediaries could cross one of the reporting thresholds without increasing its position at any single intermediary by an amount that triggered intermediary reporting. Conversely, registered intermediary reports would not necessarily reflect actual crossing of a threshold by a beneficial owner. A report by such an intermediary that a threshold had been crossed could merely reflect the fact that several of the intermediary's clients (some of whom might themselves be intermediaries and some of whom might be beneficial owners) had made small increases in their positions. In short, reports filed by registered intermediaries would be incomplete at best and misleading at worst to issuers.

While the value of registered intermediary reporting on the crossing of thresholds would be limited, the costs and burdens of compliance with such a requirement would be great. Compliance would require each registered intermediary to monitor, on a daily basis, all of its non-resident clients' holdings in every French security; to aggregate these positions; and to report when there has been a change in any of the six

thresholds.[2] Because of the ability of French issuers to adopt their own additional thresholds, such reporting would also require the registered intermediary to continuously review the requirements of every French company and to add new thresholds to its monitoring as they were adopted. This would result in an enormous expenditure of resources for little benefit in terms of the transparency of the beneficial ownership of French companies. In addition, registered intermediaries would incur costs associated with the filing of reports each time a threshold was crossed. Ultimately, of course, these monitoring and reporting costs might be passed on to institutions that invest in France, reducing the attractiveness of such investment.[3]

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[2] The difficulty and complexity of this task would be compounded if indirect and derivative interests in securities must also be considered in determining beneficial ownership and whether a threshold has been crossed. It is not clear whether a registered intermediary's determinations could be based on its clients' aggregate ownership of shares only, or whether warrants, convertible bonds, ADRs, futures, options and other types of derivative interests would also need to be included. Although Article L233-9 of the Commercial Code mentions "agreements" which confer rights to shares, it is uncertain whether a registered intermediary is required to treat these types of publicly-traded instruments as "agreements" for these purposes. The need to include derivatives in calculating ownership levels could be technically very challenging for registered intermediaries.

[3] Other countries appear to have addressed this problem without imposing threshold reporting requirements on intermediaries. In the United Kingdom, for example, custodians acting for third party clients are "bare trustees" in that they lack discretion and act only on instructions from the beneficial owner or its appointed agents. Section 198 of the Companies Act requires persons with an interest in shares to report to the stock exchange when certain thresholds are reached (generally 3% for the beneficial owner and 10% for the fund manager) and to report any subsequent whole percentage point increase or decrease. Under Section 209, the bare trustee is exempted from this provision, since it has no discretion. Issuers can, however, compel a bare trustee to disclose the identity of persons who have an interest in the shares. Section 212 permits that process to be repeated, if the company believes that a disclosed party is an intermediary, until the beneficial owner is uncovered.

Local Custodians Should Serve as Registered Intermediaries

The problems that would result from requiring intermediaries to report when their clients' aggregate holdings have crossed a threshold are compounded by the confusion surrounding the question of who is permitted or required to register as an intermediary. In our view, the appropriate registered intermediary is the French subcustodian bank through which foreign investor positions are held in the French markets. While, as explained above, we do not believe that registered intermediaries should be required to report threshold crossings, the logic of permitting French banks to serve as registered intermediaries is especially compelling if such reporting is nonetheless required.

Some French banks have reportedly taken the position that only global custodians -- i.e., non-French banks -- are required to register. We find nothing in the law to support this view. The definition of the term registered intermediary appears in Commercial Code Article L228-1 and in Decree No 2002-803. These authorities do not preclude a French custodian bank from acting as a registered intermediary. Conversely, these provisions in no way state that only foreign banks, such as global custodians, must be registered intermediaries. However, because there is confusion on this point in the French banking community, we ask that the CMF clarify that French subcustodian banks may register as intermediaries under the new law.

Further, as a practical matter, we believe that French subcustodians are far better positioned to act as registered intermediaries than are global custodians. This is particularly true if the CMF concludes, notwithstanding our position above, that the registered intermediary must report on the crossing of thresholds. First, since the French custodian operates in the market and has better access to local developments, it has the best ability to monitor issuer reporting thresholds, changes in outstanding share positions, and similar matters that affect threshold reporting. In fact, if a global custodian were required to make such reports, it would presumably have to obtain this type of information from its French subcustodian. Second, there are far fewer French banks that act as subcustodians than there are global custodians with clients that hold positions in French companies. Therefore, if French subcustodians act as registered intermediaries, the number of reports that will have to be filed will be reduced and the issuer confusion associated with multiple intermediary reports will correspondingly decline.

Conclusion

For the reasons stated above, the Association urges that the CMF not require registered intermediaries that hold shares of a French issuer to report the crossing of ownership thresholds. The registered intermediary's obligations should be limited to disclosing the identity of its client; reporting should remain the duty of the beneficial owner. We also urge that the CMF make clear that French subcustodian banks may act as registered intermediaries when the shares of non-resident beneficial owners are held through accounts on the books of such French banks. Considerations of both law and of practical reality dictate that the registered intermediary obligation not fall on global custodian banks.

If you wish to discuss this matter, or have any questions concerning these comments, please contact either Diana Dijmarescu (JPMorgan Chase-London) at (44) 207-742-0327, or the undersigned at (202) 452-7013.

Sincerely,

Daniel L. Goelzer
Counsel to the Association

Doc. #7142301.1