

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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November 19, 2003

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

Dear Mr. Kazarian:

Attached you will find a copy of an executive summary and attachment prepared by the Association of Global Custodians ("Association")<sup>1/</sup> summarizing comments made to the Committee of European Securities Regulators and the European System of Central Banks (together "ESCB-CESR") in response to its request for comments regarding documents entitled, "Standards for securities clearing and settlement systems in the European Union" ("Standards Report") and "The scope of application of the ESCB-CESR standards" ("Scope Statement").<sup>2/</sup>

As you may be aware, the proposed standards set forth in the Standards Report ("Standards") include significant provisions that in some cases could be applied to

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<sup>1/</sup> The Association is an informal group of ten banks with affiliates and branches in numerous European countries that provide global custody services to cross-border institutional investors. The members of the Association are listed on the letterhead above.

<sup>2/</sup> The Association submitted two letters to ESCB-CESR in response to the request for comments. Both letters are available on the Association's Website, [www.theagc.com](http://www.theagc.com).

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banking institutions that engage in securities custody activities for institutional investors. The Association's letters discuss the various Standards and express concern about the scope of the Standards and the potential for impairing customary, regulated banking activities.

We understand that the ESCB-CESR representatives will be meeting with various regulatory authorities over the ensuing weeks to discuss the Standards, and we wanted you to be aware of the Association's comments and views in the event you will be involved in such a meeting.

We are sending you the executive summary for your information, as we believe you will find the views of interest. Please feel free to distribute this executive summary to members of the Banking Supervision Committee of the European System of Central Banks.

To the extent you have questions or would like to discuss Association comments, we would be happy to speak with you.

Sincerely,



Margaret R. Blake  
Baker & McKenzie  
Counsel to the Association  
202/452-7020

Attachment - Executive Summary and Attachment.

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### **The Association of Global Custodians' Response to "Standards for securities clearing and settlement in the European Union"**

#### **Executive Summary**

The Association of Global Custodians (the "Association")<sup>1</sup> submitted letters of comment to the European System of Central Banks and the Committee of European Securities Regulators (together, "ESCB-CESR"), concerning the ESCB-CESR "Standards for securities clearing and settlement in the European Union" (the "Standards Report") and "The scope of application of the ESCB-CESR standards" ("Scope Statement"). The letters discuss the Association's views on each of the 19 standards for regulation as proposed by the ESCB-CESR ("Standards"), as well as the Association's concerns regarding the scope of the proposals and the absence of well-defined, risk-based reasons to apply the Standards to custodian banks, particularly global custodians. The letters also express the Association's support for the ESCB-CESR goal of systemic safety and soundness in securities clearing and settlement and the continuing effort to clarify and unify laws, regulations and processes applicable to safekeeping and settlement throughout the EU, including the laws and procedures applicable to security interests in investment securities.

The following summarizes the main points conveyed to the ESCB-CESR in the Association's comment letters. Although the Association's comments necessarily reflect the viewpoint of *global custodians*, key aspects of the letters focus on the functions and activities of custodians generally. The comment letters -- dated October 1, 2003, and October 31, 2003 -- can be viewed on the Association's Website, [www.theagc.com](http://www.theagc.com).

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<sup>1</sup> The Association is an informal group of ten banks with extensive European branches and affiliates that provide various securities safekeeping and related services to large cross-border investor clients, including major institutional investors, pension funds and investment companies, from all regions of the world with a significant concentration in Europe. The members of the Association are listed on the letterhead above.

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### **Comments on the Scope of the Standards**

In the Association's view, the ESCB-CESR Standards, by their nature, should be directed to infrastructure utilities, such as Central Securities Depositories and International Central Securities Depositories (collectively, "CSDs"). The Standards should not equate custodians -- of any size -- with CSDs for any regulatory purposes. The original CPSS-IOSCO recommendations, on which the ESCB-CESR Standards are based, focused on infrastructure utilities and did not equate the functions of intermediaries with those of CSDs, and the Association believes that the ESCB-CESR Standards need to be refocused accordingly.

Fundamental functional differences exist between market-servicing infrastructure utilities and client-servicing commercial custodians. CSDs occupy an exclusive, central-utility position in their respective markets and provide "one-size-fits-all" settlement services to the full community of intermediaries, including custodians. In that role, CSDs bear responsibility for measuring, controlling and managing aggregate settlements and the related systemic risks for the entire participant community. In contrast, custodians act as safekeeping agents for institutional investors, facilitating individualized settlements for their clients, primarily through the facilities of CSDs that custodians must use. Unlike CSDs, custodians -- even sizeable custodians -- do not act as "operators" of "systemically important systems," and they do not apply "rules" to "participants."

### **Comments on Risk-based Functional Regulation**

The Standards Report does not identify reasons based on functions or risks for proposing to regulate sizeable custodians as CSDs. In the Association's view, regulation that may be appropriate for depositories as the core infrastructure components of the EU clearance and settlement system is neither necessary nor appropriate for highly-regulated, commercially-competitive custodian banks. If particular banking activities, service arrangements, or credit determinations of custodians raise particular issues of interest to ESCB-CESR, whether systemic or otherwise, those issues should be suitably targeted for separate review. Before imposing new requirements -- particularly requirements that may conflict with existing functional regulation -- specific risks that are otherwise not addressed within the current regulatory regime should be identified and assessed by the regulatory authorities.

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In connection with making any revisions to the Standards, the Association believes the following basic points need to be recognized --

- **Custodians are effectively 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, undergo frequent professional audits and regulatory exams, and routinely assess client creditworthiness and manage client credit usage.** Additional regulation of custodians, as proposed in the Standards, is unnecessary and inappropriate.
- **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. Custodians should not be subject to additional credit or collateral regulation.** 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.
- **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 cannot be avoided and should be addressed by appropriate EU competition policy authorities in connection with developing regulations for the evolving markets, perhaps in consultation with ESCB-CESR.
- **The systemic risks associated with the operation of infrastructure settlement facilities are different from the risks presented in settlement-related activities of custodian banks. The latter risks are already regulated and subject to controls.** Functional differences between these different types of entities, and the very different risk profiles of each type, should be recognized in regulatory recommendations and any resulting regulations should be tailored accordingly.

### Conclusion

The Association supports the Standards as they would apply to infrastructure utilities, particularly the Standards addressed to governance, access, efficiency, risk control, transparency, operational reliability, and improvements in processing integrity. Virtually all aspects of the Standards, however, do not make sense when applied to the

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functional and commercial context of custodians; and the Association urges the ESCB-CESR to recast its regulatory recommendations so as to fully recognize critical functional differences between CSDs and custodians and to take into account the existing regulatory regimes, risk-management techniques, and commercial contexts that separately apply to each different type of entity. Recasting the proposals in those ways would avoid the potential for conflicting, inappropriate and potentially confusing regulation.<sup>2</sup>

Attachment -- Summary Chart of 19 Standards

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<sup>2</sup> A chart that summarizes the Association's detailed comments on each of the 19 Standards is attached hereto.

## Summary Chart of the Association of Global Custodians' Comments on the ESCB-CESR 19 Standards

Standard	Association Comments
<p><b>Standard 1: Legal framework</b> Securities clearing and settlement systems and links between them should have a well-founded, clear and transparent legal basis in the relevant jurisdictions.</p>	<p>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 and CCPs, and to make their application understood and uniform. However, the Association does not support the application of this Standard to global custodians. Infrastructure utilities such as CSDs and CCPs 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. In contrast, custodians are private commercial enterprises. 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.</p>
<p><b>Standard 2: Trade confirmation and settlement matching</b> 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.</p>	<p>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. Compliance with these principles will only be possible with an investment by market participants in technology that enables speedier communication of confirmation and settlement information and the adoption of operations aimed at dealing with issues resulting from time zone differences.</p>
<p><b>Standard 3: Settlement Cycles</b> 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.</p>	<p>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. 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, 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.</p>

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<p><b>Standard 4: Central Counterparties (CCPs)</b> 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.</p>	<p>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. 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. We note, however, 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.</p>
<p><b>Standard 5: Securities lending</b> 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.</p>	<p>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. 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. 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.</p>
<p><b>Standard 6: Central securities depositories (CSDs)</b> 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.</p>	<p>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.</p>
<p><b>Standard 7: Delivery versus payment (DVP)</b> Principal risk should be eliminated by linking securities transfers to funds transfers in a way that achieves actual delivery versus payment.</p>	<p>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.</p>
<p><b>Standard 8: Timing of settlement finality</b> Intraday settlement finality should be provided through real-time or multiple-batch processing in order to reduce risks and allow effective settlement across systems.</p>	<p>The Association supports efforts to promote settlement finality, including by requiring suitable arrangements among CSDs and harmonization of laws across Europe. The Association does not support the application of this Standard to global custodians. Unlike CSDs, global custodians do not provide settlement services as infrastructure utilities. Custodian banks as intermediaries record settlement, whereas infrastructure utilities such as CSDs perform settlement. Paragraphs in this Standard refer to "rules of the system" and system "participants". 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 particularly client-by-client.</p>

<p><b>Standard 9: Risk controls in systemically important systems</b> 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.</p>	<p>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. Even though custodians may from time to time facilitate a high proportion of settlements or a high percentage of settlement values, they are merely a conduit into the settlement system and do not themselves "settle" transactions. 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 though different from those that may be imposed on market infrastructures.</p> <p>Further, the exclusive use of only one method of risk management (collateralization) 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.</p>
<p><b>Standard 10: Cash settlement assets</b> 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.</p>	<p>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. 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. It is not reasonable for custodians to bear the responsibility of protecting participants in the case of failure of the cash settlement agent as custodians are not responsible for either the CSD's choice of cash settlement agent or its decision not to settle in central bank money. 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.</p>

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<p><b>Standard 11: Operational reliability</b> 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.</p>	<p>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 as custodians are already subject to regulation in respect of operational risk management. However, 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.</p>
<p><b>Standard 12: Protection of customers' securities</b> 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.</p>	<p>The Association supports this Standard. We agree that safekeeping client assets free 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. We support 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.</p>
<p><b>Standard 13: Governance</b> 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.</p>	<p>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. The Association believes that custodian banks provide adequate and appropriate information to clients and regulators based on strict regulatory requirements and competitive pressures. 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. 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.</p>

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<p><b>Standard 14: Access</b> 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.</p>	<p>The Association supports this Standard as it applies to CSDs and CCPs but does not support the application of this Standard to global custodians. The Association 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. Custodians, as commercial intermediaries, are not market utilities and lack the status afforded CSDs and CCPs. 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. Accordingly, terms of access and terms of service cannot be subject to regulation under this Standard as if custodians were infrastructure utilities.</p>
<p><b>Standard 15: Efficiency</b> 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.</p>	<p>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. The Association agrees that efficiency must be achieved at both the domestic and cross-border levels for the successful integration of securities infrastructure in Europe. The Association also 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 set forth in our comments under Standard 19.</p>
<p><b>Standard 16: Communication procedures, messaging standards and straight through processing</b> 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.</p>	<p>The Association 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 Association also feels, however, that the securities market participants groups should continue to work further towards standardization at all levels within the EU.</p>

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<p><b>Standard 17: Transparency</b> 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.</p>	<p>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.</p>
<p><b>Standard 18: Regulation, supervision and oversight</b> 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 cooperate with each other and with other relevant authorities, both nationally and across borders (in particular within the European Union), in a transparent manner.</p>	<p>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.</p>
<p><b>Standard 19: Risks in cross-system links</b> 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.</p>	<p>Although Standard 19 only refers to CSDs, key element 1 indicates that this Standard is intended to include custodians operating systemically important systems. As such, 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 its scope. Inter-CSD and CSD linkage is the inevitable component of an approach to improving the settlement infrastructure that is predicated on interoperability. Interoperability leverages distributed processing in order to create a single platform effect <i>among utilities</i>, under multilaterally agreed uniform conditions. Banks do not seek -- and should not be expected -- to link with their competitors in the fashion contemplated for infrastructure utilities in this Standard.</p>