

THE ASSOCIATION OF GLOBAL CUSTODIANS

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March 31, 2006

Commissioner Charles McCreevy
Member of the European Commission
B – 1049 Brussels
Belgium

**Re: Views Regarding Cross-Border Clearing and Settlement in Europe
and the Commission's Regulatory and Legislative Assessment
Project**

Dear Commissioner McCreevy:

This letter, submitted on behalf of the Association of Global Custodians ("Association"),¹ responds to the March 7, 2006, request of the European Commission (the "Commission") for market participants to come forward with recommendations for actions aimed at reducing the remaining barriers to safe and efficient cross-border securities clearing and settlement in the European Union.² The Association supports the Commission's effort to promote progress in this area and is encouraged by the continued public sector interest in achieving an effective clearing and settlement model in Europe.

Implicit in the Commission's request for private sector recommendations is a call for comment regarding potential EU-level legislation or further regulation in this area. This presumably includes a call for comment on provisions that could advance the integration of infrastructure facilities (i.e., exchanges, clearing organizations, and securities depositories), as well as provisions aimed at reducing costs to infrastructure users and, ultimately, to cross-border investors.

¹ The Association members are listed on the letterhead above.

² Press Release IP/06/273, 7 March 2006 ("Release 273").

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In addition to the request for recommendations, Release 273 confirms that the Commission is nearing completion of its regulatory impact assessment. Although the analysis and conclusions drawn in that assessment will likely be subject to consultation soon, it appears that it would be helpful to the Commission to have comments at this time on relevant issues affecting potential legislative and regulatory approaches and considerations.

The Association is an informal group of ten global custodian banks with extensive business in Europe through European offices, branches and affiliates that provide securities safekeeping services and related asset-servicing functions to cross-border institutional investors, including pension funds, insurance companies and investment companies, many of which are located outside Europe. Through their intermediary activities, Association members play a critical role in enabling the flow of investment capital from market to market and facilitating customers' investments in European securities. Additionally, Association members participate directly or indirectly in European securities depositories and, as infrastructure users, depend on the safety and efficiency of those depository operations and facilities. As significant participants in European markets and market facilities, Association members are keenly interested in efforts to increase safety and efficiency in cross-border clearing and settlement in Europe.

Comments and Considerations

We encourage the Commission, in assessing potential legislative or regulatory action in this area, to take into account the following views and recommendations.

1. Efforts to achieve integration and consolidation of clearing or settlement facilities and processes in Europe should continue to be led by private sector initiatives and market forces.

The Association concurs with the view expressed in Release 273 that market-led solutions which promote safe, efficient and competitive markets are preferable to legislative direction. Considerable industry energy and resources continue to be devoted to initiatives, including those in which Association members are engaged, that pursue the recommendations set out in the second Giovannini Report ("Second

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Giovannini Report”).³ To be sure, as that report recommended, removal of certain barriers requires concerted and coordinated national-level public law changes, coupled with EU-level oversight. However, particularly in matters of market structure, we urge the Commission to give weight to serious private sector initiatives and to focus any new EU-level legislative detail narrowly, imposing affirmative requirements only where strictly necessary. Such a standard would limit the possibility that legislation could hamper or delay ongoing collective efforts to advance efficiencies and reduce overall costs.

2. Legislative or regulatory proposals addressing matters of clearing and settlement system efficiency or infrastructure integration should be directed to the distinct systemic roles and functions of infrastructure entities and should avoid confusing those roles and functions with the activities of intermediaries.

In identifying potential legislative steps to increase safety and efficiency in cross-border investing, we believe Release 273 appropriately focuses on matters and issues pertaining to infrastructure entities; that is, exchanges, clearing organizations and Central Securities Depositories (including International Central Securities Depositories) (together, “CSDs”). CSDs play specialized functional roles in servicing market professionals and providing “one-size-fits-all” central recordkeeping and related settlement and transfer services to the full community of commercial intermediaries. Because CSDs occupy an exclusive position in their respective market(s), and because market participants generally are obligated to use a particular jurisdiction’s CSD (albeit indirectly in many cases), CSDs operate “essential facilities” for markets and market participants. As such, CSDs constitute public service utilities,⁴ providing back-stop safety to the entire intermediary community, and – together with clearing organizations and exchanges – CSDs form the basic infrastructure necessary for markets to handle transaction and settlement volume.

Custodian banks, in contrast, provide institutional investors, including pension funds, insurance companies, and mutual funds, with securities safekeeping services

³ The Giovannini Group, Second Report on EU Clearing and Settlement Arrangements, April 2003.

⁴ In Europe, many CSDs also perform registrar functions for all the outstanding securities of various issuers, thereby providing definitive and exclusive asset ownership registration and transfer services to all investors and their agents.

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and related asset-servicing functions and deliver these services as commercial intermediaries. Global custodians provide these services to cross-border investors seeking access to multiple markets in Europe. In servicing their customers, custodians use European depository infrastructure facilities either directly or indirectly through sub-custodian banks.⁵ Custodians and global custodians are thus *users – not providers* -- of infrastructure services and facilities.

The Association believes these functional differences between infrastructure CSDs and intermediaries are fundamental to any effort to conceive legislation or regulation in this area. Overbroad or imprecise legislative or regulatory proposals – even if directed toward infrastructure issues and matters of market structure – could inadvertently inject or produce costs and regulatory burdens for intermediaries. By taking critical functional differences into account and by using clear and consistent terminology, however, the Commission can precisely tailor any legislative or regulatory proposals that it determines to be strictly necessary, thereby avoiding the imposition of unnecessary costs or burdens on intermediary custodians. We therefore urge the Commission to base its determinations on clear and accurate definitions of the respective roles of relevant market participants so as not to blur their distinct functions.

3. New legislation or regulation should be introduced *only to the extent the Commission determines* that existing legislative guidance and regulatory detail is not sufficient and that new dictates are strictly necessary to enhance the prospect for better market performance.

The Association believes that existing regulation, as it applies to industry participants, should be thoroughly considered before new regulation is introduced. In particular, we note, custodian banks are already comprehensively regulated and supervised as credit institutions, including in respect of custodians' securities safekeeping and related investor-servicing activities. The existing regulatory scheme requires banks to maintain adequate risk-based capital, employ professional risk management controls covering all steps in the custody/settlement operation, undergo

⁵ Custodians deliver services to investors as participants in a chain of custody and recordkeeping arrangements and pursuant to commercial agreements and service relationships. We would be happy to provide further information about the nature of the chain of custody and recordkeeping/service arrangements if it would be helpful to the Commission.

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frequent audits and examinations by professional auditors and regulatory examiners, and regularly assess client creditworthiness and manage client credit performance. Credit and collateral determinations are based on established risk-management disciplines and client-monitoring controls and are carried out subject to close and often continuous bank regulator supervision. New regulations for intermediary custodians, therefore, do not appear warranted. Accordingly, we urge the Commission, in considering legislative action in the field of clearing and settlement, not to introduce provisions or mandates that affect custodian banks or that are directed to custodian activities.

4. As efforts advance toward EU-wide integration of facilities, the Commission should promote regulatory actions at both the national and EU levels that ensure that any expansion by infrastructure entities – whether exchanges, clearing organizations or central depositories -- into non-core lines of business does not affect core service integrity or increase systemic risk.

The Association believes that movement by infrastructure utilities into non-traditional areas of business should be carefully scrutinized and regulated so as to avoid affecting utility service quality or systemic integrity. With respect to CSDs, in particular, the Commission and national regulatory authorities should ensure that CSD expansion into ancillary lines of business is subject to effective functional and governance separation. Until recently, CSDs have operated on a user-owned, not-for-profit basis, and their exclusive position in the market has provided them with critical infrastructure and special regulatory status in European clearing and settlement operations. In the view of Association members, CSD expansion into intermediary services reflects a departure from the principle of separation of functions, which traditionally has been observed in the markets to insure against potential conflicts and risk concentrations. Accordingly, we encourage the Commission and national regulatory authorities to apply suitably rigorous functional segregation principles to CSD expansion. Segregation should include separate governance structures for the separate activities and should be designed to avert risks to any aspect of infrastructure services.

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We appreciate the opportunity to express the Association's general views on matters before you, and we hope the foregoing comments are helpful. Association members would be pleased to supply additional information to you if that would be

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useful. If you have questions or would like additional information, please contact either of the undersigned.

Sincerely yours,



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