

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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June 21, 2004

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### **Re: Revised ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union**

Dear Sirs:

On behalf of the Association of Global Custodians (the "Association"), we are writing to express the Association's views on the "Draft Standards for Securities Clearing and Settlement Systems in the European Union", dated May 2004 (the "Revised Standards"). The Association previously submitted several comment letters to the European System of Central Banks and the Committee of European Securities Regulators (together, "ESCB-CESR") in respect of the "Standards for securities clearing

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and settlement systems in the European Union”, dated August 1, 2003 (the “Standards”), the ensuing schedule for revisions thereto, and the Revised Standards.<sup>1</sup>

The Association acknowledges ESCB-CESR’s efforts to modify the Revised Standards to consider select views and commentary conveyed during the Fall 2003 Consultation, and we commend the ESCB-CESR Working Group for recognizing the critical functional differences between infrastructure utilities, such as central securities depositories (“CSDs”), and intermediaries, such as global custodians. However, the Association continues to believe that further study and revision will be essential to accurately reflect actual and appropriate functional differences between infrastructure utilities and intermediaries and to provide a sound basis for any additional regulation.

## **I. Comments**

**A. The concepts of “internal settlement” and “systemically important” custodian in Paragraph 14 lack sharp definition and need substantially more explanation before the Revised Standards can provide a basis for new regulation of custodians. ESCB-CESR needs to identify specific custodian activities that present financial or operational risks and demonstrate why those activities are not effectively regulated at present. On the present ESCB-CESR record, neither custodians in general nor global custodians in particular should be included in the scope of the Standards.**

- Paragraph 14 is the sole base in the Revised Standards for the concepts of “internal settlement” and “systemically important” custodian, and that paragraph offers the only justification for including “systemically important” custodians in the Standards. Paragraph 14 is brief and general, however, and the conclusions it contains depend on conceptual building blocks and terms, such as “clearing” and “settlement”, that are not accurately set out in relation to actual custodian activities.

The resulting imprecision in Paragraph 14 has made it unfortunately necessary, in preparing comments on the Revised Standards, to speculate about the particular business circumstances and operating activities of custodians that might constitute “internal settlement” and trigger “systemic” significance. In addition, the generality of Paragraph 14 fails to provide custodians, or implementing authorities, with sufficiently precise information to know which activities at which level in the chain of custody trigger, or merit, regulatory attention. On issues of such importance, ESCB-CESR should give market participants, national regulators and banking supervisors compelling analysis and better-defined guidance that can be confidently and consistently applied.

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- Paragraph 14 makes “internal settlement” activity at “custodian banks”, including at *global* custodians, the pivotal concern underlying the application of the Revised Standards to custodians. Neither that paragraph, however, nor the balance of the Revised Standards provides a detailed explanation of particular custodian operations that should be considered systemically important “internal settlements,” nor does the report explain why such operations merit new regulation. In our view, *neither global custodians, nor custodians generally, should be included in the scope of the Revised Standards*, and certainly not based on the Paragraph 14 reference to “internal” settlements.

*Global custodians should be entirely excluded from the Revised Standards.*  
Global custodians do not effect “internal” settlement of deliveries and receipts in depository-eligible securities between institutional customers and customers’ executing brokers -- via accounting operations or otherwise. At the global custody level in the chain of custody, such deliveries and receipts on behalf of customers are facilitated typically and routinely through third parties – i.e., through local sub-custodians and central depositories – and not via internal accounting operations in records maintained by global custodians.

*Similarly, the Revised Standards should not be applied to custodians generally.*  
Few custodians at any level in the chain of custody are positioned to enable “internal settlement.” For those custodians, the relevant internal debit and credit operations merely record delivery and receipt of depository-eligible securities and related funds bilaterally between an institutional customer and the customer’s executing broker. The occasion for such accounting operations occurs by chance, not predictably; and when the occasion arises, the underlying transactions are typically and routinely settled through the depository, *subject to the depository’s settlement operations*, and the relevant depository-eligible securities are held in safekeeping at the depository in any event. *Those recordkeeping and facilitation operations thus do not supplant depository-level settlement and transfer operations.*

- Recording changes in customers’ securities entitlements and facilitating related cash payments are necessary features of providing commercial intermediary services, as described in greater detail in the attached Appendix. For custodians, those activities are surrounded by existing regulation and are carried out subject to the oversight of banking supervisors. ESCB-CESR has not identified particular financial or operational risks associated with those activities, however, nor has it explained shortcomings in the existing regime of regulation and oversight. In our view, the Standards can justifiably be applied to custody functions or activities only if ESCB-CESR effectively demonstrates that particular activities or operations present identified financial or operational risks for which existing regulation is not sufficient or effective.

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Absent such a demonstration, the Revised Standards may have the inappropriate effect of sweeping ordinary and necessary customer recordkeeping operations at multiple levels in the chain of custody and recordkeeping into unnecessary new regulation.

**B. ESCB-CESR should focus the Revised Standards on infrastructure regulation.**

The Revised Standards should focus on the regulation and control of systemic risk, i.e., the risk presented to markets, intermediaries and investors by the clearing and settlement activities of central counterparties ("CCPs") and CSDs and leave the regulation of intermediary banking activities and the risks associated with those activities to banking regulation and bank supervisors. Such a focus would return the Standards to conformity with the scope of the CPSS-IOSCO recommendations and also to the definition of "systemically important systems" currently in use by regulators in other regional markets.<sup>2</sup>

- ESCB-CESR should remove the ambiguity that is created by general references throughout the Standards to terms and phrases such as "rules of the system" and "participants". Such terms, which often appear in proximity to paragraphs that apply to custodians, have meaning for cooperative infrastructure facilities, but are not appropriately applied to custodial intermediaries.

- ESCB-CESR should expand the instruction to banking supervisors set out in Paragraph 15 and in Key Element 4 of Revised Standard 9 by clarifying that any aspect of any of the Standards that applies to banks (and not merely those Standards that apply to "custodians operating systemically important systems") should be the subject of separate assessment and review by banking supervisors, should be implemented consistent with the final framework and details of Basle II, and should be adopted only as necessary to address a well-defined risk that is not otherwise controlled or regulated.

- Inadequate consideration has been given to the increased systemic risks and uncertain market effects posed by CSDs and CCPs' provision of non-core services on a competitive commercial basis. As we and others have observed in earlier comments, infrastructure utilities historically operated on a user-owned, not-for-profit basis and their exclusive central position in the market has given them critical and special status in European clearance and settlement. Such entities' expansion into commercial intermediary activities reflects a fundamental change from the well-established separation of functions in the market and should not be facilitated by ESCB-CESR absent a careful assessment of risks and effects.

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**C. Terms defined in the Glossary of the Revised Standards should match those used in the European Commission Communication on Clearing and Settlement, or at least the current differences (e.g., terms such as “clearing”) should be highlighted and explained.**

The final standards report should note that the Communication anticipates a Framework Directive which will provide a sound set of definitions based on broad consultation; and ESCB-CESR should confirm that when the Directive is finalized, ESCB-CESR will revise the Standards based on consultations with industry participants to ensure the use of common, accepted definitions.<sup>3</sup>

**D. Particular aspects of the Revised Standards should be amended as follows:**

- The reference to custodians in Standard 5 – Securities lending – should be removed. The text of the Revised Standard appears to exclusively address, as it should, securities lending by and through central utility facilities. The sole reference to custodians -- in Key Element 1 -- appears to be unintended and should be deleted.
- Standard 9 – Credit and liquidity risk controls – continues to envision, inappropriately, that extensions of credit by “systemically significant” custodians should be permitted only when collateralized, presumably based on arbitrary levels to be set by new “systemic” regulation. Credit activities of banks should continue to be subject to traditional credit controls and regulations. Additionally, introducing collateralization requirements only for sizeable custodians creates arbitrary competitive consequences that would disserve investor protection.
- Standard 17 – Transparency – includes an inappropriate requirement that custodians “publicly” disclose their risk exposure policy and risk management methodology. Such bank policies and methodologies are proprietary and competitively significant, and for risk reasons, are not publicly disclosed. In addition, the Explanatory Memorandum accompanying this standard, at point 189, could be read to suggest – perhaps unintentionally -- that custodians publicly disclose prices and service details in order to promote competition. This suggestion is entirely inconsistent with commercial market practices and likely conflicts with competition policy. These public disclosure directives for custodians should be eliminated from the Revised Standards.

## **II. Conclusion.**

We urge ESCB-CESR to recognize the weaknesses in the conceptual and definitional building blocks in Paragraph 14, and accordingly remove the concepts of

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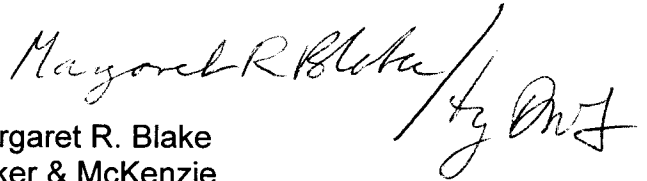
"internal settlement" and "systemically important custodian" from the Revised Standards. We encourage ESCB-CESR to enter into a focused consultation with a broad range of industry participants and banking supervisors to define the elements of special risk, *if any*, that may be associated with specific banking activities relative to the chain of custody and evaluate the adequacy of existing regulation in the light of Basle II. In addition, ESCB-CESR should give sharper definition to terms used in the Glossary and should clarify that custody functions and activities are not encompassed in any of the Revised Standards.

Thank you on behalf of the Association for the opportunity again to express the Association's views. If you have questions concerning the foregoing, please contact the undersigned.

Sincerely,



Dan W. Schneider  
Baker & McKenzie  
Counsel to the Association



Margaret R. Blake  
Baker & McKenzie  
Counsel to the Association

Attached: APPENDIX

CHIDMS1/409463.9

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<sup>1</sup> Letters, dated October 1, 2003 and October 31, 2003, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank and Eddy Wymeersch, Chairman, Banking and Finance Commission, Regarding Request for Comment on Consultative Report -- Standards for Securities Clearing and Settlement Systems in the European Union. In addition, letter, dated November 19, 2003, to Elias Kazarian, Secretariat, European Central Bank, letter, dated February 23, 2004, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank, letter, dated April 16, 2004, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank and Eddy Wymeersch, Chairman, Banking and Finance Commission, and letter dated May 17, 2004 to Arthur Docters van Leeuwen, Chairman, Committee of European Securities Regulators Regarding Procedural and Scheduling Issues. Most recently, letter dated May 25, 2004, to Messrs. Godeffroy and Wymeersch Setting Forth Association Concerns with the Revised Standards as Presented at the ESCB-CESR Hearing on May 25, 2004.

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(Endnotes continued.)

<sup>2</sup> Since the Association submitted its comment letters on the Standards last Fall, for example, the Board of Governors of the Federal Reserve System of the United States (the "Board") has proposed a more expansive policy regarding "systemically important securities settlement systems", but even that expansion remains focused on infrastructure entities. Thus, in its release, the Board has clarified the definition of such a system to be a *multilateral arrangement among financial institutions* for the purposes of clearing, netting and/or settling funds or securities *transactions among themselves* that is based, among other things, on *a set of governing rules common to all the institutions* and a *structure in which credit losses are shared among participating institutions*. To underscore that such a definition would not encompass typical custody activities of banks, the release notes that the policy "does not apply to bilateral relationships between financial institutions and their customers", as "those relationships do not constitute 'a system'" and it distinguishes "system operators" from other entities, such as settlement banks and custody banks. See Federal Reserve System Docket No. OP-1191, April 21, 2004, at text accompanying notes 16 to 20.

<sup>3</sup> The term "global custodian", for example, should be redefined for accuracy, to reflect the following elements: A global custodian provides securities safekeeping services and related asset-servicing functions to institutional and other investors in securities in numerous markets around the globe. A global custodian delivers these services to its customers typically by engaging the safekeeping and related services of local sub-custodians in each relevant market, by facilitating the safekeeping and related activities of the sub-custodians, and often by coordinating oversight of the various custody arrangements on a global basis as a global custody manager. Sub-custodians so engaged typically participate in the local securities depository, holding the assets of the global custodian at the depository and acting on instructions of the global custodian in respect thereof.

## APPENDIX

### **Chain of Custody and Recordkeeping Operations**

#### *A. Ownership Chain : Institutional Investor – Global Custodian – Local Sub-custodian – Local Depository*

1. Institutional investors that invest in securities traded in multiple jurisdictions around the globe engage a global custodian to act as safekeeping agent and to provide related services in respect of the investors' securities and the coordination of global activities. The global custodian maintains securities account records for each institutional customer and provides, or responds to, instructions as necessary to facilitate the completion of purchases and sales in foreign markets for the customer's account. The securities positions carried for the institutional customer take the form of "securities entitlements", which entail property and contract rights owned by the customer vis-à-vis the global custodian.

2. While specific contractual arrangements may vary among global custodians, in general, the global custodian engages a local sub-custodian (which may be an affiliate) in each relevant market to act as agent to the global custodian, and the local sub-custodian provides the global custodian with local safekeeping services, typically as a participant in the local depository. The local sub-custodian maintains account records for the global custodian (the global custodian effectively being the local sub-custodian's "customer") and facilitates completion of settlements on purchases and sales of securities based on the global custodian's instructions. The securities positions maintained on behalf of the global custodian take the form of "securities entitlements", carrying rights owned by the global custodian as customer vis-à-vis the local sub-custodian.

3. The local sub-custodian deposits and maintains in the local depository all locally-traded securities in depository-eligible issues that are recorded in the global custodian's account at the local sub-custodian. The depository maintains participant securities records on behalf of the local sub-custodian and posts debits and credits to the local sub-custodian's account incident to settlement operations at the depository (and based on input from the local sub-custodian or based on the results of settlement accounting operations in coordination with any linked CCP or CSD). In EU jurisdictions, the depository typically serves as the issuer's registrar, in which case the local sub-custodian will be the "registered" owner, or the owner of record, with enforceable rights in respect of the securities against the issuer.



B. *Recordkeeping operations:*

The following synopsis is very general and focuses on securities position accounting for customer-side settlements of local exchange trades in depository-eligible securities.

With each change in an institutional customer's securities position, as determined by settlement of the institutional customer's purchase or sale, a recordkeeping debit or credit, as applicable, must be made both to the relevant customer account at the global custodian level and to the global custodian's account at the local sub-custodian level. In some, but not all cases, a corresponding change in the local sub-custodian's participant account at the depository (and the resulting transfer of securities to or from that account) would also be made at the depository level.

Where, for example, the institutional customer selects a broker for execution of transactions and that broker (or that broker's broker, as applicable) uses a local custodian other than the local sub-custodian servicing the customer's global custodian, the completion of the settlement of the purchase or sale will be accomplished through depository facilities and operations and will entail each entity in the chain recording a concurrent but independent credit or debit, as applicable (i.e., at (a) the depository (in respect of the local sub-custodian's account), (b) the local sub-custodian (in respect of the global custodian's account), and (c) the global custodian (in respect of the institutional customer's account)).

In contrast, where the institutional customer selects a broker for execution that uses the same local sub-custodian as the global custodian and the local sub-custodian is permitted to use an omnibus account at the depository, the local sub-custodian would be positioned to debit or credit, as applicable, the global custodian's account and also the account of the executing broker. In that circumstance, the local sub-custodian would not provide the depository with any settlement input (and no transfer operation would occur at the depository) in respect of the internal accounting on the "customer-side" settlement leg of the executed trade. Instead, in those circumstances, the local sub-custodian would make internal accounting entries in both the global custodian's account and the broker's account (and at the global custodian level, only a debit or credit to the institutional customer's account, against cash, would be made).

Notably – on all such local exchange trades – the broker executing for the customer must settle the "broker-side" of the sale or purchase, and that settlement will be encompassed in depository operations and facilitated by the local sub-custodian, normally on the same day the customer leg is settled. In that regard, the "settlement" of the customer leg that is reflected on the local sub-custodians' records is transitory, as the accounting entry on the broker's records at the local sub-custodian will be accompanied by the custodian's authorization to release or receive securities on behalf of the broker through depository settlement operations.

Effectively, every trade in depository-eligible securities that is executed in the local market (and for which a local custodian bank is involved) is encompassed in the depository settlement operations and its systemic risk controls.

It is possible that in some markets, where a customer transaction is executed by the customer's broker outside the local exchange facilities, including where the customer's broker acts as dealer, the internal accounting steps at the local sub-custodian serving both the customer's global custodian and the broker might not be accompanied by depository settlement operations. Such trades might not be offset by the broker in a matched transaction with another broker on the same day as the customer transaction, or they might be completed without settlement instructions passing through the depository. In such instances, the accounting operations at the local sub-custodian could be less transitory in character, even though still bilateral in operative effect. We understand that such trades occur infrequently and in very limited volume in EU markets. In any case, the opportunity for internal completion of the settlement of such trades would depend on a variety of factors, including the nature of the settlement account requirements applicable to the parties in the market.