THE ASSOCIATION OF GLOBAL CUSTODIANS

THE BANK OF NEW YORK
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RBC GLOBAL SERVICES
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

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DG MARKT G1
European Commission
B-1049
Brussels
BELGIUM

Re: Communication from the Commission to the Council and the European Parliament – Clearing and Settlement in the European Union – the way forward

Dear Sirs/Madams:

This letter is submitted on behalf of the Association of Global Custodians ("Association") in response to the invitation of the European Commission (the "Commission") to comment on the Communication entitled, "Securities Clearing and Settlement in the European Union – the way forward", issued by the Commission on April 28, 2004 (the "Communication"). This letter is intended to assist the Commission in formulating policies and setting implementation initiatives relating to market infrastructure and regulation in the evolving European securities markets.

The Association is an informal group of nine banks, headquartered in North America, with extensive European branches and affiliates that provide securities safekeeping services and related asset-servicing functions to cross-border institutional investors, including pension funds and investment companies.[1] Many customers of Association members invest in a full range of securities traded in European markets. Such securities ultimately are held on behalf of members' customers in European central securities depositories either directly through members' European branches and

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1 The Association members are listed on the letterhead above.

affiliates, or indirectly through members' use of agent banks in Europe acting as local sub-custodians.

These comments are submitted in view of the extensive and varied roles Association members play in European markets and members' interest in increased safety and efficiency throughout the European Union (the "EU").[2] These comments reflect members' experience and perspective as global custodians and as banking institutions familiar with comparable matters of securities market structure and regulation in the United States.

I. General Points

The Association concurs with the core legal, policy and process objectives identified in the Communication. In particular, the Association supports efforts towards achieving safety and efficiency in cross-border securities clearance and settlement throughout the EU; harmonizing and clarifying relevant laws that underpin and affect clearance and settlement and intermediation across the EU; and ensuring that authorities receive and take into account formal advisory input from market and legal experts in EU policy-setting and law-implementation processes.

The Association agrees with the Commission's observation that the coordinated efforts necessary to bring about these objectives will entail time and complexity. In this regard, we believe the "Practical Initiatives" identified on pages 12 and 13 in the Communication -- particularly the development of a Framework Directive and formal use of broadly representative advisory groups throughout the process -- will promote flexible leadership on the part of regulatory and supervisory authorities tasked with implementing the objectives while also promoting informed action.

In addition, the Association believes that certain elements of the Communication should be modified and refined in the interest of providing the markets and interested parties with the most useful and informed guidance at the outset of the process. The

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[2] The Association has provided extensive comments on regulatory and market structure issues to the European System of Central Banks and the Committee of European Securities Regulators. See, e.g., Association Letters dated October 1, 2003, October 31, 2003, May 25, 2004, and June 21, 2004, to ESCB-CESR Working Group Co-Chairs, Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank and Eddy Wymeersch, Chairman, Banking, Finance and Insurance Commission, Belgium. Similarly, the Association is currently assisting the Group of Thirty ("G30") in monitoring the progress of the implementation of certain of the G30's global clearance and settlement recommendations.

Association makes the following points, as supplemented in the succeeding sections of the letter --

- The Communication identifies the importance of well-defined, activity-based functional definitions as the basis for policy direction and regulatory action. In our view the terms and definitions used in the Communication should be even more precisely and accurately drawn. Greater precision would limit confusion in the concepts and policy recommendations that appear in the Communication and would ensure that ensuing guidance fully reflects the functional differences between custodian banking services for institutional investors as compared to the mutualized utility operations of central securities depositories, including international central securities depositories ("CSDs")

- The Communication seems to suggest that there is a significant range of business comparability and potential competition between intermediaries and the clearing and settlement utilities. We believe such comparability is very limited in practice in inter-regional market contexts, including the EU. A more accurate delineation of the activity-based functions of custodian banks as compared to those of CSDs would reveal the very different lines of business and market roles of each type of entity, which in turn would lead to different regulatory policy guidance in the Communication.

- The Commission's guidance in its final Communication should lay the foundation for a "common regulatory/supervisory framework" and a Framework Directive that are fully synchronous with actual market conditions and circumstances. The distinct customer service activities of custodian banks, particularly when contrasted with the centralized operational focus of CSDs, constitutes traditional banking activity, which should continue to be regulated and supervised within the ambit of bank regulation. No basis has been identified to date – by ESCB-CESR or others – as to why custody and related activities of commercial banks should be folded into a new regulatory framework appropriate for clearing and settlement "systems". This is so even if additional regulation of the inherently systemic operations of CSDs and central counterparties ("CCPs") is necessary.[3]

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[3] Custodians are regulated, examined and supervised by bank regulators as credit institutions and safekeeping entities, and that regulatory regime is extensive and well-tested. The existing regulatory scheme applicable to banks requires banks to maintain adequate risk-based capital, employ professional risk management controls covering all steps in the custody/settlement operation, undergo frequent audits and examinations by professional auditors and regulatory examiners, and regularly assess client creditworthiness and manage client credit performance. There has been no showing that the safekeeping

II. Detailed Comments

A. The Communication's problematic terminology and the Commission's blurring of functions. The Communication should use definitions and terms that fully and accurately reflect the substantial functional differences between custodian bank safekeeping and related services as compared to the collective settlement/transfer activities of utility CSDs.

The term "settlement" is defined in the text of the Communication, at page 6, as "including the *final transfer* of securities from the seller to the buyer and of funds from the buyer to the seller." [Emphasis added.] (Incidentally, although the term "clearing" is included in the glossary, the term "settlement" is not.) In turn, the term "custodian" is defined as "an intermediary in the *provision* of settlement services." [Emphasis added.] A CSD is defined as a "securities settlement system", while a "securities clearing and settlement system" is described in the Communication as "the full set of institutional arrangements required to finalize a securities transaction". The Communication effectively makes custodians a component element in those "system" arrangements, but does so via a series of inaccurate definitional steps. We believe that a careful recitation of the specific activities of custodians confirms the distinct and specialized functional role they play.

Custodians provide their institutional customers with access to local market settlement facilities and conventions by engaging third parties to safe keep their customers' securities and to facilitate settlements on customers' behalf. *Global* custodians typically engage local sub-custodians to provide custody and related facilitative services to the global custodian (and indirectly, its customers). In turn, these local sub-custodians deposit customers' securities with the local market CSD (either directly or, less commonly, through an additional intermediary). At the end of the chain of custody, institutional investors and their custodians and local sub-custodians have no choice but to use the local CSD.

When institutional customers instruct their brokers to purchase or sell securities, custodians facilitate settlement by authorizing delivery of securities to, or receipt of securities from, the customer's broker as instructed by the customer, thereby enabling the broker to complete settlement with its counterparty through CCP and CSD facilities and operations. *Final* settlement activities and *final transfers* between buyers and

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and related agency services of custodian banks merit a different form of regulation based on their use of CSD infrastructure services.

sellers occur through CSD operations and facilities.[4] The steps a custodian takes on behalf of customers are in fact transitory steps typically pertaining to only one leg of a market trade – the sale leg or purchase leg -- and are antecedent to final settlements and transfers that take place at the CSD. Custodians thus do not "provide" services that constitute "settlement" as those terms are defined and used in the Communication. We encourage the Commission to revise the Communication by modifying the definitions and terminology to more clearly reflect the distinct functionalities of intermediaries, CSDs and CCPs.

Of greater concern than imprecise use of terminology, is the fact that the Communication builds on its definitions to erroneously create comparability for some regulatory and policy purposes between custodian banks -- mere participants in one segment of the settlement process – and CSDs. For example, the Communication recommends that the component elements of the clearing and settlement system should be subject to a common regulatory/supervisory framework, at least some of which should include comparable regulation of custodians and CSDs. (See, e.g., the discussion of risk management, capital, and investor protection on page 19 and the discussion of transparency and governance requirements for intermediaries on page 21 of the Communication.) The Communication produces this comparability without specifying how particular service features or processes at custodians bear functional similarity to the market operations of CSDs.[5] In this respect, we note that the Communication refers to the ESCB-CESR standards for securities clearing and settlement. Those standards equated custodians with CSDs for regulatory purposes, and that equation received significant adverse reaction from commenters. Particularly in view of that ESCB-CESR history, we would encourage the Commission to be very precise about activity-specific functionality in the Communication and any ensuing guidance it provides on regulatory matters affecting banks in their custody role.

B. Respective custodian and CSD roles and activities in safekeeping and settlement activities. More precise definitions based on accurate characterization of the differing activities and service focuses of custodians as compared to CSDs would promote more compelling guidance based on market realities and would discourage,

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[4] We have assumed by the Communication's definition, that the references to seller and buyer mean the seller and buyer in market transactions. Settlements of market transactions typically and routinely occur through CCP operations and CSD facilities between the relevant brokers.

[5] Other intermediaries also participate in various ways in the settlement process and some institutional investors provide their own safekeeping services; but the Communication does not identify those entities as integral components in settlement, nor does the Communication suggest that regulatory attention be given to those entities as if they have comparability to CSDs.

rather than invite, unnecessary new regulation of intermediaries or confused regulation of clearing and settlement systems.

Custodians provide their institutional banking customers, including pension funds and mutual funds, with safekeeping, asset servicing, and related facilitative services as part of an array of traditional banking services. *Global custodians* provide these services to customers that invest in multiple markets around the world and require the coordination and global custody management capabilities of a global custodian. Local sub-custodians serve as the point of connection for the global custodian and its institutional investors to the local market settlement facilities and operations.

All custodian banks provide banking services in a commercially competitive environment in terms of price, range of services and flexibility. Custody customers -- unlike depository participants – are not professional securities processors. They require the intermediation of professional safekeeping agents and asset servicers, and they demand flexibly-structured servicing arrangements that are commonly heavily negotiated.

In contrast to the individualized services delivered competitively to customers by custodian banks, CSDs occupy an exclusive, central-utility position in their respective markets, providing "one-size-fits-all" central recordkeeping and related settlement and transfer services to the full community of commercial intermediaries, including custodians. Market participants generally are obligated to use a particular jurisdiction's CSD (albeit indirectly in many cases). CSD facilities are thus essential facilities for markets and market participants, and as such CSDs operate as service utilities. In addition, in the EU, many CSDs perform registrar functions for all the outstanding securities of various issuers, thereby providing definitive and exclusive asset ownership recordation and transfer services to all investors and their agents.

In view of their utility role and critical systemic significance, CSDs necessarily mutualize risk across the community of participants they serve (something custodian customers would never authorize at the custodian service level). Indeed, a critical public function of CSDs is to act as a back-stop to the entire intermediary community, by measuring, controlling and managing aggregate settlements and the related systemic risks and by protecting the collective user community (and customers of users) against the spread of losses caused by a participant's default, including defaults occurring for reasons of participant insolvency.

CSD risk-management, settlement and transfer activity thus serves the full community of intermediaries and issuers, and CSD safekeeping operations should be viewed as core centralized services germane to utility status. In comparison, safekeeping activity at a custodian is one of several customer-specific banking services that enables individual customers to access markets without having to run a back office

or meet market or CSD membership requirements. Custodian bank safekeeping activities for institutional investors are thus fundamentally different in function, purpose and character from the centralized risk-management and settlement activities of CSDs.

We submit that those various differences constitute different functions for purposes of the Communication. Accordingly, regulation of the clearing and settlement *system* based on the objectives of the Communication should focus on the market-servicing systemic elements. Absent particularized problems not otherwise effectively regulated, neither the Communication nor the Framework Directive should encourage new or supplemental regulation for system users as if they are integral functional components of the system or somehow fungible with system providers.[6] Banking activities are effectively regulated pursuant to applicable banking laws and supervisory regimes.

C. CSD Expansion. The Communication should set strict ground rules for any business expansion of critical infrastructure utilities into commercial intermediation and should focus any policy development efforts relating to governance and transparency on the quasi-public CSDs and CCPs, not on commercial intermediaries.

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[6] Keeping the regulation of banking services distinct from the general regulatory scheme for market infrastructure facilities would usefully parallel the pattern taken for discrete regulation of clearing and settlement system operations in the U.S., even in respect of matters of systemic risk. In this regard, for example, the Board of Governors of the Federal Reserve System of the United States (the "Board") recently proposed a more expansive policy regarding "systemically important securities settlement systems", but even that expansion focuses on infrastructure entities. In its release, for example, the Board 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 does 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. Similarly, we note that CPSS-IOSCO specifically did not include custodians within the ambit of their system-focused recommendations, and was very specific about the functionalities that might cause custodians to be included.

The Commission invites CSDs to expand into commercial banking services as intermediaries, notably to promote efficient cross-border servicing among separate depositories and to facilitate eventual consolidation as dictated by market events. The invitation does not appear to be limited to the provision of such services for purposes of cross-links between central depository facilities. Moreover, CSD expansion appears to be encouraged in order to provide a fair field of competition between intermediaries and infrastructure entities. The Communication even suggests, at page 9, that intermediaries should have the opportunity to provide infrastructure services -- likely a by-product of the implications created by the Communication's over-broad "clearing and settlement *system*" concept.

We think the Commission overestimates the extent to which intermediaries do or may compete with utility infrastructure providers and therefore overstates the extent to which a two-way "level playing field" would be meaningful. We think this is a misinterpretation of market realities and leads to two particular problems in the Communication.

First, the Communication appears to suggest, at page 21, that governance arrangements for intermediaries need to be newly addressed and that those arrangements should compare favorably to CSD governance arrangements, so as "to ensure transparency", among other things. As the Communication recognizes, CSDs have quasi-public functions as well as many interested constituents, and appropriate governance principles for such organizations entail complex balance. In contrast, commercial intermediaries are subject to governance policies and principles under existing business organization and financial services laws, and there is no reason to think that these policies and principles are not well-designed for intermediary activities. In addition, competitive market forces effectively require intermediaries to provide customers and potential customers – but not the general public – with robust information about prices, services, and business history. Such information should not be required to be publicly disclosed, and such disclosure would not be consistent with the requirements of competition laws and policies.

Second, the Communication encourages CSD expansion into non-core lines of business without ensuring that such expansion does not affect core service integrity. Because CSDs perform critical market functions as essential facilities and because expansion of CSD activities would pose risk to core service integrity, we believe it is important to see that CSD expansion is subject to effective functional separation. The Communication identifies, on page 22, accounting separation and unbundling of services as general principles that will need to be incorporated in the Framework Directive and observed by CSDs that expand beyond core services. However, the Communication declines, at page 12, to require that CSD expansion be subject to functional segregation between core and value-added activities. In contrast, the

European Parliament, in its Resolution of January 2003, suggested that the provision of value-added services by CSDs should be subject to effective functional separation from core CSD services, in the interest of controlling risks to core capabilities that such expansion entails.

The Association believes that effective functional separation of core CSD services from CSD intermediary services is an important means of containing systemic risk. 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. CSD expansion, in the view of Association members, reflects a fundamental departure from the well-established separation of functions in the market that is designed to insure against potential conflicts and risk concentrations. Accordingly, we encourage the Commission to establish functional segregation requirements for CSD expansion that are stricter than the general accounting and unbundling principles it has identified in the Communication. Segregation requirements should include separate governance structures for the separate activities and should be designed to ensure that the full range of risks to infrastructure services is taken into account before CSD service expansion proceeds.

III. Conclusion

The Association commends the Commission for the thoughtful work reflected in the Communication and for setting forth Practical Initiatives to facilitate progressive evolution. The development of increasingly safe and efficient cross-border clearing and settlement facilities and operations will be fundamental to sound EU securities markets, and continued leadership and oversight by the Commission will be important to effective evolution. The Association also encourages the Commission to modify the definitions and terminology used in the final Communication so as to more accurately reflect the respective functionalities of intermediaries as compared to CSDs. We believe that use of accurate definitions and suitable terminology will promote more refined recommendations regarding functional regulation and will provide better-informed guidance for all aspects of the Practical Initiatives. In particular, we believe the Commission should focus regulatory and policy efforts for the securities clearing and settlement *system* on the systemic components -- CSDs and CCPs -- and should ensure that expansion of CSD services into intermediary activities is subject to appropriate functional separation requirements.

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On behalf of the Association, we express appreciation for the opportunity to comment on the Communication. Questions can be directed to the undersigned.

Sincerely yours,

Dan W. Schneider
Baker & McKenzie Ltd
Counsel to the Association

Margaret R. Blake
Baker & McKenzie Ltd
Counsel to the Association

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