

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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September 13, 2005

Mr. Jean-Michel Godeffroy  
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Chairman  
Banking and Finance Commission  
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Belgium

**Re: Public Statement -- Follow-up Work by the ESCB/CESR Joint Working Group**

Dear Messrs. Godeffroy and Wymeersch:

On behalf of the Association of Global Custodians (the "Association"), we are responding to the invitation extended by the Joint Working Group of the European System of Central Banks and the Committee of European Securities Regulators (together, "ESCB-CESR") to comment on the follow-up steps and processes of the working group as set out in the ESCB-CESR public statement of August 1, 2005 (the "Public Statement").<sup>1</sup> The Association previously submitted several comment letters in

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<sup>1</sup> The members of the Association are identified in the letterhead above. Please note the addition of HSBC Securities Services to the Association, effective August 2005.

## THE ASSOCIATION OF GLOBAL CUSTODIANS

Mr. Jean-Michel Godeffroy

Mr. Eddy Wymeersch

September 13, 2005

Page 2

respect of the ESCB-CESR "Standards for securities clearing and settlement systems in the European Union" (the "Standards") and ESCB-CESR's underlying processes and methodologies.<sup>2</sup>

### Background: The Public Statement and the Working Group Process.

In its Public Statement, ESCB-CESR confirms that the next set of Standards to be issued will mirror the CPSS-IOSCO recommendations and follow globally applicable regulatory approaches. As noted in our letters of October 1 and 31, 2003,<sup>3</sup> the CPSS-IOSCO recommendations were addressed, appropriately, to infrastructure issues and facilities and did not include custodians in the scope of those recommendations.<sup>4</sup> We urge ESCB-CESR to follow the CPSS-IOSCO approach in finalizing its Standards.

The Public Statement also indicates, however, that the assessment methodology and thus the Standards may -- *unlike the CPSS-IOSCO recommendations* -- encompass the open issues listed in paragraph 27 of the September 2004 version of the Standards. Several of those open issues directly relate to custodian banks,

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<sup>2</sup> Letters, dated October 1, 2003 and October 31, 2003, to Messrs Godeffroy and Wymeersch 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 Elian Kazarian, Secretariat, European Central Bank; letter, dated February 23, 2004, to Messrs. Godeffroy and Wymeersch; letter, dated May 17, 2004, to Arthur Docteurs van Leeuwen, Chairman, Committee of European Securities Regulators, Regarding Procedural and Scheduling Issues; letter, dated May 25, 2004, to Messrs. Godeffroy and Wymeersch Regarding the Revised Standards as Presented at the ESCB-CESR Hearing on May 25, 2004. Most recently, letter, dated June 21, 2004, to Messrs. Godeffroy and Wymeersch Addressing the Revised ESCB-CESR Standards issued in May 2004.

<sup>3</sup> See footnote 2, *infra*.

<sup>4</sup> The Introduction to those recommendations noted without explanation that in some markets where there are few custodians, internalized settlements may occur; but the recommendations did not identify any particular risks associated with such settlement activities nor did they identify any needed additional regulation in respect thereto.

## THE ASSOCIATION OF GLOBAL CUSTODIANS

Mr. Jean-Michel Godeffroy

Mr. Eddy Wymeersch

September 13, 2005

Page 3

including the possible inclusion of a designated category of custodians in certain of the Standards and the potential that the Standards may impose or generate new regulations affecting the credit activities or settlement practices of the custodians designated to fall within the Standards.

In its prior comments, the Association expressed members' ongoing concerns about the reasoning and objectives for seeking additional regulation of intermediaries -- and particularly for focusing on only one category of intermediaries -- in the context of regulatory proposals that purport to address systemic matters of infrastructure facilities and operations. Given the existing regulatory schemes and supervisory mechanisms applicable to intermediaries, any new regulatory proposals affecting intermediaries should be supported by clear reasoning and sound objectives. The Association has also expressed concern in its letters about the processes ESCB-CESR has used to develop the Standards, generate definitions, and identify entities that will be included in the scope of the Standards. In this regard, since last Fall, the ESCB-CESR working group has discussed the assessment methodology relative to the open issues in private discussions with some industry participants, including Association members, but the specific methodology and analyses now evolving have not been publicly shared for comment. Indeed, the Public Statement does not set forth this information; nor does it identify the process or the timetable for public consultation concerning the methodology or the role the methodology will play in the structure of the Standards.

### Comments.

We believe it crucial that ESCB-CESR provide market participants with full disclosure about the proposed assessment methodology for the revised Standards as *well* as the ways in which the methodology informs the Standards. Only with an understanding of the specific proposed methodology will market participants be able to meaningfully evaluate and comment on the integrity of the Standards. Similarly, only when the substantive Standards have been proposed for review can commenters realistically address the integrity of the methodology on which the Standards depend.

In addition, we believe ESCB-CESR should conclude its assessment of the open issues only when it has had the benefit of public consultation on the full range of its proposals and the reasoning underlying these proposals. We therefore look forward to reviewing and addressing -- in a public consultation -- the revised Standards as well as the methodology, analyses and explanations that underlie the proposals. In this

## THE ASSOCIATION OF GLOBAL CUSTODIANS

Mr. Jean-Michel Godeffroy

Mr. Eddy Wymeersch

September 13, 2005

Page 4

regard, we anticipate that the next set of proposals will meet the following protocols. They will: (1) clearly articulate the risks that ESCB-CESR perceives as posed by the included intermediaries and describe the shortcomings of existing regulation and supervision in respect of those risks; (2) set out the specific Standards that are to be applied to manage such risks; and (3) define and explain the assessment methodology to be used to measure such risks.

We make the following specific observations and suggestions directed to developing the assessment methodology and advancing a fair underlying process. These comments are necessarily preliminary, given the limited information available.

- Exclusion of Custodians from the Scope of the Standards. The Association has anticipated that ESCB-CESR would undertake a rigorous assessment of the open issues and that such a review would confirm whether *any* sound policy bases exist for including intermediaries in the scope of the Standards. However, the process appears to have pre-supposed (rather than demonstrated) that sizeable custodians have the potential to disrupt the clearance and settlement systems and therefore should be included in the scope of the Standards. Given that pre-supposition, the review of open issues has focused on defining which custodian banks -- among all intermediaries -- should be pushed into the scope of the Standards. We think that approach is faulty in three respects.

1. As we have explained in earlier comments, we believe that custodians should not be included in the scope of the Standards given the extensive regulations and supervisory oversight processes applicable to banks and given the comprehensive controls and disciplines banks employ to manage and mitigate risk. In our view, no case has been made that custodians present particular defined risks that require new regulation, nor have previous drafts of the Standards identified shortcomings in the existing bank regulatory scheme and supervisory processes relative to such risks.

In this regard, we note that for any given banking institution the existing supervisory processes and risk-management disciplines are brought to bear across the bank's full range of activities. For banks acting as custodians, supervision thus encompasses custody and related credit activities and includes reviews and monitoring of credit risks, including intra-day credit risk, arising out of custody activities and settlement operations. Additionally, banks' comprehensive risk controls and disaster contingency disciplines include rigorous attention to custody and related credit activities.

## THE ASSOCIATION OF GLOBAL CUSTODIANS

Mr. Jean-Michel Godeffroy

Mr. Eddy Wymeersch

September 13, 2005

Page 5

Indeed, for global custodians, as large diversified banks, custody-related risks -- albeit only one element in the bank's overall risk exposure -- are closely monitored as a component part of the ongoing bank-wide risk-management process. In our view, then, the existing supervisory processes, coupled with established risk-management disciplines, mitigate both custody risk and related credit risk; and those processes and disciplines effectively monitor and mitigate disruptive risk to clearing and settlement systems from custodian activities.

2. No evidence has been presented -- and we believe none exists -- that custodians internalize settlements to a significant degree in most markets in Europe. Moreover, no case has been made that internalized settlements -- even if a wide-spread practice -- present risk to central infrastructure facilities or processes. Certainly, *global custodians* do not effect "internal" settlements and cannot reasonably be included in the scope of the Standards based on concerns about theoretical netting or offset *operations that do not take place*. As a result, ESCB-CESR should not employ a methodology or propose Standards that include custodians in their scope based on notions of internalization absent a full analysis of actual practices and the effectiveness of existing controls and regulation. Any resulting proposals should set out a precise definition of the specific risk that included custodians and the relevant practices present.

3. We have yet to see the basis for including custodians in the Standards or regulating custodians based on their size and activity as EU depository users while excluding other types of intermediaries that fit the same criteria, including investment firms and investment banks that are not credit institutions. In this regard, we note that the U.S. Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System (April 7, 2003) -- to which ESCB-CESR has referred as a model for the Standards' focus -- limited its substantive recommendations to business continuity and disaster recovery disciplines and included in its scope for those purposes significant broker-dealers as well as banks. The disciplines generated in the industry following those recommendations are now well established in global markets. ESCB-CESR should emulate the scope set out in that paper -- particularly if it wishes to "follow the globally applicable" methodology, as indicated in the Public Statement.

- Review of Open Issues and the Need for Soundly-Based Criteria. There is very limited information publicly available at this time about the specific assessment methodology and criteria under consideration. At present, we understand that ESCB-CESR may be considering use of size per se, as supplemented by certain business

THE ASSOCIATION OF GLOBAL CUSTODIANS

Mr. Jean-Michel Godeffroy  
Mr. Eddy Wymeersch  
September 13, 2005  
Page 6

activity criteria, to define which custodians could be included in the scope of the Standards. We further understand that size may be measured by assets under custody alone. We submit, however, that, as a criterion, the value or scale of assets under custody has no predictive connection to disruptive risk. Indeed, the size of an intermediary's asset base does not convey information about operational activities, scale of settlements, or product/service concentrations.

Instead of using such a generic measurement, the criteria chosen to designate a category of included intermediaries should be closely connected to a clearly defined risk and a genuine need for a specific proposed regulation. We therefore continue to urge ESCB-CESR to review the open issues with an eye toward providing a clear and persuasive set of conclusions, and anticipate that those conclusions will produce a set of Standards that is confined to infrastructure regulation. We also anticipate that any proposals that encompass custodians will include the well-documented cost-benefit analysis referenced in paragraph 110 of the latest Standards report and the "analysis of the potential risks that significant custodians may trigger in terms of financial stability," noted as an open issue in paragraph 27 of the Standards.

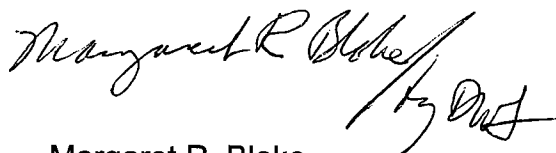
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On behalf of the Association, thank you for the opportunity to express the Association's views. If you have questions concerning the foregoing, please contact the undersigned.

Sincerely,



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Baker & McKenzie LLP  
Counsel to the Association



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