

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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COUNSEL AND SECRETARIAT TO THE ASSOCIATION:  
BAKER & MCKENZIE LLP  
815 CONNECTICUT AVENUE, N.W.  
WASHINGTON, D.C. 20006  
TELEPHONE: 202/452-7000  
FACSIMILE: 202/452-7074  
WWW.THEAGC.COM

20 October 2009

Mr. Pierre Francotte  
Chief Executive Officer  
Euroclear S.A.

Mr. Jeff Tessler  
Chief Executive Officer  
Clearstream

### **Re: Reversals of Payments of Principal and Income at ICSDs**

Dear Sirs:

We write on behalf of the members of the Association of Global Custodians ("Association"),<sup>1</sup> to briefly convey members' concerns and suggestions regarding the practice that is generally, but not invariably, followed by ICSDs of reversing credits related to interest payments or principal redemptions to participants without prior authorization from the affected participants. Based on members' discussions with you over time about this practice, we understand that these reversals are customarily made either to correct payment/credit errors at the ICSD or to correct errors or adjustments initiated by issuers through their paying agents or common depositaries. In some cases the ICSD reversals we describe occur several weeks or more after the original credit.

Association members recognize that ISMAG has in place a working group that is engaged in analyzing root causes of late payment information and is assessing information timeliness and payment performance generally. Significantly, that process has included various parties in interest, and the Association encourages that work to progress as rapidly as feasible. Members also understand that ISMAG's work has encompassed both principal and income payment issues. Given the size and

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<sup>1</sup> As you know, members of the Association, listed on the letterhead above, provide cross-border securities custody services and related functions to institutional investors globally and in carrying out those functions necessarily participate either directly or indirectly in ICSDs.

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significance of risk on principal payments, the comments below emphasize the particular complications and the potential changes in practice relating to such payments.

### **Summary of Concerns**

The practice of unilateral ICSD reversal of payments results in two problems. First, for interest reversals and adjustments, Global Custodians or other intermediaries who are ICSD participants are required to make adjustments to their clients' accounts. Not only are those adjustments disruptive of settled investment/income expectations, but they often affect fund valuations reported in prior months. Second, for reversals of principal, Global Custodians or their clients can be exposed to significant financial risks whenever they are unable to reverse the credit all the way down the custody chain. This can happen when custody relationships have been terminated, when the investor disagrees with the basis for the reversal, or when an intermediary or the investor is no longer in a position to pay a resulting net debit.

Financial risk is further compounded whenever the underlying client requires payment in a different currency. In that instance, the relevant intermediary must effect a foreign exchange transaction in order to fulfill the payment, and reversals after that date necessarily create FX exposure for that intermediary. It is typically very difficult to get anyone higher in the payment chain to cover that exposure following the reversal.

While reversals of income payments can also present collection shortfalls, the financial risks and finality issues described below are typically much more sizable and thus of greater consequence with respect to reversals of principal. Indeed, the second problem noted above – inability to reverse principal credits all the way down the custody chain – effectively means that payments related to redemptions or corporate actions lack finality, which is clearly an unacceptable consequence for the industry in terms of risk as it affords little protection to intermediaries (other than paying agents) and inappropriately can draw both ICSDs and participants into legal disputes between issuers and investors. Although ICSDs customarily pre-advise their participants about imminent reversals of principal, there is effectively no way for intermediaries, including Global Custodians, to control or limit the financial risk attributable to payment reversals; and the more open-ended the timeframe over which reversals can be made, the greater the risk, uncertainty and lack of finality.

Association members believe that the only reason this systemic risk exists is current market practice, formalized in ICSD operating rules and procedures. The Association is not aware of any law or regulation in Europe in the securities or

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payments arena that contemplates practices which create such risk, and members are not aware of any law or regulation granting rights of unilateral reversal to issuers' agents, depositories, or custodians. Further, no law or regulation requires – or even permits -- ICSDs to process such reversals without any consideration of the time elapsed since the original credit. In the case of inordinately-delayed reversals of principal, Association members firmly believe that collection of proceeds earlier credited to investors or their direct intermediaries should not be the responsibility of Global Custodians or ICSDs, but should be accomplished through issuers' direct claims against investors. Indeed, the ICSD reversal practice places ICSDs as well as intermediaries in a position of risk that should be borne by issuers and their investors.

Given the importance of these issues, some Association members have conferred with their Issuing and Paying Agency departments about the foregoing problems and risks to intermediaries. Those departments have shown support in principle for the concerns expressed here and for the changes in practice parameters suggested below.

### **Proposed Practice Changes for Discussion**

For all *principal redemptions* of international securities or the payment of *proceeds of corporate actions* on such instruments, when valued above 1,000,000 Euros or the equivalent, we propose that unilateral reversals by ICSDs should be possible only if completed within 2 business days of the credit following pre-advice to the participant, irrespective of the reason for the reversal. In all other cases in this category, the ICSD will obtain its participant's authorization before executing the reversal.

For principal redemptions or corporate actions payments of *smaller amounts* on international securities, we propose that the current practice of reversal with pre-advice to the participant -- but without prior participant authorization -- be permitted up to a period of 5 business days after the original credit date.<sup>2</sup>

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<sup>2</sup> We understand that where underlying securities are held by you with other depositories directly or via agent banks, rules applicable in the applicable home jurisdiction would apply; and that hence the above rules on reversals of principal redemptions/corporate action proceeds may need to be adjusted or subject to exceptions for certain cases.

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For all reversals of *interest or dividends* on Eurobonds or Euronotes, unilateral reversal should be possible only if it relates to payments completed within the previous 30 days. All others will require prior participant approval.

**Suggested Steps to Facilitate Broad Consensus**

We understand that the foregoing changes will require agreement from some other market participants. We are therefore interested in discussing the matter with ISMAG and with leading paying agents and are prepared to assist the ISMAG working group effort in order to establish broad consensus, without need to refer the issues to regulators. At the same time, we would appreciate any efforts you can make to reach out to other affected industry segments so that solutions are put in place promptly. We would also welcome any other suggestions you may have to address the situation.

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Thank you for your consideration of the Association's concerns and suggestions. Members will be pleased to discuss the matter further with you directly and with others involved in ISMAG, and we look forward to your early reply. Please contact the undersigned at 312.861.2620 to initiate discussions.

Sincerely yours,



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

CC: John Gubert