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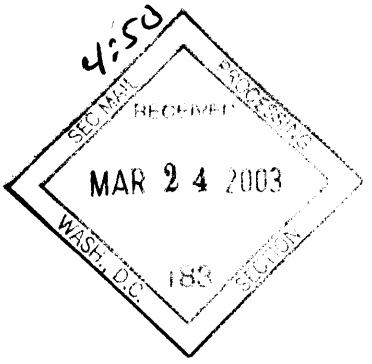
March 24, 2003



Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20541

RE: Government Securities Clearing Corporation Proposed Standard of Care; File No. SR-GSCC-2002-10

Dear Mr. Katz:

We submit this comment letter on behalf of our client, the Association of Global Custodians (the "Association"), to address policy and infrastructure issues of concern to Association members that are raised by the proposed rule change of the Government Securities Clearing Corporation ("GSCC"),[1] File No. SR-GSCC-2002-10, published for comment on January 7, 2003.[2] In its rule change, GSCC proposes to modify its rules to limit liability to its members to losses caused directly by GSCC's gross negligence, willful misconduct, or violation of federal securities laws for which there is a private right of action. GSCC also proposes to disclaim liability for actions or omissions of third parties with which GSCC interacts absent GSCC's gross negligence, willful misconduct, or violation of federal securities laws in selecting the third party. These modifications would establish a general gross negligence standard in respect of GSCC services and would replace certain references in GSCC Rules 31 and 39 to liability based on GSCC's negligence.

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[1] Subsequent to filing the rule change, the Mortgage-Backed Securities Clearing Corporation merged into GSCC, and GSCC changed its name to the Fixed Income Clearing Corporation. Securities Exchange Act Release No. 47015 (December 17, 2002), 67 FR 78531 (December 24, 2002). To reduce confusion, in this letter we continue to refer to GSCC as such.

[2] Securities Exchange Act Release No. 47135 (January 7, 2003), 68 FR 1876 (January 14, 2003). Because the Association believes that there are important policy issues raised by the GSCC proposal that are germane to the Investment Company Act of 1940, as well as the Securities Exchange Act of 1934, the Association is providing a copy of this letter to members of the Commission staff in the Division of Investment Management, as well as the Division of Market Regulation. If the rule change is approved as filed, the Association anticipates providing the Division of Investment Management with further comments related to these issues.

The Association is an informal group of ten North American custodian banks that provide global custody and securities processing services to institutional investors from around the world, including investment companies registered under the Investment Company Act of 1940. In delivering transaction settlement and custody services to their clients, Association members use securities depositories and settlement organizations around the globe, both directly and through sub-custodians. In providing these securities processing services through myriad processing networks, members observe, among other things, rules and policies imposed by the Securities and Exchange Commission ("Commission"). Such rules and policies include those adopted under the Investment Company Act of 1940, that effectively require bank custodians to observe reasonable care in respect of processing investment company assets, as well as rules, policies and practices adopted by the Commission and self-regulatory organizations pursuant to the dictates of Section 17A of the Securities Exchange Act of 1934 (the National System for the Clearance and Settlement of Securities Transactions (the "National System")).

In sum, delivering securities processing services to institutional investors subjects Association members to extensive Commission regulation in an elaborate and tiered securities processing chain. That operating environment generates very considerable interdependencies, and Association members and their investor clients rely on continuity and predictability in clearance and settlement networks and infrastructure. In addition, as necessary participants in the clearance and settlement infrastructure, Association members expect the ground-rules for safe and efficient operations to be appropriate, fair and reasonably uniform.

Accordingly, the Association has a direct interest in regulatory and self-regulatory actions and decisions, including actions that affect the performance or liability standards for clearing agencies, custodians or other intermediaries, actions that affect processing infrastructure and ground-rules or terms of service, and actions that produce inequitably divergent performance standards among securities processors.

In this regard, we note that only a few Association members are direct members of GSCC, and those members that participate in GSCC directly do so for varying clearance and settlement purposes. As custodians, however, members necessarily participate in one or more layers in the processes of delivering and receiving securities and funds for customers that buy, sell and repo government securities. Moreover, as bank custody and settlement services evolve over time, custodian banks may become active, direct users of various GSCC services. GSCC's performance and the standards it observes, therefore, inevitably affect and will continue to affect the securities services and operating performance Association members and their clients encounter in processing government securities transactions.

Summary of the Association's View

The Association urges the Commission to review GSCC's proposal carefully and with reference to the issues and points noted herein. Although the Association's comments are not intended to convey any view about GSCC's present operating capability and integrity, the Association believes that a gross negligence standard does not reflect customary commercial practice in the securities processing community in general and conflicts with the reasonable care standard effectively imposed on custodian banks under the Investment Company Act of 1940. Approval of the proposal in its current form would be a departure from the general negligence standard the Commission has historically emphasized as appropriate to clearing agencies and could create an inappropriate precedent generally for registered clearing agencies, exempt clearing entities, and securities intermediaries with which Association members interact. Gross negligence should not be enshrined as the general liability standard for registered clearing agencies or, for that matter, exempt clearing entities that provide essential National System facility services to securities intermediaries, including custodian banks, that depend critically on the National System. Such a change in the liability standards expected of National System utilities implicates performance standards systemically, and would be a change in direction for the Commission's oversight of the National System. This seems particularly inappropriate following the experiences of September 11, 2001, and in view of the increasing effort across markets globally to secure safe, efficient and harmonized performance standards in clearance and settlement infrastructure.

The Association, therefore, respectfully urges the Commission to seek suitable amendments to GSCC's proposal – consistent with the Standards for the Registration of Clearing Agencies and other orders of the Commission that have been issued in analogous proceedings in the past – before acting on the proposal. Were the Commission to approve GSCC's proposal and permit gross negligence as a general standard for the first time, however, the Association believes it incumbent on the Commission to provide a reasoned explanation of the statutory and public policy bases for the change in fundamental policy as it applies to the National System and National System users. In addition, in the event the proposal were approved, the Association believes the Commission must ensure fair and equitable regulatory treatment of entities participating at various levels in the National System, including by revising the performance and liability standards it imposes on custodian banks under rules the Commission administers pursuant to the Investment Company Act of 1940. It is difficult to see any justifiable regulatory or public policy basis for permitting substantial disparities in performance standards; and the resulting liability gap creates unnecessary risk, unpredictability and investor confusion.

Association Comments

1. **Registered clearing agencies should be subject to the high standard of care expected in safeguarding investor funds and securities and in performing processing obligations relating to "custody functions," as the Commission has broadly defined that phrase.** The high standards historically required of clearing agencies pursuant to Section 17A of the Securities Exchange Act of 1934 were summarized initially in the Standards for the Registration of Clearing Agencies announced by the Commission on June 17, 1980, and they have been reiterated periodically since then.[3] Although the Commission has declined to impose strict liability on clearing agencies and has not attempted to create a single uniform federal standard, neither has it permitted registered clearing agencies that provide a broad range of services -- whether custodial depositories or netting and settlement agencies -- to employ gross negligence as the performance standard and liability trigger. Instead, it has pointed to ordinary care and negligence as the appropriate tests in view of the statutory requirements under Section 17A.[4] In addition, the Commission has not permitted registered clearing agencies, as GSCC proposes, to generally disclaim liability absent gross negligence, for the acts of sub-custodians or other agents that the clearing agency uses and on which participants and indirect users must depend.[5]

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[3] Regulation of Clearing Agencies, Securities Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980) ("Standards Release"); Order Granting Full Registration as Clearing Agencies, Securities Exchange Act Release No. 20221 (September 23, 1983), 48 FR 45167 (October 3, 1983); Intermarket Clearing Corporation – Order Granting Temporary Registration as a Clearing Agency, Securities Exchange Act Release No. 26154 (October 3, 1988), 53 FR 39556 (October 7, 1988); Emerging Markets Clearing Corporation ("EMCC") – Order Granting Temporary Registration as a Clearing Agency, Securities Exchange Act Release No. 39661 (February 13, 1998), 63 FR 8711 (February 20, 1998).

[4] As stated in the Standards Release, "The rules of a clearing agency should also provide that it is liable to a participant for the failure to deliver the participant's securities resulting from: (i) the negligence or misconduct of the clearing agency, the clearing agency's sub-custodian or agent, or any of their respective agents or employees * * *." Standards Release at 63. More recently, the Commission again emphasized the high standard of care expected in the operation of a clearing agency, "[s]ubsequent to issuance of the Standards Release, the Commission has stated that clearing agencies should perform their functions under a high standard of care and that at a minimum custody functions should be performed under an ordinary negligence standard. The Commission has also stated that custody functions include all functions related to transaction processing and the safekeeping of customer funds and securities." EMCC - Order Granting Temporary Registration as a Clearing Agency at 59. Early Commission releases addressing GSCC's gross negligence standard of care as set forth at its outset emphasized the temporary nature of that standard in view of the limited activities in which GSCC was involved at the time. ("GSCC plans to offer comparison services under a gross negligence standard of care. The Commission believes that this standard of care is consistent with the Act and earlier interpretations of Section 17A concerning non-custodial clearing agency functions. * * * Nevertheless, the Commission is concerned that GSCC's failure to perform accurately and timely the comparison service could affect adversely the ability of GSCC members to deliver securities and effect trade settlements. Considering the size of the Government Securities market and the next-day time frame for trade settlements, the Commission believes it is appropriate for GSCC to undertake, in the near future, an ordinary negligence standard of care in performing all functions affecting member settlements of Government Securities." GSCC – Order Granting Temporary Registration as a Clearing Agency, Securities Exchange Release No. 25740 (May 24, 1988), 53 FR 19839 (May 31, 1988) at 25-27 (emphasis added)).

Any departure from the negligence standard generally expected of registered clearing agencies should be based on a record demonstrating clearly that a lower standard at the clearing agency level is consistent with all statutory and National System standards and requirements, including the protection of investors and safe and efficient securities processing. The Association, however, sees no basis in the current record or relevant commercial practice for a change in the general clearing agency standard the Commission has required. GSCC's services, like those reviewed by the Commission in the EMCC registration proceeding,[6] encompass "custody functions" as the Commission has used that term – i.e., "all functions related to transaction processing and the safekeeping of customer funds and securities."[7] Indeed, as the Commission staff previously recognized, GSCC acts as a "securities depository" for purposes of Rule 17f-4 under the Investment Company Act of 1940, enabling registered investment companies to enter into general collateral repos with dealers using the interbank mechanism integral to GSCC's GCF Repo Service.[8] Today, GSCC provides, among other services, obligation netting services, repo services, and obligation settlement and fail management services, including effecting deliveries of government securities to and from GSCC members through designated banks and Fedwire facilities. These services are all central to transaction processing and the safekeeping of funds and securities. Given the broad range of transaction processing and custodial functions in which GSCC engages, GSCC – like EMCC – should be subject to the reasonable care standard expected of a critical infrastructure utility. [9] In addition, in Association members' experience, commercial agreements used by securities intermediaries today for clearance and settlement services encompassing custody functions typically – though not universally – incorporate a negligence standard, not a lesser standard.

Any change permitted in the negligence standard historically required – as reiterated recently in the EMCC Order -- should take into account the precedential effect of such a change on the National System infrastructure, other registered clearing agencies, securities

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5 See the Commission's statement in the Standards Release as quoted in footnote 4, supra.

6 EMCC – Notice of Filing of Application for Registration as a Clearing Agency, Securities Exchange Release No. 38810 (July 1, 1997), 62 FR 37093 (July 10, 1997) and EMCC – Order Granting Temporary Registration as a Clearing Agency.

7 EMCC – Order Granting Temporary Registration as a Clearing Agency at 59.

8 See GSCC No-Action Letter, 2001 SEC No-Act. LEXIS 764 (Oct. 19, 2001).

9 The Association believes that a negligence standard is also the appropriate general standard for exempt clearing entities, such as OMGEO, that provide essential facility services to National System users. To the extent that the Commission in the past permitted any limited-purpose exempt clearing entities to employ a gross negligence standard of care - see Release Nos. 26154 (ICC) and 25740 (GSCC) in notes 3 and 4 supra - the Commission should reassess the appropriateness of those standards for today's clearance and settlement environment and in any case not extend low standards to other clearing contexts.

intermediaries using GSCC facilities to process and complete transactions, and custodian banks, which are subject to securities processing regulation under multiple statutes that the Commission administers. Were a shift to gross negligence permitted for GSCC, what principles consistent with Section 17A could the Commission apply to preclude the use of that standard by securities depositories or other clearing agencies that deliver a wide array of securities handling services to National System participants? In addition, beyond Section 17A, a relaxation of the general standard of care expected of clearing agencies seems particularly inappropriate following the events of September 11, 2001 and the lessons those events provided for the securities market infrastructure. In this regard, how can a relaxation of standards for National System facilities be reconciled with the expectations for increased systemic reliability and rigor called for in the Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System?[10] Finally, as discussed below, from a systemic standpoint, how can the Commission reconcile a low performance standard for central and essential facilities in the National System with the high standard required of custodian banks, securities depositories, and clearing corporations under Rules 17f-4, 17f–5, and 17f–7 of the Investment Company Act of 1940?

2. **Registered clearing agencies like GSCC that provide the securities markets and the securities processing community with centralized "essential utility" services and that become focal points for concentrated risk should meet at least the same standard of care that is required of commercial custodians under Commission rules designed to protect investors.** Under rules the Commission has adopted pursuant to Section 17(f) of the Investment Company Act, a fund's global custodian, in effect, must provide securities intermediary services to registered investment companies at a performance level no lower than reasonable care. Even under the most recent iteration of Rule 17f-4 -- applicable to the processing of investment company assets by domestic registered clearing agencies -- an investment company's custodian and any intermediary custodian is obligated at a minimum "to exercise due care in accordance with reasonable commercial standards."[11] It is difficult to see how the Commission can rationalize the use of a "reasonable care" standard in the interest of investor protection and

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[10] Securities Exchange Act Release No. 46432 (Aug. 29, 2002), 67 FR 56835 (September 5, 2002) ("Interagency Report"). The Interagency Report, issued in part by the Commission, noted that "core clearing and settlement organizations represent potential single points of failure in the financial system and therefore have *the greatest responsibility* for ensuring that they can recover and fully resume those activities in a timely manner." Interagency Report at 56839 (emphasis added).

[11] Rule 17f-4 as revised in Investment Company Act Release No. 25934 (February 13, 2003), 68 FR 8438 (February 20, 2003) (effective date March 28, 2003). Under revised Rule 17f-4, reasonable care is also required of any registered clearing agency that maintains financial assets of a registered investment company directly. GSCC's rules continue to permit registered investment companies to become members, and it would appear that approval of GSCC's proposed standard of care might disable that class of participants from using GSCC for securities intermediary services consistent with Rule 17f-4.

safeguarding of funds and securities at the custodian level, while tolerating a lesser standard for a central National System utility on which the general securities processing community is dependent. In the event the Commission approves GSCC's proposal, the Association believes the Commission needs to explain the statutory, regulatory and public policy bases for maintaining a disparity in performance standards at different service levels in the interdependent processing chain. It would seem that any relaxation in performance standards at the clearing agency level should be accompanied by a compensating change in the rules binding custodians and other intermediaries under the Investment Company Act.

In making its determination regarding GSCC's rule change, the Association also believes that the Commission should carefully consider the "global context" implications of Commission decisions that distinguish standards under the Exchange Act from those established under the securities processing sections of the Investment Company Act. How can the Commission promote harmonization of standards and formation of high standards globally if it requires a reasonable safeguards standard in connection with use of foreign clearing systems by U.S. registered investment companies as well as a reasonable care standard for custodians servicing the investment companies' use of foreign clearing systems, pursuant to Investment Company Act Rules 17f-5 and 17f-7, while permitting U.S. registered clearing agencies that service securities intermediaries and their investor-customers domestically to slip to gross negligence? As the Commission knows well, actions taken and standards set in U.S. markets frequently provide the basis for actions and standards in non-U.S. markets. As a result, approval of this rule change may well be seen as signaling the Commission's approval of a new, lower standard for the core elements of the U.S. clearance and settlement infrastructure – and a standard that is not consistent with those set by the Commission for non-U.S. depositories under the Investment Company Act of 1940. The recent Report of the Group of Thirty on Global Clearing and Settlement noted that inconsistent regulatory underpinnings make clearance and settlement networks inefficient and potentially unreliable for cross-border transacting, and the report recognized that regulatory decisions that advance localized incentives do not facilitate best practices globally.[12]

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[12] See "Global Clearing and Settlement: A Plan of Action," The Group of Thirty (January 23, 2003) ("Report"). In particular, see Recommendation 20 - Encourage Consistent Regulation and Oversight of Securities Clearing and Settlement Service Providers, which notes that, "* * * any inconsistencies in regulation and oversight between jurisdictions traversed by a cross-border trade may lead to ambiguity about which standards should apply and therefore to a greater risk of noncompliance." Report at 123. Similarly, Recommendation 20 states that, "Variation in regulation and oversight approaches can affect the risk management and financial and liquidity requirements of supervised organizations, which can in turn affect the competitive positions of those organizations, as well as the overall safety of connected systems." Report at 124.

3. **Permitting registered clearing agencies that are central facilities in the National System to conform their conduct to gross negligence while requiring bank custodians to adhere to a higher standard of care creates a liability differential for which no appropriate statutory or policy basis exists.** Such a differential would produce an uneven field among processors, would promote different operational quality at the clearing agency level as compared to the custodian level, would promote a relaxation of contractual standards and a related reduction in performance quality among securities processors, and would shift liability risk for clearing agency errors to investors. [13] Those consequences seem inconsistent with the characteristics of the National System as outlined in Section 17A, inconsistent with the uniformity in performance standards required of securities intermediaries and clearing agencies under the Investment Company Act Rules referenced above, inconsistent with the increased rigor expected of infrastructure entities following September 11, 2001, and inconsistent with the recommendations being promoted for safe and efficient clearance and settlement globally.

In addition, under a guiding principle like the one GSCC's filing proposes, if the clearing agency's action or inaction produces a loss or delay where the loss is not attributable directly to its gross negligence, it might be anticipated that National System participants, including custodians, would absorb the losses without being able to seek reimbursement from the central National System service provider or its outsourced suppliers that caused the loss. Such risk-shifting, if adopted generally in the National System, would obviously affect costs and risks for intermediaries -- and investors -- , perhaps in material ways. Association members believe that such a general disparity in standards of care and accompanying changes in risk and liability management would be difficult for institutional investors to understand and evaluate and would create an undesirable structural characteristic for U.S. institutional markets.

* * *

[13] Custodians, generally, do not assume contractual liability for losses caused by third parties, including clearing agencies. Accordingly, a shift in the standard of care at the clearing agency level generally, and the resulting shift in liability risk, will mean either that investors assume the incremental risks or that they incur increased costs for intermediary services. (If incremental risks are assumed by intermediaries, it is likely that intermediary fees will have to increase.) If the Commission approves GSCC's rule change, it should clarify that the new risks are not necessarily to be borne by intermediaries and should inform public investors of the increased risks and/or costs that may well accompany a decrease in the general clearing agency standard of care.

We appreciate the opportunity to comment on the proposed rule change and those policy considerations the Association considers important to clearance and settlement processing. If you would like to discuss the foregoing comments, please contact the undersigned at 312/861-2620.

Respectfully submitted,

Dan W. Schneider,
by Margaret R. Blake, attorney

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