THE ASSOCIATION OF GLOBAL CUSTODIANS

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October 1, 2003

Mr. Jean-Michel Godeffroy
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Payment Systems
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Mr. Eddy Wymeersch
Chairman
Banking and Finance Commission
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Re: Request for Comment on Consultative Report -- Standards for Securities Clearing and Settlement Systems in the European Union

Dear Messrs Godeffroy and Wymeersch:

This letter is submitted on behalf of the Association of Global Custodians ("Association") in response to the request for comments regarding documents entitled, "Standards for securities clearing and settlement systems in the European Union" ("Standards Report") and "The scope of application of the ESCB-CESR standards" ("Scope Statement"), prepared by the European System of Central Banks and the Committee of European Securities Regulators (together "ESCB-CESR"), dated August 1, 2003.

This letter provides the Association's preliminary comments on the Standards Report and Scope Statement, and sets forth the Association's overall position on these documents. We prepared this document in anticipation of the ESCB-CESR open

hearing scheduled for October 2, 2003 in Paris and intend to provide a more detailed document with comments on each of the 19 Standards set forth in the Standards Report ("Standards") before the October 31, 2003 comment deadline.

The Association is an informal group of ten banks with extensive European branches and affiliates that provide global custody services to cross-border institutional investors, including pension funds and investment companies. The members of the Association are listed on the letterhead above. Through members' European branches and affiliates, or through members' use of agent banks in Europe acting as subcustodians, Association members safekeep substantial positions in securities of European companies on behalf of their European and global institutional client base.[1/] Given the extensive role Association members play in European markets, the Association wishes to provide its comments on the Standards Report and the Scope Statement.

Introduction and Summary of Main Comments

Association members provide their institutional clients with an array of competitive commercial services related to the safekeeping function, including asset servicing and value-added services. At its core, safekeeping involves the receipt or delivery of securities by a custodian on behalf of its client, usually against a corresponding delivery or receipt of cash. Virtually all of these receipts and deliveries of securities occur by transfer of securities on the books of central depository facilities that market participants must use. Indeed, these central depository facilities are essential to markets and market participants; and in that role, the central securities depositories ("CSDs") and the international central securities depositories ("ICSDs") constitute infrastructure utilities.

Custodian safekeeping functions for institutional investors are thus fundamentally different in function and character from the clearing and settlement activities performed by the infrastructure utilities serving the market. These fundamental differences are reflected in the array of regulations specifically addressed

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1/ As reported in the Buttonwood Global Custody Yearbook 2002, the 10 member banks of the Association safe keep, in the aggregate, securities assets valued at approximately US$35 trillion.

to the commercial custodian function as compared to the essential facility function of infrastructure utilities.

The Association accordingly believes it paramount that the ESCB-CESR sharply differentiate the roles and functions of custodians as compared to infrastructure utilities in developing its standards and in giving focus and direction to the prospective regulatory effort. In our view, the scope of the ESCB-CESR Standards should be addressed to CSDs, ICSDs and CCPs, as infrastructure utilities essential to markets and to clearing and settlement operations in the European Union ("EU"). The Standards should not encompass custodians -- of any size -- as if they are infrastructure utilities, operating "systemically important systems". Although custodians act as safekeeping agents to institutional investors, some institutional investors choose to provide their own safekeeping services. For obvious reasons, the Standards do not treat such investors as utilities or clearing and settlement "systems". For similar reasons, custodians -- of any size -- should not be included in the Standards as if they play an infrastructure role or operate systemically important systems.

In this regard, we note that the Standards Report and the Scope Statement draw on concepts used in the CPSS/IOSCO recommendations document, the Group of Thirty ("G-30") report on Global Clearing and Settlement, and the U.S. Interagency Paper on market resilience.[2/] Each of these earlier documents on which the ESCB-CESR relies, however, had critically different goals, and scopes of coverage reflecting these different goals. The combination in the Standards Report and Scope Statement of concepts drawn from those disparate documents produces a result suggesting that the ESCB-CESR envisions a radical reconfiguration of the roles of participants in the securities

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[2/] When the CPSS/IOSCO report was first issued, Association members supported its recommendations for securities settlement systems. (Letter, dated April 30, 2001, to the Secretariat to the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, from the Association of Global Custodians, Re: "Recommendations for Securities Settlement Systems," CPSS/IOSCO Consultative Report (January 2001)). Similarly, individual members expressed support for the objectives of the U.S. Interagency Paper -- "US Interagency Paper on Sound Practices to Strengthen the Resilience of the US Financial System" (April 7, 2003) ("US Interagency Paper"), and provided recommendations (which were adopted) on how to better achieve those objectives.

markets. Such a sharp reconfiguration would implicate fundamental principles of market regulation and governance, and we do not believe that the ESCB-CESR intends such radical change.

Until recently, CSDs and ICSDs 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. It is apparent that some of these utilities seek to expand from their central infrastructure position into the arena of commercial intermediaries.[3/] This 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. We would anticipate that -- if it is the intention of the ESCB-CESR to accept this expansion -- the Standards would address the terms and conditions appropriate to such expansion and would include a careful assessment of the effects on market structure and systemic risk that such expansion necessarily introduces.

Finally, we think it would be useful to the ESCB-CESR Working Group to have broad representative expert advice on these matters, including expert input from custodians active in Europe. The Association would like to offer its assistance to the ESCB-CESR in developing the Standards. In particular, Association representatives would be pleased to participate as expert advisors.

[3/] The desire of these utilities to expand into the arena of commercial intermediaries could be compared to the hypothetical desire of a stock exchange seeking to provide investment advisory services. In that case, one would expect that the exchange would be required to operate as an investment adviser in accordance with the full range of regulations applicable to investment advisers. One would not expect that, instead, all investment advisers would become subject to the rules and regulations applicable to the stock exchange. Indeed, such an outcome would not only seem anomalous, but would provide the exchange with immediate regulatory advantages that could be leveraged to competitive advantage. In our view, the Standards Report, by equating custodians with infrastructure utilities, and potentially subjecting custodians to regulation as "systemically important systems", in effect would produce such a result.

In summary, in our view the Standards Report does not set out a public policy basis for treating commercial custodians – sizeable or otherwise -- like infrastructure utilities or for subjecting custodian banks to additional regulation.

General Comments

The Association supports the ESCB-CESR goal of safety and soundness in clearance and settlement of securities transactions in the EU.[4/] The Association recognizes the importance of such initiatives, including the CPSS/IOSCO, G-30 and Giovannini initiatives. While Association members favor the proposed coordination of settlement activity and regulation of those entities engaged in such activity in the EU, members also believe that it is inappropriate to include custodians within the scope of the Standards and especially by placing them on the same regulatory footing as CSDs and ICSDs.

While the Standards make sense in the context of the functions performed and role played by infrastructure utilities, they do not make sense when applied to the functional and commercial context of custodians. Custodian banks fill functionally different roles and provide different services to clients in the settlement process than do market-servicing CDSs, ICSDs and CCPs. Regulation of these various entities, in Europe as elsewhere, should take into account these functional differences and consider the existing regulatory regimes and risk-management controls applicable to each. Custodians -- by virtue of being financial institutions and commercial entities -- already operate in a highly-regulated environment, subject to the pressures of a competitive commercial setting.

The Association appreciates the difficulties the ESCB-CESR faces in determining the scope of application of the Standards, and fully concurs in the ESCB-CESR's declaration in the Scope Statement that regulatory standards must be carefully differentiated depending on the function of the entity type in question. In the Association's view, however, the designation of custodians as "systemically important

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4/ The Association previously set forth its view in a letter, dated May 23, 2002, to Christoph Crüwell (CESR) and Elias Kazarian (European Central Bank) in response to the ESCB-CESR March 15, 2002 joint paper on clearing and settlement. A copy of the Association's comment letter is attached.

systems" or "dominant" providers of settlement services misstates the role of custodians. Regulating any custodians based on such a misperception would not advance the ESCB-CESR's stated objective of creating harmonization in the EU clearance and settlement arena.

In this regard, for the reasons developed below, the Association believes that the criteria set forth in the Standards Report and the Scope Statement for identifying "systemically important" or "dominant" custodians would lead to regulation of intermediaries as infrastructure utilities – a wholly inappropriate result in our view. The Association believes that the use of the concepts of "systemically important systems" and "dominant provider" cannot be employed relative to custodians in the ways alluded to in the Standards. Instead, we believe that virtually all the Standards should be addressed exclusively to CSDs, ICSDs, and CCPs.

Request for Comment on the Scope Statement

The Scope Statement sets out criteria purporting to differentiate among custodians based largely on the size of a custodian's client base. The Scope Statement requests comment on these criteria and the terminology and definitions relied upon in the Standards. In particular, Item 11 of the Scope Statement - Issues to be addressed - requests responses to specific questions relevant to the application of the Standards to custodians deemed to be "systemically important systems" or "dominant".

Below, we discuss the proposed criteria and terminology and the questions they raise in principle. We may supplement these comments and address the specific questions set out in the Scope Statement in a subsequent letter. Please understand that these comments are offered on the fundamental premise that the Standards should not apply to custodians.

A. Reliance on the US Interagency Paper as a Source of the Terminology

The Scope Statement refers to the US Interagency Paper as the source of the definition of sizeable custodians as "systemically important" and indicates that the special treatment of such custodians proposed in the Standards is based on the US "example".

The US Interagency Paper, however, had a relatively narrow focus, addressing the business continuity and disaster recovery needs apparent following the September 11, 2001 experiences in US financial markets. The US Interagency Paper focused exclusively on various staffing, capacity, and back-up arrangements appropriate to "core clearing and settlement organizations" and "firms that play significant roles in critical financial markets", including sizable intermediaries and custodians, so as to "minimize the immediate systemic effects of a wide-scale disruption on critical financial markets". The US Interagency Paper did not suggest that those concepts should be used for broad regulatory purposes in setting general requirements and standards regarding legal framework, corporate governance, financial safety and soundness, access, and transparency, for example, all of which are currently subject to extensive oversight by various regulators of financial institutions.

In contrast, the Standards encompass a wide range of clearance and settlement topics, and identify many potential areas in which a one-size-fits-all approach would be applied both to the quasi-public infrastructure utilities and equally to private sector intermediaries. Because the Standards do not focus the use of the "systemically important" concept on the disaster recovery context, the Standards would extend far beyond the US Interagency Paper. Only one of the more than ten Standards that would be applied to "systemically important custodians" -- Standard 11, Operational Reliability -- deals with wide-scale disruption and recovery matters. All other Standards address various aspects of market structure or clearance and settlement activities generally.

In our view, the one-size-fits-all approach is not workable. Infrastructure utilities perform centralized clearance and settlement functions for the markets and for the intermediary community on an essentially compulsory basis subject to non-negotiable terms, while private sector intermediaries provide heavily-negotiated commercial services to market investors in a highly competitive business context. These fundamental differences have historically led to differing regulatory regimes for each entity type that are tailored to the differing functions and roles. We do not see a basis today in European markets -- or elsewhere -- for reconfiguring the existing set of regulatory paradigms.

In addition, other significant European and global initiatives addressing the issue of clearance and settlement in the EU have not proposed treating custodians as systemically important systems (e.g., Giovannini, CPSS/IOSCO and G-30), but instead have focused primarily on business continuity across all entities involved in the clearing

process. As noted throughout these comments, banks are already subject to significant regulation both through jurisdictional laws as well as other function-specific initiatives (e.g., the Basle II Accords impose risk-based, carefully-calibrated capital adequacy standards on banks). The Association believes that additional regulation of banks as custodians (e.g., through the proposed Standards) is neither practicable nor needed in the current market environment. In sum, we see no basis in the US Interagency Paper to support the broad reach of the Standards.

B. Shortcomings of Size-Based Definitions and Use of Utility Terminology

The Standards Report does not connect the concept of "systemically important custodian" to any particular function custodians perform, or to any assessment of particular risks that custodians or custodian activities present to markets or customers; nor does the Standards Report connect perceived risks to identified shortcomings in existing regulations and control regimes applicable to custodian banks. The Standards thus encourage the adoption of special regulations for those custodians that meet a size test without identifying a regulatory need for the special treatment. Such a number-based definition is not risk-based and would contribute to uncertainty and arbitrary results in applying the recommendations. Finally, reliance on such a designation would lead to vagueness in the application of the Standards and would mask critical distinctions between intermediary custodians as compared to infrastructure utilities.

Custodians provide commercial services in dynamic, competitive markets. As a result, we believe it would be difficult for European regulators to use the Standards to develop rules specific to "sizable" custodians that would be both fair and workable -- particularly rules addressing Standards involving collateralization and special customer credit criteria or activity limits. In addition, use of size-based definitional categories for policy purposes seems out of sync with risk-based capital requirements already imposed on banking institutions, including custodians, and out of step with the commercial need for flexibility in custodians' internal controls and risk-management decisions.

In addition to these shortcomings, we think that the Standards, which are based on CPSS/IOSCO recommendations originally addressed to ICSDS and CSDs, lack sufficient focus and detail in relation to "systemically important custodians" to establish a meaningful basis for additional regulation of the intermediary commercial functions of custodians. It is not clear, for example, what adjustments in regulatory approach or

rules should be made for which type of organization, or even why as a policy matter infrastructure utilities are compared to intermediaries (whether systemically important or not).

It may be that some primarily European-based agent banks have clients which, on an incidental basis, need to transfer securities between themselves on the agent's books. Such transfers do not occur with any frequency on the books of *global* custodians, however, and in any case the underlying transactions that trigger such transfers are not originated or executed through the agent banks *in a custodian capacity*. If this type of transaction/transfer activity underlies the special focus in the Standards on sizeable custodians, this activity should be given separate attention by the ESCB-CESR. In our view, this necessarily limited activity -- involving certain intermediaries in Europe -- does not provide a sound basis for a general inclusion of custodians in the scope of the Standards.

In each of the Standards that are addressed to ICSDs and CSDs, as well as to "systemically important custodians", the discussions contain references to such things as "system members", "rules of the settlement system", "loss-sharing arrangements among users or members", and "guarantee funds." The discussions also use the terms "access" and "transparency". Those phrases have clear meaning in relation to ICSDs and CSDs, which act as centralized user-cooperatives providing utility services to markets pursuant to a system of rules. However, none of the phrases have meaning in the context of a custodian's activities as commercial agent for institutional investor clients. Custodians do not have or use "rules" of uniform applicability to "members", and their service agreements are typically negotiated with particularity client-by-client. Custodian services are available on a competitive commercial basis, not on the restricted membership basis associated with infrastructure utilities for which open "access" requirements are necessary as a matter of public policy. Similarly, custodians are already subject to transparency requirements driven by client expectations, regulatory provisions and risk management policies, unlike infrastructure utilities that lack commercial pressures for information disclosure.

The foregoing comments also apply to any broad and differential treatment of select custodians as "dominant", based on a numerical criterion.

C. Relationship (or lack thereof) of Terminology to Actual Systemic Risk

We believe that the general treatment in the Standards of some custodians as systemically significant, or dominant, without identifying and assessing in systemic terms a particular risk that volume or value of activity presents – is inappropriate. For example, one might expect to see in the Standards Report an evaluation of how the failure of a bank custodian (sizable or not) -- as a custodian -- could generate for clients or other financial institutions risks that are not fully addressed through current bank regulatory requirements and risk-management regimens employed by banks. The Standards Report does not include such an evaluation. In our view, however, an evaluation of this nature would reaffirm that adequate and effective regulation and controls currently apply to commercial custodian activities. Custodians segregate client assets from proprietary assets and facilitate settlements on a DVP basis or in the manner the CSD or other settlement system in the market permits. As discussed in the previous section -- and unlike infrastructure clearing facilities -- custodians do not typically generate any material inter-client settlement risks.

In a competitive market, investor clients can select among a wide variety of alternative intermediary service providers; and in our experience, account transfers among intermediaries are readily accomplished whenever needed. One of the key functions of the infrastructure settlement utilities -- the CSDs and ICSDs -- is to act as a back-stop to the settlement community, by measuring collective risk and 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. To the extent the ESCB-CESR sees weaknesses in account transfer procedures or insolvency laws that affect the integrity of clearance and settlement, the Standards should identify particular needed changes in insolvency laws and account transfer procedures across the EU. We do not see how any specific systemic improvements are introduced by equating custodians with infrastructure utilities and encouraging broad regulation of "sizable" custodians.

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The Association appreciates the opportunity to comment on the Standards Report and Scope Statement and looks forward to providing more detailed commentary on the 19 Standards. Members of the Association would be grateful for the opportunity to meet with members of the ESCB-CESR Working Group to provide consultation in

further development of the Standards and in particular, to serve as expert advisers. If you have questions or comments, please contact either of the undersigned.

Sincerely,

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Sincerely,

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cc: Mr. Wim Moeliker (CESR)
Mr. Elias Kazarian (ECB)

Attachment -- Letter, dated May 23, 2002, to Christoph Crüwell (CESR) and Elias Kazarian (European Central Bank), Re: the ESCB-CESR March 15, 2002 joint paper ("Joint Consultation Paper") on clearing and settlement.

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THE ASSOCIATION OF GLOBAL CUSTODIANS

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May 23, 2002

BY AIR COURIER AND E-MAIL

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RE: Joint Work of the European System of Central Banks and the Committee of European Securities Regulators in the Field of Clearing and Settlement

Dear Messrs. Crüwell and Kazarian:

The Association of Global Custodians (the "Association")[1] appreciates the opportunity to respond to the request of the Committee of European Securities Regulators and the European System of Central Banks (together "the Group") for

1/ The Association of Global Custodians is an informal association of nine banks that are major providers of cross-border custody services to institutional investors. The members of the Association are The Bank of New York, Brown Brothers Harriman, Citibank, N.A., Deutsche Bank Trust Company Americas, Investors Bank & Trust Company, JPMorgan Chase Bank, Mellon Trust/Boston Safe Deposit & Trust Company, Northern Trust Company, and State Street Bank and Trust Company.

comments on the Group's March 15, 2002 joint paper ("Joint Consultation Paper") on clearing and settlement. The Association welcomes the determination of the European Union to address the continued fragmentation of the European financial markets resulting from disparate legal frameworks, dissimilar clearing and settlement systems, and varying rights of access to those systems. Initiatives such as the project the Group has undertaken are key to enhancing the efficiency and integration of the European capital markets and to strengthening Europe's role in the international financial system.

The Association's comments on the specific issues raised in the Joint Consultation Paper are set forth below. The major themes of our comments are highlighted in boldface type and underscored.

Issue 2.1: Nature of the recommendations

> What should be the legal nature of the recommendations and/or standards to be issued by the Group? Are there issues for which a European legal instrument is deemed appropriate? Are there recommendations and standards that should be adopted by national law?

The Association believes that the Group's recommendations will only be effective if implemented by the adoption of a legal framework that has the force of law in each member state. The Group's recommendations and standards should be comprehensive and unambiguous. In order to accomplish this goal, fundamental legislative and regulatory reform will be necessary, although the option to implement change through new market practices should be preserved in those cases where it would be more expeditious to proceed in that fashion.

The European financial markets suffer from an absence of a uniform legal framework addressing core issues, such as supervision, share ownership rights, insolvency, and taxation. Europe also lacks consistent application of those common standards that do exist. In the past, industry organizations such as the Group of Thirty and the International Securities Services Association have succeeded in obtaining impressive support from the financial community and regulators for a set of broad standards, and such initiatives should be encouraged. Likewise, the Association supports the broad-based work of the Hague Conference on Private International Law and the joint efforts of the Committee on Payments and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions. However, the European financial markets face issues that are far more complex than can be cured by a non-binding or a piece-meal approach. For this reason, the Group's

recommendations and standards will need to have the direct force of law in each member state. This will require the use of regulations rather than directives. Variances in the manner in which the member states have historically implemented, or not implemented, directives have been an obstacle to EU securities market integration.

Issue 2.2: Addressee

> Who is the appropriate addressee of the possible standards or recommendations to be drawn up by the Group: the regulators, the systems, the operators or the users? In such cases where standards and/or recommendations are addressed neither to regulators nor to legislators, what are the appropriate incentives for their implementation and compliance?

In general, the Group's recommendations and standards should be addressed to legislators and regulators. The Group's recommendations and standards must, in the Group's own words, "overcom[e] the significant heterogeneity with the legislative frameworks of European countries." The creation of a harmonised legal framework can only occur by the action of those bodies with the power to make law. It would be futile to attempt to use non-binding recommendations or standards to achieve change in the intractable areas identified in the Joint Consultation Paper.[2]

While we believe that the end product of much of the Group's work must be changes in the law, the Association recognizes that successful integration and harmonization of the European clearance and settlement environment will also depend on harnessing commercial and competitive forces. The Group should strive to identify those changes that can be effected at a market practice level. Change that is accomplished by the alignment of market forces and regulatory goals is more efficient than change that is dependent on the legislative process.

Issue 2.3: Scope

> Do you agree that the scope of the Group's work includes any entity providing clearing and settlement services or associated aspects and is not limited to any

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2/ Similarly, removal of many of the barriers to efficient cross-border clearance and settlement identified by the Giovannini Group would require changes in the law. See The Giovanni Group, Cross-Border Clearing and Settlement Arrangements in the European Union at 44-59 (Brussels, November 2001).

particular type of service provider? More specifically, do you agree that central securities depositories (CSDs), international central securities depositories (ICSDs), CCPs, custodians and registrars are included? Do you think that some standards should apply on a differentiated basis to these parties given that the scope of their business is not directly comparable? Should standards apply to other parties? If so, which standards and to which parties? With regard to custody and safekeeping services, what are the advantages or disadvantages of a distinction being drawn between custody services, on the one hand, and clearing and settlement on the other? Do particular considerations apply where custody and safekeeping services are provided by credit institutions or investment services firms? With regard to the securities covered, do you agree that sovereign and private debt, equity and other securities, as well as depository certificates, receipts, derivatives, etc., are included, or where would differentiation be necessary? Should some standards/recommendations be specifically addressed to cross-border transactions? If so, which ones?

The scope of the Group's work should include all entities that are involved in the trade settlement process, and in the "chain of custody," including CSDs, ICSDs, central counterparties ("CCPs"), custodians, and registrars. However, the applicable standards must be carefully differentiated depending on the entity type in question. Differences in the legal status, structure, and supervision of CSDs, ICSDs, CCPs, custodians, and registrars reflect fundamental differences in the roles of each. For example --

- CSDs typically provide, either on a mandatory or optional basis, market infrastructure services with respect to specific eligible securities. Such services may include clearing and settlement, acting as central registrar, and book-entry transfer of ownership. In the case of sovereign debt, the CSD may be a governmental entity.

- ICSDs originally served as central depository facilities for "stateless" instruments that lacked a home country market. Today, however, the securities for which ICSDs play this role is a small and declining fraction of the total number of number of instruments ICSDs handle. In effect, ICSDs have begun to act as global custodians with respect to the majority of the assets they hold, and, like traditional bank global custodians, are establishing multi-jurisdictional global custody networks. Because of this changing role, we believe it is particularly

important that ICSDs be regulated based on the functions they perform, not based on the label under which they act.

- CCPs, in contrast, have a limited and specific market function. CCPs are intended to minimize counterparty risk and provide greater efficiencies in the use of capital. By their nature, CCPs are either appendages of a particular exchange or group of exchanges, or are components of the settlement mechanism for those markets.

- Traditional bank custodians are also part of the market infrastructure. Custodians typically hold, maintain, and service a wide range of customer assets, including both cash and securities, some of which may be depository-eligible and some of which may be held directly by the custodian. These services may be provided with respect to a single market or a number of markets, and may extend to accounting, corporate actions, proxy voting, and similar functions. Typically, clients use global custodians to provide centralization of their recordkeeping and accounting and to avoid the need to organize and manage interfaces with securities systems in many markets and for many instruments. The most fundamental difference between bank custodians and CSDs is that, unlike many CSDs, bank custodians are not de facto or de jure monopolies, either with respect to particular markets or with respect to particular instruments. Bank custodians are selected at the discretion of their clients and can survive only if they are able to offer clients a competitively attractive service.

As these brief points suggest, bank custodians have traditionally filled different roles and provided different services than have depositories and CCPs. Depositories have traditionally acted as components or agents of particular markets, while custodians have acted as agents of investors. It is critical that the Group tailor its recommendations to these differing functions; recommendations that seek to impose uniform requirements across entities that perform different functions under different economic and regulatory regimes will be unworkable.

Preserving the differences between bank custodians and depositories is important to controlling and assigning risk. There are two reasons why a blurring of the lines between utilities or "market agents" and investor agents increases risk. First, as ICSDs (and even some CSDs) seek to have a foot in each camp, they are taking advantage of their regulatory status as market utilities to offer

commercial services without necessarily being subject to the full panoply of legal, regulatory, and supervision requirements that apply to commercial custodians. If those requirements serve investor protection purposes, they should apply to all providers of custody service. If they serve no purpose, they should be abolished. Regulating traditional providers and deregulating those that have evolved from single market or international depositories is illogical and unfair. Further, it re-exposes market participants to the risks that regulation was designed to ameliorate.

Second, permitting CSDs and ICSDs to offer cross-border services increases risk because these entities tend to shift risk to their participants, who are also their commercial competitors. Custodians that hold assets through ICSDs bear a disproportionate amount of risk because ICSDs (and some CSDs) use their market position to disclaim this risk. These entities typically offer the services on a take-it-or-leave-it basis, and are rarely subject to the competitive checks that preclude other providers from transferring the risks of their business to those with whom they deal.

The Group's recommendations must accommodate the expectations and practices of institutions that invest globally. This requires equal focus on the role in the European market integration process of market participants that act as agents and of those that act as principals. Ultimately, the success of any market reform must be measured by its effect on the investor, particularly institutional investors. Institutional investors typically believe that their interests are best protected when there is a separation of functions between the execution of trades, the management of investments, and recordkeeping and custody of assets. We believe there is little doubt that institutional investors will continue to insist on operating in all of the markets to which they commit capital -- whether in Europe, the US, or elsewhere -- through agents, such as independent investment managers and custodians. Market infrastructure must accommodate this expectation. The role of agents is not simply one of providing "value added" services. Rather, agents constitute the key link between the market place and the institutional investor.

The Group's recommendations and standards should address "cross-border" transactions, both within the boundaries of the European Union and between the EU and other markets. The Association does not believe that it would be effective to create one framework for transactions occurring within the European Union and another for transactions that cross the borders of the EU. The harmonization of the intra-European framework should lay the groundwork for more efficient resolution of intercontinental securities market issues.

Issue 2.4: Objectives

A priori, the objectives of central banks and securities regulators in the field of securities clearing and settlement systems could be summarized as follows: 1) risk mitigation, including investor protection, for both the system and the users; 2) efficiency, including for cross-border activities; 3) creation of a level playing field between participants and service providers, irrespective of their legal status or their geographical location; 4) promotion of integration of the EU securities markets infrastructure. Do you agree? Do you consider that these objectives are sufficient?

The Association agrees that these four goals are appropriate objectives of clearing and settlement integration.[3] However, accomplishing these objectives is a long term undertaking, and a fifth objective should be pursued while that effort is underway: **The Group should also take steps to encourage interoperability among entities within the European Union (and beyond)**.

Interoperability is a first step to realizing the efficiencies and benefits of integration of the EU securities markets infrastructure. Interoperability can be achieved through efficient regulation that encourages, rather than discourages, innovation, and allows market participants to be legally structured in a way that does not interfere with co-operative initiatives. Interoperability also involves the promotion of compatible technology standards and interaction between competing parties, potentially allowing settlement systems access through a single network connection.

Issue 2.5: Access conditions

Are you aware of access conditions to specific service providers, which could be considered discriminatory? If so, where do the main problems lie? Do you consider that the present rules do/do not establish a level playing field in this respect? Do they relate to the access criteria of the system or to other conditions such as operational features? If so, which ones?

3/ We note that objective 2) refers to "cross-border activities" with respect to the objective of achieving efficiency in clearance and settlement systems. The reason for the express inclusion of cross-border activities only in 2) is unclear. The Association believes that the concept of cross-border activity should be implicit in all of the Joint Consultation paper objectives.

Open access to clearing and settlement services should be a fundamental principle of the Group's work. The Association believes that access rights must be based on objective and disclosed standards that are nondiscriminatory. Refusal of access to potential users should be justifiable only on the basis of clear, objective, and publicly-available criteria, applied uniformly to all existing and potential participants, so as not to interfere with competition. Common standards of this nature would reduce systemic settlement risk.

In addressing the issue of open access, consideration should be given to both formal barriers and more subtle forms of discrimination. In some instances, for example, geographical or operational variations operate to the detriment of some potential participants. Time zone differences may result in a disconnect between movements of cash or securities in cross border transactions that clearly favor one entity's participants over those participants of another. In other situations, inefficiencies may be preserved to the disadvantage of certain participant groups. The Group should be sensitive to these types of de facto unequal access.

Issue 2.6: Risks and weaknesses

What are the most relevant factors to risks and weaknesses in terms of clearing and settlement of domestic and cross-border transactions (i.e. legal, settlement, custody and operational risks)?

As far as legal risks are concerned, what kind of problems can different legal approaches create? When looking in particular at cross-border transactions, how does the existence of different jurisdictions and the involvement of several actors such as local agents, global custodians, foreign CSDs or ICSDs in the process of cross-border clearing and settlement affect the nature and magnitude of these risks? What would be the most appropriate manner of addressing these issues?

As far as custody activities are concerned, do you agree that the segregation of assets and the reconciliation of positions are the most crucial issues to be addressed?

As far as settlement risk is concerned, do you agree that the definition and timing of finality (including the need for intraday settlement finality), delivery versus payment, access to central bank money as settlement assets for systemically important systems and conditions of use of central bank money versus

commercial bank money are the most crucial issues to be addressed with regard to clearing and settlement of domestic transactions? What specific impact could these issues have on clearing and settlement of cross-border transactions?

Finally, as far as operational risks are concerned, what are the main factors to be considered?

Participants in the clearing and settlement system must reasonably be able to determine – in advance and with certainty – the law applicable to their transactions; their rights under that law to securities, cash, and collateral; and mechanisms available for enforcing those rights. Legal predictability would substantially reduce the risk of loss that may result from unanticipated entitlement or liability gaps between different legal jurisdictions. We believe that the absence of uniform standards across the European Union addressing systemic operational, legal, and financial risk contributes to sub-optimal shareholder and market-user protection.

The involvement of multiple entities in the clearing and settlement process is not a source of added risk; the participation of agents reduces risk in the cross-border environment. Agent participants, such as local agent banks, global custodians, and other intermediaries, play a key role in trade processing control and settlement authorization. These agents identify and manage risk points under the execution of mandates from their clients, the investors. In performing that role, agents contribute significantly to the overall safety of the system. Therefore, the roles of the different participants should be preserved to avoid excessive concentration of risk.

Segregation of client assets from agent assets is critical to asset safety, as is reconciliation of positions.[4] Client securities are separately identified on the books and records of the global custodian. Similarly, at the subcustodian level, securities held for the global custodian's clients are segregated on the books of the subcustodian from other assets which the subcustodian holds for other depositors or for its own account. As a result of these practices, client securities are not included on either the custodian's or the subcustodian's balance sheet and are not available to creditors in the event of insolvency. CSDs and ICSDs typically determine whether the participant may have one or more omnibus accounts for all client assets, or subaccounting to reflect underlying

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4/ Reconciliation is increasingly an automated function. Automation is essential to ensuring high levels of accuracy at reasonable cost.

client holdings. Virtually all ICSDs and CSDs permit or require members to segregate their own assets from client assets[5].

The Group has correctly identified the key elements of settlement risk in both cross-border and domestic transactions. DVP and settlement finality must occur in the context of a well-organized system that provides risk controls. A settlement system that handles both cash and securities is more likely to meet strict DVP, although a system which utilizes a separate cash agent for settlement would not necessarily preclude DVP. Ultimately, the objectives of a settlement system must include safety and soundness, true DVP settlement, proper controls, and settlement finality. While settlement in central bank money may be more certain, commercial bank money settlements would be equally acceptable in a robust banking system where markets are moving toward a true DVP environment.

Operational risk is dependent on the capacity of the system to handle foreseeable transaction volumes efficiently and accurately. As trading volume continues to increase, it is important that system capacity be substantial enough to comfortably accommodate such traffic. Beyond raw technological capabilities, organizational policies and procedures should be geared heavily towards a risk management framework, and towards robust stress testing of the systems, including contingency and continuity planning.

Issue 2.7: Settlement cycles

> What are the arguments for and against harmonised and/or shorter settlement cycles? It appears, for instance, that while a very short cycle could increase settlement default rates, a longer cycle could increase uncertainty and settlement risk. Is there a need to adopt different settlement cycles for different securities, such as for equities and government debt instruments, etc?

Shortening settlement cycles would have substantial benefits, provided that market participants have adequate systems in place to support shortened timeframes. While shorter settlement cycles may temporarily increase fail rates, those

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5/ Where there is a choice of account structures, factors that influence the choice may include a need to have separate per-client accounts or omnibus accounts based on tax domicile. In addition, aspects of the interaction with brokers may make it safer to choose or avoid use of individual accounts.

rates are likely to drop as market participants adapt to the new timeframes. Any residual, persistent causes of fails can then be identified and addressed systemically. Further, the exposure of market participants and investors to risk associated with outstanding trades in the event of a market disaster is less in a shorter settlement cycle environment. The dangers of an over-ambitious implementation schedule, however, are clear and potentially expensive in terms of cost and market confidence. It is also important, particularly in the cross-border environment, to coordinate acceleration of securities settlement timeframes with foreign exchange transaction timeframes.

Issue 2.8: Structural issues

> The structure of the securities clearing and settlement industry in Europe has been hotly debated recently. An integrated market can be achieved via a number of routes, with concentration, interoperability and open access being the most obvious alternatives. What are the arguments, if any, for a public policy intervention relating to (i) centralised or decentralised structures for infrastructure and service providers; and (ii) the governance structure of infrastructure and service providers? Are custodians, CCPs, CSDs and ICSDs to be considered as commercial firms, driven by regular competition, or should they (or some categories of these entities) be considered as utilities whether or not they operate within a monopoly environment? Does the same reasoning apply to the provider of trading services?

Many of the questions raised in this section are addressed in prior responses. The Association is, of course, aware of the contrasting approaches of the "horizontal" and the "vertical" schools of thought. In the short term, such differences will continue to exist, and custodians must therefore be prepared to deal with a variety of approaches.

To the extent utilities are created to centralize specific market functions, such utilities should be user-owned and governed. In general, we do not believe that the markets or the user community have fully understood the ramifications of "for-profit" market utilities. Such entities would, by definition, be responsive primarily to shareholder pressures, rather than to the needs of users and investors. This is not to say that a user-owned utility cannot or should not act aggressively or ambitiously in service expansion. However, the returns that would be of paramount importance to

user-owners would be measured in terms of quality and costs of service, not levels of dividends paid on share ownership interests.[6]

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Finally, we note that the Group is considering the possible adaptation of the CPSS/IOSCO "Recommendations for Securities Settlement Systems" to the European environment. The work of CPSS/IOSCO has been instrumental in identifying and shaping core principles for the securities market. However, we believe that the Group should also take into consideration the results of other initiatives in this area. Those initiatives include the "Recommendations 2000" published by the International Securities Services Association, and the expected report of the Group of Thirty. These groups address securities settlement systems from a variety of perspectives, and both have had the advantage of broad industry input, including by many members of the Association. In the case of the Group of Thirty, of course, there was also very significant regulatory participation.

The Association appreciates the opportunity to comment on the issues raised in the Joint Consultation Paper. If you have any questions concerning this letter, please contact the undersigned at 202/452-7013.

Sincerely,

Daniel L. Goelzer
Counsel to the Association

6/ In contrast, bank custodians, as discussed above, are not utilities. Custodians are private, non-monopoly service providers that compete for clients by providing service levels that investors require. Unlike market utilities, bank custodians do not seek to serve the needs of all participants in the market.