

## THE ASSOCIATION OF GLOBAL CUSTODIANS

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May 25, 2004

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### **Re: Revised ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union**

Dear Sirs:

The Association of Global Custodians (the "Association") has submitted several comment letters to the European System of Central Banks and the Committee of European Securities Regulators (together, "ESCB-CESR") in respect of the "Standards for securities clearing and settlement systems in the European Union" (the "Standards"), dated August 1, 2003 and the ensuing schedule for revisions thereto.<sup>1</sup> Association

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<sup>1</sup> Letters, dated October 1, 2003 and October 31, 2003, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank and Eddy Wymeersch, Chairman, Banking and Finance Commission, 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 Elias Kazarian, Secretariat, European Central Bank, letter, dated February 23, 2004, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank, letter, dated April 16, 2004, to Jean-Michel Godeffroy, Director General, Payment Systems, European Central Bank and Eddy Wymeersch, Chairman, Banking and Finance Commission, and letter dated May 17, 2004, to Arthur Docters van Leeuwen, regarding procedural and scheduling issues associated with revisions to the Standards.

Jean-Michel Godeffroy

Eddy Wymeersch

May 25, 2004

Page 2

letters have addressed matters of substantive importance and complexity as well as procedural issues, including the need to ensure representative consultative processes and suitable timeframes for analysis and comment.

The Association appreciates the ESCB-CESR Joint Working Group's progress in acknowledging the differing roles that different types of market participants play in the investment chain and settlement processes. In particular, the Working Group in certain segments of the report expressly delineates between the core infrastructure and public-service role that CSDs perform for markets and issuers as centralized clearance, settlement and transfer facilities, as compared to the safekeeping, administrative and value-added intermediary service role that custodians play for institutional and private investors in a competitive commercial context. We commend ESCB-CESR and the Working Group for its clarification efforts and for the progress that has been made.

Below we set out a brief statement of our views in respect of the extensively-revised Standards for Clearing and Settlement Systems in the European Union, issued on May 5, 2004 (the "Revised Standards") and the abbreviated hearing and assessment schedule identified in the ESCB-CESR Announcement which accompanied the Revised Standards document. Thereafter, we include point-by-point comments on Paragraph 14 of the Revised Standards report, which attempts to describe a new term, "Custodians that Operate Systemically Important Systems," and brief comments on aspects of the new Glossary. We anticipate providing ESCB-CESR with extensive comments addressing the Revised Standards when our full review and assessment is completed sometime subsequent to ESCB-CESR's May 25 hearing.

**I. Brief Summary of Views and Recommendations Concerning the Revised Standards and the Apparent ESCB-CESR Schedule to Finalize and Adopt the Standards.**

A. The Association urges ESCB-CESR to exclude custodians from the scope of the Standards and to limit the scope of the Standards -- at least at this time -- to infrastructure entities, i.e., CCPs, ICSDs and CSDs. Narrowing the scope of the Revised Standards at this time would concentrate the Standards -- *as they should be* -- on infrastructure entities and on the risks associated with such entities' facilities, systems and expansion plans. Such a narrowing would enable ESCB-CESR subsequently to give more focused attention, on a more consultative timetable, to any principles that may be suitable to intermediary issues. An assessment of that sort could fruitfully be undertaken after the work is completed on Basle II and the relevant Communications and Directives at the European Union level are finalized. The Association would be pleased to participate with ESCB-CESR in such a separate consultation.

Jean-Michel Godeffroy  
Eddy Wymeersch  
May 25, 2004  
Page 3

B. ESCB-CESR's inclusion of custodians in the scope of the Standards and the Revised Standards has stirred considerable controversy and disagreement regarding the terminology used, the conceptual and political underpinnings of the Standards, and the resulting ambiguity and misdirection in ESCB-CESR's recommendations. The controversy threatens to impair the way in which the Revised Standards and the role of ESCB-CESR will be viewed by market participants, national regulators, and the banking community going forward and unnecessarily risks harming rather than enhancing the long-term structural and competitive landscape of European markets. Moreover, as matters stand at present, the Revised Standards will provide confusing directions to national regulators and will invite discretionary inconsistencies that will lead to uneven playing fields and competitive distortions in European markets and among member states. Narrowing the scope of the Revised Standards to exclude custodians would reduce the level of opposition that now exists on the part of banking organizations and banking supervisors to ESCB-CESR's radical efforts to re-regulate banks as clearing/settlement systems and would increase the chance that implementation could proceed with safer and sounder results for the European markets.

C. The controversy surrounding inclusion of custodians in the Standards is based in large measure on the misconceptions embedded in the Standards, and in the Revised Standards, about the role and service characteristics of custodians. The misconceptions are most clearly evident in the description in the Revised Standards, Paragraph 14, of certain custodians whose operating characteristics and activity volumes may make them "systemically important systems" (with the underlying, but unsubstantiated, implication being that such operations and activity levels are currently not effectively controlled and regulated by banking supervisors). However, the misconceptions also affect the text of the Revised Standards' discussion and treatment of the functions of custodians generally as well as the differences between global custodians and local agent banks.<sup>2</sup> We note three points about these misconceptions and the confusion they engender:

- To the extent that there may be some categories of banks that have systemic significance for European financial markets, the characteristics of such banks and any additional or special risks that contribute to systemic significance for regulatory purposes have not been effectively explained. A distinct ESCB-CESR review of the sort we suggest above – and one separate from the current process – could give sharper focus and more critical assessment to the possible relationships, if any, between such banking activities and systemic risks.

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<sup>2</sup> To underscore the nature and extent of the misconceptions, we provide in Part II below detailed comments about Paragraph 14 and related implications that are carried forward from that paragraph throughout those Revised Standards that are made applicable to custodians.

Jean-Michel Godeffroy

Eddy Wymeersch

May 25, 2004

Page 4

- We believe that the misconceptions and resulting misdirections will materially confuse national regulatory authorities and banking supervisors in their efforts to implement the Revised Standards as they relate to custodians and systemic risk issues.

- Whatever may be said about systemic risks that may be associated with the size or activities of European agent banks, it is critical that the Revised Standards be amended to expressly exclude custodians from their scope.

D. The Revised Standards were released on May 5, 2004, and on the same date ESCB-CESR announced a hearing for May 25, 2004 -- only three weeks after the issuance of the lengthy, extensively rewritten Revised Standards report. The ESCB-CESR Hearing Announcement does not make it clear whether comments filed after the hearing date will be considered, and unfortunately, ESCB-CESR has not identified a closing date for receipt of comments. It is certain, however, that discussions at the hearing will reveal new arguments and considerations; and in that case, interested persons can only respond to those developments after the hearing.

Accordingly, we urge ESCB-CESR at this time to set a closing date for return of written comments and to set the closing date in the beginning of July, or later. In addition, we urge you to confirm at this time that the ESCB-CESR Working Group and the governing Board will take comments received up to the closing date into careful consideration in finalizing its Standards.

**II. The Concept of a "Custodian Operating a Systemically Important System" is Ambiguously Defined and Inaccurately Described; Custodians should not be Subject to New Regulation based on such Misconceptions, nor should they be regulated as Infrastructure Entities.**

As we noted above, the ESCB-CESR Working Group has made progress in the Revised Standards report in differentiating among types of institutions and their operating roles and positions in the European markets. Significantly in this regard, the report acknowledges the "unique" role of CSDs. Yet Paragraph 14 of the Revised Standards report reveals that the Working Group is still laboring under critical misconceptions, and these misconceptions -- carried throughout the Revised Standards -- are amplified by the use of terms as defined in the new Glossary.

The characteristics imputed in Paragraph 14 to custodian banks "that operate systemically important systems" lead to various recommendations in the Revised Standards that such custodians be treated comparably to CSDs (and presumably

Jean-Michel Godeffroy  
Eddy Wymeersch  
May 25, 2004  
Page 5

differently in unspecified ways from other banking institutions).<sup>3</sup> Surprisingly, Paragraph 14 is brief and stands as the only explanation offered by the Working Group in its 94-page document for this fundamental change in regulatory approach from the CPSS/IOSCO recommendations.

The specific points below illustrate flaws in the elements of Paragraph 14 and the underlying understanding about the actual workings of custodian activities and related market operations. (Sentences and phrases that are quoted and italicized below are directly extracted from Paragraph 14 of the Glossary.)

- Paragraph 14 states that “[c]ustodian banks (*hereafter referred to simply as custodians*) are very active in the field of clearing and settlement.” Using the Glossary definitions of the terms “clearing” and “settlement”, this statement is not correct. Custodians do not perform “*the [clearing] process of calculating the mutual obligations of market participants, usually on a net basis, for the exchange of securities and money.*” This function is undertaken by market infrastructure entities such as a clearing house, i.e., a CCP or CSD. Similarly, custodians generally do not *perform* the settlement process – “*the completion of a transaction through final transfer of securities and funds between the buyer and the seller.*” Custodians *facilitate* the completion of customer settlements of purchase transactions, and separately, sale transactions, as agent for their customers, by authorizing release and receipt of customer funds and securities, as instructed by each customer for each trade. Such receipts and deliveries incident to settlement are accomplished in most markets at or through depository facilities pursuant to depository settlement operations and conventions, and any netting or offsetting operation that may be carried out customarily occurs at the depository through its customary operations. In most markets, global custodians typically enable local sub-custodians to facilitate such settlements, though varying sub-custodian and depository conventions necessarily apply from market to market and from entity to entity.

- Paragraph 14 states that “[custodians] serve the retail and wholesale market segment, with regional and global custodian banks acting as nominees for large foreign investors.” Custodians act as agent-intermediaries for their client, not mere nominees.

- Paragraph 14 states that “some [custodians] have their own settlement infrastructure for their clients and networks of sub-custodians, allowing them to clear

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<sup>3</sup> As a related consequence, the Revised Standards lay the foundation for enabling market infrastructure CSDs to compete directly with custodian banks – and in a preferential regulatory and commercial environment that is established by ESCB/CESR rather than by market conditions.

Jean-Michel Godeffroy

Eddy Wymeersch

May 25, 2004

Page 6

*and settle transactions in-house (internal settlement) rather than having to forward them directly to the local or foreign CSDs.*" These few words appear to be the central justification offered for the Working Group's approach, yet they are laden with misconceptions and non-sequiturs, and as such, do not substantiate the conclusion. Custodians do not have or operate "settlement infrastructure" -- certainly not in any sense in which that term characterizes a CSD. Global custodians carry out their global activities through their relationships with numerous sub-custodians in numerous markets. There is no mystery to this, nor does the use of sub-custodians enable global custodians to "*settle transactions in-house.*" Indeed, customer securities are virtually always deposited with the relevant CSD as required by law or market practice; settlements always occur through facilities of third parties, reflected on the books of CSDs; crossed settlements or netted settlements do not occur at global custodians.

In our earlier comment letters, we noted that some primarily European-based agent banks may be organized and positioned to arrange settlements of investor transactions with brokers internally -- on the books and through the facilities of the bank. These settlements would occur, if at all, by chance -- where all parties involved happen to be using the same bank for the transactions; and even where chance internal settlements occur, depository-eligible securities will always be reflected on the books of the relevant depository. In any event, these activities do not occur at global custodians. Of course, customers occasionally make account adjustments even with their global custodian, which are then effected internally, but such adjustments are infrequent and are tantamount to a customer transferring cash from one account to another.

If the activities of local European agent banks are the focus of ESCB-CESR interest because of their impact in particular markets, ESCB-CESR should make it absolutely clear in the final standards that global custodians are not included in the universe of entities considered systemically important. In addition, ESCB-CESR should identify why internalization activity of local agent banks is of concern and what aspects of that activity create systemic risk that is not already addressed by regulators and overseers.

- Paragraph 14 states that "*[s]ome [custodians] have clearing and settlement activities comparable to those of national CSDs in terms of volume and value.*" This is an incorrect assertion, given the inaccuracies of the definitions as noted above. It is also fallacious to equate custodians with CSDs based on business volume given the different roles of each, and is akin to asserting that commercial banks should be treated like central banks because of the currency volumes that pass through them. Additionally, no data has been supplied that would demonstrate economically meaningful comparability for regulatory purposes between CSD settlement activities and the customer service activities of sizeable custodian banks.

Jean-Michel Godeffroy

Eddy Wymeersch

May 25, 2004

Page 7

- Paragraph 14 states that “[s]uch custodians could be described as custodians operating systemically important systems.” Which “such” custodians? Are the stated characteristics – which lack definitional precision and data support – to be applied cumulatively or in the alternative? Is it proposed that custodians that have the local capability to perform some internalized settlements should be considered systemically important even if they are relatively small banks in regional terms with few internalized settlements, or, instead, only if they are also sizeable institutions by some absolute measure? And in that case, must they be both absolutely sizeable and in control of a sizeable volume of settlements? What “activities” or “volume” levels would make a custodian systemically important? On all these points, we believe that national regulators and banking supervisors attempting to implement the Revised Standards will not be able to apply the merely suggestive descriptions in Paragraph 14.

- Paragraph 14 states that “[c]onsequently, the level of systemic risk triggered by the largest custodians may affect the entire financial market of the European Union.” Because of the misconceptions and ambiguities identified above, this conclusion is conjectural. While the Revised Standards report at Paragraphs 14 and 15 indicate that banking regulators and banking regulations will be centrally involved at the implementation stage and that implementation is to be informed by the framework established in Basle II, the Revised Standards report does not provide a reasoned basis for the type of systemic concerns or regulatory prescriptions that banking regulators are supposed to have in view during the implementation process. The report says merely that, “[f]or this reason, several standards will also be applied to custodians that operate systemically important systems. National regulators and overseers will determine whether or not a custodian operates a systemically important system by analysing whether or not disruptions in its settlement activities would have implications for the stability of the financial system.” We submit, however, that national regulators and overseers are already well armed with a full regulatory arsenal that is structured to carry out the types of assessments and remedial actions needed to ensure the stability of the market. They have been using that arsenal for years, and it is surprising to see the Working Group suggest additional regulation without identifying a specific risk associated with specific activities of custodians that is currently unsupervised or unregulated.

Standards derived from such a flawed foundation appear in effect to be addressed less to controlling custody risk and more to enabling infrastructure entities to expand their range of activities into the commercial service sector. To date, ESCB-CESR has not explained how the public interest or investor protection is served by encouraging infrastructure entities to assume greater risk. Nor has it created a framework for managing the inherent, systemic risk that would accompany consolidation of multiple public-service functions with commercial functions under the control of a few regional infrastructure organizations.

Jean-Michel Godeffroy  
Eddy Wymeersch  
May 25, 2004  
Page 8

**III. The Definitions in the Glossary differ from those used in the European Commission Communication on Clearing and Settlement. The differences should be explained or changed to conform in the final Standards report.**

It is logical that the Glossary, like the Revised Standards, is based on the CPSS-IOSCO original text. However, the European Commission Communication on Clearing and Settlement has defined some major terms quite differently (such as "clearing"), and it is important that the differences be highlighted and explained. In addition, the final standards report should note that the Communication anticipates a Framework Directive which will, as one of its main objectives, provide a sound set of definitions that is based on full consultation with affected industry participants.

It would be helpful in the future to have ESCB-CESR offer guidance on the use of definitions that appear in its final Glossary and that may be given a different meaning in the proposed Directive, and ESCB-CESR should confirm that when the Directive is finalized ESCB-CESR will undertake a revision of the Standards to ensure that common terms carry the same meaning.

In the new Glossary, many terms are broadly or imprecisely defined, which will contribute to general confusion about the Standards during implementation. In this regard, it would be useful for ESCB-CESR to consult with a representative base of market participants on this very lengthy and worthwhile list of definitions.

Also, some key terms used in the Standards should be added to the Glossary, such as *financial instrument*, *international securities*, *notary* and *notary function*.

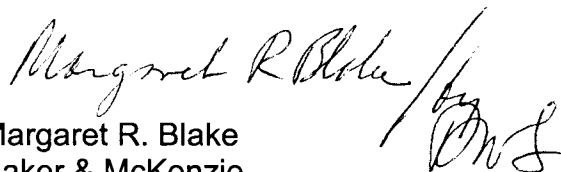
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Thank you for the opportunity again to express our views. If you have questions concerning the foregoing, please contact the undersigned.

Sincerely,



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Counsel to the Association



Margaret R. Blake  
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