

**Draft Response to CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments: Safeguarding of Clients' Assets (Article 13(7) and (8))**

This paper responds to the section of the CESR Consultation Paper in which CESR advises the European Commission on the implementing measures for Articles 13(7) and (8) of Directive 2004/39/EC (The Directive on Markets in Financial Instruments). Articles 13(7) and (8) refer to the need for an investment firm holding financial instruments and funds belonging to clients to make adequate arrangements to safeguard clients' ownership rights to financial instruments (especially in the event of the investment firm's insolvency), and clients' rights to funds, and to prevent use for the firm's own account of a client's funds (except if the firm is a credit institution) or a client's instruments (except with the express consent of the client).

The draft Level 2 advice intended to implement Articles 13(7) and (8), and the impact of the proposed requirements on global custody business, has been considered in some detail by the following entities in their capacity as custodians: The Bank of New York, Citibank, N.A., JPMorgan Chase Bank, The Northern Trust Company, and State Street Bank and Trust Company and its continental European group companies. The aggregate worldwide assets under custody held by these custodians is around EUR 28,340 billion, constituting about 60 per cent of the market.<sup>1</sup> Given the size of asset holdings involved, the custodians are concerned to ensure that the proposed requirements are appropriate to the nature of custody business, both including customer protections suitable for different types of custody clients and omitting terms which would disrupt or unduly restrict global custody services since this would not be in the interests of customers.

As a general point, as the Consultation Paper notes, national insolvency and property laws within the European Union are not harmonised. Implementing measures which are too detailed would be unworkable, and the appropriate approach is to have general requirements. In keeping with this, to minimise difficulties with implementation at a national level, it is strongly recommended that the Level 2 measures take the form of a Directive rather than Regulations in order to facilitate incorporation into local law by each member state in the manner appropriate for each such state.

The following comments consist of general issues of concern, as well as more detailed focus on the wording proposed by CESR. (References to "Sections" are to the numbered sections of the Draft Level 2 advice.)

1. **GENERAL**

- 1.1 To the extent that any changes are required to current market practices, it will be essential to have appropriate grandfathering and transitional provisions, since any changes are likely to require extensive operational changes which will take some time to put in place.

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<sup>1</sup> Based on data from [www.globalcustody.net](http://www.globalcustody.net) on 14 September 2004. The figures are historical.

Both existing agreements between custodians and clients, and existing agreements between custodians and subcustodians, must be permanently grandfathered. Such agreements will usually have been individually negotiated, and the terms are unlikely to permit unilateral amendment, therefore to make any amendment to reflect new requirements would be an extremely lengthy process. As an administrative matter, the amendment of existing documentation would be an enormous task. The numbers of agreements involved are considerable: each of the custodians contributing to this response has, at even a conservative estimate, thousands of custody agreements (in some cases over 4000) and around 100 subcustodian agreements, hence lack of grandfathering arrangements would necessitate renegotiation of thousands of custody agreements and many hundreds of subcustodian agreements for these custodians alone. We expect that the task for other custodians would be similar, therefore the impact on custody services would be immense. We do not see that amending existing mutually agreed arrangements under which the parties are already operating and with which they are familiar would be beneficial to any of the parties.

In relation to the production of agreements for new clients to reflect the new requirements, a lengthy transitional period will be essential. The creation of new standard documentation takes a long time since it is necessary to ensure that the new requirements and consequent new market standards are appropriately reflected, and to ensure that all relevant operational systems and procedures have been restructured accordingly.

- 1.2 The stated aim of Level 2 text is to require a particular outcome, rather than specifying particular arrangements, because of the differences between the various European jurisdictions. However, there are several instances where the proposed wording appears to specify a particular procedure rather than focusing on the result intended. In particular, see the discussion below in relation to Questions 5.2 (at 2.12 below), where reference to "appropriate systems and controls" is considered sufficient, without need for additional detail. In relation to Question 5.3 (see 2.14 below), the requirement of detail regarding different depository holdings will cause difficulties if the local law to which the custodian or depository is subject does not analyse holdings of assets in this way.
- 1.3 Article 13(8) requires an investment firm to make "adequate" arrangements to safeguard client assets. In order to decide what arrangements are adequate, it is essential to consider the nature and capacity of the relevant clients. In our view there must be different levels of protection for different types of client. The protections suggested in the advice are (if amended as requested) appropriate for custody services provided to retail clients, but are not necessary for professional clients and will not enhance services provided to them since such persons will be well aware of the relevant issues. It is important to put in place protections where there are real risks and protections are appropriate, but not to impose onerous requirements where such protection is not necessary. Professional clients will negotiate their preferred arrangements in order to suit the commercial context of the relevant deal. (For example, the arrangements for a commercial entity requiring custody services, or mere

safekeeping of assets without any administrative functions, as part of a securitisation would be unduly restricted if subject to the same level of protections appropriate for custody services provided to retail clients.)

There is concern that inappropriate restrictions will discourage use of custodians which are subject to European regulation, putting them at a competitive disadvantage. In order to facilitate business it is therefore regarded as very important that, where custodians are providing services to professional clients, the requirements should be disapplied or that opt outs should be available.

- 1.4 In deciding what are "adequate" arrangements, it is also important to consider what type of safeguarding service is being provided. The Level 2 advice potentially applies to the activities of any investment firm holding financial instruments or funds for another person. It will therefore apply not just to a custodian, but also to any person providing services as an escrow agent, depository, nominee, issuer of depository receipts, trustee for a unit trusts, bond trustee, trustee in a securitisation or holder of safe deposits.

Any entity which is acting as a trustee is already subject to specific requirements of trust law which protect trust beneficiaries and should not be subject to additional obligations. The requirements should therefore be disapplied for trustees.

An entity holding assets in the context of a depository receipt or bond issuance, a securitisation or other financing transaction where the parties are all institutions should not be required to comply with restrictions on subdeposit of assets (Sections 7 and 8) or specific liability requirements and risk warnings (Section 12) since the parties involved are able to negotiate such terms as required for the nature of the transaction. To impose restrictions would unnecessarily restrict commercial operations.

- 1.5 The use of the general term "depository" to refer to any third party with whom a custodian holds client assets is not appropriate. As defined, a depository may be a national or international settlement system, a nominee, or some other entity. It is unworkable to impose the same requirements for use of a nominee as for use of a settlement system, since it is typically not possible for a custodian to exercise any choice in the selection of a settlement system (use of a particular settlement system will in effect in most cases be mandatory, based on the actual or practical market requirements for a given instrument, and is driven by trading decisions of the client). Therefore, for example, the custodian's ability to control, supervise or obtain information from a settlement system will be very different from its abilities in relation to a nominee. This is particularly significant in relation to liability of a custodian for depositories (see further discussion at 2.17 below).
- 1.6 The general approach of the draft advice assumes that an investment firm imposes its own custody terms on the client. In practice, it is not unusual for major clients to insist on using their own agreements, or specific terms, when using custodians. In such cases, a custodian faces a conflict and therefore should be permitted to opt out of these

requirements to the extent there is a conflict, or if the client specifically wishes to do so.

2. **DRAFT LEVEL 2 ADVICE**

- 2.1 Section 3. Since the requirements will need to be given effect at a national level, it must be clear that the question of what is "due skill, care and diligence" will be determined by reference to the jurisdiction in which the relevant custodian is providing services.
- 2.2 Section 4. These requirements should not apply if a client specifically instructs the custodian to hold assets in a particular way. A custodian does not advise its clients on how to conduct their business, and cannot be responsible for the business decisions of the clients, therefore if directed by the client to hold assets in a particular manner (for example, in street names), it is the client's decision to take the relevant risk involved, and in such cases this requirement must be disapplied. General comment 1.5 also applies in this context as regards settlement systems.
- 2.3 Section 4(a), (b), Section 8(b) It is impractical to require that the relevant arrangements must meet the necessary standard "to the fullest extent" since in practice it would never be possible to be sure of this. Investment firms would seek legal opinions on this point, and it will never be possible for legal advisers to confirm that a result has been achieved "to the fullest extent" since in reality it is never possible to confirm that no additional action can or should be taken. A requirement of "to the extent practicable in accordance with the relevant systems of law" would give appropriate protection, since this would give clients' assets the protection available under the relevant legal system.
- 2.4 Section 4(a), (b). The wording should not refer to a "guarantee", since this is a technical term which could be interpreted as a requirement for a formal guarantee, the provision of which would be highly unusual and extremely onerous since it would have capital adequacy implications. The situation would be unworkable in situations where a custodian delegates holding of assets to its parent company, since the subsidiary would be required to provide a guarantee in relation to its parent and is unlikely to be able to do so. The wording should state that the relevant arrangements "must have the result" (not "guarantee") that the relevant effect is achieved.
- 2.5 Section 4, final sentence. These requirements must not restrict any rights granted by the client in favour of any third parties or the custodian, whether by contract or arising as a matter of law, as this would restrict the client's use of its own assets. The wording must be amended to state clearly that it is not intended to prevent investment firms, depositories or any third parties exercising relevant lawful rights.
- 2.6 Section 5(a). The requirement of obtaining express consent is unnecessarily onerous if the client is a professional client, and would delay business activities. Where the client is a professional client, notification from the custodian is sufficient. This wording

should therefore be amended to state that express consent is only required if the client is a retail client, and that notification will be given to a professional client.

- 2.7 Section 5(c). It is not clear what level of information is required to be provided.

It is not consistent with the function of a custodian to provide investment advice or detailed explanations and risk warnings to a client. A custodian provides the service of holding assets in accordance with the instructions of the client (or the client's delegate, for example its investment manager) who takes the decision to invest in the relevant jurisdiction and will therefore familiarise itself with the risks involved before making the investment decision. To require the custodian to inform the client about the risks involved would be requiring the custodian to give investment advice. This is not the function of a custodian. Any explanation or warnings for professional clients are unnecessary since such clients will be well aware of the relevant issues.

The requirement should be for a custodian to notify retail clients that there may be risks relating to use by the custodian of the relevant assets and warn it to satisfy itself that it has taken appropriate advice. This warning is unnecessary for professional clients. The same point applies to the requirement for a "description of the risks" required by Section 12(b) and 12(c), and the similar requirements in Sections 12(d) and (e) (see 2.18 below).

- 2.8 Section 7. A firm which is not a credit institution is required to deposit client cash with a central bank or authorised credit institution. Provided the firm has complied with this requirement, compliance with the Section 8 requirements in relation to the bank appointed is unnecessary and should therefore be disapplied.
- 2.9 Section 8(a). A custodian is required to exercise "due skill, care and diligence" in the "periodic review" of a depository, therefore there is no need for an additional obligation of an "annual review". Custody clients are protected by the requirement of periodic review in this Section 8(a) since this reflects the ongoing assessment of subcustodians which is carried out by all good custodians. There is no need for an arbitrary requirement for a review once a year, since this adds nothing to the benefits of the periodic review. General comment 1.5 also applies here.
- 2.10 Section 8(a)(i), Question 5.1. Section 8(a)(i) refers to "specific regulation and supervision", but the level of such regulation and supervision may vary widely between different jurisdictions. It is therefore not true that a depository subject to specific regulation and supervision would always be an appropriate choice of delegate. The two options in italics should therefore be deleted, so that reference to regulation and supervision is simply one of the factors for selecting a depository, not a compulsory requirement.

The best approach is to delete both the options in italics. However, if it is felt necessary to adopt one or the other, the first option is preferable, although we do not understand what is meant by "must have recourse to a regulated institution". A custodian should be permitted to use unregulated depositories where other relevant

considerations mean it is appropriate to do so. Clients will be protected by the fact that the custodian is under a duty to exercise all due skill, care and diligence in selection. It is therefore appropriate for the custodian to decide what is suitable in the relevant circumstances. To restrict the custodian's scope for choice will not necessarily result in the best service to the client. Moreover, this additional requirement is unnecessary if the relevant client is a professional client, therefore should only apply where the custodian is providing services to retail clients.

Examples of circumstances where it may be appropriate to use an unregulated depository include situations where: (i) the level or type of regulation applicable to depositories in the relevant jurisdiction is not relevant to the holding of assets; (ii) the particular structure means use of a particular depository is necessary or advisable; (iii) the client directs use of a particular depository; or (iv) if the custodian can exercise better control over such depository (for example, if the delegate is in the same group).

- 2.11 Section 8(b). This wording must read "to the extent practicable" rather than "to the fullest extent practicable" for the reasons discussed in 2.3 above. The wording must clarify that holding assets in an omnibus client account with a depository is permitted. A requirement for individual segregated accounts with depositories for each client would be administratively unworkable given the numbers involved, and in some jurisdictions it is only possible to hold assets in omnibus client accounts.
- 2.12 Section 9, Question 5.2. This section does not need to specify the relevant systems and controls, since what is appropriate in each case will depend on the circumstances and the nature of the applicable national laws. The clients are protected by the custodian's obligation to exercise due skill, care and diligence as stated in Section 3, therefore Section 9 does not require further detail.
- 2.13 Section 11(a). This wording should clarify that this requirement applies to cash as well as securities, except where the custodian is a credit institution in which case the exception in Section 2 applies. The reference to a record maintained by the investment firm should refer to the records on its own books.
- 2.14 Section 11, Question 5.3. A requirement for the identification of which client's assets are held with which particular depository is undesirable for the following reasons.
- 2.14.1 While custodians can make such identification in some circumstances, this requirement is inconsistent with the way in which many custodians generally hold securities. Unless a custodian is maintaining separate segregated accounts with its delegates in relation to client assets, a custodian normally holds assets with a depository on the basis that a proportion is held for each relevant client, such proportion being calculated by reference to the number of securities recorded on the custodian's books. The custodian therefore does not, where there is more than one such depository for the relevant type of asset, identify to the client the specific depository to which holding of assets has been delegated, since in principle each such holding is held for all clients entitled to assets of that kind on a proportional basis. To require a custodian

to always identify different depository holdings for specific clients would require the custodian to maintain segregated rather than omnibus client accounts with the depository. This would increase the operating costs for the custodian and therefore the custody fees charged to the clients, and administratively would be impractical.

- 2.14.2 Unless the custodian has agreed with the client to maintain a separate account for the client with a particular depository, the allocation by the custodian of holdings with particular depositories would be arbitrary. This would be unfair to the clients which bear the loss caused by failure of a specific depository.
  - 2.14.3 One reason why a custodian might maintain several accounts holding securities of the same type with different depositories is in order to have the benefit of different settlement cycles in different time zones. If a custodian is required to specify the holdings with a particular depository for a particular client, it would deprive the client of the benefit of settlement flexibility.
  - 2.14.4 Custodians regularly reconcile their records of client assets with their depositories' records of assets. This provides appropriate protection. To impose an additional requirement would increase costs and administrative complexity, but would not give any significant benefit to the custodians' clients.
- 2.15 Section 11(b). This seems to be a systems issue which should be part of the implementation of Article 13(4) rather than Articles 13(7) and (8).
- 2.16 Section 12 (a). In relation to cash: As currently drafted, this section applies to holding cash as well as holding securities, i.e. imposes liability for banks as well as for depositories. It should be clarified that Section 2 applies so that this wording does not apply where cash is held by the custodian itself in its capacity as a credit institution. In addition, when a custodian is not a credit institution, it should not be required to accept liability for a bank. A client is protected appropriately because it takes either the credit risk of the custodian (if the custodian is a credit institution) or the credit risk of a third party bank. There is no reason to impose on the custodian additional liability for the operations of the third party bank. We comment on the section in italics in the response to Question 5.4 below.
- 2.17 Section 12(a), Question 5.4. In relation to securities: The term "depository" means any delegate by a custodian, therefore covers any kind of subcustodian, whether a nominee, a subcustodian or a settlement system. Consequently, neither of the suggestions for liability is appropriate as drafted, because the wording does not reflect the fact that different kinds of subcustodian will be used. For example, a custodian has little control or monitoring capacity in relation to a large settlement system, but has absolute control over its own nominee, therefore it is unreasonable to impose the same levels of liability in relation to a settlement system and a nominee. Option (a) is preferable, but must be amended in accordance with the following.

- 2.17.1 It is reasonable to require that a firm does not exclude or limit its responsibility for losses directly arising from the investment firm's failure to exercise all due skill, care and diligence in the selection and periodic review of the depository, but this must be disapplied if: (i) the client has directed the custodian to appoint the relevant depository; or (ii) the custodian has no, or only severely restricted, opportunity to make any choice or review of the depository (because there is no other depository in the relevant jurisdiction, or the depository is a large settlement system which restricts information available, or use of a given depository may be mandatory for certain securities).
- 2.17.2 A custodian cannot accept the same responsibility in relation to ALL group member depositories as it accepts for itself, since this could, for example, result in requiring the custodian to accept liability for its parent or other entities over which it has no real control. The wording should therefore be restricted to responsibility for group members controlled by the custodian.
- 2.17.3 To require that a custodian always accepts the same liability for other group members as itself would in practice limit the possibility of offering clients a more favourable level of liability for the custodian's own actions, since any such extension of liability would automatically require increase of liability for group members which may not be possible. This provision is therefore detrimental to the flexibility of custody arrangements.
- 2.17.4 In practice, the custodian can never have exactly the "same liability" for other group members as it has for itself since such group members are invariably operating in different jurisdictions. The level of liability undertaken by a custodian for relevant group members should therefore be that the custodian is liable for acts or omissions of such group members if such acts or omissions, if carried out by the custodian itself in the relevant jurisdiction where the group member operates, would result in liability of the custodian under the terms of the custody agreement.
- 2.17.5 Option (b) should not be adopted. It would be extremely onerous since the liability of the custodian would be very broad, depending on the meaning of "directly or indirectly linked". This wording could result in the custodian being liable even if the loss has no connection to any fault of the custodian, and taking liability for consequential loss. The reversal of burden of proof is a very severe provision and very unusual. These terms would create a high risk of the custodian being regarded as providing a guarantee in relation the assets held which would have capital adequacy implications. In addition, the costs of providing such protection would be enormous. These requirements would increase the risks for custodians significantly, hence would increase costs to the custodian and to custody clients.
- 2.17.6 Option (a), if modified as suggested, would be appropriate protection for retail clients. It should not apply where the custodian provides services to

professional clients, since such clients can negotiate an appropriate arrangement to suit the commercial requirements of the relevant arrangements, and an overriding requirement would restrict business flexibility.

- 2.18 Sections 12(b), (c), (d), (e). A description or warning of risks for professional clients is unnecessary as protection since such clients will be well aware of the relevant issues, and to require unnecessary protections is impractical and unhelpful for business operations. As explained at 2.17 above, a custodian must not be required to give detailed information which could constitute legal advice or investment advice. It is sufficient to warn retail clients that risks may exist as a result of pooling, local market practices regarding separate identification of assets, and local laws applicable to the assets, and to suggest that the retail client should obtain its own legal advice or investment advice if it is in any doubt about the extent of such risks.

Section 12(e) is unnecessary because as a contractual matter the agreement will contain the terms of any lien or security interest. A custodian should not be asked to give a "description" in addition which could constitute legal advice or investment advice.

- 2.19 Sections 14, 15. The increase in audit requirements will increase the costs of custodians and therefore the cost of custody services for clients. It is unclear why an external audit is required, given that we are not aware this is required in any of the other implementing measures relating to the Directive.

**The Bank of New York**

**Citibank, N.A.**

**JPMorgan Chase Bank**

**The Northern Trust Company**

**State Street Bank and Trust Company and its continental European group companies.**

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