

THE ASSOCIATION OF GLOBAL CUSTODIANS

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COUNSEL AND SECRETARIAT TO THE ASSOCIATION:

BAKER & MCKENZIE LLP

EUROPE
ATT: ARUN SRIVASTAVA
100 NEW BRIDGE STREET
LONDON EC4V 6JA, ENGLAND
INT'L TEL: 44 20 7919 1000

GLOBAL
ATT: ROBIN TRUESDALE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL: 202 452 7000
FAX: 202 452 7074

WWW.THEAGC.COM

9 July 2010

By Electronic Delivery

anandsinha@rbi.org.in

jeevans@sebi.gov.in

Mr. Anand Sinha
Executive Director
Department of Banking Operations and Development
Reserve Bank of India

Mr. Jeevan Sonparote
General Manager, FII Division
SEBI Bhavan, Plot No. C4-A, "G" Block
Bandra Kurla Complex,
Mumbai - 400 051

RE: IPCs Issued by Bank Custodians to Securities Exchanges

Dear Sirs:

We write on behalf of the members of the Association of Global Custodians (the "Association") with regard to the issues raised by Irrevocable Payment Commitment ("IPC") requirements as they would apply to custodians' equity exchange-trade confirmations for Foreign Institutional Investors ("FIIs"). Such requirements continue to be of concern to investors in the Indian capital market and to their intermediaries.¹

Members' comments below follow recent discussions in the offices of the Reserve Bank of India ("RBI") and the Securities and Exchange Board of India ("SEBI") concerning related margin and IPC issues. Those discussions included representatives of one of the Association's member banks, State Street Bank and Trust Co. We are addressing this letter to both agencies for your convenience.

¹ Members of the Association are listed on the letterhead above. As you know, members act as custodians for cross-border institutional investors world wide, providing custody services and asset-servicing functions through a global network of agents and subcustodians. Members provide these services to institutions that are substantial investors in securities listed and traded in Indian markets.

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Background to Comments Regarding IPC Requirements

In 2007, RBI issued a notification concerning IPCs that are given by custodian banks in favor of stock exchanges to facilitate settlement of transactions executed by domestic entities like mutual funds and FIIs/sub accounts. The notification indicated that trade confirmations affirmed by bank custodians on the stock exchanges on T+1 would constitute an IPC unless funds were in hand from the client prior to the respective confirmation. Based on that notification, banks were obliged to confirm trades only to the extent funds are provided in the client local currency account prior to the confirmation and the FII clients are not permitted to avail any kind of fund or non-fund based credit facilities.

We understand that local Indian market participants have described for you the constraints they face and concerns they have about this requirement. The RBI has periodically extended the deadline for the application of the notification, with the latest extension to 31 July 2010. Additionally, we understand that the RBI SEBI Standing Technical Committee has proposed a set of norms ("Conditions") for custodian bank provision of IPCs to FIIs as a non-fund based credit facility.

Comments regarding the IPC requirements and the Proposed Conditions

- Under the proposed Conditions as we understand them, custodian banks would be permitted to affirm confirmed purchase transactions to the stock exchange only if (a) the FII's INR account provides adequate funds to cover the applicable margin requirement on T+1 (i.e. on Trade confirmation date) and is accompanied by an FX contract for value on T+2 (i.e. on Trade settlement date) for the settlement amount or (b) the FII's INR account has all funds necessary for the full trade settlement value on T+1.
- From an investor's perspective, the alignment of an FX-transaction to the underlying stock transaction should help ensure that all payment obligations in INR are covered, while at the same time enabling local subcustodians to confirm trades on typical timeframes – assuming an irrevocable FX contract is available.
- In contrast, a blanket requirement to fully pre-fund settlements on T+1 in every case imposes significant operational and procedural issues on market participants because each FII's middle- and back-offices would have to verify that payments for purchases have been obtained before traders release orders. Trading activity would suffer unique timing risks and delayed order execution, which potentially impairs service quality and promotes less-than-best execution prices.
- In addition, any currency amount to be fully funded by T+1 would need to be estimated based on the anticipated volume of trading and the estimated trade price. However, both a pre-execution estimate of the amount needed and the currency amount obtained in fact could be materially inaccurate, particularly when the local market is volatile. Dealing with that uncertainty would inject process inefficiencies and would produce

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higher costs for FII's. Furthermore, because an investor cannot know the exact amount of funds needed in advance of the trade, investors will likely arrange excess funding in order to avoid fails, which will further increase the costs of investment in Indian equities.

- As a related point, members believe, if a trade confirmation meets the proposed Conditions, the relevant local custodian should not be required to set aside capital or be subject to limits such as "Capital Markets Exposure" limits. Taking this approach in India would promote consistency with investment destinations in other jurisdictions and would avoid inflating the ultimate costs of post-trade settlements in the Indian market.
- In the event that limits are still considered necessary, the Association suggests that limits apply only in respect of the market risk element of the settlement amount – i.e., limits should be set at a level no greater than the total purchase obligation less the pre-funded amount plus sale proceeds settling in the same settlement cycle for the FII/sub account. This approach would minimize the additional costs ultimately borne by investors and would avoid double-counting worst-case risk exposures.

* * * *

Our comments above are intended to illustrate complications and trade processing burdens that full settlement pre-funding requirements would create, disproportionately, for FII's. The comments also describe potential financing inefficiencies and increased settlement costs that IPC requirements, as proposed, would create for FII's. Further, our comments suggest ways to adjust IPC requirements so as to reduce complications, burdens and costs. Members would be pleased to discuss the foregoing with you at your convenience.

The Association appreciates the opportunity to convey members' views on these topics. If you have questions or would like further dialogue, please contact the undersigned at 1.312.861.2620 as an initial matter.

Sincerely yours,



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