

THE ASSOCIATION OF GLOBAL CUSTODIANS

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October 1, 2002

VIA AIR COURIER AND E-MAIL

DG MARKT F2
European Commission
B-1049 Brussels
Belgium

Re: Communication From the Commission to the Council and the European Parliament on Clearing and Settlement in the European Union

Ladies and Gentlemen:

This letter is submitted on behalf of the Association of Global Custodians in response to the invitation of the European Commission ("Commission") to comment on the Communication from the Commission to the Council and the European Parliament on Clearing and Settlement in the European Union ("the Communication"). The Association is an informal coalition of ten North American banks that are major providers of cross-border custody services to institutional investors. We recognize that the comment deadline in the Communication has passed and apologize for the tardiness of this letter. The Association nonetheless respectfully requests that the Commission consider the views set forth herein as part of its review of the important questions raised in the Communication.

Interest of the Association

The members of the Association hold substantial positions in securities that trade in the securities markets of the European Union. Accordingly, the Association has a deep interest in the evolution and development of the financial infrastructure in the EU. The Association shares the Commission's goal of creating an efficient, integrated cross-border clearing and settlement system and removing barriers to the finalization of individual cross-border transactions. The Association also believes, however, that in its

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efforts to promote integration, the Commission should not lose sight of the differing responsibilities of the various participants in the clearing and settlement process. In particular, we are concerned that the Communication reflects confusion concerning the respective roles of securities depositories and custodian banks.

With these basic principles in mind, our comments on the matters discussed in the Communication are set forth below.

Discussion

A. Objective No. 1: Removal of barriers to the finalization of transactions

Based on the findings of the Giovannini Report,¹ the Communication groups the barriers to the finalization of cross-border transactions into three categories -- technical and market practice barriers, tax barriers, and legal barriers. As to the technical barriers, the Communication states that the absence of inter-operability (*i.e.*, the ability of "systems to inter-connect, compete or integrate") is a "market failure." It attributes that failure to either the fact that "parties involved derive profit in some way from the current fragmented environment" or that "those who would bear the costs of technical developments are not the ones who stand to gain."² As to legal barriers, the Communication refers to the proposed Hague Convention on Indirectly Held Securities as a potential solution and also raises the possibility of a uniform EU-wide securities code.

1. Interoperability

The Association has reservations about the pursuit of "interoperability" as a solution to the current fragmentation of clearing and settlement systems in the EU. If, by interoperability, the Communication means that all eligible participants in the clearing and settlement process should have the ability to inter-connect with an EU-wide clearing and settlement facility, we fully agree. If, however, by interoperability, the Communication means that, rather than seeking to create a single, harmonized clearing and settlement system, the Commission should strive to assure that the existing, rival

^{1/} Cross Border Clearing and Settlement Arrangements in the European Union, (November 2001), in European Commission Economic Communication No. 163.

^{2/} Communication at 10.

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systems are inter-connected, we disagree. The Association regards interoperability in this latter sense as a goal that would divert time and resources from efforts to attain more fundamental, and more efficient, harmonization and integration.

In our view, the Commission's objective should be the creation of a single, EU-wide clearing and settlement facility, industry-owned, operated and not-for-profit, comparable to DTCC in the United States. That entity should function in accordance with the standards set forth in Objective No. 2, below. That facility should, of course, be "interoperable" with all of the different types of institutions that are eligible to participate in it. Time and effort should not, however, be devoted to the less fruitful, but equally difficult, task of interconnecting rival clearing and settlement facilities.³

2. Legal Framework

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. 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 EU 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. Such initiatives should be encouraged. The Association also supports the 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.

^{3/} The issue of the proper role of interoperability is discussed in greater detail in the comment letter submitted to the Commission by one of the Association's members, State Street Bank. See Letter, dated August 30, 2002, from Robert L. Pierre, Vice President, State Street Bank & Trust Company at 2-4.

3. Responses to Specific Questions

- a. *Is the combination of actions outlined in Annex II the best approach to the removal of this category of barrier? Which actions should be priorities?*

Subject to the foregoing comments, the Association agrees with the comprehensive menu of actions identified in Annex II. We are reluctant to set priorities among these important steps. However, the Association believes that the various proposed actions that aim to eliminate restrictions embodied in national law, and to create a common legal framework to support transfers of securities throughout the EU, are among the most critical.

- b. *Are further measures, beyond the adoption of the Hague Convention, required to achieve effective resolution of conflicts of law in the EU? Would adoption of these measures be sufficient to resolve the main legal uncertainties for securities transactions in the EU? If not, is a 'securities code', establishing a uniform legal treatment of securities across the EU, either necessary or desirable?*

The Association is a participant in, and supporter of, the Hague Convention process. However, the proposed Convention is a solution to only one facet of the larger problem of conflicting national laws and uncertainty concerning the law applicable to securities intermediaries. In our view, a uniform EU securities code is a necessary corollary to a harmonized, integrated European clearing and settlement system. In addition, we believe that the effective administration of such a code will require the creation of an agency with jurisdiction and enforcement powers across the EU.

B. Objective No. 2: Removal of competitive distortions or unequal treatment of entities performing similar clearing and settlement activities

The Communication also identifies the goal of removing competitive distortions or unequal treatment of entities performing similar clearing and settlement activities. The Communication divides the steps necessary to remove "competitive distortions" into four areas -- level playing field, rights of access and choice, common regulatory view, and competition policy.

1. Distinctions Between Types of Participants

In its discussion of removing “competitive distortions or unequal treatment of entities performing similar clearing and settlement activities,” the Communication fails to draw important distinctions between the various types of participants in the clearing and settlement process. While we support this objective in concept, it must be effectuated with sensitivity to the differing roles and functions of the participants.

As an example of “uneven treatment of clearing and settlement activity” the Communication cites the differences in regulatory treatment between “bank-licensed custodians” and Central Securities Depositories (“CSDs”) not licensed as banks. Banks, according to the Communication, have an implicit “passport” to provide settlement throughout the EU.⁴ CSDs that are not banks or investment firms do not enjoy a similar right. However, the suggestion that banks therefore have an unfair advantage over CSDs is premised on the erroneous notion that banks and depositories are simply competitors engaged in rival business activities. We believe the Communication fails to recognize that bank custodians offer individualized, value-added commercial services to their clients, while CSDs essentially operate as market utilities.

The relationship between a custodian and its investor-clients is negotiated and governed by contract. Typically, custodians owe a range of legally enforceable duties to their clients, including obligations to protect and service their assets and interests efficiently and with due professional care. Custodians also provide, and are compensated for, value-added services, such as banking, administration of securities lending programs, recordkeeping, and the furnishing of market-related information. A custodian that fails to perform its duties with the appropriate level of care may be liable to its client for any resulting losses.

In contrast, a CSD functions as a market utility. CSDs can be viewed as operating in a wholesale capacity, since they provide services primarily to market professionals, including the broker-dealers, local subcustodians, and (occasionally) global custodians.⁵ Unlike global custodians, CSDs do not typically deal directly with

^{4/} This “implicit passport” is asserted to arise as a result of the fact that custody is a non-core service under the Investment Services Directive (“ISD”) and custody has been interpreted to include settlement across accounts.

^{5/} In order to perform these duties, a global custodian must establish, monitor, and maintain a network of subcustodians in various markets. Network

investors. CSDs are a basic component of the financial infrastructure on which all market participants must depend. They provide high-volume automated clearing and settlement facilities and basic asset servicing to all comers. They do not, however, negotiate with participants or participants' clients and do not provide differing levels of value added services in return for differing levels of compensation. Unlike custodians, CSDs assume only very limited liability for losses suffered through their facilities.

The distinctions between custodians and CSDs have important regulatory ramifications. For example --

- The standards applicable to participants in the clearing and settlement process must be carefully differentiated depending on the entity type in question. Differences in the legal status, structure, and supervision of CSDs, ICSDs, and custodians reflect fundamental differences in the roles of each. Regulation that seeks to "level the playing field" by imposing uniform standards on entities that perform different functions under different economic and regulatory regimes will be unworkable.
- 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.
- A blurring of the lines between utilities or "market agents" and investor agents increases risk. 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.

management, which includes the selection and evaluation of these subcustodians, is a major facet of the business of global custody. Typically, these subcustodians are participants in the local CSD, although, in some cases, the global custodian may be a direct participant in the local CSD or in an ICSD ("International Central Securities Depository").

- Permitting CSDs and ICSDs to, in effect, become global custodians and offer cross-border services would increase 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 liability for losses that other providers accept. 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.

2. Discriminatory Access to Clearing and Settlement Systems

The Communication also states that there should be no discrimination with respect to membership in central counterparty clearing houses and settlement systems. The Communication concludes that “[c]ommon, objective criteria for regulators to assess the risks posed by different systems and links are required in order to avoid arbitrary restriction of access and choice.”⁶

The Association agrees that open access to clearing and settlement services should be a fundamental principle. 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.

^{6/} Communication at 14.

3. Responses to Specific Questions

- a. *Does the creation of a level playing field require that common functional definitions of clearing and settlement activities be developed at EU level? Which post-trade activities should such definitions encompass?*

The Association believes that the activities inherent in the clearing and settlement process should be commonly defined throughout the EU. We also believe that such definitions should be "functional" in the sense that the definitions should be based on the functions performed. However, for the reasons discussed above, it is essential that definitions be based on a sophisticated understanding of the differences in the roles of various types of participants in the process. For example, a definitional approach that treated global custodian banks and CSDs as performing the same "function" would be inaccurate and counter-productive.⁷

- b. *Should EU legislation be used to provide comprehensive rights of access and choice across and between all levels of the trading and settlement chain?*

As discussed above, the Association believes that open access to clearing and settlement services should be a fundamental principle and that access rights should be based on objective and nondiscriminatory standards. The best vehicle to implement this basic concept would be EU legislation.

- c. *What factors should market regulators be concerned with in deciding whether to grant use of a system in another member state?*

In the Association's view, the Commission's efforts should be devoted to the development of a single settlement platform for all securities that trade in the EU. The development of such a single, EU-wide clearing and settlement facility would obviate the need for rules governing the ability of national regulators to grant or bar access to local systems.

^{7/} We defer to other commentators to list the post-trade activities that should be defined. See, e.g., State Street Bank comment letter, supra note 3, at 7.

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- d. *Is there a need for framework legislation governing these functions at EU level? If so, what particular aspects should be included in any such legislation?*

As discussed above, the Association recommends the enactment of a uniform EU securities code. Such a code should include a basic framework for clearing and settlement. At the same time, we also believe that the temptation to impose detailed regulation that would stifle market evolution should be resisted. Successful integration and harmonization of the European clearing and settlement environment will depend on harnessing commercial and competitive forces. Change that is accomplished by the alignment of market forces and regulatory goals is more efficient than change that is solely dependent on legislative prescription.

* * *

The Association supports the efforts of the European Commission to attain the important goal of integration of clearing and settlement in the European Union. We would be pleased to work with the Commission and other interested parties to address issues related to this effort. If you have any questions concerning these comments, or if there are specific issues concerning the activities and practices of global custodians that would be of interest, please contact the undersigned at 202/452-7013.

Sincerely,


Daniel L. Goelzer