

THE ASSOCIATION OF GLOBAL CUSTODIANS

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June 30, 2006

Mr. Mario Nava
DG Internal Market
European Commission
B – 1049 Brussels
Belgium

Re: Comments on the Draft Working Document on Post-Trading

Dear Mr. Nava:

This letter, submitted on behalf of the Association of Global Custodians ("Association"),¹ discusses aspects of the Draft Working Document on Post-Trading (the "Draft"), a component of the anticipated Regulatory Impact Assessment undertaken by DG Internal Market for the European Commission (the "Commission"). The Draft was made available to interested parties in conjunction with the Commission's issuance of a consultative issues paper entitled, "Competition in EU securities trading and post-trading," dated May 24, 2006 (the "Competition Issues Paper"). We are separately providing comments to DG Competition addressing the Competition Issues Paper.

The Association is encouraged by the Commission's active interest in safe and efficient clearance and settlement mechanisms and arrangements in European markets.

¹ The Association is an informal group of ten global custodian banks with extensive business in Europe through European offices, branches and affiliates that provide securities safekeeping services and related asset-servicing functions to cross-border institutional investors, including pension funds, insurance companies and investment companies, many of which are located outside Europe. Through their intermediary activities, Association members play a critical role in enabling the flow of investment capital from market to market and facilitating customers' investments in European securities. The Association members are listed on the letterhead above.

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On various occasions in the past, the Association has provided the Commission and the European System of Central Banks/Committee of European Securities Regulators with the Association's views and recommendations on regulatory and market structure issues and initiatives affecting clearance and settlement.² At this point, as the Commission nears completion of its regulatory impact assessment and considers the potential for additional framework legislation respecting clearance and settlement, and while the Draft is under continued development, we are providing a few additional comments.

Our comments below are intended primarily to clarify the functions, activities, and market position of *global* custodians, including vis-à-vis central securities depositories ("CSDs" used here to include International CSDs). The clarification comments are designed to supplement the Commission's understanding of institutional functions and the industrial landscape. In addition, brief concluding comments address issues raised in the Draft and note certain considerations referenced in the Draft that may misdirect the Commission's impact assessment.

Clarification Comments

The Draft states, at Part 2.2.1.3, that custodians "perform, albeit at different levels, some of the same functions performed by CSDs"..., including "the settlement function". "Settlement" is defined in Part 2.1.1.4 as "the act of crediting and debiting the transferee's and transferor's accounts respectively, with the aim of completing a transaction in securities." The Draft then states, in Part 2.2.1.3., that custodians, in performing settlement, "need to mirror the credits and debits carried out at the CSD

² See, for example, Association Letter, dated March 31, 2006, to Commissioner Charles McCreevy regarding Cross-border Clearing and Settlement; Letter, dated September 13, 2005, to Messrs Godeffroy and Wymeersch, regarding ESCB/CESR Working Group Public Statement. In addition, Letters, dated October 1, 2003 and October 31, 2003 to Messrs Godeffroy and Wymeersch regarding possible Standards for securities clearing and settlement in the European Union; Letter, dated May 25, 2004, to Messrs Godeffroy and Wymeersch regarding Revised Standards; and Letter, dated June 21, 2004, to Messrs Godeffroy and Wymeersch addressing the Revised Standards as issued in May 2004.

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level"... or "internalize settlement, in which case they do not need recourse to a book entry change in their account with the CSD."

In making these statements, the Draft does not distinguish sufficiently between local market sub-custodians and global custodians, nor does it explain the basis for the Commission's conclusion that custodians, in general, "perform settlement" and have the ability to "internalize settlement". We believe it would be helpful to include such distinctions and explanations in the Draft; doing so would lead to greater clarity in the Draft's conclusions. As it stands, the quoted statements in Part 2 of the Draft and the ensuing analysis are conceptually unclear. This continues in Part 3.1, where the Draft discusses "global custodians" and "cross-border settlement", and then concludes by stating that "CSDs, acting in their intermediary capacity, and the custodians and settlement agents are, at least potentially, in competition with each other."³

These statements and the resulting analysis appear to be based on a misunderstanding of the functions, settlement-related role, and operating characteristics of custodians, and global custodians in particular. We respectfully urge the Commission to clarify these portions of the Draft, and to assist the Commission in this regard we provide the following summaries.

- Global custodians perform a distinct role in the securities markets by providing specialized services primarily to cross-border institutional investors; these services are fundamentally different from the centralized, market-support services delivered to professional intermediaries by CSDs.

Custodian banks provide institutional investors, including pension funds, insurance companies, and mutual funds, with securities safekeeping services and related asset-servicing functions. They deliver these services as commercial intermediaries and as part of an array of banking services for bank customers. *Global custodians* provide these services to cross-border investors seeking access to multiple markets, including various markets in Europe. Typically, these customers - unlike CSD users - are not professional securities processors, and they therefore require the intermediation of professional safekeeping agents and asset servicers. Most of these

³ In comparable terms, the Competition Issues Paper, at footnote 16, states that "Global custodians and ICSDs compete at this [settlement] level and in the provision of related services" as illustrated by the mechanism of internalization.

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customers demand flexibly-structured servicing arrangements that are commonly heavily negotiated.

Custodians provide their institutional customers with access to local market settlement facilities and conventions by engaging third parties to safe keep their customers' securities and to facilitate settlements on customers' behalf. *Global* custodians typically engage local sub-custodians to provide custody and related facilitative services to the global custodian (and indirectly, its customers). In turn, these local sub-custodians deposit customers' securities with the local market CSD (either directly or, less commonly, through an additional intermediary). At the end of the chain of custody, institutional investors and their global custodians and local sub-custodians have no choice but to use the local CSD.⁴

In contrast, CSDs perform fundamentally different and also specialized market functions. Although both depositories and custodians hold securities for others, the similarities in function, market position and scope of responsibility end there. CSDs occupy an exclusive, central-utility position in their respective markets, providing one-size-fits-all settlement services to the full community of professional intermediaries, including custodians. In that role, utility depositories bear responsibility for measuring, controlling and managing aggregate settlements and the related systemic risks for the entire community of intermediaries and other organizations that must use the utilities' central facilities. As the Draft notes, many CSDs also perform registrar functions for all the outstanding securities of various issuers, thereby providing definitive asset ownership recordation and transfer services to all intermediaries, and indirectly to all investors.

- Global custodians do not compete with International CSDs ("ICSDs") with respect to central depository activities, though ICSDs, when authorized to provide cross-border intermediary services, may compete with global custodians with respect to global custody and ancillary services. We believe that ICSD expansion into

⁴ The Competition Issues Paper at part 4.1 states that "the limited degree of competition in EU securities trading and post-trading is striking." This is largely true at the level of domestic CSDs, but is not accurate in relation to commercial custodians, notably at the global custodian level. This segment of the intermediary market is characterized by intense commercial competition among service providers.

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intermediary services should be subject to certain segregation and regulatory conditions.

We think the Draft as well as the Competition Issues Paper overstate the extent to which custodians and other intermediaries do or may compete with utility ICSDs and therefore overestimates the extent to which a level playing field for intermediary services is meaningful where ICSDs are permitted to provide such services. To be sure, as explained in the next section, competition between CSDs (including ICSDs) and *global* custodians cannot be analyzed as a function of custodian internalization; and any analysis of potential competition should not be based on the mistaken assumption that internalization occurs at the global custodian level.

The Association does not, in principle, oppose ICSD expansion into intermediary services, but believes that any such expansion must be accompanied by effective functional separation, careful monitoring to prevent cross-subsidies or other abuses of monopoly position, and suitable regulation of the ICSD's expansion steps and ancillary business activities. ICSDs perform critical market functions as essential facilities, and their expansion into ancillary lines of business can pose risks to core utility services or systemic integrity. In addition, ICSD expansion beyond utility activities poses a risk that the ICSD's position as a utility service provider can be used to extract from captive users above-market fees for intermediary and ancillary services. Indeed, such expansion can otherwise affect the quality and character of competition in intermediary service markets between ICSDs and intermediary banks.

Some ICSD expansion into intermediary activities has already taken place, as a result of historical needs to service the Eurobond market. Cash management activities, for example, are a source of profits for ICSDs. These types of ancillary revenue opportunities are not subject to the typical constraints of competitive market forces; and further ICSD growth and consolidation may magnify such opportunities.

Accordingly, the Association believes that ICSD expansion beyond utility infrastructure functions requires effective functional separation principles and suitable regulatory oversight. Separation should include separate governance structures for the specific activities, should be designed to avert risks to any aspect of infrastructure services, and should be structured to foreclose the leveraging of a monopoly position into ancillary business ventures. In particular, ICSD expansion beyond core utility

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services into intermediary activities and custody services should be subject to suitable regulation and appropriate regulator oversight.

- Global custodians do not “perform settlement” nor do they necessarily “mirror the credits and debits carried out at the CSD level” as those phrases are used in the Draft. Global custodians are not organized or positioned to internalize settlements, and they do not do so.

Global custodians *facilitate the completion* of customer settlements of purchase transactions – and, separately, of sale transactions – with the customer’s execution agent or dealer, by authorizing release and receipt of customer funds and securities, as instructed by each customer for each purchase or each sale. In most markets, global custodians typically effect those authorizations trade-by-trade by instructing their local sub-custodians to facilitate the deliveries and receipts for the account of the global custodian. The resulting receipts and deliveries 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.

As a related matter, recordkeeping adjustments to a customer’s account at a particular global custodian or sub-custodian to record each customer transaction do not typically, “mirror” the settlement debits and credits to depository accounts. Depository-level settlements and transfers commonly account for both sides of each market trade. In contrast, the record adjustments at the custodian level ordinarily involve only one side of the trade; those entries thus relate to only one component of the normal accounting entries at the depository.

As a general illustration, on a cross-border market transaction involving two institutional customers, a number of intermediaries are typically involved – the global custodian acting for the selling institutional customer; the sub-custodian acting for that global custodian; that customer’s executing broker and the broker’s agent bank; as well as the various agents servicing the buying customer or its global custodian. Given that array of intermediaries, it is typically the case that a buying customer’s broker will be using a different settlement bank than does the selling customer’s broker or that customer’s global custodian. As a result, in connection with settlement of this transaction multiple accounting operations occur at multiple intermediaries as they each record the appropriate position change in the relevant account. At the global custodian

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level, in particular, on its customer's sale transaction, the only securities record adjustment will be a debit to the customer's securities account. Credit entries for the purchase side of that transaction will normally occur on records maintained by other intermediaries. Significantly, in this common example, neither the selling customer's global custodian nor the other intermediaries make entries "mirroring" those made at the depository.

It should be clear from the foregoing that *global custodians* are not positioned to effect "internal" "settlements". Indeed, the steps a global custodian takes on behalf of customers – i.e., authorizations to deliver or receive and related accounting adjustments – are in fact transitory steps, typically pertaining to only one leg of a market trade - the sale leg or purchase leg – and occurring antecedent to actual settlements and transfers that take place through third parties.

In addition, few custodians at any level in the chain of custody are positioned to carry out "internal settlements" between a customer and its broker on even one leg of customers' market trades, and for those custodians, the relevant internal debit and credit operations merely record delivery and receipt of depository-eligible securities and related funds bilaterally between an institutional customer and the customer's executing broker. The occasion for such accounting operations necessarily occurs by chance, not predictably, and even when the occasion arises, the underlying transactions are typically and routinely settled through the depository, subject to the depository's settlement operations and safekeeping regime.

General Comments

- The Draft implies that expanded access to CSDs through linkages and harmonized processes across markets would enable global custodians to be direct users of CSD facilities in lieu of their reliance on a network of sub-custodians. The Competition Issues Paper, at Part 5.3.1, makes this point explicitly. While this outcome is feasible in theory, in practice changes in standard arrangements may be more limited.

The Association is anxious to see both harmonization and open access; and believes that expanded competition between CSDs and local custodians – and the consumer benefits of such competition – would be good for the market. There are a number of markets where intermediaries cannot link in remotely; and eliminating that

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structural restriction would increase the range of access alternatives and likely be accompanied by various efficiencies.

Despite the access choices that exist today and the expanded benefits that would likely flow from open access and greater competition between CSDs and local custodians, it should be noted that individual global custodians choose among access alternatives, even today, based primarily on quality and range of services. As a result, global custodians would not necessarily respond to expanded access alternatives by opting to participate in CSDs directly rather than through sub-custodian networks.

Considerable private sector energy and resources continue to be devoted to initiatives, including those in which Association members are engaged, in pursuit of the framework recommendations set out in the second Giovannini Report ("Second Giovannini Report").⁵ Much less visible progress, however, has been made in removing barriers that the Second Giovannini Report consigned to national-level public authorities, supported by EU-level oversight.

We think the markets would be best served if the Commission directed its efforts towards stimulating progress in public sector coordination that is already authorized and called for, rather than devising new framework principles and initiatives. The Association believes that such actions, together with market-led initiatives, would best advance the prospects for harmonized, open, and competitive markets.⁶ In our view, a new set of duties under a new Directive could divert energies and hamper or delay ongoing collective efforts to advance the efficiencies and reduce the overall costs in accordance with the framework identified in the Second Giovannini Report.

* * *

⁵ The Giovannini Group, Second Report on EU Clearing and Settlement Arrangements, April 2003.

⁶ It is in this way that markets could best realize the Draft's recommendation at Part 5.4, that "given the sizable benefits that would stem from integration/consolidation of the post-trading industry, action should be taken to eliminate the barriers that hamper these processes."

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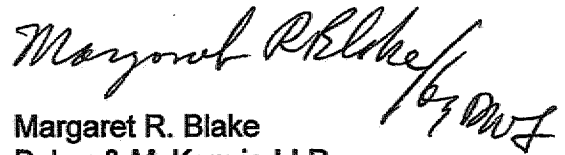
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We appreciate the opportunity to convey the Association's views, and we hope the foregoing comments are valuable. Association representatives would appreciate the opportunity to meet with you and others on your staff to discuss the foregoing. We will contact you soon to try to arrange a mutually convenient time for such a discussion. In any case, if you have questions or would like additional information, please contact either of the undersigned.

Sincerely yours,



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Counsel to the Association



Margaret R. Blake
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Counsel to the Association

Cc: Commissioner Charles McCreevy
DG Competition