

THE ASSOCIATION OF GLOBAL CUSTODIANS

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27 April 2011

VIA HAND DELIVERY

Jose Aquino *61F*  
Director, Market Regulation Department  
Securities and Exchange Commission  
SEC Building, EDSA  
Mandaluyong City,  
Philippines



Re: **Electronic Direct Registration (EDR) of the PASTRA for Settlement of Securities**

Dear Sir:

We write on behalf of the members of the Association of Global Custodians<sup>1</sup> to set out members' views regarding certain aspects of the Capital Market Development Plan for the Philippine economy (2005-2010). We welcome and express general support for the main objectives of this plan, although for the reasons outlined below we wish to note our concerns with the Commission's envisaged registry model within the plan -- specifically, the electronic interconnection of the electronic direct registry system ("registry system", "proposed registry model" or "EDR") of the Philippine stock transfer agents (the "registrars") with the Securities Clearing Corporation of the Philippines (SCCP), the central clearing house for the clearing and settlement of trades executed on the Philippine Stock Exchange (PSE).

Regardless of whether EDR is intended to operate in parallel with the Philippines Depository and Trust Company (PDTC) or to replace the current depository

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<sup>1</sup> The Association is an informal group of 11 member banks, listed on the letterhead above, that provide securities safekeeping and asset-servicing functions to cross-border institutional investors worldwide. Members provide custody-related services to most types of institutional investors, including investment funds, pension funds, and insurance companies; and in that role facilitate transactions and settlements of transactions for a significant number of cross-border investors in the Philippine securities markets.

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infrastructure, Association members anticipate that the operation of this registry system would lead to an undesirable split of the centralized depository and securities settlement functions in the market. In turn, members believe this will likely create significant regulatory, market access and operational concerns for cross-border investors and their various custodial intermediaries.

The Association considers central securities depositories to be systemically important financial market infrastructures that serve the essential role of ensuring the safe and efficient functioning of securities markets. The Association supports innovation of settlement and safekeeping infrastructure provided that, in principle, the changes promote competition on a level playing field, greater market transparency, legal certainty in securities settlement and ownership, mitigation of systemic risks, and consistency in terms of international best practices. In the Association's view, the envisaged EDR model diverges from these important principles, and we encourage the Commission to re-evaluate the particulars of this model within the Capital Market Development Plan. We set out in greater detail below members' core concerns with the model.

1. The proposed registry model will not increase investor protection and transparency.

Association members understand that the aim of the proposed registry model is to support a higher level of investor protection and transparency to issuers, drawing on elements of the US direct registration system. The US direct registration system was introduced to provide domestic individual investors an alternative to broker-dealers who were keeping final ownership records.

Hence, while the drivers for both the US and Philippines appear similar, a fundamental difference is that the US direct registration system does not perform settlement activities with the central counterparty, which the Philippine model is envisioned to do. Moreover:

- a. The US system is only made available to domestic retail accounts and does not interject itself into the functioning of the institutional delivery system of the Depository Trust Company ("DTC") for confirmation, affirmation and settlement of institutional investor transactions.
- b. DTC continued to develop its facilities for institutional trade settlement, supported by related exchange-level rules that effectively required institutional trades to be settled through the central depository book-entry system.



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The registration system for the Philippines could also achieve transparency and investor protection by interacting with the central securities depository and the central counterparty / clearinghouse, and by performing its recording functions post-settlement (i.e., the registrars operating on a post-settlement basis, with linkage to the central depository). This would provide additional transparency to issuers and regulators while ensuring that new, unintended risks and complexities in the financial market infrastructure are avoided.

2. The proposed registry model introduces regulatory uncertainty and investment barriers for many non-resident investors.

US SEC Rule 17f-7 under the Investment Company Act of 1940 governs custody arrangements with foreign securities depositories (i.e., eligible securities depositories), which U.S. registered investment company funds access through their global and local custodial relationships. Rule 17f-7 defines the term *eligible securities depository* at the most basic level as a system for the central handling of securities either on a transnational level or in its country of incorporation. Going beyond this basic threshold, however, a depository must also meet the following criteria before registered investment company funds may utilize the entity:

- a. It must be regulated by a foreign financial regulatory authority;
- b. It must hold assets for the custodian that participates in the system under safekeeping conditions no less favorable than the conditions that apply to other participants in the system;
- c. It must maintain records that identify the assets of each participant and segregate the system's own assets from the assets of participants;
- d. It must provide periodic reports to its participants with respect to its safekeeping of assets, including notice of transfers to or from any participant's account;
- e. It must be subject to periodic examination by regulatory authorities or independent accountants.

Although PDTC is licensed and regulated as a central securities depository by the Philippines' SEC, and US registered funds generally consider PDTC an eligible securities depository within the meaning of Rule 17f-7, Association members are concerned that implementation of the EDR model will introduce uncertainties with respect to Rule 17f-7 eligibility considerations. Different licensing and capital requirements for the registrars, the unregulated nature of the EDR, and the decentralization of the current depository model will raise doubts for US registered

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funds (and Canadian funds registered in the US) whether or not the appropriate conditions exist that would permit them to continue maintaining assets via the Philippine market infrastructure.

Furthermore, Rule 17f-7 sets out conditions that enable a registered fund to determine if the custody arrangements with the depository provide reasonable safeguards against the custody risks associated with maintaining assets with the depository. The Rule requires due diligence and risk analysis to be performed by the fund's global custodian. The proposed registry model introduces artificial barriers to Association members' due diligence as they would then need to perform these time-intensive activities across all securities transfer agents connecting through EDR. The significantly increased efforts and resources needed to comply with such requirements will cause impediments to fund access to the Philippines market.

3. The proposed registry model will hinder development of new investment products and services.
  - a. As an example, an efficient Exchange Traded Fund (ETF) process flow requires a central depository, with no fragmentation of settlement activities, to create and redeem ETF units within a short processing timeframe. The registrar plays a role in ETF flows by maintaining records of the ultimate beneficiaries and providing end-investors communications, dividend distributions, etc. If the proposed registry model is implemented, there will be no single securities settlement/recording system for the issuance and redemption of ETF units. This serves as an entrance and growth barrier for this market, as registrars will face challenges in expanding their activities in line with financial market development and servicing needs of investors.
  - b. Another example is the stock lending program instituted to prevent settlement failures. Stock lending requires a consolidated view of settlement, inventory and a consistent legal framework and these characteristics would be fragmented under the proposed registry model.
4. The proposed registry model introduces new operational and systemic risks.
  - a. As there will be more than 20 registrars connecting to the EDR (i.e. PASTRA.NET), with some remaining outside of the EDR due to manual back-



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office systems, the proposed registry model increases the number of potential fail points within the clearing and settlement processes. Systems failure can occur unexpectedly, and prevention of resultant systemic risks would demand complex and heavily coordinated business contingency planning. Having multiple potential points of failure raises members' concerns about the manageability of crises and unforeseeable knock-on effects.

- b. The lack of a central legal entity that would be ultimately accountable for proper management and accountability raises additional serious concern. The added systemic, operational and settlement risks, as well as the added uncertainty regarding competency, financial capacity and governance arrangements of the market infrastructure, would not be consistent with international best practices (such as those articulated by BIS and OICV-IOSCO's Principle of Financial Market Infrastructure).

5. The proposed registry model creates potential conflicts of interests with respect to the maintenance of core ownership records.

Registrars are owned by issuers, and a single registrar is the majority shareholder of EDR (PASTRA.NET). Under the proposed registry model both registrars and EDR (PASTRA.NET) would be expected to perform settlement and maintain the final book of records for securities ownership. As a result, Association members believe that such arrangements will not aid in ensuring transparency in the recording of ownership interests and may well create the potential for significant conflicts of interest. The existing central securities depository and settlement model does not create such concerns.

6. The proposed registry model is inconsistent with regional harmonization efforts and integration with ASEAN initiatives.

The PDTC is a member of the Asia Pacific CSD Group, which has "harmonization" as its collective mission. However, the proposed registry model is inconsistent with the spirit of regional harmonization, and indeed may well serve as a backwards step for the Philippines in terms of coordination with regional initiatives and cooperation with other ASEAN members.

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The Association appreciates the opportunity to provide you with member's views on the forgoing matters, which are of significant interest and concern to global custodians. It is members' view that the existing PDTC depository model -- a single central depository for equity securities -- provides market participants and investors with the optimal basis for settlement efficiency and safety, without the various noted drawbacks of the proposed registry model. Members would welcome an opportunity to discuss these views with you further. For additional information or to initiate such a discussion, please contact the undersigned.

Sincerely yours,

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

Cc: Chairperson *8/F*  
Securities and Exchange Commission

RECEIVED  
Securities & Exchange Commission  
OFFICE OF CHAIRPERSON FE'B. BARTIN  
By: *Vivian F.*  
Date: *4-27-11*  
*1:30*

Securities Clearing Corp of the Philippines  
PASTRA.NET INC  
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Philippine Stock Exchange  
Philippine Depository & Trust Corp  
HSBC  
Citibank  
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Standard Chartered Bank

*Kate Adreas*

*Wahid* *4/27/11*

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