

THE ASSOCIATION OF GLOBAL CUSTODIANS

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1 April 2008

Mr. Jean-Michel Godeffroy
Director General Payment Systems and Market Infrastructure
European Central Bank
Postfach 16 03 19
D-60066 Frankfurt am Main
Germany

Dear Mr. Godeffroy:

We write on behalf of the Association of Global Custodians (the "Association")¹ with regard to the European Central Bank's ("ECB") public consultation papers on T2S user requirements and T2S economic impact, issued together on 12 December 2007 (collectively, "Consultation Papers")². This letter follows up the Association's earlier comments to the ECB regarding T2S configuration and features,³ and it continues members' discussions with ECB officials over the past several months.

¹ The Association is an informal group of eight 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. Through their intermediary activities, Association members play a critical role in enabling the flow of investment capital from market to market and facilitating investments in European securities. The Association members are listed on the letterhead above.

² The documents included in the Consultation Papers and referenced in this comment letter are: the User Requirements document (hereafter, "URD"); the User Requirements Management Summary (hereafter, "Management Summary"); and the T2S Economic Impact Analysis (hereafter, "Impact Analysis").

³ Association Letters to Jean-Michel Godeffroy, 7 February 2007 and 26 June 2007.

THE ASSOCIATION OF GLOBAL CUSTODIANS

Jean-Michel Godeffroy

1 April 2008

Page 2

As a preliminary point, the Association reaffirms members' interest in the ECB's efforts to create a cost-effective, efficient and harmonized securities settlement system for a pan-European market and commends the ECB for the work it has done to date to push T2S forward. The Consultation Papers are extensive in scope and substance, and members applaud the ECB's impressive effort. We appreciate the ECB's inclusion of users in defining user requirements via the Technical and Advisory groups and periodic consultations; and we encourage continued progress in shaping the functional specifications and assessing the economic impact.

The following comments address aspects of the Consultation Papers that are of particular importance or concern to members. Most of our points are higher-level in nature, and we are submitting them via letter rather than using the Consultation Papers' template.

Comments.

I. Future Governance.

The Management Summary states that T2S will be controlled via the Eurosystem's ownership rights, will be operated on a full cost-recovery/not-for-profit basis, and will be administered to ensure full accountability and transparency of costs and prices. However, neither the Management Summary nor other parts of the Consultation papers underscore a full commitment to principles of user-governance and user-responsiveness. We understand that the T2S Advisory Group will be deliberating further about the governance framework for future stages of the initiative, and during that process we encourage the ECB to draw heavily on the industry's very favorable experience with user participation in governance of infrastructure entities via formal user input into ongoing entity decision-making.

More specifically, the T2S governing board should include a representative number of intermediary service providers, including custodians, that service end investors. Global custodians and local custodians play critical roles in the chain of custody that supports European cross-border investment/settlement activity and that enables global capital to move to and from European markets. Custodians therefore should have suitable representation and voting rights in setting T2S strategic priorities; evaluating system investment choices; developing policies; providing financial oversight; and planning operational changes as T2S becomes operational. Intermediary participation in T2S governance can be achieved here, as in other infrastructure contexts, through use of advisory and operating committees that include users.

Jean-Michel Godeffroy

1 April 2008

Page 3

We encourage the ECB to make representative user participation in T2S-related decision making a basic organizational feature of T2S no matter how many market infrastructure entities join T2S or how many CSDs consolidate post-implementation. Eurosystem ownership of T2S should not be allowed to overshadow the interests, views and service needs of market participants.

To facilitate user participation in governance, we encourage the ECB to continue to provide opportunities for public review and comment on proposed governance recommendations to the Governing Council and on developments that emerge from the Advisory and Technical Groups -- whether relating to legal requirements, contractual issues, harmonization or financial matters (including pricing for services). As T2S moves beyond implementation, we are hopeful that the consultative process will continue through formal procedures that involve users in operational, policy and pricing decisions and in evaluating T2S reports concerning transparency-related events.

II. Continued T2S separation of settlement from asset servicing increases operational risk as well as intermediary cost in executing corporate actions.

There are significant interdependencies between settlement and asset servicing. Core asset-servicing operations of CSDs, including features such as process timelines and funding, are -- and need to be -- closely linked with the settlement functionalities envisioned for T2S. The T2S design decision to disconnect settlement and asset servicing necessarily sacrifices cost savings and efficiencies.

The separation of T2S settlement from asset servicing also imposes operational risk. With respect to corporate action processing, the URD notes that a CSD may either rely on holdings balances at T2S or replicate those holdings balances and then rely on the balance on the CSD's own systems to execute corporate action steps. Significantly, under both approaches the separation will create an extra layer in the chain of data transmission before a broadcast message can be delivered to holders of the securities involved. In addition, under the second approach updates and reconciliations between the CSD and T2S will be necessary to ensure that all parties employ the same holdings balance. Given these added steps and their attendant risks, we strongly encourage the ECB, in subsequent T2S design and specification developments, to address the separation issues by considering ways to maximize synchronization of settlement and asset servicing and thereby minimize risks of error and financial loss.

Jean-Michel Godeffroy
1 April 2008
Page 4

III. In designing and phasing in T2S, discriminatory or preferential effects among market participants should be avoided.

The Management Summary states that T2S will serve the markets and intermediaries as “neutral infrastructure... supporting the different business models adopted by CSDs and market participants without discrimination.” (Management Summary at page 5.) The summary underscores, however, the potential for CSDs to invest in asset servicing and investor services; and it suggests that custodians “will need to consider their strategy,” suggesting that their “wholesale customers in particular... are likely to wish to reduce their number of suppliers by seeking partners with pan-European ... services.”

We agree that T2S neutrality is critical in view of T2S’s central role in the post-implementation service/account infrastructure, and we appreciate the ECB’s neutrality intentions. We also agree that the advent of T2S will require infrastructure entities as well as intermediaries to innovate their business models to remain value-added servicers of investor needs. We are concerned, however, that the ECB’s emphasis on CSD expansion into non-traditional lines of business skews the innovation opportunities in favor of CSD-re-positioning into investor services and may suggest that the post-T2S service and interconnection protocols will be configured to enable CSDs to exploit the new environment. CSD re-positioning into investor services could expose markets, investors, and market participants to increased systemic risks (e.g., by enabling CSDs to conduct activities that involve taking credit risks) or could create anti-competitive effects in the environment in which added-value services are currently performed (e.g., by enabling CSDs to leverage their unique position as central risk-management facilities).

As one illustration, the URD reserves certain fail-management processes to CSDs, which may lay a privileged foundation for CSD-based lending services. As another, the ECB should ensure that CSDs do not incur special privilege or leverage in connection with unilateral cancellation of matched instructions that are not given to CSD participants. As a third example, where T2S processing involves securities registered through a non-participating issuer-CSD the ECB should ensure that no special privileges are vested in T2S-participating CSDs that hold such securities (e.g., creating in T2S special roles for those CSDs or modifying the daily processing timetable to accommodate those CSDs).

Jean-Michel Godeffroy
1 April 2008
Page 5

IV. T2S and European Harmonization Efforts.

The Management Summary observes that T2S “will facilitate” further harmonization in market practices, though it also notes that further exploration of T2S and harmonization may lead to discovery of additional Giovanni-type barriers. The URD, at Annex 16, lists potential harmonization initiatives and issues that impact the user requirements (or that would facilitate use of T2S without affecting user requirements).

The Association believes that well-coordinated harmonization steps are critical to efficiency and cost-reduction in European market clearance and settlement, and members appreciate the ECB’s attention to this subject. The Association encourages the ECB to elaborate on the role it expects to play in defining action steps and alleviating barriers and, further, to expand its leadership effort so as to leverage harmonization initiatives and synchronize those with the design and use of T2S. Of particular value, we believe, will be close attention to ways to coordinate settlement processes with the integrally-related but now fragmented asset-servicing functionalities. The implementation of T2S, together with expanded ECB leadership efforts, can be a powerful driver in accelerating harmonization and processing/functional coordination or synchronization.

We offer four examples of ways in which the ECB’s leadership and coordination effort could be applied toward harmonization.

- The Project Team could collaborate with SWIFT on enhancing messaging standards for securities communications and promoting use of ISO 20022;
- The ECB could stay abreast of the work led by ISMAG on improving and standardizing industry protocols for the issuance and processing of international securities held at CSDs and ICSDs;
- The ECB can stimulate the relevant national authorities to address specific harmonization steps in regulatory and fiscal areas; and
- The ECB could encourage those involved in developing market standards and practices to have those documents reflect the changes and improvements that are introduced via T2S.

Jean-Michel Godeffroy

1 April 2008

Page 6

V. Economic Impact Analysis; Business Case Issues Affecting Intermediaries.

The Consultative Papers include the ECB's methodology in projecting costs and benefits of T2S. We list below, however, various costs of consequence to intermediaries that are not encompassed in the current Impact Analysis. These costs and their impacts necessarily affect the business case for intermediaries.⁴

- Market participants will need to see (or develop) information about the full end-to-end costs in a T2S environment of cross-border securities settlement and related services. Related services include asset-servicing and the specific national settlement facilitation processes deemed essential but not offered within T2S.

- Similarly, ongoing costs of investment by market entities and intermediaries in harmonization initiatives that are directed to systems, market practices and legal/regulatory/financial frameworks, such as removal of Giovannini barriers, are necessarily part of the business case. Those costs, likely to be substantial, impact aggregate user costs both during implementation and thereafter.

- Further, migration to T2S necessarily involves both operational and economic impacts on users. These "transitional costs", including for example, the costs associated with non-participation decisions by some CSDs, will be a substantial element of the overall investment and migration costs affecting intermediaries. In addition, much of the overall transition – both within T2S and in respect of the interrelated infrastructure components -- will take place in phases over time, as CSDs opt in or out, as they consolidate, and as their migrations entail delays or failures; and the ongoing costs and impact of those changes and effects will impact intermediaries and investors. As the following sub-points illustrate, the migration cost impact on intermediaries is not yet dimensioned.

- The Impact Analysis notes at footnote 4 that the customers of those CSDs that do not choose to participate may well "participate anyway..., using other channels." To be sure, CSD non-participation will impact intermediaries, including global custodians (where, for example, the appointed local

⁴ Association member banks may provide the ECB with comments by 15 April that incorporate some of the relevant and needed cost/impact information. If, as the impact review proceeds, the ECB issues a consultative summary encompassing these cost areas, the Association will provide more detailed views and comments.

Jean-Michel Godeffroy

1 April 2008

Page 7

subcustodian is unable to “use other channels” or cannot do so economically). That impact will entail costs to affected intermediaries.

α As a related point, the Impact Analysis, at Section 2.1.3, page13, states that “in a single process for settlement, intermediaries will no longer need to maintain many different settlement interfaces with several CSDs and/or other intermediaries... [and] indirectly connected T2S users may require fewer changes because they will continue to use the existing interface to their CSD.”

In our view, global custodians will need to maintain multiple settlement interfaces with local CSDs and intermediaries in the T2S environment in order to continue to support investor-customer demands beyond the transaction settlement function. Once T2S is operational, non-local CSDs will not be able to provide the same asset-servicing qualities and timeliness as a local CSD. Multiple interfaces will therefore be needed, including for asset-servicing, various value-added services, such as securities lending, and national market settlement specificities that remain essential post-implementation. Migration costs will necessarily accompany those interconnections.

In addition, as T2S becomes operational indirectly connected intermediaries will not necessarily face fewer change requirements. The reshaping of the service functionalities of CSDs post-implementation – including the split envisioned by T2S between settlement and asset servicing – will likely require downstream operational changes that involve migration costs for intermediaries. Custodians, for example, will need to make internal process/system changes as well as adjustments in external service arrangements to ensure that they can support investor demands.

- CSDs that settle in both euro and non-euro currencies (in the UK and Ireland, for example) may not be able to decommission their settlement processing as anticipated; and intermediaries will need to create separate settlement links and functionality in order to handle multi-currency activity, at least for some period of time. Both of those consequences will impose new ancillary costs on markets and intermediaries and will sacrifice savings that T2S is intended to achieve. Affected intermediaries will need to understand the “business case” dimensions and impact of those costs as part of transition to T2S.

THE ASSOCIATION OF GLOBAL CUSTODIANS

Jean-Michel Godeffroy

1 April 2008

Page 8

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We appreciate the opportunity to provide the ECB again with the Association's views. We look forward to providing additional commentary as T2S moves forward. If you have questions or would like additional information, please contact the undersigned.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Dan W. Schneider". The signature is fluid and cursive, with a long horizontal stroke at the end.

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