Tackling Rule 17f-7

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Pressure has been building for some years on investors and industry participants worldwide to analyse and better understand Central Securities Depositories (CSDs) and the risks associated with local market settlement and custody.

In the US, this commercial pressure became a regulatory imperative when the US Securities and Exchange Commission (SEC) released Rule 17f-7. This came into effect in mid-2000 with a compliance date of July 2nd 2001). Rule 17f-7 requires US mutual fund managers, whenever they make an investment decision, to take into consideration the local market depositories and the safety of underlying assets during the settlement process and in ongoing safe custody.

Building on the existing CSD research platform and publications (i.e., CSD Guides 1997 and 1999) Thomas Murray was encouraged to develop a solution to help meet these existing and growing industry requirements. Our response has been to organise the collection, validation and review of depository and associated data. The Depository Review and Risk Evaluation Service (Depository Service) is an annual programme, which will formally analyse equity and fixed income depositories around the world. It also evaluates the structural and operational effectiveness of each depository and related risks associated with local market settlement and custody. The Depository Service is an inclusive and industry neutral initiative open to all interested parties.

Cross-industry Co operation

The Depository Service is being managed and led by Thomas Murray in London with the depository risk assessments provided by Standard & Poor's. The service represents a milestone in cross-industry co-operation.

It combines our strong position as a provider of research, evaluation and assessment of

global custodians, agent banks and CSDs with S&P's extensive analytical resources and experience in evaluating risk. It also draws further on the expertise contributed by the industry and other third parties. The Depository Service is being supported by a core group of leading banking groups who have contracted to act as data collection and validation banks globally. These banks include:
ABN AMRO Bank of New York
BNP Paribas Citibank
State Street Mellon Trust
HSBC (Validation Support Bank) SE Banken

Depository Service Scope

Depositories exist in most securities markets and act as a facility for holding equity and/or debt instruments (storage), which enable securities transactions to be processed by book entry. A depository safeguards and records securities either physically or electronically and may record ownership of these securities.

• The scope of the Depository Service is to look at entities providing "storage only" or "storage and flow", but never "flow only", a function usually provided by clearing houses.
• The Depository Service understands that depository risks are on occasion inseparable from risks in the local marketplace, and that it would be misleading to contain analysis in all cases to risks emanating only from the depository itself. As warranted by circumstances, the service scope will not exclude consideration of exposures that may originate in market practices or other local infrastructures essential to a depository's functions. In this regard, some of the issues raised by the assessment may not be issues under the control of the depository and this will be clearly highlighted in any assessment.

provide significant benefits to the securities industry, including:
• increasing global market understanding
• providing much needed information on protection of assets, risk minimisation, and service quality to custodian banks, brokers, International Central Securities Depositories (ICSDs), asset managers and investors
• encouraging cross-border investment flows and thereby promoting increased market liquidity
• significantly reducing the number of requests for information on CSDs by providing a global central point of validated data and point of assessment for these institutions
• providing a mechanism to publicise infrastructure improvements as they take place
• supporting end investors' market risk evaluations integral to decisions to invest outside their home markets. This has become a regulatory imperative in the US, and many regulatory environments appear to be following this lead
• demonstrating via publication of assessment reports those areas where the depository is strong and also identifying weaknesses that could use improvement. In this context the reports will also assist depositories who can use the results to focus efforts to improve specific levels of services available to participants and customers.

Governance

An advisory group performs the governance of the Depository service. This is an industry representative group created to maintain neutrality and to assist in the development and oversight of the structure and content of the Service. The advisory group has met several times over the past year and is comprised of senior representatives from Thomas Murray, S&P, ABN AMRO, Bank of New York, BNP Paribas, Citibank, Goldman Sachs, IFC/World Bank, Mellon Trust, Merrill Lynch, and State Street.

There is also a working group, comprised of global market and risk specialists from entities participating in the service. The working group has met regularly over the second half of 2000 to define and draft the risk criteria against which each depository will be assessed. The group prepared a data collection workbook to be used as part of the data collection phase to support the operational and risk analysis.

Risk Assessment

In general, the role of any CSD in the financial market and economy of a country requires them to exhibit a low-risk profile. The owners and management of CSDs typically operate them like quasi-public utilities rather than as profit-making businesses. The participants exert pressure on these entities to ensure that they are structured to operate in a prudent manner. To varying degrees, CSDs build internal safeguard mechanisms to allow them to withstand occasional market adversity. Against this background, the institutions involved in the Depository Service defined the categories of risks to be covered and the evaluation criteria to be used in the assessment.

The categories include six specific risk areas associated with a depository's involvement with local market transaction processing and safekeeping. The main risk areas are: asset commitment risk, counterparty risk, CSD on CSD credit risk, financial risk, liquidity risk and operational risk.

The risks identified by the Depository Service clearly offer a different perspective and exclude many of the common risk categories/terminology used by investors when considering investing in a particular country. In this regard, sovereign risk is excluded from the assessments as it is covered by the rating agencies, while systemic risk is covered under counterparty risk. Legal risk is also considered outside the scope of the Depository Service. Notwithstanding this, as part of the data collection exercise the service will request information supporting a number of legal issues directly from the CSDs (e.g., copies of depository agreements, details of the law(s) and regulations that established the CSD, when is a security transfer binding, how are disputes settled, what rights does the CSD have over assets it is holding, etc.).

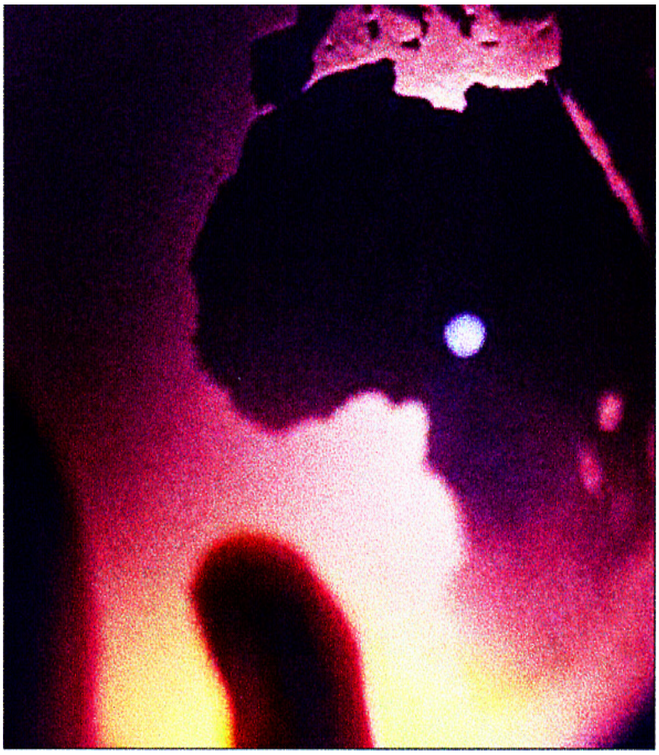
When undertaking assessments, these will be carried out at a given point in time. The assessment will not take into consideration any future enhancements or developments, however close to implementation. Ongoing reporting of material changes, market by market, will follow the initial analysis.

Regulatory Oversight

Because of their central role in the financial markets, CSDs are subject to local regulatory scrutiny. The Depository Service looks favourably on the role of the regulators to the extent they provide a backstop by setting and/or approving minimum financial and operating standards and rules of conduct for the CSD(s). Regulators occasionally audit these institutions for enforcement of their own rules and discipline violators. The regulators also police market participants to ensure that they adhere to the rules and regulations controlling the marketplace or otherwise putting the CSD at undue risk. The Depository Service does not in any way attempt to cut across the activities of the regulators. Indeed, we envisage our work being of assistance to the local market regulator(s) as the scope of the assessments goes beyond the depository to look at settlement and custody risk exposures linked to equity and fixed income transaction processing.

Embedded Checks and Balances to Support the Assessments

It is the commitment of the Depository Service to make the service and the criteria for assessments as transparent as possible. Significant effort and discussion has taken place across the industry to ensure that appropriate levels of checks and balances have been put in place to provide comfort to all those involved in the service, either as a CSD being



assessed or as a participant taking any element of the service outputs. This allows each CSD the opportunity to review and confirm the base data workbooks, completed and validated by the support banks to the service and comment on the draft reports produced before they are finalised and published.

Data Collection Process & Reports

The scope of the service and the risk analysis includes settlement and custody risks linked to equity and fixed income transaction processes in local markets, particularly as they impact depositories. Hence, the data required goes beyond depository specific data. The collection and verification of the base information is, therefore, a mix of the support banks and the depositories. Hence, part of the workbook initially goes to both the depository and the support banks for completion.

A copy of the completed workbook will be sent to each depository for confirmation and sign off. Where a depository is unable to provide information or the required support, Thomas Murray and S&P will necessarily have to place reliance on the primary and secondary support banks completing the workbook as far as possible and the output report may be qualified accordingly.

Thomas Murray and S&P will prepare and publish an assessment on each depository. It is important to note that these are written assessments; they are not ratings and will be largely qualitative reports. The reports will be stand-alone, written from a local market perspective and not be comparable across markets. The reports will bear in mind local conditions outside the control of the depository. The reports will be structured to provide information to assist all users in meeting commercial standards including those, which relate to asset safety, risk minimisation and service quality. The risk analyses will include risks associated with local market securities transaction processing as they impact depositories.

Timings

US mutual funds subject to Rule 17f-7 have a need to better understand risks associated with maintaining assets at depositories and are putting considerable pressure on their custodians and asset managers for support in this regard. Custodians are required under the new rule to supply their clients and/or their investment managers with analyses of depositories pertaining to custody risks. In this regard, the Depository Service is seeking to evaluate all operational equity and fixed income depositories in the first year. The initial data gathering exercise commenced in November 2000 and the assessments will be available from the end of Q1 2001.

The Depository Service is non-exclusive and therefore available to all institutional and wholesale participants. Drawing on raw data that is often publicly available, the service will have, as its main output for institutional participants, the summary assessment reports produced on each individual CSD based on Thomas Murray/S&P proprietary risk analysis.

| Global Custody Review | **Market Developments**

Risk Assessment Areas

Asset commitment risk: The risk associated with the period of time from which use of securities or cash is lost (control given up) before receipt of counter value. It focuses on concerns regarding the asset commitment periods. This is the amount of time participant assets, either cash or stock, are frozen within the CSD, pending settlement of the underlying transaction(s) and the irrevocable receipt of value. Following initial settlement the risk period is extended until the transfer of funds and stock becomes irrevocable. It excludes any periods when assets, cash or stock, are committed to a market participant including brokers, banks and custodians, not caused by CSD processing.

Counterparty risk: The risk that a counterparty (i.e., an entity) will fail to settle its obligations for full value at any time, and the risk that such a failure will trigger a chain reaction. This risk occurs when a participant is unable to meet its financial liability to the CSD and possibly other creditors. Counterparty risk depends on who the other participants are and examines the effectiveness of the monitoring of those participants.

CSD on CSD credit risk: When a CSD links with a peer group CSD, the credit risks that host and inward CSDs are taking. Today this is a relatively uncommon risk, but given market developments, particularly in the Eurozone, this risk will gain in potential importance. The Depository Service will this year restrict itself to the credit risk associated with these links, as well as the collection of data surrounding links, including operating rules for the link and a description of the initial and on-going due diligence in place to support the link.

Financial risk: Risk associated with the ability of the CSD to operate as an ongoing concern. Issues considered include if the capital is sufficient to meet the ongoing operation of the organisation and its revenues, cash flow and ongoing profitability. It is not looking at when the CSD is counterparty to a transaction, as this is covered under counterparty risk.

Liquidity risk: The risk that insufficient securities and/or funds are available to meet commitments; with obligation being covered sometime later. This is where for certain technical reasons (e.g., stock out on loan; stock in course of registration, turn round of recently deposited stock is not possible) one or both parties to the trade have a shortfall in the amount of funds (credit line) or unencumbered stock available to meet settlement obligations when due. These shortfalls may lead to settlement "fails" but do not normally lead to a default.