



**Gerard B.J. Hartsink**  
Executive Chairman

**CLS Bank International**  
32 Old Slip, 23rd Floor  
New York, NY 10005

Tel: +1 (212) 943-2506  
Fax: +1 (212) 363-6998  
[ghartsink@cls-bank.com](mailto:ghartsink@cls-bank.com)

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Via E-mail

Secretariat  
Committee on Payment and Settlement Systems  
Bank for International Settlements  
4002 Basel, Switzerland  
Sent by email to: [cpss@bis.org](mailto:cpss@bis.org)

Secretariat  
Technical Committee  
International Organization of Securities Commissions  
C/ Oquendo 12  
28006 Madrid  
Spain  
Sent by email to: [fmi@iosco.org](mailto:fmi@iosco.org)

Ladies and Gentlemen:

CLS Bank International (“CLS”) welcomes the opportunity to share its views on the consultative report on the *Assessment Methodology for the Principles for FMIs and the Responsibilities of Authorities* (the “Proposed Assessment Methodology”) prepared by the Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”). The Proposed Assessment Methodology, once finalized, is intended to provide a methodology for assessing the observance of the 24 principles and five responsibilities as defined in the CPSS-IOSCO report on *Principles for Financial Market Infrastructures* (“Principles”), published by CPSS and IOSCO in April 2012. The Principles provide standards for systemically important payment systems (“Payment Systems”), central securities depositories, securities settlement systems (“SSSs”), central counterparties (“CCPs”) and trade repositories (together “FMIs”).

CLS was established by the private sector as a payment versus payment (“PvP”) system to mitigate settlement risk—loss of principal—associated with the settlement of

payments relating to foreign exchange (“FX”) transactions.<sup>1</sup> CLS is the predominant settlement system for FX transactions and provides a PvP settlement service for 17 currencies. These currencies represent a substantial majority of the total daily value of FX swaps and FX forwards traded globally.<sup>2</sup> Over the years, CLS has grown consistently with the FX market to mitigate settlement risk, which is generally considered to be the primary risk in FX transactions. Today, CLS serves over 60 Settlement Members, all of which are financial institutions subject to prudential supervision and regulation, and over 14,000 third-party users. While CLS is owned by many of the largest participants in the FX market, it continues to acknowledge and further the dual public-private purpose that gave rise to its creation.

The settlement service operated by CLS is viewed as a systemically important system for settling payment instructions relating to certain types of underlying foreign exchange and other transactions (i.e., FX contracts, NDF contracts and OTC credit derivative contracts) in specifically authorized currencies. As an Edge corporation, CLS Bank is regulated and supervised by the Federal Reserve under a program of ongoing supervision, combining full-scope and targeted on-site examinations with a variety of off-site monitoring activities.<sup>3</sup> In addition, the central banks whose currencies are settled in CLS have established a cooperative oversight arrangement for CLS (the “CLS Oversight Committee”) as a mechanism for the fulfillment of their responsibilities to promote safety, efficiency, and stability in the local markets and payment systems in which CLS participates. The Federal Reserve organizes and administers the CLS Oversight Committee, which is the primary forum for the participating central banks to carry out their cooperative oversight of CLS, pursuant to the Protocol for Cooperative Oversight of CLS.<sup>4</sup>

## I. General Comments on the Proposed Assessment Methodology

CLS recognizes the significant efforts of the regulatory community in creating the Proposed Assessment Methodology as a guide for the implementation of the Principles and broadly supports the Proposed Assessment Methodology. As a result, CLS’s comments below are limited to those instances where CLS believes that the particular Key Element (“KE”) or Question (“Q”) relating to a Principle or Key Consideration (“KC”) is either unclear or inappropriate when considered in light of the policy underlying the relevant Principle or KC.

CLS notes that many of its prior comments in response to the Consultative Report relating to the Principles were addressed in the adoption of the Principles.<sup>5</sup> Certain comments below mirror those comments to ensure that they are appropriately reflected in the corresponding KEs and Qs. In other cases, the comments below clarify CLS’s earlier comments on the Consultative Report in cases where the comment is of continuing concern to CLS.

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<sup>1</sup> See “Settlement Risk in Foreign Exchange Transactions,” CPSS (March 1996) (the “Allsopp Report”).

<sup>2</sup> CLS provides other services to over-the-counter FX market participants, such as an Aggregation Service through CLS Aggregation Services LLC and an In/Out Swap Program through CLS Services Ltd.

<sup>3</sup> CLS Bank operates pursuant to a charter issued by the Federal Reserve in accordance with Section 25A of the Federal Reserve Act of November 1999.

<sup>4</sup> [http://www.federalreserve.gov/paymentsystems/cls\\_protocol.htm](http://www.federalreserve.gov/paymentsystems/cls_protocol.htm)

<sup>5</sup> <http://www.bis.org/publ/cpss101a.pdf>

## II. Specific Comments on the Proposed Assessment Methodology

Set forth below are CLS's comments and proposed changes relating to particular Qs and KEs.

### A. Principle 1: Legal Basis

***An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions.***

With respect to Q. 1.1.3, while CLS agrees that an FMI should strive to provide a high degree of legal certainty for material aspects of its activities in all relevant jurisdictions, CLS cautions that Q. 1.1.3 may be overbroad. Q. 1.1.3 suggests that an FMI must view material legal issues from its participants' perspectives as well as from its own perspective. An FMI is unlikely to have insight into all issues that are pertinent to each of its participants, save those that will have a monetary impact on a participant. It may also be difficult for an FMI to obtain legal opinions that provide a high degree of legal certainty on all of the material issues relating to its participants because the analysis of those issues may depend on information that is uniquely within the knowledge or control of the participants. As a result, CLS recommends that Q. 1.1.3 be revised as follows: "What is the legal framework and how does it provide a high degree of legal certainty for each material aspect of the FMI's activities in all relevant jurisdictions? Do/does the legal opinion(s)/analysis(es) examine all relevant legal aspects regarding the different perspectives (for example, the FMI's perspective or the participant's perspective if relevant)?"

For the sake of consistency with the Principle, KC 1.1, and the other KEs, CLS recommends that KE 1 to KC 1.1 and Q. 1.1.1 reference "a high degree" of legal certainty rather than the currently drafted "legal certainty." For example, KE 1 to KC 1.1 should read: "Identification of each material aspect of the FMI's activity requiring a high degree of legal certainty," and Q. 1.1.1 should read: "What are the material aspect(s) of the FMI's activities that require a high degree of legal certainty (for example, rights and interests in financial instruments, settlement finality, and netting)?"

CLS agrees that in order for an FMI to function as intended, it must adopt clear rules and procedures that are consistent with relevant laws and regulations. Nevertheless, CLS notes that with respect to Q. 1.2.1, it is not apparent how the term "clearly formulated" will be applied because the question does not identify from whose perspective the formulation of the rules, procedures, and contracts must be clear. CLS believes that it is implicit that "clearly formulated" rules, procedures, and contracts are to be evaluated in the context of the specialized and technical environment in which these rules operate, rather in the context of the general public. Those without knowledge of the FMI's operations may not easily understand rules that are clear and understandable to the FMI and relevant stakeholders. CLS suggests that Q. 1.2.1 might benefit from clarification in this regard. Additionally, it would be particularly onerous for an FMI to demonstrate that all of its rules, procedures, and contracts are clearly and understandably formulated. It would be more consistent with Principle 1 for Q. 1.2.1 and Q. 1.2.2 to address rules, procedures, and contracts that are material to the FMI's operation, its participants and its customers. Therefore, Q. 1.2.1 should be amended to read: "How has the

FMI demonstrated that its material rules, procedures, and contracts are clearly and understandably formulated?”

Additionally, with respect to Q. 1.2.2 generally, CLS recommends that references to inconsistencies in the FMI’s rules, procedures and contracts be removed. For complex FMIs, it is burdensome and unnecessary to disclose each and every inconsistency. The vast majority of such inconsistencies are immaterial, alone or in the aggregate, to the operation of an FMI. Given that the Principle itself focuses on material aspects of an FMI’s operation, the disclosure of immaterial inconsistencies would not further this purpose. Moreover, to the extent such inconsistencies have been remedied and are no longer outstanding (particularly if the inconsistency was immaterial to begin with) disclosure would not benefit participants. Therefore, CLS suggests that only those inconsistencies that have had or could have a material impact on an FMI should be disclosed.

Finally, with respect to Q. 1.2.2, CLS recommends that the question be amended to require an FMI to “demonstrate,” rather than “ensure,” that its “material rules, procedures, and contracts are consistent with relevant regulations.” Given that Principle 1 itself requires a high degree of legal certainty rather than outright legal certainty, it is inconsistent to require an FMI to ensure compliance rather than demonstrate compliance to a high degree of certainty. An FMI cannot ensure that new regulations and laws, or their interpretations, will not conflict with its rules, procedures, and contracts. While CLS monitors the development of relevant laws, regulations, and interpretations in order to prevent such an occurrence, it is often unclear how courts or regulators will interpret new laws and issues, or how they will affect an FMI’s rules, procedures, and contracts. Accordingly, CLS recommends that Q. 1.2.2 be revised to ask the following: “How does the FMI ~~ensure~~ demonstrate that its material rules, procedures, and contracts are consistent with relevant laws and regulations? For example, has a legal opinion confirmed that these are consistent with relevant laws and regulations? Are the FMI’s material rules, procedures, and contracts reviewed or assessed by external authorities or entities? Do the FMI’s rules, procedures, and contracts have to be approved before coming into force, by whom and how? ~~Have any inconsistencies been identified and remedied?~~”

Similar to the comments on Q. 1.2.1 and Q 1.2.2 above, CLS recommends that Q. 1.4.1, Q. 1.4.2, and Q 1.4.3 be revised to refer to “material” rules, procedures, and contracts. As previously noted, this construction is consistent with Principle 1 itself and with the Principles broadly (for example, Principle 23). Additionally, without this qualifier, the term “procedure” could be interpreted in an overly broad manner to include any aspect of an FMI’s business. CLS believes that FMIs should generally obtain legal opinions only with respect to issues that are material to the operation of the FMI, and that these questions should be amended accordingly as follows:

- Q. 1.4.1 “How does the FMI achieve a high level of confidence that its material rules, procedures, and contracts related to its operations are enforceable in all relevant jurisdictions identified in KC 1.1? For example, has a legal opinion verified that the FMI’s material rules, procedures (including default procedures), and contracts are enforceable in all relevant jurisdictions when a participant defaults or becomes insolvent, or when the FMI is implementing its plan for

recovery or orderly wind down?”

- Q. 1.4.2: “What legal precedence, if any, could void or reverse the FMI’s actions under its material rules, procedures, and contracts?”
- Q. 1.4.3: “How does the FMI achieve a high degree of certainty that its material rules, procedures, and contracts will not be voided, reversed, or subject to stays?”

Additionally, Explanatory Note 3.1.9. (at footnote 30) acknowledges that in certain circumstances rights triggered because of entry into resolution or the exercise of resolution powers may be subject to stays. CLS therefore suggests that Q. 1.4.3 be amended to reflect that possibility.

B. Principle 2: Governance

***An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.***

With respect to Q. 2.2.4, CLS recommends that the disclosure of governance arrangements to the public occur “at a more general” level in order to maintain consistency between the question and KC 2.2, and therefore the question should be revised to ask: “How are the governance arrangements disclosed to owners, relevant authorities, users, and, at a more general level, the public?”

With respect to Q. 2.3.3, CLS agrees that a board of directors should have processes to address and manage conflicts of interest, however, the question appears to go beyond the scope of KC 2.3 and KE 3 by implying that there is a requirement that such processes be made public. CLS therefore recommends that the question be revised as follows so that it is consistent with the relevant KC and KE: “How does the Board identify, address, and manage conflicts of interest? What document describes these processes? Are such documents ~~public or~~ available to owners, relevant authorities, and users?”

C. Principle 3: Framework for the Comprehensive Management of Risks

***An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.***

CLS agrees that each FMI should have comprehensive risk management policies that encompass the risks related to each material aspect of an FMI’s operation. Nevertheless, CLS notes that certain questions relating to Principle 3 may not be applicable to all of an FMI’s operations. For example, it is not apparent from Q. 3.1.4 how an FMI’s systems can always aggregate exposures across the FMI or other relevant parties. As a result, CLS suggests that the question should be revised to inquire: “How do these systems provide the capacity to aggregate exposures across the FMI or other relevant parties, where appropriate, such as the FMI’s participants and their customers?”

Additionally, Q. 3.2.2 refers to information collected from a participant's customers. However, the corresponding KC 3.2 only encourages providing incentives to manage and contain risks to participants' customers "where relevant," and indeed CLS does not generally communicate directly with its participants' customers. Therefore, CLS recommends that Q. 3.2.2 be amended in the following manner: "What information does the FMI provide to its participants and their customers, where relevant, to monitor the risks they pose to the FMI? For example, does the FMI provide them information on their credit and liquidity exposures, overall credit and liquidity limits, and the relationship between the exposures and limits?"

CLS notes that Q. 3.2.3 refers to "policies and systems" for risk mitigation, while KE 3 to KC 3.2 refers to "policies, procedures, and systems." For the sake of clarity, this question should be amended to reflect the language of the KE. Moreover, similar to the comment on Q. 1.2.2 above, with respect to Q. 3.2.3, CLS notes that an FMI cannot "ensure" that its policies are effective. However, an FMI should "design" policies, procedures, and systems with the goal of effective risk mitigation, and thus CLS suggests that the question should be revised to read: "What policies and systems does the FMI have to enable participants to understand and manage risks? How does the FMI ~~ensure~~ design that its policies, procedures, and systems so that they are effective over time in allowing their participants and, as appropriate, their participants' customers to manage and contain their risks?"

Additionally, Q. 3.4.1 references processes used by an FMI to identify scenarios that may affect its critical operations or services. However, CLS notes that the use of "processes" is somewhat limited in scope and could be interpreted as referring to only to the high-level steps used by an FMI to identify scenarios affecting its critical operations and services. CLS proposes that the question should take a comprehensive approach and include all of the methods, rules, procedures, or otherwise, used by an FMI to identify such scenarios and therefore recommends the following amendments to Q. 3.4.1: "~~What are the FMI's processes to~~ How has the FMI identified scenarios that may potentially prevent the FMI from being able to provide its critical operations and services? What scenarios have been identified as a result of these processes?"

D. Principle 4: Credit risk

*An FMI should effectively measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. In addition, a CCP that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would*

*potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.*

Q. 4.1.3 and Q. 4.1.4 ask the FMI to provide a description of its framework and evidence of the validity of its framework for managing the credit risks from its payment, clearing, and settlement processes. CLS notes that not all FMIs engage in payment, clearing, and settlement processes and thus are not subject to the attendant credit risks. For that reason, CLS recommends that these questions be amended as follows to require disclosure only as applicable:

- Q. 4.1.3: “What is the FMI’s framework for managing credit risks from its payment, clearing and settlement processes, as applicable?”
- Q. 4.1.4: “What evidence supports the validity of the framework for managing credit risks from the FMI’s payment, clearing, and settlement processes, as applicable (for example, backtesting)?”

With respect to Q. 4.3.1, CLS notes that the question implies that an FMI is required to have multiple types of financial resources to cover its current and future exposures. However, this is not reflected in KC 4.3, which provides that a payment system or SSS should cover its exposure to its participants “using collateral and other equivalent financial resources.” Additionally, CLS notes that KC 4.3 is focused on the current and future exposures of each of the FMI’s participants, rather than on the FMI’s exposure generally. Therefore, CLS recommends that the question be revised as follows to both clarify this point and to reflect the language of the KC: “What composition of financial resources does the FMI use to cover its current and potential future exposures to each participant?”

KC 4.3 requires that a DNS payment system and a DNS SSS “maintain . . . sufficient resources to cover the exposures of the two participants and their affiliates that would create the largest aggregate credit exposure in the system.” Therefore, for the avoidance of doubt, CLS requests that Q. 4.3.4, which implements this portion of the KC, be amended as follows to reflect the language of KC 4.3 and KE 2: “If ~~the FMI~~ a DNS payment system or DNS SSS has credit exposures among its participants, do the FMI’s financial resources cover, at a minimum, the default of the two participants and their affiliates that would create the largest credit exposure in the system?”

With respect to Q. 4.7.2, which asks about the rules and procedures related to the replenishment of an FMI’s financial resources during a stress event, CLS notes that not every rule and procedure for dealing with a stress event will require the use of an FMI’s funds. For example, an FMI may have rules or procedures that require its shareholders, participants, or customers to contribute capital in certain stress events. Therefore, CLS recommends that Q. 4.7.2 be amended as follows: “What are the FMI’s rules and procedures on the replenishment, as applicable, of the financial resources that are exhausted during a stress event?”

E. Principle 5: Collateral

***An FMI that requires collateral to manage its or its participants' credit exposure should accept collateral with low credit, liquidity, and market risks. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.***

CLS appreciates the regulatory community's desire to require that FMIs be appropriately conservative in their acceptance, management and valuation of collateral. However, not every FMI is exposed to credit risk from its participants that requires attendant collateral. For example, CLS maintains a single multi-currency account in respect of each of its participants. While it permits negative balances in some currencies, it does so if and only if there are offsetting positive balances in the other currencies. Accordingly, under CLS' rules and procedures, the overall account balance for each participant must at all times remain positive for settlement to occur and CLS is therefore not subject to credit exposure resulting from participant liability in connection with a negative account balance. The laws of the jurisdictions in which CLS operates support this single account approach. Thus, FMIs such as CLS do not have credit exposures that require collateralization. For the sake of clarity, CLS therefore suggests the following amendment to question 5.1.1: "If applicable, what guidelines are used in determining whether a specific asset can be accepted as collateral, including for collateral to be accepted on an exceptional basis and the circumstances that would qualify as an exceptional basis?"

F. Principle 7: Liquidity risk

***An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.***

With respect to Q. 7.7.2, CLS agrees that an FMI should be required to make available to its liquidity providers all relevant information that the liquidity provider may consider necessary to enable it to make an informed judgment about and manage the liquidity (and other) risks associated with the potential provision of liquidity to the FMI. However, it is impracticable and inappropriate to impose on the FMI the obligation to ensure that the liquidity provider adequately understands the risks associated with its liquidity commitment or that it has engaged in adequate due diligence. This obligation belongs to the liquidity provider, and, of course, would be an appropriate issue for its prudential regulator to consider as part of its supervisory activities with regard to the liquidity provider. Accordingly, CLS recommends that Q. 7.7.2 be amended to require that an FMI provide its liquidity providers with all information necessary to evaluate the risks associated with providing liquidity to the FMI, rather than requiring an FMI to ensure that the liquidity provider has actually engaged in its due diligence. This can be accomplished by changing the question as follows: "~~How, and on what basis, has~~ Has the FMI ~~determined that provided~~ provided each of its liquidity providers ~~has~~ with sufficient information



to understand and to manage its associated liquidity risk in each relevant currency on an ongoing basis?”

Additionally, while CLS agrees that an FMI should have rules and procedures that are designed to enable the FMI to timely settle payment obligations following the default of any individual member, it would be exceedingly difficult for an FMI to ensure that its rules will enable timely settlement in every conceivable default scenario. Therefore, CLS recommends that Q. 7.10.1 be amended to as follows: “What are the rules and procedures that are designed to ~~would~~ enable the FMI to settle payment obligations on time following any individual or combined default among its participants?”

Moreover, for the sake of consistency, CLS suggests the following amendment to Q. 7.10.2 to reflect the language of KC 7.10 and Paragraph 3.7.18 of the Principles: “How, and to what extent, would these rules and procedures address unforeseen and potentially uncovered liquidity shortfalls aim to avoid unwinding, revoking, or delaying the same-day settlement of payment obligations?” The current language suggesting an outright requirement does not reflect the Explanatory Note and would impose an unrealistic burden upon an FMI.

Finally, as discussed in reference to Q. 4.7.2 above, an FMI may have rules or procedures that do not require the use of its own capital in certain stress events. Therefore, CLS recommends that Q. 7.10.3 be amended as follows: “What rules and procedures does the FMI have in place for replenishing any liquidity resources employed during a stress event, if applicable?”

G. Principle 8: Settlement Finality

***An FMI should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.***

With respect to Q. 8.1.2, CLS notes that more than one body of insolvency law is relevant to CLS and many other FMIs and as a result recommends that Q. 8.1.2 be amended accordingly to ask: “How does the FMI’s legal framework and rules, including applicable ~~the~~ insolvency law(s), acknowledge the discharge of a payment, transfer instruction, or other obligation between the FMI and its participants, or between participants?”

Moreover, with respect to Q. 8.1.3, CLS contends that it is not possible for an FMI to “ensure” settlement finality is achieved in the absence of an actual attempt to unwind a transaction in an actual insolvency. While CLS agrees that it is important to demonstrate settlement finality with a high degree of legal certainty, the question, as written, may suggest that FMIs must engage in guaranteed settlement, which is not the intent of the Principles or the Key Considerations. Therefore, CLS recommends that question Q. 8.1.3, be amended as follows: “How does the FMI demonstrate ensure that there is a high degree of legal certainty that finality will be achieved in all relevant jurisdictions?”

CLS agrees with the regulatory community's desire to ensure that an FMI completes final settlement no later than the end of the value date in normal circumstances. However, in unusual circumstances, such as during a market disruption, an FMI may not be able to ensure that settlement occurs on the value date and may determine that deferred settlement, pursuant to its rules and policies, is in the best interest of the FMI and/or its participants. Therefore, CLS recommends that Q. 8.2.1 be revised as follows: "Is the FMI designed, under normal circumstances, to provide final settlement on the value date (or same-day settlement)? How does the FMI attempt to ensure that final settlement occurs no later than the end of the intended value date?"

Additionally, CLS notes that deferral of final settlement can occur in circumstances that are not the result of the FMI's actions, and therefore suggests that the implication in Q. 8.2.2 that deferral is always preventable by an FMI is unwarranted. CLS recommends that Q. 8.2.2 be amended to encompass these circumstances and ask the following: "Has the FMI ever experienced ~~any~~ deferral of final settlement to the next business day that was not contemplated by its rules, procedures, and contracts? If so, under which circumstances? If deferral is a result of the FMI's actions, ~~W~~what steps have been taken to prevent a similar situation in the future?"

With respect to Q. 8.2.3, CLS notes that not every FMI provides settlement on an intraday or real-time basis. Therefore, the question should be amended as follows to acknowledge that possibility: "~~How d~~Does the FMI provide intraday or real-time final settlement? If so, how?"

Finally, with respect to Q. 8.2.5, CLS recommends that the question acknowledge instances where participants have access to their final account balances with the FMI, but the FMI does not affirmatively inform the participant of the balance. This concept can be incorporated by changing the question to ask: "Does the FMI inform participants of, or provide access to, final account balances as quickly as possible, preferably in real time?"

#### H. Principle 12: Exchange of Value Settlement Systems

***If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.***

As noted above, it is difficult for an FMI to "ensure" final settlement under all circumstances. However, CLS agrees that an FMI should "design" its settlement mechanisms to eliminate principal risk. Furthermore, CLS recommends that Q. 12.1.1, which asks about linked settlement, be broadened to reference "processes" in addition to "procedures." Thus CLS suggests that Q. 12.1.1 be amended as follows: "~~How does~~Is the FMI's settlement mechanism designed so ~~ensure~~ that final settlement of relevant financial instruments eliminates principal risk? ~~What Are the~~ procedures or processes designed so ~~ensure~~ that the final settlement of one obligation occurs if and only if the final settlement of a linked obligation also occurs?"

Finally, with respect to Q. 12.1.3, CLS notes that the blocking of assets refers to

FMI's who do not engage in simultaneous settlement. As a result, CLS recommends that the question be amended as follows: "Is the finality of settlement of linked obligations simultaneous? If not, what is the timing of finality for both obligations? Is the length of time between the blocking and final settlement of both obligations minimized? If applicable, ~~Are~~ are blocked assets protected from a claim by a third party?"

I. Principle 13: Participant-Default Rules and Procedures

***An FMI should have effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the FMI can take timely action to contain losses and liquidity pressures and continue to meet its obligations.***

There are a variety of ways in which an FMI may use its own financial resources in the event of a participant default, if it uses them at all. Therefore, CLS suggests that Q. 13.1.4 and 13.1.5 be amended to clarify that the FMI's rules and procedures may afford discretion as to how the FMI allocates resources in a default scenario, and that Q. 13.1.4 should read: "How do the FMI's rules and procedures address the order in which, or provide discretion for how, financial resources can be used?" and Q. 13.1.5 should read: "How do the FMI's rules and procedures address the replenishment of resources, if applicable, following a default?"

Additionally, a number of questions, such as Q. 13.2.1, Q. 13.2.3, and Q. 13.3.2, would benefit from the following revisions, which would make each question consistent with the Explanatory Notes to the Principles—in particular Paragraphs 3.13.5 and 3.13.6:

- Q. 13.2.1: "Does the FMI's management have ~~clearly articulated internal~~ plans to address a participant default, which clearly delineate roles and responsibilities, including in respect to any discretionary procedures?"
- Q. 13.2.3: "How frequently are the internal plans ~~processes~~ to manage a default reviewed?"
- Q. 13.3.2 "Do they include: (a) the circumstances in which action may be taken; (b) who may take those actions; (c) the scope of the actions which may be taken, including the treatment of both proprietary and customer positions, funds, and other assets; (d) the mechanisms to address an FMI's obligations to non-defaulting participants; and (e) where direct relationships exist with participants' customers, the mechanisms to help address the defaulting participant's obligations to its customers?"

With respect to Q. 13.4.2, CLS suggests further clarification. This question requires an FMI to "test the implementation of the resolution regime for its participants." A "resolution regime" describes a wide variety of potential "tools" at the disposal of regulators in different jurisdictions, which differ greatly depending on jurisdiction, facts and circumstances. An FMI cannot accurately predict which legal, financial, operational, or other requirements or practical issues will arise if such tool or tools were used and it is therefore unclear how an FMI

would be able to test the implementation of a resolution regime. A more practical approach would be to require FMIs to address the extent to which they have incorporated the possibility of a participant's resolution regime into their rules and processes. Moreover, CLS notes that Q. 13.4.2 also appears to go beyond the scope of both the Principle and KC 13.4. While KC 13.4 requires an FMI to involve its participants in the testing and review of its default procedures, it does not require that the procedures test the implementation of a resolution regime as to its participants. Therefore, CLS recommends that Q. 13.4.2 be amended as follows: "To what extent does the FMI incorporate the possibility of a participant's resolution regime into its rules and/or processes? What range of potential participant default scenarios and procedures do these tests cover? How does the FMI test the implementation of the resolution regime for its participants?"

J. Principle 15: General Business Risk

***An FMI should identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialise. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.***

KC 15.3 states that "equity held under international risk-based capital standards can be included where relevant and appropriate to avoid duplicate capital requirements." However, CLS notes that Q. 15.3.5, which reflects this portion of the KC, does not include the same "where relevant and appropriate" qualifier. For the sake of consistency, CLS suggests that the question should be rephrased to inquire: "If applicable, What guidelines are used in determining whether a specific asset can be accepted as collateral, including for collateral to be accepted on an exceptional basis and the circumstances that would qualify as an exceptional basis?"

K. Principle 16: Custody and Investment Risks

***An FMI should safeguard its own and its participants' assets and minimise the risk of loss on and delay in access to these assets. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.***

CLS agrees that an FMI should have procedures and safeguards in place to minimize delays and the risk of loss in its own investments. Therefore, the only comments CLS suggests would be changes to a number of questions, in particular, Q. 16.3.1, Q. 16.4.3, Q. 16.4.5 and Q. 16.4.6, to make each question consistent with Paragraphs 3.16.4 and 3.16.5 of the Explanatory Notes to the Principles:

- Q. 16.3.1: "How does the FMI evaluate and understand its exposures to its custodian banks? In managing those exposures, how does it take into account the full scope of its relationships with each custodian bank? For instance, does the FMI use multiple custodians for the safekeeping of its assets to diversify exposure to any single custodian? How does the FMI monitor concentration of risk

exposures to its custodian banks?”

- Q. 16.4.3: “How does the FMI consider its overall exposure to an obligor in choosing investments? What investments are subject to limits to avoid concentration of credit risk exposures? Does the FMI invest participant assets in the participant’s own securities or those of its affiliates?”
- Q. 16.4.5 and Q. 16.4.6: “How does the FMI ensure that its investments allow for quick liquidation? ~~Q.16.4.6: How does the FMI ensure that its investments are exposed to~~ with little, if any, adverse price effects?”

CLS also notes that certain FMIs, such as CLS, may not have securities that are held by a custodian, and as a result Q. 16.2.2 should be amended to inquire: “How does the FMI ensure that it can have prompt access to its assets, including, if applicable, securities that are held with a custodian in another time zone or legal jurisdiction, in the event of participant default?”

L. Principle 17: Operational Risk

***An FMI should identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfillment of the FMI’s obligations, including in the event of a wide-scale or major disruption.***

CLS agrees that all FMIs should establish a robust framework that is designed to identify the plausible sources of operational risk to which an FMI is exposed. However, while an FMI may design its system to identify operational risks with a high degree of certainty, it is not possible for an FMI to ensure that all risks will be identified. As a result, CLS suggests that a number of the questions would benefit from amendments that highlight this distinction:

- Q. 17.1.2: *See below for suggested amendments.*
- Q. 17.1.4: “What systems, policies, processes, and controls does the FMI employ that are designed to ensure that operational procedures are implemented appropriately? ~~To what extent~~ Do the FMI’s systems, policies, processes, and controls appropriately take into consideration relevant international, national, and industry-level operational risk-management standards?”
- Q. 17.1.6: “How, and to what extent, ~~do~~ are the FMI’s change-management and project-management policies and processes designed to ensure that changes and major projects do not affect the smooth functioning of the system?”
- Q. 17.3.2: “How are ~~do~~ these objectives designed to ensure a high degree of security and operational reliability?”

- Q. 17.5.3: “How, and to what extent, ~~are~~ the FMI’s change-management and project-management policies and processes designed to ensure that changes and major projects do not affect the physical security of the system?”
- Q. 17.6.3: “How ~~is~~ does the contingency plan designed to ensure that the status of all transactions can be identified in a timely manner, at the time of the disruption and if there is a possibility of data loss, what are the procedures to deal with such loss (for example, reconciliation with participants or third parties)?”
- Q. 17.7.2: “If the FMI has outsourced some of its operations to an external service provider, how, and to what extent, ~~does~~ is the FMI designed to ensure that those operations meet the same reliability and contingency requirements they would need to meet if they were provided internally?”

Moreover, while an FMI’s framework can be designed to identify extreme but plausible sources of operational risk, an FMI cannot design a framework to identify risks that are outside the realm of plausibility. The Principle itself recognizes this distinction by requiring an FMI to identify only “the plausible sources of operational risk.” As a result, CLS suggest that Q. 17.1.1, Q. 17.1.2, Q. 17.5.1, and 17.5.4, which each refer to the “full range” of operational risks, be amended to refer to “plausible sources” of operational risks to reflect the language and intent of the Principle.

- Q. 17.1.1: “What are the FMI’s policies and processes for identifying the ~~full range~~ plausible sources of operational risks on an ongoing basis?”
- Q. 17.1.2: “What are the sources of operational risks identified by the FMI? How ~~are~~ the FMI’s processes designed to identify ~~ensure that the full range~~ plausible sources of operational risks ~~is identified~~, whether these risks arise from internal sources (for example, the arrangements of the system itself, including human resources), from the FMI’s participants, or from external sources? How has the FMI identified and addressed potential single points of failure, if any, in its operations?”
- Q. 17.5.1: “What are the FMI’s policies and processes for identifying, monitoring, assessing, and managing the plausible sources ~~full range~~ of physical vulnerabilities and threats on an ongoing basis?”
- Q. 17.5.4: “What are the FMI’s policies and processes for identifying, monitoring, assessing, and managing the ~~full range~~ plausible sources of information security vulnerabilities and threats on an ongoing basis?”

Likewise, CLS notes that KC 17.2 and the relevant Explanatory Notes do not require an FMI to have its operational risk management framework subject to an external audit. While certain FMIs may be required to engage in an external review of operational risk management framework by a regulator, a review is not always required, particularly when the

FMI has demonstrated proper operational risk management systems. Therefore, CLS recommends that Q. 17.2.4 be amended as follows: “To what extent, if necessary, is the FMI’s operational risk-management framework subject to external audit?” This will clarify that although an external audit may be appropriate, it is not required to satisfy the Principles.

Additionally, to ensure proper focus with respect to KC 17.3 and KE 2, CLS recommends that Q. 17.3.5 refer to operational reliability objectives rather than to all of the FMI’s objectives by asking: “What are the processes to review the FMI’s operational reliability objectives and performance and take appropriate action as needed?”

With respect to Q. 17.5.2, CLS notes that the KC and the Explanatory Notes to the Principles do not require that the FMI document deviations from its security policies and risk mitigations. CLS therefore recommends the following amendment to the question: “~~To what extent~~ Do the FMI’s policies, processes, controls, and testing appropriately take into consideration relevant international, national, and industry-level standards for physical security? How are deviations from the security policies and risk mitigations documented?”

Finally, with respect to Q. 17.5.6, the question as drafted might be read to imply that an FMI is required to test its systems’ resilience with outside experts. However, as reflected in the Explanatory Notes to the Principle and the Key Consideration (which do not require such outside reliance testing), such testing may not always be appropriate. Therefore, CLS recommends that the question be amended as follows: “How, and to what extent, are ~~do~~ the FMI’s change-management and project-management policies and processes designed to ensure that changes and major projects do not affect the information security of the system? What reliance, if any, is placed on outside expertise to test resilience?”

M. Principle 18: Access and Participation Requirements

***An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.***

CLS supports fair and open access to FMIs. However, KC 18.1 and the Principle itself acknowledge that fair and open access must be based on risk-related participation requirements designed to ensure that participants “have the requisite operational capacity, financial resources, legal powers, and risk-management expertise to prevent unacceptable risk exposure for the FMI and other participants.” Q. 18.1.2, which inquires whether there is any evidence that an FMI’s open access requirements are successful, should therefore be amended as follows: “What evidence is there that these requirements allow for fair and open access to its services, including by direct and, where relevant, indirect participants and other FMIs, based on reasonable risk-related participation requirements?”<sup>6</sup>

With respect to Q. 18.3.1, an FMI cannot ensure, under all circumstances, that the information used to monitor its compliance with the participation criteria is timely and accurate; although an FMI should certainly strive to have policies that are designed to ensure that the

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<sup>6</sup> Paragraph 3.18.1 of the Final Principles.

information is as accurate as possible. CLS suggests that the question be amended as follows: “How does the FMI monitor the participants’ ongoing compliance with the access criteria? How are does the FMI policies designed to ensure that the information it uses to monitor compliance with participation criteria is timely and accurate?”

Finally, Q. 18.3.1 addresses disclosure of the FMI’s procedures for managing suspension and orderly exit of a participant. Because the question could be read to require disclosure, which goes beyond the requirements in KC 18.3, CLS suggests that the question be amended as follows: “~~How and to whom~~ Are the FMI’s procedures for managing the suspension and orderly exit of a participant disclosed?”

N. Principle 22: Communication Procedures and Standards

***An FMI should use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, settlement, and recording.***

CLS notes that, as drafted, Q. 22.1.1 could be read to require an FMI to communicate with customers of its participants. No such requirement is reflected in KC 22.1 and, moreover, certain FMIs are not designed to require direct communication between the FMI and its participants’ customers. As a result, CLS recommends that the question be amended as follows: “How do the FMI’s operational procedures, processes, and systems use or otherwise accommodate internationally accepted communication procedures to interact with participants; ~~the customers of participants~~, and other connected parties (including, where relevant, other linked FMIs or the customers of participants)?”

O. Principle 23: Disclosure of Rules, Key Procedures and Market Data

***An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees, and other material costs they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.***

CLS agrees that an FMI should have rules and procedures that provide sufficient information to enable its participants to have an accurate understanding of the FMI’s business. However, CLS suggest revisions to a number of the questions in order maintain consistency with the Explanatory Notes to the Principles—in particular Paragraphs 3.23.1, 3.23.2, 3.23.3, and 3.23.5. The suggested revisions are as follows:

- Q. 23.1.1: “Which documents comprise the system’s rules and procedures so that participants can fully understand the system’s design and operations, their rights and obligations, and the risks of participating in the system?”
- Q. 23.1.3: “What information do the FMI’s rules and procedures contain on procedures it will follow in non-routine, though foreseeable, events?”



- Q. 23.2.4: “How and to whom does the FMI disclose the degree of discretion it can exercise over key decisions that directly affect the operation of the system?”
- Q. 23.3.3: “In the event that the FMI identifies a participant whose behaviour demonstrates a lack of understanding, of the FMI’s rules, procedures, and risks of participation; what remedial actions are taken by the FMI?”

With respect to Q. 23.1.2, it is not apparent how the term “clearly articulated” is to be applied because the question does not identify from whose perspective the formulation of the relevant rules and key procedures must be clear. CLS avers that it is implicit that “clearly articulated” rules and procedures must be evaluated in the context of the specialized and technical environment in which these rules operate, rather than in the context of the general public. Parties without knowledge of the FMI’s operations may not easily understand rules that are clear and understandable to the FMI, its participants, and regulators. Thus, Q. 23.1.2 would benefit from clarification in this regard.

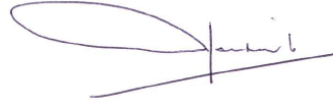
Likewise with respect to Q. 23.3.2, while an FMI should be required to provide its participants with sufficient information. It would be unduly burdensome to require an FMI to ensure that its participants actually understand the risks related to the FMI. Moreover, many FMIs’ participants are sophisticated financial institutions who are required by their regulator to understand and appreciate the risks related to the FMI. As a result, this burden appropriately lies with the participant, rather than the FMI, which may not have sufficient knowledge of its participants’ understanding. Therefore, given that there does not appear to be any basis in the Principle, the Key Considerations, or the Explanatory Notes for this requirement, CLS recommends that this question be deleted.

Finally, with respect to the latter portion of Q. 23.4.4 relating to the comparability of definitions, there does not appear to be any basis in the Key Considerations or the Explanatory Notes to the Principle for this requirement. While, subject to the comment above, an FMI is required to have clearly formulated rules and procedures that conform to the relevant regulatory requirements, it would be unduly burdensome to require that an FMI further conform its rules to match those of its competitors (assuming this is possible). CLS also notes that such coordination among competitors may raise legal issues, e.g., under antitrust or competition laws. As a result, CLS recommends that this portion of the question be deleted so that the question only asks: “How does the FMI define its priced services? ~~Is there evidence that service definitions are clearly described in a manner that allows for comparability?~~”

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CLS appreciates this opportunity to comment on the Proposed Assessment Methodology and remains available to answer any questions that CPSS and IOSCO may have concerning this letter.

Sincerely,

A handwritten signature in purple ink, consisting of a large, stylized 'G' followed by 'B.J. Hartsink'.

Gerard B.J. Hartsink  
Executive Chairman