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International Organization of Securities Commissions
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Re: Consultative Reports: *Assessment Methodology for the Principles for FMIs and the Responsibilities of Authorities* and *Disclosure Framework for Financial Market Infrastructures*

Dear Sirs:

The Clearing House Association L.L.C. ("Association") and The Clearing House Payments Company L.L.C. ("PaymentsCo," and, together with the Association, "The Clearing House")[1] are pleased to provide comments to the Committee on Payment and Settlement Systems ("CPSS") and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") on their consultative reports *Assessment Methodology for the Principles for FMIs and the Responsibilities of Authorities* ("*Assessment Methodology*") and *Disclosure Framework for Financial Market Infrastructures* ("*Disclosure Framework*").

[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs, and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. See The Clearing House's web page at www.theclearinghouse.org for additional information.

These consultative reports follow up on *Principles for Financial Market Infrastructures* ("*PFMI Report*"; the individual principles set out in the *PFMI Report* are referred to as "Principles") that CPSS and IOSCO released in April. The *PFMI Report* established 24 Principles that should be adhered to by and financial market infrastructures ("FMIs"), which include payment systems, central securities depositaries, securities settlement systems, central counterparties, and trade repositories. The *Assessment Methodology* aims at setting a common method for various stakeholders, including local supervisors, external assessors, and FMIs themselves, to assess an FMI's observance of each of the relevant Principles and key considerations set out in the *PFMI Report*. The *Disclosure Framework* sets out a template for the disclosure of each FMI's self-assessments to ensure that the FMI observes Principle 23, which calls for disclosure of rules, key procedures, and market data, including an FMI's completion and public disclosure of the *Disclosure Framework*.

PaymentsCo operates the Clearing House Interbank Payments System ("CHIPS"), the largest private-sector funds-transfer system in the world. CHIPS has been regarded as a systemically important system under the Federal Reserve Board's policy statement on payment system risk[2] and for years has been following previous CPSS standards such as the *Core Principles for Systemically Important Payment Systems* ("*Core Principles*"). The views expressed in this letter are informed by our experience operating CHIPS and observing global standards for systemically important payment systems and our expectation that PaymentsCo will be required to apply the Principles set out in the *PFMI Report* as they are eventually adopted by the Federal Reserve.

SUMMARY

1. The Clearing House supports the *Assessment Methodology* and the *Disclosure Framework*, but believes that the some of the details should be clarified.

2. FMIs should be given at least one year from the time their home-country supervisors adopt the Principles to come into compliance—longer if they are new to regulation as FMIs or if certain involve new issues or difficult actions.

3. After an FMI comes into compliance with the Principles, it should be given at least one year before its initial self-assessment is required.

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[2] PaymentsCo expects to be designated as a systemically important financial market utility under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act because of its operation of CHIPS.

4. Thereafter, FMIs should be expected to review its self-assessment every two years, but this should not require a completely new self-evaluation, except for those Principles where there have been material changes in circumstances or in order to correct a deficiency.

5. The Clearing House agrees with the proposed rating scheme and with the proposed templates for assessment report and public disclosure document.

6. While "reasoned" legal opinions may be appropriate to assess the legal basis for an FMI's operation as an FMI, they should not be required for other corporate transactions or operations.

7. Principle 7 (Liquidity Risk) should be clarified to ensure that it does not apply to FMIs that do not require liquidity in processing payments or other financial transactions.

8. In their analysis of Principle 15 (Business Risk), CPSS, IOSCO, and local regulators must take account of the costs involved in regulation and the threat that unwise or very costly regulations pose to the continued viability of private-sector FMIs.

9. In their analysis of Principle 8 (Access and Participation Requirements), CPSS, IOSCO, and local regulators should realize that regular, direct access to the central-bank liquidity facilities is an important risk-control feature for FMIs, and limiting participation to institutions that have access to central-bank liquidity does not violate this Principle.

10. Tiered participation arrangements do not include bank-customer arrangements in which the customer's only connection to an FMI is that the bank may execute the customer's payment orders by sending a corresponding payment order through the FMI.

11. Principle 20 (FMI Links) should not include informal dependencies, such as when participants fund their positions on an FMI by use of another FMI.

12. The Clearing House supports the full application of Principle 23 (Disclosure) and believes that it should apply equally to CPSS and IOSCO. We believe CPSS and IOSCO should adopt their own recommendation whenever they issue final papers and summarize comments received in response to their consultative papers, identifying the major comments, stating their reasons for accepting or rejecting those comments, and

identifying the significant changes made in a final paper from the one released for comment.

DETAILED COMMENTS

Frequency of Assessments

CPSS and IOSCO report that "CPSS and IOSCO members will strive to adopt the new principles by the end of 2012 and put them into effect as soon as possible. FMIs are also expected to observe the principles as soon as possible."[3] It would seem, however, that adoption by the end of 2012, while a worthy goal, will not be realistic for all countries.

Each member country will have to go through its legally required rulemaking procedures to adopt and enforce the Principles, and as part of that process, would be expected to adapt the Principles to the extent required to maintain consistency with its own legal, regulatory, and market conditions. Depending on the procedures that need to be followed and the amount of other work that needs to be done to conform the Principles to local conditions, it may take longer than currently forecast—perhaps as long as another year (i.e., the end of 2013)—before regulations are adopted in final form.

Once final regulations adopting the Principles become final in a country, we would anticipate that FMIs in that country would be accorded a reasonable time to come into compliance. The time needed will differ from one FMI to another and may depend on whether, or the extent to which, the FMI was regulated under a prior set of standards (e.g., the *Core Principles*), the extent to which the previously applicable principles have changed, and the difficulty of coming into compliance with those Principles that are completely new. The Clearing House believes that previously regulated FMIs should receive not less than one year after the final rules come into effect in the home country to come into complete compliance while not less than two years may be required if the FMI is to be regulated for the first time or if a new rule is applied to a previously regulated FMI requires considerable effort to attain compliance (e.g., raising capital under Principle 15). FMIs should also have an additional period following this deadline to complete their self-assessment process, document compliance, prepare the disclosure documents, submit draft disclosure documents to their regulators, make changes to respond to the regulators' comments, and obtain board approval. The Clearing House believes a minimum of period of six months (and perhaps longer if applicable regulators are unable to respond to requests for comment promptly, how extensive those comments are, and whether a second round of

[3] Co-chairs' Summary Note for the CPSS-IOSCO *Principles for Financial Market Infrastructures* (Apr. 16, 2012) at 8, available at http://www.bis.org/publ/cpss101e.pdf.

consultation is necessary). In order to allow reasonable time to address these contingencies, self-assessment by an FMI under the *Assessment Methodology* and release of a public report under the *Disclosure Framework* should not be mandatory until one year after the compliance date.

The Clearing House agrees that FMIs should be required to periodically review their self-assessment and believes a biannual review requirement would be reasonable, with an additional requirement for earlier or more frequent self-assessment if during the period there are substantial changes in the FMI's rules, operations, or legal environment, or if a regulator finds significant deficiencies that require correction.

We believe however, that effective periodic reviews need not require a "ground-up" reassessment of each Principle. For example, while an initial self-assessment of an FMI's legal basis would require a thorough review of all legal issues and the rendering of a legal opinion, subsequent self-assessments of this Principle could reasonably be limited to a review designed to ensure that there have been no significant changes to the legal environment (laws, regulations, or the FMI's rules or operations) and a review of the existing legal opinions to ensure that they are still applicable rather than a requirement for completely new legal opinions.

Frequency of an external assessment by regulators should depend on each regulator's assessment of an FMI's systemic importance and riskiness.

Principles Subject to Assessment

The Clearing House believes that an FMI's initial self-assessment should cover in depth all of the Principles that apply to it. As noted in the prior section, subsequent assessments should review all of the applicable Principles, but should focus on those that (i) require correction from the last self-assessment; (ii) have changed significantly from the last self-assessment; or (iii) have been affected by significant market, legal, or other conditions.

External assessments should be based on the regulator's assessment of the relative importance of each of the Principles to an FMI's operations and risk. Each country's regulator should determine how the Principles should be applied and whether its assessment of an FMI should evaluate the FMI's compliance with each key consideration for each of the Principles, or whether compliance should be based on the overall Principles.

Ratings

The Clearing House agrees with the proposed ratings framework: observed, broadly observed, partially observed, not observed, and not applicable, and we agree

that local authorities should have flexibility to determine the time frame for addressing areas of concern that examiners have identified.

Template for Assessment Report

The Clearing House believes that the overall structure that has been proposed for the assessment report is reasonable for external assessments. For self-assessments, however, there should be no need for an overview of the payments, clearing, and settlement landscape or for recommendations, which are more appropriate for external assessors. The template for self-assessments should follow that set out in the *Disclosure Framework*, with the addition of the rating that the FMI has given itself for each of the Principles.

The approach of using the questions set out in Appendix 3 in the manner of an examination manual appears reasonable, although we have some points to make about the questions used for some of the individual Principles. These are set out in the next section.

Notes on Individual Principles

Principle 1—Legal Basis. This Principle requires a clear, well-founded legal basis for each material aspect of the FMI's activities in all relevant jurisdictions. The questions for this Principle set out in Appendix 3 lead the evaluator (i.e., the FMI itself or an external evaluator) to an identify the material aspects that require legal certainty and the extent to which the legal opinions adequately address those issues. The Clearing House believes that this requirement and its evaluation require some additional clarity.

While it may be advisable to have a reasoned legal opinion to allow all the relevant parties to assess the reasoning behind the opinion that cover core aspects of its operation as an FMI (e.g., finality of payments, enforceability of rules, participant defaults) because the legal rules underlying these activities may be unusually complex or may not be fully developed in all jurisdictions, The Clearing House believes that reasoned opinions should be required only with respect to the rules, laws, and agreements relating to the FMI's operation as such. While it may also be appropriate for other significant corporate activities (e.g., significant debt or equity issues, mergers, significant acquisitions) to be supported by legal opinions, the format for these opinions should follow local practice, which may customarily require delivery of "unexplained" opinions that do not set out the reasoning behind the opinion giver's conclusions. The reason for this preference is the belief that "reasoned" or "explained" opinions are considered appropriate and acceptable in situations where the law is uncertain or the legal question is novel.[4] Use of a reasoned opinion could thus be seen as suggesting the

[4] Comm. on Legal Opinions, American Bar Assoc., *Guidelines for the Preparation of Closing Opinions*, 57 Bus. Law. 875, 879 (2002).

existence of some level of uncertainty that is not in fact present in a transaction that counsel would customarily cover with an unexplained opinion. We believe that it would be a mistake to suggest this level of uncertainty with respect to well-settled legal questions into more routine corporate transactions that do not specifically related to the company's operation as an FMI.

Other material contracts (e.g., software licenses, hardware leases) should be subject to the FMI's comprehensive contracting policy providing for levels of executive approval or legal review commensurate with the significance of the contract, but should recognize that in many cases would not require a formal legal opinion.

Principle 7—Liquidity Risk. This Principle deals with the FMI's own liquidity risks, not the liquidity risks incurred by the FMI's participants through their participation in the system. Accordingly, we believe that the analysis for this Principle should make clear that the Principle does not apply to an FMI that does not incur liquidity risks as a result of its operations. As a separate matter, we agree that an FMI has a responsibility to assist its participants understand and manage the liquidity risks they incur by participating on the system, and those responsibilities should be covered under Principles 13 (Principal Default Rules and Procedures) and 23 (Disclosure of Rules, Key Procedures, and Market Data).

Principle 13—Participant Default Rules and Procedures. This Principle has two aspects: (i) clarity of the rules and (ii) the ability of an FMI to contain its losses and liquidity pressures and continue to meet its obligations. As to the first aspect, we agree that every FMI should have clear rules regarding participant defaults and that all participants should know and understand the rules so that they will understand and be able to anticipate the risk of, and prepare for, either their own default or the default of another participant, which may be a major counterparty. The second aspect, however, should not apply where an FMI has no financial obligation with respect to the payment orders it processes.[5]

Principle 15—General Business Risk. This Principle deals with threats to an FMI's viability as a going concern. These can include the possible obsolescence of an FMI's business model in the face of changing technologies and payments practices (e.g., migration of payments away from the FMI to lower-cost alternatives), competition from other existing FMIs (including central-bank systems), and new entrants. The Clearing House believes it should also be clear that overregulation may create a significant threat

[5] We also note that for CHIPS, the failure of a participant to fund at the end of the day is not a default. A sending participant has no obligation with respect to a CHIPS payment message until CHIPS releases the payment message to the receiving participant and settlement of the sending participant's obligation to pay the amount of the payment message to the receiving participant is accomplished at the same time the payment message is released through the CHIPS settlement process.

to FMIs, as regulators may underestimate the cost of their rules. Regulatory compliance is a significant overhead cost that must be recovered in the fees that an FMI charges its participants, and higher costs may inhibit its ability to compete with lower-cost alternatives (e.g., unregulated new entrants that have not yet been designated systemically important or public-sector systems).

Principle 18—Access and Participation Requirements. The Clearing House supports fair and open access and believes that and FMIs should effectively reflect this Principle. Nevertheless, this Principle should be interpreted in light of the legal structures and payment services that exist in each country. For example, depending on how an FMI is structured, an FMI may require its participants to have regular direct access to the central bank's discount window, and access in some countries is limited to certain classes of financial institutions (e.g., commercial banks and other depository institutions but not securities brokers or dealers). In these circumstances, The Clearing House believes that direct access to the discount window by participants is vital to an FMI's risk-control procedures. Thus the principle of "open access" is not inconsistent with an FMI limiting access to its services to institutions with regular direct access to the discount window.

Principle 19—Tiered Participation Arrangements. Our comment letter on the proposed *PFMI Report*, suggested that the definition of tiered participation arrangement be clarified to provide more information about what exactly is covered and to avoid any suggestion that traditional correspondent banking arrangements represent tiered participation or that a FMI participant's customer becomes an "indirect participant" of an FMI simply because the participant elects to process some of the customer's transactions through the FMI.[6] Unfortunately, the final *PFMI Report* remains unclear on these points.

In a footnote, the *PFMI Report* states that FMIs can have two kinds of "relationships." The first are with "direct participants" that are bound by the FMI's rules and agreements. "The second type of relationship is with entities that are not bound by the rules of the FMI, but whose transactions are cleared, settled, or recorded by or through the FMI. These entities are defined as 'indirect participants' in the FMI in this principle."[7] The Principle goes on to state that monitoring of the risks from tiered participation arrangements would normally be "focused on financial institutions that are the immediate customers of direct participants and depend on the direct participant for access to an FMI's services."[8]

[6] *See*, Letter from Joseph R. Alexander, The Clearing House Payments Co., to CPSS & IOSCO (July 29, 2011) ("2011 Comment Letter") at 9–11.

[7] *PFMI Report* at 105, n. 148.

[8] *Id*. at 106.

U.S. regulators have told us informally that this Principle is intended to cover situations in which a major nonbank financial institution "connects" to an FMU through a "direct participant," for example, Bank X clears for Broker Y. The regulators maintain that the FMI should understand the risks inherent in this situation. But this example points out both the difficulty of performing this analysis and the lack of any real connection between Broker Y and the FMI.

Suppose Broker Y orders Bank X to pay an amount of money to Customer A at Bank B. The first thing Bank X will do is determine whether it will accept the order and it will check to see if Broker Y has a sufficient balance in its account or a sufficient line of credit to accommodate the payment. If balances or credit lines are insufficient, the payment order will be rejected and the payment will not be made. If Bank X decides to accept Broker Y's payment order, it will then have to decide how the funds transfer will be routed to Bank B. If Bank B has an account at Bank X or Bank X has an account with Bank B, Bank X will process the payment internally as a book transfer and it will never be sent to any FMI. If the payment cannot be sent as a book transfer, Bank X may be able to execute Broker Y's payment order by sending a corresponding payment order through one of several FMIs, and the decision of which FMI to use will be made based on a number of factors and may change from time to time and even from minute to minute. It seems highly unusual, to say the least, to take the position, as the *PFMI Report* appears to do, that this state of affairs makes Broker Y an indirect participant of any FMI through which Bank X might chose to route Broker Y's payments. In any case, the risk to Bank X that arises through these transactions results not from Bank X's "direct" or Broker Y's "indirect" participation in the FMI but from the fact that Bank X is dealing with Broker Y. Bank X will mitigate this risk not by doing anything with respect to the FMI, but by monitoring Broker Y's transactions and setting credit limits on Broker Y. Conversely, Broker Y may rely on Bank X to execute its transactions, but any risks that it incurs results from its reliance on Bank X, not the fact that some or all of its transactions may be routed through a particular FMI. Broker Y will mitigate this risk, not by taking any action with respect to the FMI, but by having relationships with more than one bank so that if one of its banks runs into operational or financial trouble it will have other options for completing its payments.

On the receipt side, receiving banks like Bank B or their customers, like Customer A, may expect to receive payments from other banks through an FMI or otherwise, and failure to receive a payment may cause problems for the customers. Nevertheless, payments fail every day for reasons that are largely (and typically) wholly unrelated to the FMI (e.g., insufficient balances or credit lines, violations of economic-sanctions laws, attachment or garnishment), and except for risks that arise directly from problems at the FMI (which are dealt with by other Principles, such as Principle 17 on operational risk), those risks result from their dealings with their counterparties, not from the fact that some payments may be made through the FMI. Moreover, as Bank B receives the payment order from Bank X over the FMI, the obligation to pay the amount of the

payment order is owed by Bank X, which provides an additional level of protection for the receiving bank.

Because of the foregoing, we submit that when an FMI is confronted with Q.19.1.1 ("What tiered participation arrangements does the FMI have?") the proper answer is "none" if the only connection that nonparticipants have to the system is that their banks may send their transactions through the FMI.

Principle 20—FMI Links. This Principle covers "contractual and operational arrangements between two of more FMIs that connect the FMIs directly or through an intermediary."[9] It should be clear that this covers only formal arrangements and that informal dependencies, for example where an FMI's participants fund their positions by funds transfers through another FMI, are not covered.

Principle 22—Communication Procedures and Standards. The point of this Principle is that an FMI should "use, or at a minimum accommodate, relevant international communication procedures and standards." CPSS and IOSCO should make it plain that this Principle is not attempting to enforce on all FMIs and their participants the ISO 20022 standard, and that an FMI that uses a format that can easily map other standard formats (e.g., SWIFT) will meet the Principle.

Principle 23—Disclosure. The Clearing House fully supports the disclosure of rules and key procedures. It also supports the template for disclosure that is set out in the *Disclosure Framework* with its summary of changes since the last update. We also believe that those recommendations apply with equal force to CPSS and IOSCO themselves, and that each should adopt its own recommendations and increase transparency by summarizing comments received in response to their consultative papers, identifying the major comments, stating their reasons for accepting or rejecting those comments, and identifying the significant changes made in a final paper from the one released for comment.

CPSS and IOSCO released the *Consultative Report* in March 2011 and received 116 comments. They then spent the better part of a year revising the work in light of the comments. In publishing the final *PFMI Report*, however, CPSS and IOSCO did not show how the final principles differ from the consultative report, did not summarize the comments, and did not discuss their reactions to substantial comments. The result is a lack of transparency that frustrates the goal of public understanding of the Principles. While there are a number of places in the *PFMI Report* where this problem occurs, one example will demonstrate this point.

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[9] *Id*. at 109.

In discussing the need for a well-founded legal basis, the *Consultative Report* stated that "One recommended approach to articulating the legal basis for each aspect of an FMI's activities is to obtain well-reasoned and independent legal opinions or analyses."[10] The Clearing House's comment letter noted that for practicing lawyers the term "reasoned opinion" refers not to an opinion that has sound reasoning behind it but one in which the lawyer giving the opinion has explained the reasoning behind his or her conclusions. We went on to explain that in some jurisdictions a reasoned opinion is thought to be less desirable than an unexplained opinion because reasoned opinions are use only where the law is uncertain or the case involves an uncertain matter of professional judgment.[11] Nevertheless, the final *PFMI Report* repeats the *Consultative Report's* wording verbatim.[12] The comment was thus apparently considered and rejected, but CPSS and IOSCO have not said why, leaving their readers to guess at the reason. Moreover, since the wording is not "reasoned opinion" but "well-reasoned opinion," we are left to wonder whether CPSS and IOSCO are looking for what lawyers would call a reasoned opinion or merely want an opinion that is supported by sound legal reasoning whether or not that reasoning is explained in the opinion. A comment summary and analysis in which CPSS and IOSCO say that they considered this comment and decided to keep the original wording for the stated reasons would clear up this confusion; as matters stand readers are left with unresolved questions.

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We hope these comments are helpful. If you have any questions about the issues raised in this letter, please contact me at joe.alexander@theclearinghouse.org or 212-612-9234.

Very truly yours,

Joseph R. Alexander
Senior Vice President, Deputy
General Counsel, and Secretary

[10] *Consultative Report* at 20.

[11] 2011 Comment Letter at 6.

[12] *PFMI Report* at 22.