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Via E-mail

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RE: CLS Bank International Response to the CPSS-IOSCO Recovery and Resolution of Financial Market Infrastructures Consultative Report

Ladies and Gentlemen:

CLS Bank International ("CLS") welcomes the opportunity to share its views on the Committee on Payment and Settlement Systems' ("CPSS") and the Board of International Organization of Securities Commissions' ("IOSCO") *Recovery and resolution of financial market infrastructures Consultative report*, July 2012 (the "Consultative Report").

As CPSS-IOSCO is aware, CLS is a special purpose corporation, organized under the laws of the United States, 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 (the "CLS System"). CLS was created as a result of the collaborative efforts of central banks and financial institutions headquartered in multiple jurisdictions. The CLS System was designated in the United Kingdom in 2002 by the Bank of England for the purposes of the EU's Settlement Finality Directive 98/26/EC (the "SFD"). The CLS System has also been designated or recognized for the purposes of comparable finality legislation in many other jurisdictions.

The CLS System 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. 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 members, all of which are financial institutions subject to prudential supervision and regulation, as well as thousands of 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 CLS System is 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 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. CLS has been designated as a systemically important financial market utility by the United States Financial Stability Oversight Council. In addition, the central banks whose currencies are settled in the CLS System have established a cooperative oversight arrangement for the CLS System (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 a Protocol for Cooperative Oversight of CLS.

General Comments

CLS recognizes the significant efforts of CPSS-IOSCO in creating the Consultative Report as a guide for the effective recovery and resolution of financial market infrastructures ("FMIs"). Although the framework is still evolving, both the Key Attributes[1] and the Consultative Report underscore the common understanding that the effective resolution and recovery of a distressed FMI should ensure that it continues to provide services in an appropriate manner, taking into consideration the FMI's critical role in financial markets. Consultative Report §1.1 and §1.2. CLS fully appreciates the importance of ensuring that each FMI continues to perform critical operations and services as expected during a financial crisis or other type of distress scenario.

CLS agrees with the Consultative Report's general recognition that there is a broad range of FMIs that engage in diverse activities such as the clearing, recording and settling of financial transactions, and that substantially different levels and types of risks need to be considered as a result. Consultative Report §1.5 and §3.1. Given these fundamental differences among FMIs, CLS believes that it is important to ensure that any future recovery and resolution regime will adequately distinguish among FMIs, according to their respective risk profiles and functions, and will be properly suited to each specific FMI.

[1] The Consultative Report incorporates the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions,* October 2011 (the "Key Attributes").

Specific Comments

Triggers

The Consultative Report asks "[w]hat qualitative or quantitative indicators of non-viability should be used in determining the trigger for resolution for different types of FMIs?" Consultative Report §3.18. It also provides that a resolution should be initiated once an FMI is "no longer viable or likely to be no longer viable, and has no reasonable prospect of sustaining or recovering viability." Consultative Report §4.5. Finally, it states that "[c]lear standards and suitable indicators of non-viability for FMI are likely to be similar to those for other types of SIFIs."[2] Consultative Report Annex, Commentary to Key Attribute 3.1.

CLS agrees that it is very important for indicators of non-viability to be clear and suitable for FMIs, but suggests that standards for viability and non-viability (and specifically payment non-viability) of FMIs differ significantly from the standards applicable to SIFIs, where early intervention is key to preserve customer deposits. FMIs themselves are in the best position to recognize non-viability and any regime should rely on the FMI itself, in the first instance, to alert its regulators regarding the need for recovery or resolution.[3]

CLS notes that in the United Kingdom, HM Treasury has recently suggested in its paper entitled *Financial Sector Resolution: broadening the regime,* August 2012, that the appropriate test for resolution of a non-CCP FMI (such as the CLS System) would be "a firm failing, or being likely to fail, to continue to meet its regulatory recognition/authorisation/operational requirements, with no reasonable prospect of remedial action to address this." Id. at §4.6. Such a test may be a more appropriate trigger for FMIs, as opposed to resolutions applied to SIFIs.

Moratorium on Outgoing Payments

While the suspension of payments and a stay on creditor actions may be an appropriate tool in the context of banking institutions, CLS agrees with the general statement set forth in the Consultative Report that, in practice, a moratorium on payments by an FMI would probably defeat the objective of continued operation of an FMI (particularly a payment system). Consultative Report §4.7 and §4.8. However, in certain limited circumstances the imposition of a moratorium with respect to payments to critical third parties (such as vendors) might be beneficial if the third party were temporarily prohibited from terminating its agreements to provide services to the FMI.

Additionally, in light of the fundamental objective that an FMI continue, if at all possible, to perform critical operations and services, CLS suggests that in the event an FMI in resolution were subject to a moratorium, clear exceptions to the moratorium should exist with respect to payments owed by the FMI to other FMIs, whether directly or indirectly. CLS notes that while the CLS System currently does not have any FMIs that are direct members, given the substantial volume and size of payments that are likely owing from one FMI to another, the sudden

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[2] The Financial Stability Board's *Consultative Report on the Effective Resolution of Systemically Important Financial Institutions,* July 19, 2011, provides in Section 3.1 of Annex 1 that "Resolution should be initiated when a firm is no longer viable or likely to be no longer viable and other measures have proved insufficient to prevent failure."

[3] For example, the withdrawal of a significant percentage of participants from an FMI may be a potential trigger.

imposition of a moratorium on payments by an FMI (that could participate as a third party via a member) could have a negative systemic impact and would defeat the goal of maximizing participation in FMIs by other FMIs that are subject to recovery or resolution.

Transfer to a Bridge Bank or other Third Party Financial Institution

The Consultative Paper provides that "[t]he ability to transfer ownership of a financial institution or some or all of its assets and liabilities to a transferee is one of the core components of a resolution regime for most types of financial institutions" and contemplates a transfer to a solvent third party or to a bridge institution. Consultative Report §4.10. The Consultative Report briefly acknowledges various issues to be addressed in a transfer scenario. For example, "[t]he resolution authority may also need specific powers to expedite approval or to waive or modify provisions which might otherwise prevent the resolution of the FMI, i.e. the ability to expedite licensing / authorization requirements for a bridge institution / **designation for settlement finality purposes, etc**.," (emphasis added) with respect to a transfer to a bridge bank. Consultative Report Annex, Commentary to Key Attribute 3.4.

CLS wishes to emphasize that the issue highlighted above regarding "designations for settlement finality purposes" is important and warrants careful consideration. Designation of a system is typically granted by a jurisdiction's regulatory authority after a comprehensive review and determination that the system in question fulfils the applicable designation requirements. Given the rigorous requirements for designations, jurisdictions are unlikely to transfer a designation (or to grant a new designation) on an expedited basis without satisfying themselves that designation of a successor entity will not expose the jurisdiction to additional risk. Therefore, in order to maximize the likelihood that the FMI can in fact be transferred to another entity (whether or not that entity is an existing financial institution or a bridge institution) advance planning and cooperation will be required in all jurisdictions where the FMI is designated. Such planning may require amendments to applicable finality legislation to provide for transfers of designations when requested by regulators in specific circumstances and upon the fulfilment of certain requirements.

Bail-In Within Resolution

Both the Key Attributes and the Consultative Report provide for a bail-in tool, which would allow resolution authorities to write down or convert into equity an unsecured creditor's claim to the extent necessary to absorb losses, in an order that respects the creditor hierarchy in insolvency. Consultative Report §4.13 and §4.14. CLS suggests that CPSS-IOSCO consider the merits of exemptions from bail-in similar to those set forth in Article 38 of the proposed Crisis Management Directive[4] (e.g., with respect to secured liabilities, covered deposits, liabilities with a residual maturity of less than one month and liabilities relating to essential goods or services).

In addition, CLS believes that any legislation providing for bail-in must clearly provide that bail-in powers will not extend to, or impact upon, an FMI's default arrangements set forth in its rules, such as its access to liquidity providers. Access to liquidity providers in certain situations, pursuant to CLS' rules, is fundamental to the risk design of the CLS System and cannot be

[4] The European Commission's *Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms*, June 6, 2012.

called into question. Banks may be reluctant to timely honor their obligations as liquidity providers or to agree to become liquidity providers (or to otherwise play an important role with respect to an FMI's default arrangements) if they have reason to doubt repayment from the FMI.

Statutory Loss Allocation

With respect to loss allocation, the Consultative Report recognizes as a threshold matter that "[t]his ability to mutualise loss allocation across the FMI's participants via rules and contractual agreements is not generally the case for other financial institutions and offers a valuable protection against failure." Consultative Report §3.11. It further provides however, that "loss allocation supported by statutory powers is likely to be an essential tool if critical services are to be continued. While the FMI's rules would remain the starting point for such loss allocation, **loss allocation may need to go further than what is contemplated in these rules."** Consultative Report §3.16 (emphasis added).

CLS has concerns regarding the potential adverse impact of any imposition of loss allocations by a resolution authority outside the framework memorialized in an FMI's rules, which represent the consensus reached by an FMI's regulators, participants, and other relevant stakeholders. If the resolution authority can allocate losses beyond the scope of the rules, it would be inconsistent with its powers in other areas (it cannot, for example, require other types of creditors such as bond holders whose bonds have been bailed in to purchase additional bonds that are subject to bail-in). The ability of a resolution authority to impose such loss allocations is likely to serve as a disincentive to participation in FMIs (whether directly as a member, or indirectly as a third party participant), since participants would have concerns regarding possible exposure to liabilities that they have not had the opportunity to previously analyze and assess when considering the merits of participating in a specific FMI. The resulting disincentives to participate in FMIs, if implemented, would be contrary to the expressed preference of the regulatory community to increase participation in FMIs in order to mitigate systemic risk.[5]

Stay on Early Termination Rights

The Consultative Report recognizes that in the case of resolution, a stay on early termination rights by an FMI's participants may be required. Consultative Report §3.23. For the avoidance of doubt and to avoid unintended consequences, any legislation ultimately enacted should clarify that a stay on early termination rights will not impact the ability of the FMI itself to suspend or terminate a failed member in accordance with its rules.

Resolution Authority

The Consultative Report highlights the fact that relevant supervisory, regulatory, or oversight authorities must have a comprehensive understanding of the FMI (including its ownership structure, organizational form, etc.) and are responsible for ongoing oversight and assessment and activation of an FMI's recovery plans. Consultative Report §4.25 and §4.28. However, the

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[5] CLS notes that Principle 15 of the Principles for Financial Market Infrastructures requires an FMI to maintain a viable recovery or orderly wind-down plan and to hold sufficient liquid net assets funded by equity to implement this plan. The FMI will need to fulfill this requirement, which will be reflected in plans approved by its primary regulator. Depending upon the specific needs of the FMI, such planning may include loss mutualization requirements, reflected in the rules of the FMI.

primary responsibility for planning and implementing resolution plans lies with the home resolution authority (in cooperation with other relevant authorities), which may be a different regulatory authority than the recovery authority. Consultative Report §2.9. In light of the depth and breadth of understanding that an FMI's primary supervisor or regulator will have regarding the FMI, and (in the case of cross-border and internationally active FMIs like CLS) recognizing that regulator's preestablished relationships with regulators in other jurisdictions, CLS suggests that it is highly preferable for the primary supervisor or regulator to function as the FMI's home resolution authority and that, where possible, there should be an assumption that the primary supervisor or regulator will be the resolution authority.

Additionally, the Consultative Report provides that "[a]uthorities should review the plans with the FMI to the extent necessary, but they may decide not to disclose them, or parts of them, to the FMI." §2.9. It is also preferable that planning undertaken by the authorities is disclosed to the FMI, so that the FMI has the opportunity to provide valuable feedback regarding complex operational, legal and risk-related issues.

Cooperation and Coordination Among Authorities

The Consultative Report provides that the statutory mandate of a resolution authority should empower and strongly encourage the authority to act to achieve cooperation with foreign resolution authorities and relevant foreign supervisory, regulatory and oversight authorities. Consultative Report Annex, Commentary to Key Attribute 7.1. Such cooperation should be *ex ante* and "in the moment" and should include (a) an FMI's regulator, supervisor or overseer, (b) an FMI's resolution authority (if it is different from the FMI's direct supervisor, regulator or overseer) and (c) other relevant authorities, including resolution authorities of the FMI's participants and relevant authorities for the markets that the FMI supports. Consultative Report §2.10.

CLS agrees that international coordination is fundamental to a successful resolution. Cooperation and coordination (and potentially pre-emptive changes in law) will likely be required to ensure that the exercise of resolution powers does not result in (i) the revocation of the FMI's designations in other jurisdictions under applicable settlement finality legislation or (ii) the suspension or termination of the FMI that is in resolution from its participation in another FMI (e.g., because the nature of the resolution proceedings brings to an end finality protections in the jurisdiction applicable to the latter FMI).[6]

In connection with cross-border and internationally active FMIs, the supervisor or regulator may have protocols in place with other supervisors or regulators that already provide for cooperative oversight, such as the Protocol for Cooperative Oversight of CLS, referred to above. In the event of the resolution of an international FMI, regulators in various jurisdictions must work together to provide for continuing services of the FMI and may wish to build upon any existing protocols.

[6] In the case of the CLS System, it is important for CLS to maintain access to the relevant RTGS systems that provide for funding to CLS' accounts with various central banks. However, if the commencement of the resolution triggers the end of applicable statutory finality and/or netting protections in the jurisdiction where the RTGS system is located, that system will likely restrict participation by the FMI that is subject to resolution.

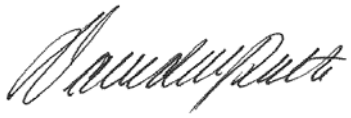
Exemptions from Disclosure Requirements

The Consultative Report contemplates that temporary exemptions from disclosure requirements may be appropriate in certain circumstances, and notes that the Principles for Financial Market Infrastructures (e.g., Principle 23: Disclosure of rules, key procedures and market data) generally require transparency to authorities and participants. Therefore, the resolution authority should assess the appropriateness of any temporary exemption in light of the need for transparency. Consultative Report Annex, Commentary to Key Attribute 5.6.

CLS wishes to highlight the fact that disclosure by an FMI of material events (including the obligation to update the FMI's public self-assessment with respect to the Core Principles for Systemically Important Payment Systems or, in due course, the Principles for Financial Market Infrastructures) may be required by law or regulation (e.g., as a condition of designation under the local settlement finality legislation in one or more jurisdictions). It is important that the decision by a resolution authority in one jurisdiction to maintain confidentiality by suspending or prohibiting disclosure does not inadvertently result in a violation by an FMI of law or regulation in another relevant jurisdiction.

Please do not hesitate to contact us if you have any questions regarding this submission.

Sincerely,



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