

Summary of ACG Members' Comments on
CPSS/IOSCO Principles for Financial Market Infrastructures
Asia-Pacific Central Securities Depository Group(ACG)
July 29, 2011

I. General comments

As the group of CSDs in the Asia-Pacific region, ACG welcomes the opportunity to comment on the CPSS/IOSCO Principles for Financial Market Infrastructures (Consultative Report). The Principles, we believe, are a very important set of international standards on payment, clearing and settlement systems, which will have great impact on the resilience and soundness of all FMIs covered.

Given different economic, financial policies and regulatory structures adopted by various jurisdictions, diversity is also the predominant characteristic of the region's CSDs, particularly in terms of structures and business practices. For instance, some of our members act as both CSDs and CCPs, while others only as CSDs. Some CSDs do not operate a settlement system. Therefore, the comments we collected here are sometimes diverged. As a group, we have tried to reflect different views equally. Therefore, there is not necessarily a single view to a single issue.

The *Principles for Financial Market Infrastructures* report takes into account CSD diversity to define a unified set of rules with the aim of achieving a target status, and takes the stance of devolving specific approaches and methods to the authorities in each country. However, in the consultative report we observe that there are considerable differences in the way the approach and method is described for achieving each principle (aim), which means that in some cases there appears to be little discretion available to each CSD, and in some cases it appears that CSDs would be required on a blanket basis to meet specific numerical standards or adopt certain risk management systems without regard for the associated burden or effectiveness of such measures.

It states in the introduction part that 'the principles do not prescribe a specific tool or arrangement to achieve their requirements and contemplate different means to satisfy a particular principle (1.19)', and the explanatory notes says, 'An accompanying explanatory note discusses the objective and rationale of the standard and provides guidance on how the standard can be implemented (1.30).' However, in the actual written contents, there is no shortage of passages in which the principles go beyond guidance to prescribe what appear to be specific methods and systems. At the very least, where a management method is included, some members suggest its status be restricted to that of guidance.

In addition, because of complexity of different FMIs and comprehensiveness of the report, there are quite a few areas where more clarifications are needed to better understand and digest the requirement of the new standards. We hope the consultation process and the communications between ACG and CPSS/IOSCO could help our members to fully appreciate the essence of the new principles.

In consideration of the fact that these principles, which include explanatory notes, will be incorporated into regulatory policies and guidelines as ‘responsibilities of central banks, market regulators and other relevant authorities for financial market infrastructures’, we hope that the major concerns we outline below can be considered and reflected appropriately in the contents of the final report.

II. Specific Comments

1. Introduction

1.21 Applicability of the principles to CSDs that do not operate an SSS

The report mentions that the applicability of certain principles for CSDs and SSSs will vary with the design of the FMI. While we agree with this, we feel that considering the differences in the way the CSDs operate, an attempt could be made to bring more clarity about which principles would be applicable to CSDs. For instance, the CSDs in some markets do not handle funds nor do they operate a settlement system, but hold the securities of investors and transfer of securities between accounts so as to facilitate settlement of securities. Accordingly, certain principles stated in the report would not apply to this type of CSD. The **list** of such principles which would not apply is enclosed. Some members feel that bringing more clarity would go a long way in assisting the regulators in each country to implement this report more effectively. (List of principles which do not apply to CSDs in India: Principle 4 / 5 / 7 / 9 / 10 / 12 / 13)

3. Principles for FMIs

3.1 Principle 1 – Legal Basis

3.1.4 / 3.1.10 Necessity and costs to secure independent legal opinions in case of conflict of laws

Securities are traded globally, and with multi-tiered participation currently growing at all levels, it is unfeasible on a practical basis for FMIs to identify and analyze ‘all potential conflicts of laws’, and also problematic to ‘obtain reasoned and independent legal opinions and analysis of the enforceability of its choice of law in relevant jurisdictions’ to help achieve legal certainty on conflict of laws issues.

FMIs already seek reports and opinions from specialists as necessary in operating their businesses, so taking into account a comprehensive consideration of importance, speed and cost, some members think a certain amount of flexibility should be allowed here.

3.3 Principle 3 – Framework for the comprehensive management of risks

3.3.4. Cost and effect of information and risk control system

With regard to the extent to which it is possible to construct effective information and risk control system, there are going to be differences depending on the nature of business undertaken by each FMI. In addition, even if it is theoretically possible to build such a system, the amount of budget that each FMI can make available is going to differ. Some members suggested, therefore, any systemization is going to require close consideration of cost and effect.

3.4 Principle 4 – Credit risk

3.7 Principle 7 – Liquidity Risk

Largest one or two defaults to CCP

In regard to avoiding credit and liquidity risks, the number of defaulting participants is only one dimension of the problem, some members suggested the amount of the exposure as a result of the participant's default is more important factor. Abundance of financial resource for CCP must take into consideration the characteristic and structure of different markets, for instance, degree of market concentration, the number and concentration of positions held by participants and/or their customers, the transparency and continuity of product price and etc. Some member holds that derivative market has longer duration, higher volatility and degree of leverage than spot market, and would have higher probability to trigger greater exposures and spill-over effects, so the demand of the financial resource should take this into consideration.

The consultative report requires CCP covering current and future potential exposures to each participant fully with a high degree of confidence by using margin. If the standard must be based on the number of defaults, some members suggested that a CCP should cover one participant with largest exposure as a minimum requirement, and different CCPs should determine to adopt “cover one”, “cover two” or “cover more” in light of particular extreme but plausible scenarios and results of stress testing. Sufficient financial resources should be posted accordingly.

3.11 Principle 11 – CSDs

Risks for CSDs that engage also in CCP business

Some members suggested it should be added in the Principle 11 that “For those CSDs that would like to engage in CCP business, they should have thorough and resourceful risk control systems.” If the CSD and CCP is the same legal entity and acts as CCP for both securities and derivatives products, the operational processes and risks must be appropriately managed for each key business area.

Some members suggested it should be added in the key considerations in the Principle 11 that “CSDs normally don't engage in CCP business in derivative products. If they do have the advantage of efficiency and low costs in this business, they should engage in CCP business in derivative products through subsidiaries or other forms of separate legal entity.”

3.13 Principle 13 – Participant-default rules and procedures

Default rules for CSDs with a retail model

Some members suggested that each CSD is to determine if default exercise is appropriate and if so, the essential participants for the exercise. The flexibility is necessary as some CSDs allow for participation up to the retail investors or beneficiaries level. It may not be practical or may be impossible to engage these retail participants in default exercise.

3.15 Principle 15 – General Business Risk

3.15.6. Time period for minimum capital

Although members can understand the importance of FMIs operating as going concerns needing to have a certain minimum quantitative level of secured capital, they hold different views on specific time framework. Some members suggested that specific amounts should be established by each FMI, as appropriate for the risk-scenario envisioned by each FMI. Some other members suggest a period of nine or twelve months, where they suggested Key Consideration 3 of Principle 15 should be clarified as “At a minimum, an FMI should hold equity capital at normal times equal to nine months of expenses.”

3.15.8 Governance requirement for winding up plan

This principle gives a detailed prescription for planning with regard to capital procurement, business withdrawal and reorganization in order to avoid systemic disruption. The plan is expected to be updated regularly (regardless of how probable withdrawal or restructuring might be) and has to be approved by the board of directors (or an appropriate board committee). While it is important to create a framework system, considering that different approaches to governance are taken by different countries, we think that including detailed methodology in this principle may have the effect of preventing a flexible response.

3.17 Principle 17 – Operational risk

Flexibility in construction of BCP

CSDs must have BCP or other contingency plans and guidelines for resumption of business. However there should not be a one-size-fits-all kind of recommendation for all CSDs. CSDs should have the flexibility to determine what is appropriate based on individual market requirements and conditions. It was proposed in the consultation paper that critical information technology systems is to be resumed within 2 hours following disruptive events and in case of extreme circumstances, settlement to be ensured by the end of the day at the latest. However under extreme circumstances such as severe earthquake and tsunamis, CSDs may not be able to resume business within the above stipulated time frame. Therefore CSDs should have the flexibility to determine what is the appropriate time frame for resumption of business based on individual market conditions.

Mutual back-up arrangement

Some members suggested it should be noted in Principle 17 that “Any single system should have the capacity of acting as back-up for systems that FMI set up in other locations.”

3.17.13 Identification of sources

Some members hold that the requirement of having to ‘consider alternative arrangements to allow for the processing of time critical transactions in the extreme circumstance that none of the FMI’s site are operational’ is, in reality, problematic in terms of cost and other factors. Rather than being required to ‘consider alternative arrangements’, they suggested that in the first instance each FMI should be required to demonstrate a thorough understanding of the risks to their locations and prepare a comprehensive business continuity plan, including consideration of scenarios involving simultaneous disasters.

3.17.18 Authorities’ access to outsourcing information and legal constraint in outsourcing contract

It is not clear what specific kind of situation is envisaged in which authorities would need “full access to the necessary information”. If the purpose is to give the authorities the right to directly investigate the FMI’s third-party service providers, we think the principle goes too far, and if the aim is to ensure effective oversight of risk assessment, we think it is sufficient for the FMI to provide the necessary information. Also, we think that the information that has to be provided to enable oversight by the authorities should be clearly defined and restricted. And given that adding this kind of condition to contracts will require legal support, a direct disadvantage arises because it would restrict the scope of potential contractors. Considering these factors, we would like to see a certain amount of flexibility retained in this principle.

ENDS

For further information, please contact :

Kazuhiro Nishimukai / Kei Umetani / Naoko Watanabe

ACG Secretariat

Japan Securities Depository Center, Inc.

acgsecretariat@jasdec.com

Tel: +81 3 3661 0139