DACSI **11-1124**

Remarks on Principles for FMIs

Response to the CPSS-IOSCO consultative report on Principles for financial market infrastructures of March 2011

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DACSI (the Dutch Advisory Committee Securities Industry) is the principal not-for-profit association in The Netherlands for firms active in the securities industry. The association represents the interests of its members as users/clients of infrastructure providers in the field of securities, e.g. exchanges, central counterparties, central securities depositories. With 12 members, DACSI represents the vast majority of the banks active in The Netherlands, and positions the Dutch view to the market infrastructure service providers and the regulatory authorities in The Netherlands and the European Union.

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Thank you for the opportunity to comment on the consultative report “Principles for financial market infrastructures”. We hope that our contribution is helpful in the debate on the various issues addressed in the report and are of course more than prepared to elaborate on particular items when helpful.

As we represent the interests of our members as users/clients of infrastructure providers in the field of securities, we have restricted our comments to those principles that are most relevant in this context and where we think a remark might have significant added value.

General Remark

We highly appreciate and fully recognise the choice to replace the existing CPSS and CPSS-IOSCO standards by a single set of standards providing greater consistency. The structure and the lay-out of the consultative report are very effective in bridging the distance between the – unavoidably – abstract language of the Principles and the Key considerations at one side and the applicability to specific types of FMIs at the other side. In particular, Annex D is very helpful.

However, there remain some possible misconceptions about the relative importance of the Principles and Key considerations for the various types of FMIs. For instance, the robustness and granularity required from a credit risk management framework will undoubtedly differ between CCPs and Payment systems. We think it will add to the entirety of the Principles when the Introduction (1.19) points out even more clearly that the nature of the FMI and the way the individual FMI is organised are significant factors in determining the practical implications of the requirements.

Specific Remarks

Principle 1: Legal basis

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

Further to this high-level principle, we would recommend a stringent regulatory approach regarding possible other services offered by FMIs, other than their core (FMI) services, as these are likely to involve additional risks, which would be detrimental to the safety and stability of the FMI.

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.

We very much welcome the principle that the objectives of all relevant stakeholders are to be supported by the FMI’s governance structure. When one organisation or a group of organisations offers services of more than one FMI type, participants in the different infrastructures may have diverging interests and objectives. Hence, when more than one FMI type is involved, the governance structure should reflect that variety and include separate (sub)structures enabling balanced decision making per individual FMI.

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.

With regard to "Incentives to manage risks (3.3.5)", we don't think that an FMI should be given responsibility for the risk management of their participants (and even more "other interdependent entities"- whoever that be).
The principles aim to strengthen the markets served by FMIs, and hence to prescribe arrangements for the FMI's own risk management, by definition including the relationship between the FMI and its participants (margins, default funds, etc.). However, the relationship between a participant and his customers is beyond the remit of the FMI. As far as the participant's risk management is critical to the market/system, he should be regulated himself; in practice, the systemically important participants are regulated indeed.
A sound and strong system would be supported by an obligation for the FMI to "provide *the information* (and tools) for its participants enabling them to identify, measure and manage their own risks".

NB: Penalties to participants failing to settle timely (mentioned as an example in 3.3.5) should not be part of a risk management system, but are critical for the efficient functioning of the market/system. Therefore, this example belongs to Principle 21: Efficiency and effectiveness.

Principle 11: Central securities depositories

A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

We believe that minimising the risks involved require that any avoidable risk should indeed be avoided by the FMI acting as a CSD.
The Principle specifies how the risks associated with the CSD's core functions – registration, central safekeeping and central settlement – are to be minimised. As a consequence, as far as a CSD is to conduct other activities, these activities should have a clear connection with the core services (e.g. the administration of corporate actions) and should not add to the FMI's risk profile other than standard operational risk. Any other activity – i.e. risk bearing activity – would unnecessarily add to the risk profile, but would also imply competition with other organisations who are risk-takers deliberately: financial institutions including banks. Prudential regulations for these competitors include capital requirements for these activities, and by implication such an activity would not fit in the risk-averse, risk avoiding nature of a CSD.

Would an organisation providing CSD services decide to perform other services that are not related to the provision of core services and that could bring in credit or liquidity risk, these services should be clearly disconnected and segregated from the provision of core services and be subject to a separate (usually banking) licensing, authorisation and supervision.

Specifically, acting as a principle in securities borrowing or lending (mentioned as example in 3.11.6) would be in conflict with risk minimising, but would (by implication) also be in competition with financial institutions. Hence, a CSD should *not* be *allowed at all* to act as principle.

Principle 14: Segregation and portability

A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

DACSI agrees that segregation of indirect participants' positions and collateral is important for the effective reduction the impact of a participant's insolvency on its customers.

We consider that under the proposed Principle 14, segregation should not be a universal requirement, and if mandated, should depend upon how bankruptcy-remote the CCP is. When arranged at the request of the participant, acting on behalf of its customer, segregation should be conditional on a specific instruction of the latter to make use of this facility and the provision of sufficient details in the trade instruction to the CCP to identify the underlying customer.

Should segregation be made universal, we fear that:

- the overall need for collateral and liquidity would increase significantly ;
- efficiency and effectiveness of processes and operations with CCPs and their participants would be negatively impacted.

Principle 17: Operational risk

An FMI should identify all plausible sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate systems, controls, and procedures. Systems should ensure a high degree of security and operational reliability, and have adequate, scalable capacity. Business continuity plans should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale disruption.

In addition to what will be required from an FMI and its business continuity plan, we suggest a requirement on FMIs to inform their participants of any operational failure they may experience. Participants of an FMI are the first to be impacted by any failure, and such a requirements would enable them to adopt appropriate internal measures to cope with the situation as soon as possible.

Principle 19: Tiered participation arrangements

An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered *participation arrangements.*

As argued in the context of Principle 3, we don't think that an FMI should be given responsibility for the risk management of their participants. The relationship between a participant and his customers is not within the realm of the FMI. Despite the relevancy of risks arising from tiered participation arrangements, an FMI cannot even be effective in actually measuring positions and risks of indirect participants. Client data should not be disclosed to the FMI for confidentiality reasons, but would conceptually never be complete and hence be ineffective.

As a consequence, we would oppose conferring discretionary regulatory power to an FMI which would go beyond its direct participants and would include end-investors.