WORLD FEDERATION OF EXCHANGES

29 July 2011

Letter to be submitted by e-mail to cpss@bis.org, and fmi@iosco.org

Reference: Principles for Financial Market Infrastructures, July 2011

Mr. Daniel Heller,
Head of Secretariat, CPSS
Mr. Masamichi Kono,
Chairman, IOSCO Technical Committee

Dear Mr. Heller and Mr. Kono,

The World Federation of Exchanges ("WFE")[1] welcomes the CPSS-IOSCO Public Consultation on *Principles for Financial Market Infrastructures* ("FMIs"), and takes this opportunity to comment on the direction in which regulators may advance on several of the interconnected issues set forth in the Consultation Report[2].

WFE agrees that a global review of market infrastructure institutions is important stock-taking in light of financial market events and operating conditions post-2007. The goal of creating a single set of overarching standards is valuable for WFE and its members, as with International Financial Reporting Standards, the OECD's Principles of Corporate Governance, and IOSCO's Principles of Regulation. The member exchanges have voted measures of public endorsement for them in years past, precisely because they promote a sounder global financial system. In this case, the CPSS-IOSCO idea of updating and synthesizing pre-existing work also makes good sense to move ahead in this direction.

[1] WFE is a non-profit trade association of publicly regulated stock, futures and options exchanges operating worldwide. The Federation contributes to the development, support and promotion of organized and regulated securities and derivatives markets. WFE is an affiliate member of IOSCO.

[2] WFE wishes to acknowledge the help in preparing this response of Thomas Murray, the London firm which helps institutional investors manage the costs and risks of buying, selling, safekeeping, valuing and servicing portfolios of cash and securities. The second essential source of expertise came from CCP12, the not-for-profit global association of central counterparties, with a membership encompassing over 35 individual CCPs from all over the world. Lastly, the WFE Secretariat acknowledges the ideas shared by the World Forum of CSDs.

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But in the course of drafting this letter, WFE has come to the view that in advancing the value of these principles for these infrastructure institutions, the "one-size-fits-all" approach has some major drawbacks, not in the questions raised by CPSS-IOSCO so much as how this would actually work. By trying to fit in the same category entities that have significantly different objectives and fulfil different duties in the sector, the CPSS-IOSCO Drafting Committee had no choice but to make the principles quite broad and generic. Admittedly, the Committee may wish to avoid being too prescriptive in its effort to align principles for the entire industry. It is noted that while the Principles mostly take a conceptual approach in many areas, in others they are very specific, as in terms of prescribing stress testing for credit risk and liquidity risk, which can be difficult to apply universally. The switch from general to very specific in this area made it harder to understand how to respond.

The objectives of this update and the advance in thinking on market infrastructure institutions are very much worthy of attention; WFE agrees that certain principles in our industry are universal, and the questions raised here do in different ways go everywhere around the world. It is the approach taken that WFE found somewhat hard to follow. At times, in WFE's view, that approach even risked undermining the objective of the document: to refine existing principles and set new ones that could contribute to strengthening systemically important financial organisations across global markets.

Given the diversity of financial infrastructure institutions as they exist and operate today, an initial, additional use of the information generated by this policy review might be to establish a standardized world-wide format of questions that would be the common basis of bilateral discussions between public authorities and the FMIs in their individual jurisdictions. This approach may also assuage the concerns we share with our oversight bodies about regulatory arbitrage across jurisdictions. Across all markets, the authorities would be asking the same questions to all parties. In this way, too, FMIs would be set out on the path towards meeting the goals set out in this body of principles.

At the outset, WFE notes that not all of its member exchanges operate institutions across the spectrum covered by this report, in other words, payment systems (which are less common for WFE), central securities depositories, securities settlement systems, central counterparties, and trade repositories. All exchanges do, of course, interact with their colleagues in these service areas in their jurisdictions – the spread of services must be integrated for the marketplace to function, whether part of the exchange group in an ownership sense or not. For that reason, the Federation believes it has a very legitimate voice to raise with this response – its members' market operations must be completed in a secure, timely and proper manner.

Introduction

The WFE notes that the regulated exchange environment has performed well around the world throughout these four extremely difficult years: trades were executed, clearing and settlement took place promptly, registries were properly kept, and so on. Even the assets connected to Lehman Brothers at the time of its bankruptcy were taken care of in our environment, mostly within a matter of days. It is with considerable relief that we write these words. The good results are due to the regulatory environment in which exchanges work, the transparency and fairness with which operations are conducted, including in post-trade services. WFE therefore approaches the CPSS-IOSCO work with a keen appreciation of the need to work with oversight bodies based on this Report in order to reinforce and solidify these institutions. The Federation would be concerned if greater change than that were proposed at this time.

From the perspective of exchanges, the true lesson of these past four years is that global regulatory reform will need to take a holistic approach in order to assure the rebalancing rapidly required among the key constituencies of the entire system – not just banks, but greater consideration given to insurers, public funds, and the public capital markets themselves, of course. In contrast to that, the CPSS-IOSCO paper is focusing on one part of the system, admittedly a crucial one; but like all questions raised in market policy in 2011, the overall context matters.

The updated thinking contained in the CPSS-IOSCO Report alone makes the review valuable. In addition to verification of operations after the events of the past four years, WFE members continue to prepare for the challenges and threats that lay ahead. For instance, one of the key changes in regulation in the US (the Dodd-Frank legislation) establishes that standardized OTC derivatives will have to be cleared through CCPs. The European Markets Infrastructure Regulation (EMIR) is the EU's parallel initiative. These are legislative responses to the prior call from G20 to move OTC derivatives to CCP clearing. CPSS-IOSCO must assure that its work remains consistent with these legislative developments and others to come.

In order not to break what has worked to date, the CCPs in our constituency must take great care as to what risks can be evaluated by them and taken on their books. For CCPs and other infrastructure institutions, the principles needed to rebalance and protect the financial sector must avoid jeopardizing the robustness maintained to date.

WFE's remarks are to be understood mainly as referring to clearing houses, especially those providing central clearing services; and central securities depositories. The other infrastructure institution types cited in the CPSS-IOSCO report are not sufficiently commonly found within this federation's environment to offer commentary.

Member exchanges will be answering CPSS-IOSCO directly with comments, which should provide context and depth on these matters from the perspectives of individual regulated market operators. *This Federation letter should be read as a complementary group view, though one which perforce does not reflect the exact views of every exchange group member, or their unanimous opinions.* The 52 member exchanges of this Federation are quite diverse in their operations, reflecting their varying market environments. The post-trade institutions which provide for essential infrastructure services are, if anything, an even more diverse group than the exchanges themselves.

Comments and questions

The first question WFE had was whether actually making payment deadlines or transfers has been at risk these past several years? This is the essential responsibility for CPSS and its member institutions, and for our colleagues assuring securities settlement. To IOSCO and its constituent members, one must ask whether it has observed infrastructure institutions under its supervision to have been so stressed these past four years as to risk systemic failure in any jurisdiction? To the knowledge of WFE concerning the exchange-operated environment, there have been few problems of this magnitude, if any. For this reason, the Federation expects to make good use of the impressive questioning and reflection in this Report to solidify these institutional structures.

Second, the CPSS-IOSCO Report appears very largely concerned about the wholesale business, with retail investors at best implied. The Report itself was at times very detailed, and at other times not, no matter which constituency it was addressing. This made answering somewhat harder.

The question about FMIs that seems central to WFE is their diversity in scale, operations, ownership, market context, risk sensitivity and management – in fact, their diversity period. It is for this essential reason that the question of assuring minimum capital to operate over three, six, nine or twelve months as a unilateral standard for all FMIs would seem hard for us to apply in practice. This may be very appropriate as part of a review by officials in a given jurisdiction as a question to be addressed, but we find it hard to see how this could work on a global basis. If, for example, some parts of a capital market infrastructure are owned by the government or one of its agencies, should nine months worth of operating costs be set aside as capital? Three instead? It is difficult enough for private sector FMIs to compete against publicly held competitors, but giving them a common capital base objective does not seem logical or practicable. While WFE can understand the CPSS-IOSCO objective of assuring that the funding bases generally prescribed should be common across the world, in order to assure fair commercial competition while mitigating the threat of a business factor to the safety of the system, in fact the instruments handled and scale of operations vary too much from one financial center to another for this to work. Were there cases recently of a systemically important FMI running out of cash for its operations? If so, they would appear to have been of a scope that enabled quiet resolution.

Many WFE members, though not all, find it perplexing to consider the question of risk management by focusing on the implications of a potential failure of one or two key participants during an extreme event. It is hard to imagine more extreme events than those experienced in the past decade, yet the FMIs fulfilled their roles. The ongoing financial crises experienced since 2007 have been less extreme in their violence when taken part by part. Should one contemplate a trading day when two or more such events occur at the same time? Another difficulty of having a default fund covering potential failure of two key participants is the liquidity requirements that would have to be established to cover them: what indeed should they be?

Instead of posing the question in this sense, perhaps the Drafting Committee could propose that FMIs make decisions regarding minimum levels of liquidity and coverage in case of defaults based on sound analysis that can be explained to the authorities. For instance, instead of asking that organisations opt for the "cover one" or "cover two" approach, the Committee could ask FMIs to consider coverage as a function of market concentration as an added consideration depending on how extreme the outcome of "cover one" and "cover two" results are. The proposed "cover one" and "cover two" approach would likely suffice in heavily concentrated markets, and some WFE members find that concept appropriate; but in places where market concentration is moderate, the proposal would not necessarily guarantee the stability of the market. Alternatively, seeking coverage for a minimum level of market share may provide better investor protection in case of default or shortage of securities/cash.

Furthermore, the market concentration approach would force entities to gather and analyse market data as part of their decision-making process, which would be far more useful than adopting a rule, which as market conditions change over time is likely to seem arbitrary. In addition, it is quite important to provide guidance on areas such as stress-testing to assure that FMI managers understand where the breaking point of their entities actually lays. Because market conditions change drastically from country to country, as do property and bankruptcy laws, it is incredibly hard to establish a single set of principles for stress-testing without giving consideration to the dynamics which may be unique to given FMIs, markets or regions at any given time.

Many member exchanges consider that a focus on potential failure of one or two participants is not the way ongoing risk management is typically evaluated, and it may be more useful instead for all to align the review with the decision-making. Many in the WFE community slice up the risk to the overall clearinghouse position differently. And while it might be tempting to think that managers ought to consider their work from the perspective of one or two firms failing, our further reflection in writing this response has led us to conclude that this could in effect oversimplify the kinds of analyses necessary. In our experience, management operates at a level of risk where it is comfortable, assuming that the survival of the enterprise is much more the goal than any near-term gain. WFE does not believe that closer regulatory supervision that could stem from imposing global norms is required or useful in this respect – the mind is focused at all times on the risk of one's own business failing. In addition, however, review at the local level with the authorities of the evaluation methods used might well be beneficial, to engender greater confidence and to explore possible new ways of thinking that would assure the ongoing strength of FMIs for the years ahead. For the benefit of CPSS-IOSCO, WFE highlights the point that FMIs have not needed state backing or capital infusions in the past four years of severe financial turbulence. WFE would want to ensure that past success continues, hence the great value in thinking these questions through.

Several areas of the CPSS-IOSCO report did not, in our view, sufficiently address the question of FMIs from the client perspective. That would be one suggestion from us for the next iteration. This can still be caught when it comes to the methodology used in the responses CPSS-IOSCO will be receiving.[3] From the perspective of WFE, what matters is clarity in informing clients as to what is going on, and also sufficient expertise on hand to assure that the business gets done properly.

Volatility in asset pricing is often raised as a potential concern by regulatory authorities in their oversight of market operations. Even during the peak volatility hit in recent years, this has not proven to be a problem for post-trade institutions in the regulated environment. In this sense, daily operations have constituted real, live "mini" stress tests that are being met.

Suggestions

The WFE shares the worry expressed by many of its members that changes in the asset portfolios currently handled by these infrastructure institutions, as may be imposed by the authorities, could have very adverse effects on current risk management frameworks. In our view, no FMI should be obliged to take into its systems or risk profile financial instruments that it cannot value, or of a complexity that they would find hard to master. It is not without good reason that one hears the word "contagion" with regard to this matter – it does sound like a disease that the financial system can do without. As matters now stand, FMI managers are handling assets and counterparties with which they are familiar and for which they are able to establish risk positions – and when required, obtain assets of sufficiently high quality and liquidity as margin. Changes in the risk profiles of FMIs should not be mandated, and should remain at the discretion of the board of directors and management.

[3] As more entities seek to add value to users and diversify their revenue streams, asset servicing becomes more important in the global context. Providing such services is not without risk. Our capital markets colleagues at the firm of Thomas Murray believe that given the responsibilities and difficulties derived from this activity, this area is the most important risk factor in its methodology for evaluating the solidity of central securities depositories in their risk ratings. In fact, it is allocated a risk weighting of 33%, by far the highest of all six weighting factors.

The particular cause of concern with the potential of new assets being forced into this environment is the variety and detail of laws on bankruptcy and priority of payout to creditors in cases of liquidation – it takes a great mastery of expertise in this field to assure proper operations in any one jurisdiction, let alone in more than that. This is a variable that WFE must make explicit in this review, and in any other discussion of opening post-trade institutions to one another.

Instead, WFE would see value in the questions being raised in this global CPSS-IOSCO Report being raised by capital markets authorities and central banks with the institutions concerned in their jurisdictions. In doing so, while the goal would be "safety first," the authorities must be mindful of not putting their local institutions at a competitive disadvantage.

There are further remedies which WFE can propose: it can be very useful to spread the transparency that regulation brings, enabling all to assess risk positions better. Some greater disclosure to the regulators might be appropriate, bearing in mind the commercial sensitivity of risk management that no institution would want its competitors to see.

WFE would also recommend that institutions presenting their financial statements to the public, including FMIs when independent and non-consolidated, join the long-term global trend towards reporting on their finances under International Financial Reporting Standards. As this movement has taken hold, it has proven helpful for reasons of clarity and comparability to have the same accounting principles apply to all across the world. Further, the statutory auditors of those firms should be reviewing reports using International Standards of Audit, so that these reviews are conducted in broadly similar fashion. The use of global standards for financial reporting is beneficial for a clear read by all involved in assessing the health of marketplace institutions.

Several WFE respondents felt that it may be helpful to develop a few statistics based on commonly agreed definitions for some of the services FMIs provide. There is much hesitation within our community on this point, however, in the sense that the service differentiation successfully provided by FMIs in their jurisdictions is the greater good to support. The provision of bespoke services that underpin the secure trading environment is what must be advanced above all else, and in the course of writing this group letter the striking feature is precisely that diversity of offer. Perhaps only a few sets of statistics on some of these businesses would help the public and their authorities to appreciate what is happening in these critical areas of the capital markets industry.

Another suggestion for CPSS-IOSCO is that the good work reflected in this Report be channeled into further rounds of consultation in view of the higher costs that will be involved in operating the world's public financial markets. Some financial market intermediaries will have difficulties in attaining the higher standards proposed here, though it is not yet certain that there would be sufficient risk mitigation achieved that would justify the loss of those participants.

Remarks on the principles

While the direction of these principles seems sound, WFE would have concerns about marketplace realities around the world making their even application practicable. As noted in the introductory comments to this letter, the CPSS-IOSCO Report is at first glance extremely relevant – but the proposed application of this Report in global principles does not yet seem to be a practical outcome given the reflections to date.

In the next iteration by CPSS-IOSCO, WFE would request getting clarification on how these principles would be applied if adapted. How would FMIs be measured against them?

Principle 2: governance

WFE agrees with the thrust of the stated Principle, and also with what has been expressed in the Key Considerations in this regard. Good governance is a preconditions for sound management of any company, and for creating shareholder value when that is the corporate objective. The Federation would, however, have some concerns regarding the details in the Explanatory Note.

Some WFE members operate many types of businesses within their company groups, not only exchanges and other trading venues, but also financial market infrastructures, such as clearing houses and CSDs. The overall governance framework of company groups and the specific frameworks of group entities depend on local legislation, the organisation of the company group, and the specific businesses being carried out. For example, there may be licenses to operate financial activities in several countries, and there may be layers of parent and subsidiary companies. The WFE community is characterized by the genuine variety that lies at the heart of global regulated marketplaces, just as nation-states in all their diversity make up the world political community.

Businesses as well as their governance may be highly integrated. There may be two-tier board systems. Many reporting lines as well as committee structures are established on a group-wide basis. The governance of FMIs and the group must be organized in a way that best serves the FMI as well as the businesses, operations and risk management across the entire consolidated group, ensuring the most appropriate reporting lines and enabling management and the board to take due considerations for safe commercial operations while assuming their full responsibilities.

This is to some extent recognized in paragraphs 3.2.4 and 3.2.5, but the paragraphs that follow must be clearly linked to this key Principle; this starting point must be kept in order to avoid confusion in the application of these recommendations. For instance, in paragraph 3.2.10, WFE would recommend clarification in the sense that the application of this recommendation must explicitly take into account the overall company structure in which the CCP is operated.

Principle 4: credit risk

For CCPs on the subject of credit risk, stress testing is the main tool that has proven its worth in protecting infrastructures against potential losses in abnormal but plausible conditions. The results of stress testing determine the level of additional financial resources to be held by a CCP, and so indirectly determine the costs for the market for gaining access to a CCP.

To preserve the integrity of the CCP, a constant concern is to give good consideration to scenarios that realistically handle the potential damage of a default. In this, WFE joins CCP12 in expressing concern about the use of extremely theoretical scenarios and historical stress moves that do not reflect market structures in 2011. WFE asks the Drafting Committee to clarify in these Principles that extremely theoretical scenarios be used for information purposes only.

Further for CCPs, managing credit exposures under normal conditions could have unintended negative procyclical impacts. CCP managers are constantly mindful of this effect. On this point, WFE joins CCP12 in recommending that the Principles should explicitly recognize that a CCP's primary systemic risk protection comes in the form of maintaining its own robustness. It must be left to each CCP to set margin rates and collateral haircuts at levels that reflect the market volatility it is experiencing. This is the best remedy WFE and CCP12 can find to mitigate the procyclical effect.

As mentioned in the text above, while it is important that there is sufficient coverage for a minimum share of the market as each FMI determines, it is also relevant to ensure that stress-testing is conducted properly. The tests that an FMI undertake are essential in identifying "breaking points" and "thresholds of tolerance" which can be used to determine limits on the exposure than an FMI can tolerate, and therefore determine the level of collateral, liquidity requirements, and in some cases operational limits for each entity. The efficiency of these tests depends on the correct understanding of "potential future exposures." In the CPSS-IOSCO draft, this concept could use further definition, in our view.

To cite one example, if the management team of an FMI attempts to define the collateral requirement but fails to properly test their models and assumptions because their understanding of "potential future exposures" is flawed, the validity of the exercise would be questioned. More gravely, the market could be under-protected from default or shortages of securities or cash.

<u>Principle 7: liquidity risk</u>

Credit and liquidity risk control mechanisms are designed to protect CCPs and the entire post-trade system against the potential losses that a participant can cause if it defaults. As delivery failures occur in default events, CCPs must be able to reschedule settlements to alleviate liquidity pressures. WFE joins CCP12 in its consideration that this flexibility is an important risk management tool, though one that should be used only in the most extreme of circumstances. As now written, the proposed standard may be interpreted by some to require that fails do not occur, and that CCPs, even in a default situation, may not defer or reschedule the defaulter's settlements. WFE believes that the better approach would be to assert management's ability to exercise its professional judgment by responding with flexibility, subject to there being sufficient clarity and transparency in a CCP's Rules concerning the right of a CCP to defer or reschedule settlements.

<u>Principle 14: segregation and portability</u>

The commercial impact and potential for unintended consequences of segregation and portability requirements on CCP users needs to be carefully considered. Collateral requirements will rise as a result of gross margining (at a client level). Portability of a significant number of a retail client's positions may be impractical in the timescales necessary for a CCP's default management. This is particularly true for securities market default handling.

Principle 15: general business risk

For CCPs, the objective of the General Business Principles seems correct, but the approach taken does not properly reflect the cost of winding down a CCP business. For this reason, WFE joins CCP 12 in proposing that the mitigation of this risk be accomplished by using internal models that would then be approved by national regulators.

Further on central securities depositories, it might be worth asking the Drafting Committee to provide some guidelines regarding the level of liability that a CSD should accept in case of default of a participant, or in case it commits errors, omissions, etc. In some jurisdictions, CSDs accept limited liability, which is capped and/or linked to direct losses only. In other countries, the CSDs are exposed to consequential losses. Thus, there is no agreement or guidance on what is the ideal level of liability that a CSD should accept. The topic is relevant in this section, because a CSD's liability is essential in establishing the level of financial risk that the entity faces. The topic gains additional relevance if the CSD provides asset servicing.

Assessment methodology

As one example only of the valid types of assessment methodologies many WFE members find useful for post-trade services, WFE refers CPSS-IOSCO to the work of Thomas Murray on central securities depositories. WFE refers readers to www.thomasmurray.com.

Of great concern to WFE is what type of assessment methodology CPSS-IOSCO Report authors are considering. That choice is going to be a key in determining the impact of the application of these principles on the institutions affected. It would be far preferable if some indications of the proposed assessment methodology would be made available at an early stage rather than when the final report is published in early 2012, as indicated.

Further, WFE would hope and expect that the scorecard and its manner of application will also be subject to market consultation, given the significant potential consequences of being judged a qualifying institution or not.

Finally, WFE respectfully requests that there be one more round of public consultation after CPSS-IOSCO has reflected on the feedback it receives, and also has had time to draft the particulars. One area of special importance for the public to comment on is the details of how the assessment methodology is expected to be applied.

Conclusions

The WFE's essential consideration is the difficulty of establishing precise prescriptions for FMIs that can be applied across the world, and in fact the risks that attempting to do so may pose. They are quite simply too disparate for that. WFE also underscores their success: these institutions have proven themselves capable of robust responses to rapidly changing market circumstances. The prudent course now, it seems to us, would be for regulators to approach these institutions on a case-by-case basis using the CPSS-IOSCO Report to see what must be made even more solid for the current, very different financial services environment. As noted above, the newly constituted, more complete set of Principles serve as good objectives- but it is best not to try too prescriptive a fix for areas of the public capital markets that were not broken.

The World Federation of Exchanges calls on CPSS-IOSCO to do its utmost to assure that in local application of its global work, there be minimum discrepancies between what different authorities implement. What will come to be applied to exchange-operated FMIs must not be handled any differently than what will pertain to independently run or state-owned FMIs. Those efforts at minimizing regulatory arbitrage will contribute mightily to a fair global playing field, and therefore the solidity of the institutions being reviewed here.

The subject matter raised in this CPSS-IOSCO Report serves as an excellent and comprehensive basis for the kinds of bilateral work that needs to be done jurisdiction by jurisdiction.

Sincerely yours,

Ronald Arculli
WFE Chairman
Chairman of Hong Kong Exchanges and Clearing Limited

Thomas Krantz
WFE Secretary General

Cc: WFE Board of Directors
IOSCO Executive Committee Chairman Maria Helena Santana
IOSCO Secretary General Greg Tanzer

Annex: 2011 WFE Board of Directors

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