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July 28, 2011

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Re: IIF Response to CPSS-IOSCO Consultative Report on Principles for financial market infrastructures

Dear Sirs,

On behalf of the Infrastructure Working Group of the Institute of International Finance (IIF), the global association of financial institutions, we welcome the opportunity to comment on the consultative report, "*Principles for financial market infrastructures*" – henceforth "the draft Principles" - prepared by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) and issued for comment in March 2011.

We would like to begin by welcoming the extensive consultation period that CPSS-IOSCO provided for a response. We believe that this is an excellent approach, which allowed a full and thorough consideration of the draft Principles and accompanying guidance. The result should be a higher quality of public and regulatory policy in the interests of all. We therefore sincerely hope that this approach will be taken on other consultations by CPSS and IOSCO as well as by other national, international and regional regulatory or legislative bodies in considering draft regulation or legislation.

Our only minor caveat to this is that, as noted, the draft Principles did not contain an assessment methodology. This made it difficult on a number of draft Principles to assess the likely practical implementation and thus the likely impact. Consistently with the laudably

consultative approach that you have taken, we would strongly recommend that before adopting the final report and assessment methodology, you make time for a further public consultation on this, perhaps in early 2012. We believe that this would lead to a better regulatory and policy outcome.

The Overall Objective

In considering our response, we felt that it was essential to consider first the broad overall objectives and key elements of a sound and well-functioning market infrastructure. In other words, what outcome should the Principles produce?

The IIF's report on "*Restoring Confidence, Creating Resilience*" of July 2009 argued that it would be important that measures be put in place that would "*retain the benefits of an interconnected and sophisticated global financial system while reducing the risks to acceptable levels*."[1]

We therefore believe that sound and well-functioning financial market infrastructure would give effect to this balance between the benefits of interconnectedness and risk mitigation and should contain the following elements:

i. **Sound and clear legal structures and governance** for FMIs, with complete clarity as to the rights and obligations of all parties at all times and under all conditions (including stressed ones), functioning effectively and clearly on a cross-border basis.

ii. **Effective risk measuring and risk monitoring systems** in FMIs and market participants, so that any risks, whether from individual parties or on a systemic level, are identified and measured at an early stage and communicated throughout the system to allow other actors to identify their own risks; and with supervisors maintaining an active dialogue with FMIs, participants and other regulated entities to gain assurances that such systems are in place.

iii. **Sufficient liquidity and effective risk mitigation techniques** for FMIs, market participants, and end-users, carried out in a way that does not create ambiguities about which actors in the system retain such risks or create unnecessary burdens, but is designed to maximize available liquidity at all times and reduces the overall level of risk in the system.

iv. FMIs should be sufficiently **transparent** to enable participants to have an accurate understanding of the risks they incur by using a given FMI, and to enable them to apply appropriate risk management policies and procedures.

v. Sound and secure **planning, procedures and preparations on all sides to deal with the failure of a major participant** or systemic shock in a predictable way without destabilizing the system, but also allowing an appropriate degree of flexibility in each actor's responses.

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[1] "Restoring Confidence, Creating Resilience", IIF, July 2009, p.65

vi. **Efficiency and cost-effectiveness** of the system as a whole to ensure high levels of liquidity, safety and soundness but in a way that does not impose disproportionate costs or unnecessary burdens on FMIs, participants or end-users.

vii. **Global access to, and participation in, FMIs on a non-discriminatory basis taking into account objective risk assessment** and in a way that is consistent with and ensures the delivery of the above elements, including the identification, communication and mitigation of risks for FMIs, market participants, end-users and supervisors.

viii. All this underpinned by **effective, independent and accountable regulation, supervision and oversight**, based on a strong legal framework and authority, and buttressed by regular and transparent communication and consultation.

Major Considerations in drafting the Principles and guidance

Given this objective and these key elements, the Infrastructure Working Group is highly supportive of producing a single set of international standards that build on existing principles and recommendations – the *Core Principles for Systemically Important Payment Systems* (CPSIPS), the *Recommendations for securities settlement systems* (RSSS), and the *Recommendations for Central Counterparties* (RCCP) - as well as the lessons from the financial crisis, and we commend the work done by CPSS-IOSCO on the draft Principles so far.

Nevertheless, delivering this in practice will be extremely difficult. In moving to final Principles and in drafting an assessment methodology, it would be useful for the CPSS and IOSCO to have in mind the following considerations:

i. Whilst it is desirable to have consistent principles across the different types of FMI, they should not lose sight of the **distinct and inherent differences between types of FMIs** and should therefore differentiate where necessary between them, especially as regards the details of implementation. This is reflected to some degree in the draft Principles as they stand - for instance Principles 6 and 14 as currently drafted only apply to CCPs – but needs to kept firmly in mind in considering all Principles. Even where a common Principle can be established for all FMIs, there should be tailored and differentiated guidance on implementation.

ii. The Principles and guidance should be unambiguous both as to their meaning and as to which types of FMI they should apply and how. For instance, it needs to be absolutely clear as to whether a given paragraph is intended to apply to all types of FMI or, say, to CCPs only.

iii. The Principles should be capable of being implemented irrespective of whether the FMI is **privately or publicly owned** or operated (e.g. by a central bank). This is essential if there is to be fair competition and clear understanding, especially for cross-border market participants.

iv. The **Principles should be at the minimum equivalent to requirements for participant financial institutions**. The failure or loss of confidence in an FMI would lead to significant uncertainty regarding the status of transactions that passed

through the FMI and, consequently, about the financial positions of its participants and their customers. This would have systemic implications. It is therefore essential to subject these organizations to risk management standards and prudential oversight that are as stringent as, if not more so than, those applied to banks.

v. The **direct and indirect cost and economic impact of any Principles** on participants in any FMIs, end-users, and the global economic system as a whole should be taken into account in their design. Any disproportionate requirements imposed on FMIs are likely to lead to increased costs that would be passed onto their customers. Where such requirements are well targeted and proportionate, they will create increased certainty and financial stability that will outweigh the short-term impact of any cost increase, but the benefits of any incremental requirements should be weighed carefully, lest layering of costly requirements on firms and on FMIs result in burdensome redundancies that reduce efficiency without proportionate benefit.

vi. Efforts should also be taken to ensure that any prudential or other requirement on FMIs not exacerbate any unintended market consequences that would arise from the global regulatory reforms already being put in place for banks (e.g. the impact on system-wide liquidity of increases in margin requirements). Regulators should consider **how any new requirements affect the net cumulative impact of reforms on banks and other financial institutions, and resulting effects on the broader economy.**

vii. The CPSS and IOSCO should therefore consider whether any requirements or Principles are **proportionate and accurately targeted**, and whether there would be more efficient or cost-effective ways of delivering the same result.

viii. Beyond this, whilst CPSS, IOSCO and their members are regulators and supervisors and do not have primary legislative authority, they should consider **whether legislative or other changes are needed** to achieve the intended outcomes (e.g. by providing legal clarity or certainty over the enforceability of contracts) and should advise governments, legislators, and the international instances, in particular the Financial Stability Board and G-20 Finance Ministers as to needed changes. It should be unacceptable for a Principle to be applied less than fully in a particular jurisdiction because the FMI or regulator does not have sufficient powers or because there is insufficient legal clarity or legal protections do not meet internationally agreed standards.

ix. CPSS and IOSCO should consider **how to give practical effect to the Principles across all jurisdictions and ensure that they are complied with** over time, including possibly through compliance reviews or through referring matters to the FSB. (Indeed this area would be a prime candidate for peer review in the Standards Implementation Committee.) This should include regular and transparent consultation with the industry. They should also consider the need for cooperation and coordination among conduct-of-business regulators, banking regulators and macroprudential oversight bodies.

x. But above all, regulators must consider whether the Principles are sufficiently **detailed and globally convergent** to deliver a seamless, globally consistent, coordinated and ever more convergent system for financial market infrastructures across all jurisdictions, permitting and securing full cross-border access and participation.

There is one essential 'litmus test' that could be used to assess the quality of the Principles and of any national implementation thereof: if another national regulator or supervisor were to implement them in full and ensure that their FMIs were in compliance with them, would the regulator feel fully comfortable in recognizing that other regulator's oversight of an FMI as 'equivalent' or 'comparable'? Would such implementation give grounds for mutual recognition of FMIs in both countries?

This must be the core consideration for the Principles. If regulators do not feel that the current level of detail of the draft Principles and Responsibilities would put them in this position, they should be further refined to provide a sound basis for mutual recognition. In its response to the CPSS-IOSCO consultative reports on OTC Derivatives in July 2010, the IIF called on CPSS and IOSCO to develop a set of international governing standards in this area. The IIF believes that events over the past year have underlined the need for this and that such international governing standards would be useful not only for CCPs but for all types of FMIs.

Key Comments on the draft Principles and Responsibilities

We attach detailed comments in the annex on each of the draft Principles and Responsibilities, but want to highlight a number of key concerns.

As a general comment, with very few exceptions, the Infrastructure Working Group is supportive of the Principles and key considerations as currently drafted. Nevertheless, as the cover note to the consultative report implicitly acknowledged, the devil is in the detail, specifically the explanatory notes and by extension assessment methodology.

Whilst there has been some attempt to confine certain Principles to certain types of FMI and whilst there has been some attempt in certain Principles to adapt specific guidance to specific types of FMI, a large number of draft Principles have lost much of the **detailed differentiated guidance** on implementation in CPSIPS, RSSS or RCCP. The result of this in many cases, has been at best a loss of useful specific detail and at worst an attempt to "shoehorn" all types of FMI into the same guidance, irrespective of whether this makes practical sense or not. In many cases, this leads to confusion as to whether a specific principle or paragraph of the explanatory notes is intended to apply solely to CCPs or to FMIs more broadly. We recommend that, as much as possible, specific existing guidance should be retained or reinserted, unless it has been manifestly superseded by developments or lessons from the financial crisis. Where such differentiated guidance does not exist, we would recommend efforts to develop it.

Another source of confusion arises from the inclusion of **Annex C** on "*Selected RSSS marketwide recommendations*" with a number of recommendations from the original RSSS that are to remain in effect. These cover a number of areas where there is considerable overlap

and confusion with the draft Principles (e.g. on CSDs or on the protection of customers' securities). We recommend either dropping this annex or including relevant recommendations in the main body of the Principles. We would also be grateful for clarity on the status of Annex F on "*Oversight expectations applicable to critical service providers*".

The applicability of the draft Principles to **OTC Derivatives** is also unclear. In May 2010, CPSS-IOSCO carried out a consultation on guidance on the application of the Recommendations on Central Counterparties to OTC Derivatives. In the accompanying press release, it was stated that:

"*The CPSS and the Technical Committee of IOSCO do not plan to issue finalised reports after the consultation period. Instead, the guidance presented in the reports, as well as the feedback received in the consultation process, will be incorporated in the general review of the international standards for financial market infrastructures that was launched by the CPSS and the Technical Committee of IOSCO*"

Despite this, the draft Principles contain only occasional references to OTC Derivatives and there is little sign of the draft guidance on which the consultation was based Also confusing is Annex E, "Guidance for CCPs that clear OTC Derivatives", which only refers to the ability of CCPs to take extraordinary emergency actions with regard to OTC derivatives. We recommend that the final Principles and guidance are far clearer as to their application to OTC Derivatives.

There also needs to be greater certainty that the Principles and Responsibilities apply **irrespective of ownership**. 1.22 says that, "*In general, the principles are applicable to FMIs operated by central banks, as well as those operated by the private sector. Central banks should apply the same standards as are applicable to similar private-sector systems. However, in certain cases, central banks also have separate public policy objectives and responsibilities for monetary and liquidity policies that may take precedence.*" There should be specific guidance in the explanatory notes on how and when those separate public policy objectives would take precedence and it should be made clear that such actions must be predictable and transparent and should not distort competition in any way.

In each area, there also needs to be more consideration of where the main responsibility for risk mitigation or action should lie, and how this should be differentiated between types of FMIs. The "*Cover note to the consultative report*" issued with the draft Principles solicits views on the stress scenarios for which FMIs should hold additional financial resources in draft **Principles 4 and 7** on credit risk and liquidity risk respectively.

We have gone into more detail in the annex but believe that a consistent approach should be taken across FMIs: the minimum requirement should be one that is proportionate and commensurate with the risks of all FMIs and does not therefore impose unnecessary burdens. As a general matter, for most FMIs, including CCPs, "cover one" would represent such a proportionate and commensurate requirement. Where, for a specific FMI such as a CCP, the risk characteristics indicate that the benefits of a greater risk coverage outweigh the detriments, it should be possible for the FMI itself or an authority to require expanded coverage.

Nevertheless, it should be recognized that "cover one" or "cover two" is at best an approximate standard and, given interplay between risks and resources in the system, a more supple and risk-sensitive approach would be preferable.

Further clarity should also be provided in the explanatory notes as to the specific meaning of the term **"customer"** for each type of FMI. It needs to be made clear when reference is made to participants, when to indirect participants or agents, and when to underlying beneficial owners of transactions. This makes the issues of segregation and portability and of tiered participation requirements more complex and thus less susceptible to seemingly simple solutions.

We have major concerns about draft **Principle 14** on segregation and portability. Whilst we support the motivation for this draft Principle and understand the attraction of segregation and portability as being, all other things equal, the simplest and most direct means of ensuring that a high degree of protection and legal certainty exists, such a Principle is neither desirable nor feasible in all circumstances. There will be a number of cases in which separating out the positions of individual underlying customers and keeping them segregated will be disproportionately difficult or inefficient. Equally, there will be cases in which a blanket application of the Principle would lead to perverse outcomes in which operational risk and settlement uncertainty would increase because liquidity would be "trapped" in individual positions or accounts. This would go against the principles of liquidity risk management and more generally risk management.

We welcome the fact that the issue of "tiered participation requirements" is addressed in draft **Principle 19**. However we have some important reservations with regard to the Principle as currently drafted, most notably with respect to requirements for information to be passed through the chain of ownership. The qualifier "*to the extent practicable*" where there needs to be much more guidance on how the term should be interpreted, making very clear the kinds of information that FMIs should reasonably be expected to collect from participants, and in particular the levels of detail on their exposures to indirect participants. It should be made clear that FMIs are not intended to be the regulators of their participants with respect to segregation or other requirements affecting clients further down the chain of custody.

A major concern is that in contrast to the extensive requirements and guidance on the duties of FMIs, the wording of the **draft Responsibilities** of supervisors, regulators and oversight bodies is modest both in its extent and in its ambition. We urge CPSS and IOSCO to review the Responsibilities guidance thoroughly, and include a specific Principle or Responsibility on the duties of appropriate authorities to ensure that regulators, supervisors and oversight bodies have sufficient powers and resources to exercise effective oversight and a specific mandate to cooperate effectively on a cross-border basis in order to achieve fair and equitable protection of all claimants holding interests through an FMI, without national ring-fencing or jurisdiction-specific distortions.

As we have argued in consideration (viii) above, in the light of the financial crisis, it can no longer be acceptable for a principle or responsibility to be only partially applied in a particular jurisdiction because the FMI or regulator does not have sufficient powers or because there is insufficient legal clarity or protection. The sufficiency of powers and the

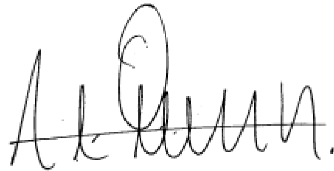
adequacy of legal clarity and protection should be a condition of membership of both CPSS and IOSCO rather than merely being desirable.

Conclusion

Once again, we welcome the opportunity to comment on the draft Principles and Responsibilities but would urge a further public consultation on the revised draft Principles and on the assessment methodology.

Should you have any questions on the issues raised in this letter, please contact Crispin Waymouth (cwaymouth@iif.com; +1 202-682-7447) or Jermy Prenio (jprenio@iif.com; +1 202 682 7455).

Sincerely,



IIF Response to CPSS-IOSCO Consultation on "Principles for Financial Market Infrastructures": Detailed Comments on Specific Draft Principles and Responsibilities

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.

We support the broad direction of the draft Principle. In particular, we agree with the five Key Considerations cited, subject to the change suggested to Key Consideration 2 below.

We strongly support both the emphasis on an FMI's being able to articulate the legal basis for its activities "*in a clear and understandable way*" and Key Consideration 5 on the need for an FMI conducting business in multiple jurisdictions to identify and mitigate the risks arising from any potential conflicts of laws. FMIs should make the necessary investment in legal research, and should proceed on the basis of reliable legal opinions in all relevant jurisdictions.

Whilst, subject to this change, the draft Principle and Key Considerations go in the right direction, there needs to be differentiation between types of FMIs in the implementation of the Principle. It would not be appropriate to apply the Principle in the same way to all types of FMIs.

We suggest that the explanatory note and assessment methodology make a distinction between the types of FMIs, and between the types of ownership (corporate, mutual, central bank or other public authority ownership), and provide detailed and tailored guidance for each type. This has already been done to some degree for Trade Repositories in 3.1.3 but should be extended to all types of FMIs with at least one paragraph for each type, looking at the specificities. This need not be difficult to draft as, in most cases, it would involve taking the existing detailed explanatory notes from the *Core Principles for Systemically Important Payment Systems* (CPSIPS), the *Recommendations for securities settlement systems* (RSSS), and the *Recommendations for Central Counterparties* (RCCP) and (re)inserting it, albeit updated to reflect the lessons of the financial crisis.

The explanatory note and assessment methodology should also set out the specific duties of legal and regulatory authorities to help ensure a strong legal basis and to promote cross-border legal certainty for FMIs. These matters are too important to leave to the more general Responsibilities.

For Key Consideration 2 and paragraph 3.1.5, rules need to be "*clear, understandable and consistent*", but also need to be balanced, to avoid a discrepancy between the rights of the FMI and the obligations of the participant, (e.g. regarding standards of care, rights in case of default etc.). An appropriate allocation of responsibilities and risks or should appropriately reflect the commercial roles of the participant and the FMI. The specific role of an FMI in its capacity as a utility should be kept in mind in assessing that balance.

In paragraph 3.1.7, we believe that the word "*bankruptcy*" should be replaced by "*insolvency*" in the fourth sentence.

In paragraph 3.1.8 (novation), we suggest adding a provision allowing a clearing member to request the CCP to put an immediate stop to the novation of trades of a non-clearing member (NCM) for which it is acting if that NCM is at risk of imminent default. The requirements for such an order should of course be defined carefully so that all parties understand clearly until what point in the processing the order can be given. There should not be a substantial time lag between the moment an NCM is considered by its clearing member no longer to be creditworthy, and the suspension of the novation by the CCP, as to do otherwise would create risks for both the CCP and clearing members.

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 support the draft Principle and Key Considerations here. In particular, we welcome the way in which protections have been reviewed in the light of the financial crisis. The stronger and more specific approach seems very sensible. We also support clear and direct lines of responsibility and accountability and the statement that "*There is no single set of governance arrangements that is appropriate for all FMIs and all market jurisdictions*."

Nevertheless, whilst we agree that an FMI's objectives should "*place a high priority on the safety and efficiency of the FMI and explicitly support financial stability and other relevant public interests*", there needs to be far more clarity on the interpretation of "*other relevant public interests*", so that it does not become a "catch all". There should be greater clarity on the extent to which public interest considerations should play a role, and definition of the types of public-interest considerations that are appropriate for authorities to consider. This is essential to ensure consistent implementation and interpretation across jurisdictions.

Linked to this, there also needs to be greater emphasis in the explanatory notes on the independence of FMIs and the balance between their public duties and their private duties to participants and shareholders. Whilst they should indeed support financial stability, market infrastructures are not an end in themselves but are ultimately service providers and should primarily deliver efficient and reliable services to their participants and end-users.

As with draft Principle 1, valuable detail on implementation and interpretation has been lost in the merger of Principles and Recommendations, and we urge that it be (re)inserted. In particular, the explanatory notes and assessment methodology should set out a clear distinction between types of FMIs. There would be great value in inserting large parts of the explanatory notes relating to central bank owned systems,

privately owned systems and jointly owned systems in CPSIPS Core Principle X and notably paragraphs 7.10.11 through 7.10.18.

We support the CPSS-IOSCO suggestion of legally separating activities with distinct risk profiles in different legal entities, as touched upon in paragraph 3.2.5 and 3.11.6. For 3.2.5, if the FMI belongs to a group which also has other activities, there need to be appropriate safeguards to ensure not only independent decision making, but also to avoid contagion effects to the FMI from risks or activities of other group entities, especially if those other entities are also FMIs.

On the role of the board of directors in 3.2.7, whilst we support strong arrangements to ensure that the board is composed of suitable members with a suitable mix of skills who are attentive to their duties, the current wording is far too prescriptive and once again should be nuanced and differentiated between different types of FMIs. In particular, parts of 3.2.8 on the need for independent board members would not be applicable to payment systems which only have financial institutions as authorized participants. In general, the role of independent directors should be understood in the context of the risk-allocation structures of each FMI's governance, and should not be understood to abridge the rights or the voice of clearing members or other participants to which risks are allocated.

We support the general thrust of paragraphs 3.2.11 and 3.2.12 on risk management, but this again is an area where there should be differentiated explanatory notes and assessment methodology between different types of FMIs and ownership structures.

Importantly, for CCPs, the Risk Committee should in most cases be composed only of clearing members, which are generally risk mutualizers, (i.e. willing to bear the risk of default by in effect contributing their own resources to the CCP's default fund and committing to participate in the default management process by mandatory bidding on portfolios during such a situation). Given that their resources are on the line, clearing members have a direct stake in getting the risk balance right, and parties that are less exposed should not participate in decisions that may increase their risk. Other parties that are non-mutualizers have a meaningful role to play in the governance of CCPs, but this should appropriately be accomplished by participation in other aspects of the CCP's governance, particularly through board membership.

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.

We support the emphasis in this draft Principle on an integrated and comprehensive view of risks. As with the other Principles, it is important to take a differentiated approach in the explanatory notes and assessment methodology to reflect the specificities of different types of FMIs. Whilst the bulk of the explanatory notes as currently drafted is applicable to all types of FMIs, individual paragraphs or subsections giving tailored guidance on the application of the Principle to specific types of FMIs

would allow an appropriately granular description of the individual issues for each type of FMI and thus a more internationally convergent approach.

Linked to the point made under draft Principle 2, in requiring FMIs to have integrated and comprehensive risk management, it must be ensured that risk management requirements are proportionate to the allocation of risk between the FMI and participants. The intent of the Principle will not be achieved if costs or risks that are best managed at the FMI level are simply displaced to participants or allocated in a disproportionate way.

Furthermore, it is imperative that sound risk management of FMIs provide participants with the means to monitor and mitigate the risks inherent in the operation of the FMI itself. (We note that many of the considerations in this Principle and accompanying explanatory notes are also pertinent to Principle 19 on tiered participation requirements.)

Paragraph 3.3.4 already mentions that "*an FMI should employ robust information and risk control systems to provide the FMI itself and, where relevant, its participants and their customers with the capacity to obtain timely information and apply risk management policies and procedures.*" This goes in the right direction, but needs to be developed in line with our comments under draft Principle 19 below.

Nevertheless, as we note in our comments on individual types of risk below and on Principle 13 on participant default rules and procedures, there are a number of detailed issues that will need to be addressed. Specifically we strongly favor the adoption of an explicit default waterfall for CCPs, of which an example (which of course would have to be adapted to the specificities of each institution) is that currently being discussed in the proposed European Market Infrastructure Regulation. More generally, there should be *ex ante* consideration of the procedures to cover any further financial difficulties of the FMI that might not be covered by the waterfall, as indicated by paragraph 3.4.16.

In 3.3.5, another example of incentives that should be mentioned is for CCPs to have buy-in procedures in place. In most structures, buy-in is a very efficient tool to mitigate risk.

We also believe that risk management of interdependencies (3.3.6) is key. Any change in FMI strategy could create substantial interdependencies and related risks need to be subject to formal risk review and board - and, if applicable, Risk Committee - approval.

Principle 4: Credit risk

An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.

We welcome the differentiated treatment in the explanatory notes between payment systems, CSDs and SSSs on the one hand and CCPs on the other.

General considerations on the impact of requirements

Measures to strengthen collateral and margin requirements in order to mitigate credit risk, while appropriate, should be reasonable so as not to result in an unnecessary increase in the amount of collateral required from FMI participants. The cost of any increase in the required amount of collateral would surely be passed on to clients. An unnecessary spike in collateral requirements could result in a system-wide liquidity drain, particularly if there is limited eligible collateral as discussed below. Clients could then have difficulty in posting the required collateral, leading to a disincentive against using FMIs where not required, or be tempted to seek to achieve the economic equivalent of relevant transactions through other channels.

Moreover, the gross amount of collateral required for FMIs will affect the overall liquidity of relevant markets, especially when conjoined with the effects of Basel III liquidity requirements and other regulatory changes. It should be a priority of the macroprudential oversight authorities to consider the comprehensive effects of all such requirements and make sure that disproportionate burdens on the system and the economy are not being created.

Prudent requirements; "cover one" vs. "cover two"

In this regard, clarification should be given as to what would be considered as "prudent" haircuts that FMIs are required to establish to mitigate fluctuations in the value of the collateral. Clarity as to how FMI regulators would assess whether an FMI's haircuts are prudent or not would go a long way to ensure that FMIs have reasonable - and thus not overly conservative - levels of collateral requirements.

The issue of "cover one" versus "cover two" raises a number of complex issues, which we will evoke briefly. We note that draft Principle 4 refers to application of a "cover one" or "cover two" exclusively for CCPs, whereas draft Principle 7 refers to the issue for all FMIs.

A consistent approach should be taken across FMIs: the minimum requirement should be proportionate and commensurate to the risks of each FMI and not impose unnecessary burdens. Whilst a more expansive requirement would provide for greater resources available to the FMI in stressed market conditions, it would result in reduced liquidity during both stressed and normal conditions, and thus might be detrimental to overall financial stability. The costs and potential systemic disruption resulting from an increase in trapped liquidity therefore need to be weighed against the potentially increased stability of the specific FMI.

Given that during the crisis, most payment systems operated in effect on a "cover one" basis without any disruption or difficulties, as a general matter, for most FMIs, including CCPs, "cover one" would represent such a proportionate and commensurate requirement. Further, firms are concerned that a "cover two" approach would immobilize excessive resources and create excessive costs compared to the gain from increased safety and stability.

Additional Considerations for a More Risk-based Approach.

While our analysis clearly supports "cover one" as the most appropriate response to the question as posed, as discussed further below, "cover one" or "cover two" is at best an approximate standard and, given interplay between risks and resources in the system, a more supple and risk-sensitive approach would be in order.

Where, for a specific FMI such as a CCP, the risk characteristics indicate that the benefits of a greater risk coverage outweigh the detriments, we accept that it should be possible for the FMI itself or an authority to require expanded coverage. Nevertheless, we believe that the explanatory notes should make clear the specific characteristics that would have to exist and the specific procedure that would apply, and that there should be a globally consistent approach. The explanatory notes should include consideration of the macroprudential implications of requiring additional resources for a given FMI, as well as the microprudential issues of the specific FMI.

It is important to consider, along with all other risk characteristics, the nature and composition of the FMI's participant base, including the number, heterogeneity and size of participants, the extent to which participation exposures are concentrated in a few firms or diversified across many, the characteristics and liquidity of the instruments accepted in the FMI, and collateral allowed, and such market factors as the time required to close out positions. To some extent these issues are covered by the explanatory notes, but these fundamental points may be obscured by the focus on "cover one" or "cover two".

Specific Issues for CCPs.

Given the concentration of risks in CCPs, and the mutualization of risks among market participants they imply, close analysis is especially important, as the discussion clearly recognizes.

Defining an appropriate standard appropriate to a given CCP needs to be based on an objective assessment of the risks created by the CCP to which both, participants and underlying customers, as well as the CCP itself, are exposed. Such risks will in turn be greatly affected by the design of the FMI and its loss-allocation rules.

Equally important is the extent to which direct participants are exposed to risks created by their and other participants' underlying clients. The 99% standard foreseen by Key Considerations 4 and 5 is generally accepted *but is predicated on the continued use of client omnibus accounts,* where clients share some of the residual fellow-customer risk upon the default of a direct clearing participant[1].

If, however, client omnibus accounts are disfavored as the draft Principles seem to contemplate, then the explanatory notes should be revised to establish an appropriate standard for client account structures that do *not* include some mutualization of fellow customer risk, or any other sort of risk mutualization for indirect participants. This is

[1] In such context, the probability of the entire omnibus account's having insufficient collateral to cover the cost of its liquidation is extremely low, as the collateral of all clients is available to cover the risk. Indeed, the standard reached—one that protects the CCP from having to access its financial safeguard—well exceeds stress market moves modeled under extreme but plausible market conditions.

important to mitigate exposures of clearing participants to underlying clients not participating in the risk sharing. Such a revision should be based on analysis along the following lines.

First, each participant should post risk collateral calculated to cover potential losses in case of its default with a high degree of confidence, under extreme but plausible market conditions (such collateral to be posted by indirect participants with their clearing firms for onward pledging to the CCP, except where specific subaccounts at the CCP for identified indirect participants are possible) .

Second, for direct (clearing) participants only, a specified portion of their risk collateral should be at risk in the event of another direct participant's default. This portion defines the size of the default fund (and by implication how it is to be allocated). Policies with respect to the default fund should be determined by the CCP's risk committee, with votes restricted to the exposed direct participants (as stated above). This would enable the CCP to cover potential losses beyond those intended to be covered by the modeling of the extreme but plausible market conditions used to derive the risk collateral amounts.

Third. The calculation of the proportion of mutualized risk margin (default fund) should, as stated more generally above, consider the heterogeneity and size of the CCP's membership, the extreme tail risks of the product cleared, the default liquidation frame, etc.

Without such analysis, simple statement of "cover one" or even "cover two" standards could give false comfort in the circumstances of a specific CCP. The goal should be to create sufficient resources, given the specifics of each system, to cover actual risks and avoid free-rider problems (including issues created if indirect participants do not share in loss-mutualization) on the most efficient basis possible, with adequate and predictable default-fund exposures for direct participants, but without excessive immobilization of resources, which would have deleterious macroeconomic and macroprudential consequences.

With reference to explanatory note 3.4.16, *contingency planning for uncovered credit losses*, contingency planning should aim to avoid CCP insolvency as a result of exhaustion of available waterfall resources, and still limit each direct participant's liability, which is important for systemic reasons, given firms' participation in multiple FMIs, as well as to create reasonably predictable risk-management conditions for participants. In such planning, the reference to the potential default of the two largest participants is not inappropriate, but can only be a rough guide that should be adapted to the nature of the system, its participants, and the markets it supports.

We further address the issue of participant defaults in our comments on Principle 13 below. We have also addressed the issue of margin in our comments on Principle 6 below.

Principle 5: Collateral

An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

As stated in our cover letter the treatment of FMIs should generally be consistent with the treatment of other types of financial institution, and regulators should consider how any new requirements affect the net cumulative impact of reforms to banks and other financial institutions. Thus, while we agree that limiting eligible collateral to instruments with "*low credit, liquidity, and market risk*" is reasonable, it must be clarified that this refers to a more expanded list of assets than those under the Basel III liquidity rules (which mention the same criteria). Relying only on Basel III "*liquid assets*" for FMI purposes would worsen the potential market effects. The scarcity of this limited set of liquid assets could trigger competition among banks and FMIs to build up and hold these assets, making the market less, rather than more, liquid.

Limiting the assets acceptable as collateral to the Basel III "*liquid assets*" would also make it difficult for FMIs to comply with the Key Consideration in draft Principle 5, which is to avoid concentration of holdings of certain assets.

Furthermore, the appropriate collateral for different systems is likely to vary by the instruments cleared, the exposures created, applicable settlement periods, and the risk-management systems of each FMI. Each FMI should therefore retain the ability to determine its own classes of acceptable collateral, subject to demonstration to its supervisor of the appropriate conservatism of the definition of such collateral and of the haircuts applied.

The Key Considerations also include the requirement for FMIs to establish "*stable and conservative haircuts that are calibrated to include periods of stressed market conditions in order to reduce the need for procyclical adjustments*." However, as pointed out by the Committee on Global Financial Systems (CGFS) in its paper "*The role of margin requirements and haircuts in procyclicality"*, there are significant practical difficulties in implementing such haircuts. Hence, as mentioned above, clear guidance needs to be given as to what would constitute a "*conservative*" haircut and how to arrive at it. In addition, we should also note the observation made by the CGFS that conservative haircuts are no panacea. Placing restrictions on haircuts may simply displace the problem to the other elements of the credit terms without any reduction of risk.

We suggest adding a Key Consideration to ensure the protection of participants' collateral against the default of the FMI or its custodian, either by segregation or other forms of ringfencing. This is especially important for excess margin (also called overcollateralization), where it is most likely that assets in excess of participants' obligations will be in the hands of the FMI or custodian, and thus in need of protection from their creditors. This topic was already raised in the BIS consultation document on "*Capitalization of bank exposures to central counterparties*" ('Bankruptcy remote collateral' paragraphs 115-116). However the principle should be applied beyond CCPs to any FMI which requires collateral or margin.

There should also be a consideration for cases where collateral cannot be provided by participants, and possible risk-mitigation mechanisms in such caases. This applies to sovereigns and supranationals which under many circumstances cannot or customarily do not provide collateral, and to custodians and asset managers, whcih are not the owners of collateral but could at most provide collateral acting as agents for underlying clients, whether disclosed or undisclosed.

We generally support the comments in paragraph 3.5.4 *Avoiding concentration of collateral*. We believe that it is critical for clients to feel confident that their assets will be returned in the case of the default of the FMI.

Principle 6: Margin

A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.

We agree with the recommendation for CCPs to adopt forward-looking and relatively conservative and stable margin requirements to limit procyclical changes. However, in addition to this, 3.6.10 also recommends that CCPs "*could consider increasing the size of its prefunded default arrangements and scheduling more frequent collection of variation margin to limit the need and likelihood of large unexpected margin calls in times of market stress*." We believe that these approaches should be considered as substitutes for, and not add-ons to, conservative margin requirements. Having all three together would be onerous, and the cost of complying with these requirements would likely be passed directly on to clients without a proportionate increase in stability and safety. Once again, the overall amount of collateral immobilized in utilities such as CCPs needs to be analyzed from a macroprudential point of view, lest the effects on the system as a whole become disproportionate.

We also would like to note in 3.6.9 the inconsistency between how general wrong-way risk is defined in this paper with how it is defined in the literature, including Basel III. The paper states that general wrong-way risk arises when "*the exposure to a counterparty is likely to increase when the creditworthiness of that counterparty is deteriorating."* This definition commonly refers to specific wrong-way risk. General wrong-way risk, as it is commonly defined, arises when the probability of default of counterparties is positively correlated with general market risk factors.

Principle 7: Liquidity risk

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources to effect same-day and, where appropriate, intraday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not limited to, the default of [one/two] participant[s] and [its/their] affiliates that would generate the largest aggregate liquidity need in extreme but plausible market conditions.

The language of this draft Principle needs to be clarified and differentiated to make clear how it would apply to different types of FMIs. The degree of exposure to liquidity risk of the different types of FMIs may vary: some perform a guarantee function that exposes them to more liquidity risk, while others may have access to central bank liquidity that significantly mitigates their liquidity risk. These differences should be taken into account in setting out expectations for FMIs.

Under Basel III, it is assumed that banks cannot draw from the credit and liquidity arrangements they have with other financial institutions under stressed market conditions. The industry generally has found the treatment of credit and liquidity facilities one of the most problematic parts of the Basel liquidity proposals, and it is understood that these provisions may be among the portions of the proposals that are subject to reconsideration. Once the issues with the treatment of credit and liquidity facilities under Basel III have been resolved, CPSS and IOSCO should revisit this issue to determine whether the treatment for FMIs should be revised to ensure consistency.

We support the requirements in paragraphs 3.7.5 and 3.7.10 for an FMI to ensure that liquidity providers are able to meet their same-day funding commitments. However, we believe that it should be emphasized that this would also include regular testing of the ability to do so in stressed situations.

On the stress scenarios, we believe that the "cover one" approach is the most sensible *a priori* requirement for FMIs in general, subject to our comments on draft Principle 4. The need for liquidity places a constraint on collateral, in that a portion of collateral needs to be in cash or cash equivalents, or acceptable by a committed liquidity facility to generate same-day cash to make good all daily payment obligations. The "cover one" standard and the default liquidation period interact to determine what portion of collateral needs to be in cash or cash equivalent, or other highly liquid form. For example, for a CCP clearing futures that are liquidated fully in one day, a very high proportion of the collateral should be in cash or cash equivalents, while for swaps clearing, where liquidation may be designed over a five-day period, a lower portion is warranted.

Principle 8: Settlement Finality

An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

We support this Principle as currently drafted. However, we suggest that CPSS-IOSCO make a statement in the explanatory notes on the desirability of reaching global agreement on the definition of settlement finality and indeed make active efforts to do so. This would be particularly useful for the smooth operation of cross-border business.

Principle 9: Money Settlements

An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

We broadly support the draft Principle and Key Considerations. However, in trying to merge the existing explanatory notes for different types of FMIs, the new explanatory notes once again end up losing much of the clarity and detail of those earlier notes.

We therefore recommend a differentiated approach between the different types of FMIs in both the explanatory notes and assessment methodology and recommend reinserting as much of the existing original text as possible, albeit subject to verification that the existing explanatory notes are still applicable post financial crisis.

In 3.9.2, the preference for settlement in central bank money is sensible as a conceptual matter but, as the explanatory note makes clear, it may not always be practical or available, nor may it be efficient either operationally or financially. Where settlement in central bank money is not feasible, a FMI should be required to analyze and understand the exposures created for the system and participants by the use of commercial bank money and cash-correspondent relationships, and disclose the resulting risks to participants, which should in turn include such risks in their risk management analyses.

Where the FMI conducts separate payment or banking activities, these activities should be segregated into a separate legal entity or otherwise ringfenced, to ensure that there is no contagion effect to the core services of the FMI.

Principle 10: Physical deliveries

An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.

We support the Principle and Key Considerations as currently drafted.

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 support the draft Principle and the majority of the Key Considerations. We also support the underlying motive of reviewing the existing principle, RSSS Recommendation 6 in the light of the financial crisis.

However, we have reservations about a number of aspects of the explanatory notes as currently drafted.

On the one hand, 3.11.5 requires the segregation of assets. Whilst we agree with the statement that "*A CSD should protect against custody risk, including the risk of loss because of the CSD's insolvency, claims by the CSD's creditors, or the CSD's negligence, misuse of assets, fraud, poor administration, inadequate recordkeeping, or failure to protect a participant's interests in securities*", it does not follow that this should necessarily require a full segregation of assets at the level of the customer. Risk reduction has and can continue to be carried out through the use of omnibus customer accounts or through other means.

On the other, 3.11.6 appears to give CSDs a large amount of freedom to offer services other than central safekeeping, merely requiring them to identify, monitor and manage the risks associated with them. In our view, in order to maintain its risk-free profile, a CSD should in principle limit its activity to its core functions and not offer any activity that could increase its risk if that activity could be done by other means. CSDs should therefore ringfence their core services from any risk-taking ancillary services in separate legal entities to ensure that: (a) CSDs do not change their low risk profile with systemic consequences; and (b) CSDs are able to diversify their services and continue to innovate.

This would also mean that securities lending services, for example, should not be provided by the CSD acting as principal, given the risks this creates. Such services should only be provided as agent or be carried out by a separate legal entity. Other examples of such activities that should be separated are banking and acting as settlement guarantor.

We also note that there are passing references to the role of the registrar, but no full consideration of the registrar's role even though such a role is related to the integrity of the issuance. We suggest that if registrars still perform this function, most securities should benefit from the safety provided by the central recording by a CSD, and the allocation of responsibilities between the registrar and the CSD should be made clear

Principle 12: Exchange of value settlement systems

If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.

We are broadly happy with this Principle and the Key Considerations as currently drafted.

Principle 13: Participant-default rules and procedures

An FMI should have effective and clearly-defined rules and procedures to manage a participant default that ensure that the FMI can take timely action to contain losses and liquidity pressures, and continue to meet its obligations.

We support this Principle and Key Considerations as currently drafted.

Nevertheless, the explanatory notes could usefully be developed even further, with more clarity as to the application to the different types of FMIs. For instance, in 3.13.3, the guidance on the use of the resources by an FMI when a participant defaults is somewhat vague.

For CCPs, the default waterfall principle as described in the proposed European Market Infrastructure Regulation (Article 42) could usefully be adopted. In line with this, the explanatory notes should make it clear that the use of resources posted by a participant in favor of the CCP to cover the default of a clearing member should be strictly defined by clearly agreed rules (with a separate clearing fund per asset cleared). Such an approach is essential to avoid any temptation to CCPs to use their risk management policy to gain new clients by reducing the amount of collateral or contributions to clearing funds that may be required.

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.

We support the motivation for this draft Principle. In the light of the weaknesses revealed by the financial crisis, in some cases there does need to be greater protection of the interests of customers and, in some circumstances, greater legal certainty about their rights in the event of a default or insolvency of a participant.

We also understand the attraction of segregation and portability as being, all other things equal, the simplest and most direct means of ensuring that a high degree of protection and legal certainty exists. To the extent to which segregation and portability are both feasible in the interests of customers and do not have any potential negative consequences, we indeed support them.

However, the draft Principle is neither desirable nor feasible in all circumstances. There will be a large number of cases in which separating out the positions of individual underlying customers and keeping them segregated will be disproportionately difficult or inefficient. Equally, there will be cases in which a blanket application of the Principle would lead to perverse outcomes in which operational risk and settlement uncertainty would increase because liquidity would be "trapped" in individual positions or accounts. This would go against the principles of liquidity risk management and more generally risk management. Similarly, as discussed under Principle 4, the presence or absence of some degree of risk mutualization among indirect participants has a very significant effect on the risk, cost, and efficiency of any FMI, particularly a CCP.

Equally, there is a significant question as to the extent to which it is possible or desirable for the CCP to identify and protect the final customer. It is far from clear who the "customer" is in the present draft. Is it the trading member firm (TMF) or the client of the TMF, or an underlying client of that client? Indeed in many cases, there may be a long string of actors between the clearing member and the ultimate, underlying client. The further along this string, the harder it is to ensure segregation (and as our comments on draft Principle 19 note, the harder it is to monitor risk exposures).

Draft Principle 14 further raises the question to what extent a CCP should be the regulator of its participants. The language could be read to require segregation all the way down the chain, but this would be extremely burdensome if not impossible for an individual CCP to enforce, and participants might face conflicting requirements of different utilities. If segregation is appropriate at levels below that of participation in the CCP, such a requirement should be addressed through regulation of custody businesses: it is not reasonable to attempt to make CCPs the regulators of segregation. Again, a given participant may be a member of many different CCPs, and should not have to deal with multiple regulators of the same underlying client relationships.

Draft Principle 14 says that "*a CCP should employ an account structure that enables it … to identify and segregate positions and collateral belonging to customers of a participant*". Is this to be interpreted to permit segregation between a participant's own account and its omnibus customer account, or does it require segregation of different customers' assets? In the latter case, for whom should segregation be required when the customer of the participant and the owner of the collateral are not the same?

To an extent, the explanatory notes that accompany the draft Principle and Key Considerations acknowledge the overall difficulty of segregation (and consequently portability). However the explanatory notes need to acknowledge more clearly that segregation is only one risk mitigation and customer protection option and that there are others that may be more useful in a particular case. In addition, some classes of customers of participants may prefer the increased cost-effectiveness and efficiency that may be gained by not requiring segregation.

We would therefore favor amending the Principle to read "*To the extent practicable, in the interests of the customer, and of optimal risk management, a CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant. It should be understood that even if segregation is provided, customers of a participant should have the right to forego such segregation if they so wish, including for reasons of efficiencies or cost savings*."

Equally, Key Considerations 1, 2 and 3 should be amended to insert the same conditional statement.

Principle 15: General business risk

An FMI should identify, monitor, and manage its general business risk and hold sufficiently liquid net assets funded by equity to cover potential general business

losses so that it can continue providing services as a going concern. This amount should at all times be sufficient to ensure an orderly wind-down or reorganization of the FMI's critical operations and services over an appropriate time period.

We note that this draft Principle focuses on capital requirements as the sole mitigating factor for general business risk. We believe that other mitigating factors such as risk management, sound corporate governance, strong IT, operational and contingency plans and other qualitative requirements should be given equal importance. Equally for payment systems, reserves are a more appropriate consideration than capital.

The draft Principle also seems to copy the requirements for banks and apply them to FMIs without consideration of the differences both between banks and FMIs, and between FMIs themselves. As with the draft Principle on liquidity risk, the language of this draft Principle needs to be clarified to make clear how it would apply to different types of FMIs and to the quite different risks they create and reorganization or resolution issues they would raise.

On a more detailed issue, 3.15.4 notes that *"… some risks may be eliminated or mitigated by appropriate internal controls, while other risks may be insured or indemnified by a third party or retained by the FMI*." We believe that this statement should be modified to reflect that risk transfer tools should be viewed as complementary to, rather than replacements for, thorough internal risk controls.

Principle 16: Custody and investment risk

An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market and liquidity risks.

We broadly support the draft Principle and key considerations as currently drafted.

The safekeeping of assets (securities or cash) is of course a major concern for FMI participants and their underlying clients. Therefore it is important for FMIs to consider carefully their custodial and cash-correspondent relationships to minimize counterparty risks. As a general matter, assets in custody should be segregated in favor of the FMI, with applicable legal opinions giving assurance of the FMI's claim on the assets in the event of the failure of the custodian. As with cash exposures, as discussed under Principle 9, any risks arising from custodial relationships should be adequately disclosed so that participants can factor such risks into their own risk management.

Principle 17: Operational risk

An FMI should identify all plausible sources of operational risk, both internal and external, and minimize 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 fulfillment of the FMI's obligations, including in the event of a wide-scale disruption.

We agree with and support the Key Considerations of this draft Principle.

Principle 18: Access and participation requirements

An FMI should have objective, risk-based and publicly disclosed criteria for participation, which permit fair and open access.

We support the Principle and Key Considerations as currently drafted. We believe that the emphasis on "*risk-based*" is particularly important. While we applaud the open access principle, an FMI must always put safety first, as the draft Principle explicitly suggests. Stringent, risk-based requirements should focus on the risks brought by each participant to the system, the collateral and clearing fund exposures created by the system for each participant, and potential participants' capital and other resources available to meet contingency requirements.

Allowing an FMI to impose less restrictive participation requirements, which it might be tempted to do for competitive reasons, would compromise the safety of such an FMI, or create additional, disproportionate risks for other participants.

In this vein, we suggest that 3.18.7 be amended as follows:

"*To help address the balance between open access and risk, an FMI should manage its participant-related risks through the use of risk management controls, risk-sharing arrangements and other operational arrangements that do not unduly restrict access and competition*."

The current drafting: "*Least restrictive impact ... that circumstances permit*" creates a standard that could severely limit the ability of FMIs to set access requirements based on risk, and is inconsistent with the tone in the rest of the draft Principle.

Principle 19: Tiered participation requirements

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

We welcome the fact that the issue of "tiered participation requirements" is addressed in these draft Principles, though we note that the issue is already raised to some degree by the more general considerations on risk management in Principle 3.

However we have some important reservations with regard to the Principle as currently drafted, most notably with the qualifier "*to the extent practicable*". We agree that some kind of qualifying clause is needed here as FMIs cannot be expected to identify,

understand and manage all risks from indirect participants. For reasons that we will go into below, they are simply not in a position to see and aggregate all exposures of all underlying claimants along the chain of ownership. Nevertheless, there needs to be more guidance on how the "practicable" standard should be interpreted, going beyond the somewhat vague guidance at present.

The explanatory notes should make very clear the kinds of information that FMIs should reasonably be expected to collect from FMI direct participants, and in particular the levels of detail of participants' exposures to indirect participants.

They should also make clearer the extent of FMIs' responsibilities when receiving that information, both as to confidentiality and as to timely dissemination to direct participants.

Rather than establish a firm list of actions applicable to all types of FMI in all jurisdictions, it is equally important on this critical topic to provide guidance about what the FMI should not be required to do.

Linked to our comments on Principle 14, it is essential that the Principles define the term "customer" and how far along the chain of ownership the FMI would be expected to collect information.

The customer is not necessarily the TMF dealing directly with the direct participant, but may be the order giver who uses one or more TMFs to execute their order. Equally the person or institution giving the order to a TMF may themselves be acting on behalf of a client or mutual fund who may in turn be acting on behalf of another client. It would be unreasonable and disproportionately costly to expect an FMI to monitor and address all the risks of all these actors along all points in the chain. We would therefore suggest that generally speaking, it should be acceptable for an FMI to monitor indirect risks from TMFs.

Therefore the term "customer" should generally be defined for these purposes to mean any entity with which the participant has a direct relationship, which would often be a TMF.

Supervisors should also be mindful of the limits to which an FMI may be able to monitor the risks even of a TMF, which may itself be using a number of FMIs. This need not of itself create substantial risk to the system. If all systemically important FMIs are subject to these standards and all are managing their risks effectively and in a comparable manner with information sharing between FMIs, and if direct participants themselves are also carrying out the necessary diligence and applying appropriate risk mitigation to their TMF clients, the risks should be adequately contained.

Principle 20: FMI links

An FMI that establishes a link with one or more FMIs should identify, monitor and manage link-related risks.

We support the draft Principle and Key Considerations as currently drafted. We believe that there is a strong case for promoting FMI interoperability. It allows for robust FMIs to compete for business and allows for the better model to evolve more quickly. Further, without it, exposures to certain FMIs may grow to uncontrollable levels. Moreover, interoperability will tend to work against the fragmentation of the market by FMI or by jurisdiction, thus increasing the overall efficiency and liquidity of the financial system.

For example, in the case of clearing interest rate swaps, it may well happen that US clients decide to clear at a US CCP and a European CCP in the EU. Since many large US clients are *paying* fixed rates to manage their fixed rate financial receivables, and EU pension funds are *receiving* fixed rates in swaps to manage liabilities responsibly, without the ability to transfer positions through interoperability, a swap dealer may find that an otherwise market-risk-balanced swap book commands enormous risk margin amounts at each of the US and EU CCPs, respectively. The swap dealer has no way to mitigate this risk exposure without starting to make separate market prices for US vs. EU cleared swaps. This may well lead to a fragmented swap market with reduced liquidity to serve end-user needs, and the health of the overall financial system.

However, whilst we support interoperability, it needs to be recognized that interoperability would require a great deal of care and caution in execution to mitigate the potential risks. Such risks vary by the type of FMI and are generally most acute where there is novation, such as for CCPs. The risks will also differ between cash and derivatives CCPs. The explanatory notes should be clearer on this and preferably have distinct guidance for these two types and a more considered approach including on identification of risk models and collateralization protocols.

On CCP-CCP links, the accompanying explanatory notes should make it clearer that when moving to a peer to peer link involving interoperability, there needs to be a far higher degree of harmonization than when establishing a participant link. Such harmonization should cover buy-in procedures, the timing of novation and calendars.

Nevertheless, we agree with the draft explanatory notes that this need not necessarily extend to having identical risk management frameworks. What matters here is that there is a substantial degree of comparability between the frameworks such that they reflect the same high quality of risk management. As such, we believe that the wording of 3.20.17 represents a fair balance here.

On the margin requirements discussed in 3.20.13 and 3.20.14, whilst we can see that there could be a rationale in theory under some circumstances from a systemic risk perspective for CCPs' not contributing to each other's default funds, the explanatory notes need to be clearer on how they should manage their risk instead. It is not clear whether the solution is intended to be the separate default fund referred to in the last sentence of 3.20.14 or some other means such as a direct re-use of the assets posted by its direct participants or via commercial bank funding. The explanatory notes should address this and be clear as to why the proposed solution or solution represents a better option than contributing to the main default fund. They should also consider the liquidity and market-efficiency implications of a restrictive solution.

Principle 21: Efficiency and effectiveness

An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.

We support the draft Principle and the Key Considerations in so far as they go. However, as with our observations on a number of the other draft Principles, there should be some explanatory notes and discussion of assessment methodology differentiating between the types of FMIs, ideally by reinserting much of the existing text from CPSIPS, RCCP and RSSS.

The new text does however provide two paragraphs on effectiveness: one for the majority of FMIs and one for TRs. Whilst this insistence on effectiveness is sensible, and whilst the crisis highlighted the dangers of cost-cutting and competition at the expense of safety, it does not mean that efficiency should not also be valued and it is difficult to see how the new wording advances the global mutual recognition of FMIs. We would therefore recommend the reinsertion of wording on the need for effective competition policies both nationally and cross-border. "*Effectiveness*" should not be used as an excuse for barriers to access.

We also believe that there should be more reference to the interests of end-users being adequately taken into account in securities FMIs.

Principle 22: Communications procedures and standards

An FMI should use or accommodate the relevant internationally accepted communication procedures and standards in order to facilitate efficient recording, payment, clearing and settlement across systems.

We support the draft Principle and Key Considerations and the general sense of the statement in 3.22.1 that "*an FMI should use or accommodate relevant internationally accepted communication procedures and standards to ensure the most reliable, efficient and accurate communication between the FMI, its participants, their customers and other users.*" In theory, this should help ensure both interoperability and reductions in costs.

However, the problem is the practicality of applying this draft Principle in detail to all FMIs and for all types of communications procedures and standards. There are some functions of FMIs where international standards are appropriate and useful for participants and end-users, but others where they are neither necessary, feasible nor cost-effective.

We therefore recommend that both 3.22.2 and 3.22.3 should be nuanced to remove the phrase "*at a minimum*" and to add "*In general and where functionally appropriate*" so that the first sentence of 3.22.3 would read "*In general, and where functionally appropriate, an FMI should adopt or accommodate internationally accepted communication standards ….*"

We also recommend that as with the other draft Principles, CPSS-IOSCO develop more detailed and differentiated guidance between types of FMIs. In addition a more detailed approach may be necessary based on differentiation of functions, although it will be important not to constrain future technical evolution in the area of communications standards.

Furthermore, as far as communication protocols and networks are concerned there should be a requirement for the regulator to verify that there is a real level playing field between different solutions. Where this is not the case, regulators should push for consistent and interoperable solutions.

Principle 23: Disclosure of rules and key procedures

An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

We broadly support the approach taken in this draft Principle and the Key Considerations, which build out and strengthen existing standards.

Nevertheless, in doing so, though and in trying to create a uniform approach for FMIs, some of the details on individual types of FMIs have been lost. For payment systems for instance, there is no longer the specification that "*if the central bank has discretion in providing intraday or overnight credit, involved parties should be aware of the fact and its implications.*" Equally for CCPs, paragraph 4.14.2 has been lost: "*Information should be readily accessible, for example through the Internet. It should also be current, accurate, and available in a language commonly used in financial markets and at least one of the domestic language(s) of the jurisdiction in which a CCP is located.*"

In line with the approach that we have suggested on other draft Principles, we believe that this detail should be (re)inserted as much as possible and that there should consequently be differentiation on the details of implementation and the assessment criteria between the different types of FMIs.

Principle 24: Disclosure of market data

A TR should provide timely and accurate data to relevant authorities and the public in line with their respective needs.

This draft Principle is taken from the May 2010 CPSS-IOSCO consultation on "*Considerations for trade repositories in OTC derivatives markets*", but once again is further developed, so that "*A TR should provide data* ***in line with regulatory and industry expectations*** *to relevant authorities and the public, respectively, that is comprehensive and* ***at a level of detail sufficient to enhance market transparency and support other public policy objectives.***" (Our italics).

We think that it would be useful to have more concrete guidance on how this would be interpreted. It is also important that privacy and data security regulations be observed; the official sector should take responsibility for reviewing such regulations to make sure they are compatible with the final Principle and with related macroprudential and financial stability goals and, where conflicts are identified, the official sector should seek to resolve them through changes in law or regulations.

Responsibilities of central banks, market regulators, and other relevant authorities for financial market infrastructures

As noted in our cover letter, whilst the draft Responsibilities go in the right direction, the wording is modest both in its extent and in its ambition. We strongly urge CPSS and IOSCO to review the explanatory notes thoroughly, including adding a specific principle on the duties of legal authorities to ensure that regulators, supervisors and oversight bodies have sufficient powers and resources to exercise effective oversight and to cooperate effectively on a cross-border basis. It can no longer be acceptable for a Principle or Responsibility to be only partially applied in a particular jurisdiction because the FMI or regulator does not have sufficient powers or because there is insufficient legal clarity or protection. The sufficiency of powers and the adequacy of legal clarity and protection should be a condition of membership of both CPSS and IOSCO rather than merely being desirable.

We also believe that all of the Responsibilities should be reviewed to make clear the duties of regulators, supervisors and oversight bodies in cases where the FMI is publicly owned and/or operated. We note that 1.22 says that "*In general, the principles are applicable to FMIs operated by central banks, as well as those operated by the private sector. Central banks should apply the same standards as are applicable to similar private-sector systems. However, in certain cases, central banks also have separate public policy objectives and responsibilities for monetary and liquidity policies that may take precedence.*" This should be made far clearer in the text of the Responsibilities including specific guidance on how and when those separate public policy objectives would take precedence and making it clear that such actions must be predictable and transparent and should not distort competition in any way.

Responsibility A: Regulation, supervision and oversight of FMIs

FMIs should be subject to appropriate and effective regulation, supervision and oversight by a central bank, market regulator, or other relevant authority.

Broadly speaking, we welcome this delineation of responsibilities. However, as we have noted above, the explanatory notes should clarify the duties of regulators in regard to FMIs which are publicly owned or operated, and should ensure the avoidance of conflicts of interest. In particular for payment systems, we would support the reinsertion of much of the specific wording in CPSIPS.

Responsibility B: Regulatory, supervisory, and oversight powers and resources

Central banks, market regulators, and other relevant authorities should have the powers and resources to carry out effectively their responsibilities in regulating, supervising and overseeing FMIs.

We support the draft Responsibility as far as it goes, though noting the need for the draft Responsibility to be clear about the duties of authorities towards both privately and publicly owned or operated FMIs. In particular we support the requirement for authorities to have appropriate powers to induce change in an FMI that is not complying with relevant regulations or policies.

Nevertheless, we believe that the draft Responsibility could usefully be strengthened in 4.2.4 to specify that sufficient resources include sufficient regulatory and supervisory resources to enable the authority to cooperate fully internationally and to devote sufficient resources to cross-border oversight. This would include an affirmative mandate to operate in cooperation with international authorities for the benefit of the overall global financial system; simple authority to cooperate within otherwise-existing mandates would be inadequate.

The draft Responsibility should make clear the need for coordination and cooperation with banking supervisors where appropriate.

CPSS and IOSCO should develop benchmarks and a monitoring process to ensure that this Responsibility is met and sustained over time. We draw attention to the comments that we have made with respect to prudential supervision in our report "*Achieving Effective Supervision: An Industry Perspective*"[2]. These are very much applicable to the regulation, supervision and oversight of FMIs.

In that report, we argue that:

"Relative numbers of supervisors are important and should be broadly aligned to absolute and relative levels of risk posed by institutions. […] While national approaches may differ, there is no inherent reason why resource levels should vary much across countries for comparable firms. […] there would be considerable benefit in taking a more global approach to the issue of resources and quality. If supervisors are to feel confident in relying on each other, they need to have the resources to engage with one another and feel confident in the resources and quality of other supervisors. The system will be undermined if supervision is intense in some jurisdictions but inappropriately relaxed in others.

Therefore, it is important that supervisors allocate appropriate resources to international supervisory issues and that their staff include a mixture of specialists on international law/issues and staff with wider supervisory experience. […] there must be no acceptance of inadequately resourced or supervised jurisdictions. […] Thought should be given to whether transfers of know-how or resources are necessary and whether a mechanism to deliver this (possibly through the IMF/World Bank) could be considered,

[2] IIF "*Achieving Effective Supervision: An Industry Perspective*", July 2011

analogous to the "twinning" programs run by the European Union in the lead-up to the 2004 EU Enlargement."

Responsibility C: Disclosure of policies with respect to FMIs

Central banks, market regulators, and other relevant authorities should clearly define and disclose their regulatory, supervisory, and oversight policies with respect to FMIs.

We support the draft Responsibility insofar as it goes, though noting the need for the draft Responsibility to be clear about the duties of authorities towards both privately and publicly owned and/or operated FMIs.

We would like to see clarification on the "*additional public policy objectives*" referred to in 4.3.1 to make it clearer what exactly this refers to.

We find the penultimate sentence of 4.3.1 "*In addition, authorities may find it beneficial to consult with the market, key stakeholders and the broader public regarding their policies"* alarmingly weak. We would strongly suggest amending this to read *"As a matter of course, authorities should consult fully and effectively with the market, key stakeholders and the broader public regarding their policies*."

4.3.2 should be strengthened to emphasize the duty of the authority to communicate effectively and regularly both with the FMI and with the participants and end-users. Once again, in our report "*Achieving Effective Supervision: An Industry Perspective*", we have emphasized the need for effective communication and accountability on both sides.

Responsibility D: Application of the Principles for FMIs

Central banks, market regulators, and other relevant authorities should adopt, where relevant, internationally accepted principles for FMIs and apply them consistently.

We urge CPSS and IOSCO to review this draft Responsibility thoroughly and to redraft it in a way that makes it substantially more effective. In particular, we suggest that a Key Consideration be added to the effect that "*Authorities shall consider that they have an affirmative obligation to converge regulatory, supervisory and oversight policies and practices, and to facilitate cross-border linkages."* The financial crisis demonstrated the weakness of relying on existing standards of cooperation, and the need for greater and ongoing efforts to converge. If current mandates of authorities preclude giving sufficient priority to international cooperation and convergence, they should be amended to permit them to do so. The IIF's recent report on supervision referred to above underlined that:

"*it is desirable to move as far as possible in the direction of harmonized supervisory approaches. […] The question should not be, "Is exact convergence necessary?" but*

instead "Are differences in approach really justified?"; "Will remaining differences complicate supervision to an unacceptable extent?" and, most important, "Are supervisors aiming for, and achieving, comparable outcomes, notwithstanding the differences of approach?"

[…]

Ultimately, this needs to be seen as a confidence-building process. The work of the World Bank and IMF through Article 4 and the Financial Sector Assessment Program (FSAP) has brought real and significant improvements. Yet despite the best efforts of these institutions and the supervisors seconded to take part in assessments, more could be done to ensure a consistency of approach and depth of analysis and to compel assessed countries to comply with any recommendations. The FSB has an essential role here in working with the BCBS and IAIS to check compliance. Maximum pressure needs to be placed on deficient jurisdictions, which may include other jurisdictions placing strict limits on the activities of firms domiciled in the non-compliant countries."

Paragraph 4.4.1 states, "*While the precise means through which the principles are applied will vary from jurisdiction to jurisdiction, all CPSS and IOSCO members are expected to apply the principles for FMIs to the relevant FMIs in their jurisdictions* ***to the fullest extent possible allowed by the legal framework in their jurisdiction****.*"

We strongly recommend that both the words "*While the precise means through which the principles are applied will vary from jurisdiction to jurisdiction*" and "*to the fullest extent possible allowed by the legal framework in their jurisdiction*" be deleted. Regulators should not be able to avoid compliance by pointing to weaknesses in their legal framework. If such deficiencies exist, they must be addressed.

Likewise, referring to variations in the application of the Principles sends exactly the wrong message.

Linked to this, we recommend a formal structure for assessing the compliance of authorities with the Principles and Responsibilities and for addressing any weaknesses identified, possibly through the FSB's Standards Implementation Group.

In 4.4.2, there is wording that "*Subject to appropriate authority, […] authorities should ensure that these […] principles are applied to all systemically important payment systems, CSDs, SSSs, CCPs and TRs.*" The explanatory notes suggests that authorities judge whether a payment system is systemically important based on certain criteria, but that other types of FMI be presumed to be systemically important. It then though says that "*Authorities should disclose which FMIs they do not regard as systemically important and to which they do not intend to apply the principles and provide a comprehensive and clear rationale. Conversely, authorities may disclose the criteria used to identify which FMIs are considered as systemically important and may disclose which FMIs they regard as systemically important against these criteria*."

This is a recipe for confusion and the explanatory notes should be clarified. What happens if one authority deems an FMI to be systemically important and another does not?

In 4.4.3 it says that "*Authorities should apply these internationally accepted principles consistently within and across jurisdictions*". There needs to be guidance here as to how this would work in practice. How would an authority know that it was applying Principles *inconsistently*? Once again, we believe that some kind of international body – possibly IOSCO or the FSB's Standards Implementation Group – to should take an active role in reviewing compliance by authorities with the Principles and Responsibilities. The explanatory notes should refer to this body and require authorities to comply with any recommendations.

Responsibility E: Cooperation with other authorities

Central banks, market regulators, and other relevant authorities should cooperate with each other, both domestically and internationally, as appropriate, in promoting the safety and efficiency of FMIs.

We agree that this draft Responsibility goes in the right direction, but once again believe that the explanatory notes should be reviewed thoroughly and made much more ambitious and demanding. Authorities are encouraged to cooperate; they are not compelled to do so. At the least, domestic mandates that may interfere with international cooperation and convergence should be amended to make the global financial system an equal priority with domestic concerns. As noted above, we recommend a formal structure for assessing the compliance of authorities with the Principles and Responsibilities and for addressing any weaknesses identified, possibly through the FSB's Standards Implementation Group. Such a structure should also address issues of perceived non-cooperation between authorities and the resolution of disputes between authorities. The explanatory notes should address these issues and refer to such mechanisms or dispute resolution, an issue that is not touched on at all in the draft.

As with draft Responsibility B, we urge that a requirement be inserted for authorities to devote adequate and increased resources to cooperation.

The Responsibility should also call for regulators of like FMIs to communicate and coordinate on interpreting Principles so that the standards are applied equivalently to all similar entities. Not doing so will encourage competition on risk management across competing FMIs in different jurisdictions. This is particularly important as the OTC derivatives market becomes increasingly cleared and there is direct cross-jurisdictional competition for clearing the same contract.