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Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov

Re: Notice of Proposed Rulemaking
Docket No. R-1477 / RIN No. 7100 AE-09

Ladies and Gentlemen:

CLS Bank International (“CLS”) welcomes the opportunity to comment on the Notice of Proposed Rulemaking issued by the Board of Governors of the Federal Reserve System (the “Board”) (No. R-1477) (the “Proposed Rules”) proposing certain amendments, based on the *Principles for financial market infrastructures* (April 2012) (the “PFMI”), to the risk management standards contained in Regulation HH, Part 234 of Title 12 of the Code of Federal Regulations. The Proposed Rules reflect a new common set of risk management standards applicable to all types of financial market utilities that are designated as systemically important (“designated FMUs”).

CLS was established by the private sector, in cooperation with a number of central banks, as a payment-versus-payment (“PvP”) system to mitigate what is generally considered to be the primary risk in foreign exchange (“FX”) transactions, loss of principal associated with the settlement of payments, or “settlement risk”. CLS is now the world’s largest multicurrency cash settlement system for FX and provides a PvP settlement service for 17 currencies. Over the years, CLS has grown consistently with the FX market and, today, CLS serves over 60 Settlement Members, all of which are financial institutions subject to prudential regulation and supervision, and over 9,000 third-party users. While CLS is owned by many of the largest participants in the FX market, it continues to acknowledge and further the dual public-private purpose that gave rise to its creation.

The settlement service operated by CLS is a systemically important system for settling payment instructions relating to certain types of underlying financial transactions (FX contracts and OTC credit derivative contracts) in specifically authorized currencies. As an Edge Act corporation, CLS is regulated and supervised by the Federal Reserve under a program of ongoing supervision, combining full-scope and targeted on-site examinations with a variety of off-site monitoring



activities.¹ Additionally, the 17 central banks whose currencies are settled in CLS have established the *CLS Oversight Committee*,² organized and administered by the Federal Reserve, as a mechanism to carry out the central banks' individual responsibilities for promoting the safety and efficiency of payment and settlement systems, and the stability of the financial system.

I. General Comments on the Proposed Rules

CLS would like to express its broad, general support for the Proposed Rules and recognize the significant efforts of the Board on their promulgation. CLS's comments below are directed to those matters where CLS believes it can provide helpful input, or where CLS believes a Proposed Rule is unclear, overbroad or would impose costs on designated FMUs, or their users, that are disproportionate with the benefits sought to be obtained by the Proposed Rule itself. As a payment system, CLS has focused its comments on the application of the Proposed Rules to payment systems.

In the commentary to the Proposed Rules, the Board indicates it is considering different compliance dates, to provide sufficient lead time for certain new or heightened requirements. CLS supports this approach, in particular the proposed six-month compliance period for the revisions which establish a standard or parts thereof that are new or heightened requirements to both Regulation HH and the current supervisory process.

As a general matter, CLS emphasizes the need for consistency and coordination among the various regulators who will implement and enforce compliance with the PFMI. CLS agrees it is important that the relevant supervisors give careful consideration to how they will implement the PFMI across all jurisdictions and how they will monitor and ensure consistent application of the relevant rules.

II. Specific Comments on the Proposed Rules

Proposed §234.2 (Definitions)

The Board specifically requests comment on whether the proposed definitions are clear and sufficiently detailed and whether additional definitions are needed to implement the Proposed Rules.

As to the proposed definitions, CLS comments as follows:

¹ CLS operates pursuant to a charter that was issued by the Federal Reserve in accordance with Section 25A of the Federal Reserve Act in November 1999.

² In addition to the European Central Bank, the CLS Oversight Committee also includes five other Eurosystem central banks, bringing the total to 22 central bank members of the CLS Oversight Committee.



Definition of “recovery”

CLS agrees with the distinction the Board draws with respect to the proposed definition of “recovery” applying to §234.3(a)(3) (Framework for the comprehensive management of risks) and §234.3(a)(15) (General business risk), but not in the context of business continuity management under §234.3(a)(17) (Operational risk). It is important to draw a clear and appropriate distinction between recovery and business continuity management, and the tools associated with each discipline, even though in some cases risk management procedures and recovery tools are part of a continuum. In CLS’s view, recovery tools are used once its own balance sheet and financial soundness are at risk, whereas tools that prevent or mitigate risk to CLS Members are risk management tools.

CLS also believes that the Board should clarify that the concept of “recovery” is financial in nature, and that the reference to “operational” in the definition is a reference only in terms of the financial impact of an operational issue or occurrence.

Finally, in order to maintain clear boundaries between “recovery” and “resolution”, authorities across jurisdictions should coordinate triggers for resolution such that the triggers are consistent and the designated FMU can deploy its various recovery tools without triggering resolution proceedings in some jurisdictions and not others. In order to ensure that a designated FMU can implement its recovery tools as necessary, without inconsistent direction, authorities should facilitate coordination amongst relevant supervisors and regulators, including resolution authorities.

Definition of “wind-down”

In CLS’s view, winding down a designated FMU and discontinuing its critical service(s) will almost certainly be inconsistent with its objectives. In the event that a designated FMU becomes financially unsustainable while still being systemically important, and if financial recovery is not possible, the only appropriate way to manage the designated FMU must be to use procedures and tools that allow for the continuation of its critical service(s). This may involve a form of bankruptcy stay or the use of resolution tools. If the intention is to transfer the critical service(s) out of a designated FMU in financial distress as part of its “termination”, unless this is done through the use of resolution powers which envisage this, it is difficult to see how this can be accomplished. Outside of a resolution, it is likely that an attempt to transfer the critical service(s) (and related assets) other than for full value would be vulnerable to challenge. Accordingly, one is driven to the assumption that a wind-down by the designated FMU itself will entail the cessation of the critical service(s).

In the case of CLS, if CLS’s critical service were to stop on a given day, the primary issue would be the amount of notice to be given to its Members (and the market they represent). The issue for CLS would not be the length of time it would take to wind down its critical service, but rather how much notice it would be expected to give its Members in this regard, and how it would retain the financial capability to offer its critical service during that period. The two considerations are related: on the assumption that revenues at that point are not covering the costs of operating the critical service and that the system is being sustained by using the wind-down capital contemplated in PFMI 15, the



longer the notice period, the more capital is required. It is difficult, and maybe impossible, for CLS to include in its recovery and wind-down plan meaningful assumptions about how the market is going to solve for CLS's absence or how long such a solution will take to implement, so the wind-down plan can only meaningfully address the wind-down of the relevant corporate entities and issues relating to their financial obligations in this period. A wind-down plan that focuses on a limited amount of cost savings and the termination of employees, and lease, services and similar contracts, is probably of limited use in the context of the objectives of the relevant regulations and, in any event, will largely be governed by general corporate and insolvency laws. CLS therefore considers guidance is necessary to clarify:

1. Whether the intention is for the designated FMU to plan for a wind-down involving a cessation of the critical service(s); and
 - a. If not, what assumptions should be made about how the critical service(s) are sustained?
 - b. If so, should the plan simply be based on the time required to wind down the corporate entities in an orderly way, or on other considerations, such as notice to the market? If the latter, what considerations should be taken into account and what assumptions can be made?
2. Other than dealing with employees, and lease, services and similar contracts, what assumptions should a designated FMU make about its orderly wind-down?

Removal of the definition of "payment system"

CLS would like to point out that, in respect of the Board's decision to remove the definition of "payment system" from Regulation HH, this would leave less flexibility if in the future it is decided to separate out the risk management standards applicable to payment systems.

Addition of "backtest" definition

The Board's proposed definition for "backtest", as used in §234.3(a)(6) (Margin), may be overly restrictive, as the term and associated requirements are only applicable to the subset of designated FMUs subject to §234.3(a)(6). The Board should consider expanding the definition beyond the narrow context of margin, as all types of designated FMUs backtest calculated parameters to validate coverage adequacy against historical data, including the haircut percentages as used in §234.3(a)(5) (Collateral).

Q.0.1. Are the proposed standards reasonable risk-mitigation tools?

Yes, CLS generally believes that the proposed standards are reasonable risk mitigation tools.



Q.0.2. Is six months from publication of the final rules for designated FMUs to comply with the proposed requirements identified above (that is, proposed §§ 234.3(a)(3)(iii), (a)(4)(vi), (a)(7)(viii), (a)(15)(i)-(ii), (a)(19), and (a)(23)(iv)) [reasonable]? Should the Board propose alternative compliance dates for these or any other proposed requirements?

Yes, CLS believes that six months is reasonable.

Q.0.3. What are the costs that are imposed by the proposed standards? Are there ways to meet the proposed standards other than those identified as examples in the discussion on each standard below?

The costs are potentially significant, in particular costs associated with a capital raise to align with enhanced regulatory standards, costs associated with increased staff for ongoing compliance with the proposed standards, and the monitoring and reporting procedures this entails. CLS also refers to its comments below in response to Question 17.2 regarding the costs involved in meeting the business continuity standards within the context of cybersecurity events.

Proposed §234.3(a)(2) (Governance)

Q.2.1. Should the Board specify in the rule text “other relevant public interest considerations” for a specific type of or even for a particular designated FMU?

No, CLS’s view is that the examples given in §234.3(a)(2)(iii), in combination with the Board providing guidance, as needed, through the supervisory process, to assist a designated FMU in identifying other public interests that are relevant to its operations (as referred to in the commentary to §234.3(a)(2)), are sufficient and further specificity is not required.

Q.2.2 Should the Board set a specific minimum percentage of individuals on the board of directors that may not be executives, officers, or employees of the designated FMU or an affiliate of the designated FMU? Alternatively, should the standard set any requirements for the participation of outside directors (that is, directors who are not participants in or management of the designated FMU)?

CLS believes that §234.3(a)(2)(iv)(D) is appropriate, and agrees that the board of directors of a designated FMU should include a majority of individuals who are not executives, officers or employees of the designated FMU or an affiliate of the designated FMU. However, the Board should not be too prescriptive in setting a particular percentage. A designated FMU should have a sufficient number of outside directors, in line with evolving industry best practices. Independent directors should chair board committees where possible.

Q.2.3 Should the Board require specifically that the chairman of the board of directors be (a) an individual who is not an executive, officer, or employee of the designated FMU or an



affiliate of the designated FMU or (b) a different individual than the designated FMU's chief executive officer?

Yes. The chairman of the board of directors should be an independent director.

Q.2.4 Should there be a requirement for the regular reviews of the performance of the board of directors and its individual board members to include periodic independent assessments?

Yes. CLS believes that it is good governance for an independent party to perform such reviews. The frequency, scope and specifics of the review, however, should be left to be determined by the designated FMU.

Q.2.5 Should the designated FMU's board of directors be required to have a committee of the board of directors that only has audit responsibilities to which the audit function reports and a risk committee of the board of directors that only has risk-management responsibilities to which the risk-management function reports? Alternatively, should the designated FMU's audit and risk-management functions be required to report directly to the entire board of directors?

Yes, CLS believes that a designated FMU's board of directors should be required to have a committee of the board of directors that has audit responsibilities and to which the audit function reports, and a risk committee of the board of directors that has risk management responsibilities and to which the risk management function reports. However, in the case of risk management, the primary functional reporting line should be to the executive management of the designated FMU, whereas in the case of audit, the reporting line should be independent of executive management.

Q.2.6 What additional guidance should the Board provide to a designated FMU's board of directors in order to identify a "major decision" that must be disclosed to relevant stakeholders under the rule?

CLS believes that §234.3(a)(2)(iv)(J), which requires that a designated FMU's board of directors clearly disclose its major decisions to relevant stakeholders, is sufficient as drafted. The board of directors of the designated FMU should identify what constitutes a "major decision" that is to be disclosed to relevant stakeholders. Alternatively, to avoid ambiguity, the Board could consider providing non-exclusive examples of what does and does not constitute such a "major decision".

Proposed §234.3(a)(3) (Framework for the comprehensive management of risks)

As to the requirement in §234.3(a)(3)(iii)(B) that a designated FMU's risk management framework include plans for the designated FMU's recovery or orderly wind-down that identify scenarios potentially preventing the designated FMU from being able to provide its critical operations and services as a going concern, CLS believes that such scenarios should contemplate severe idiosyncratic and systemic stress events that are not covered by business continuity planning or



normal crisis or failure management tools. The scenarios should represent *extreme* conditions and align with the key risks to which the designated FMU is exposed that, if realized, could prevent the designated FMU from being able to provide its critical operations and services as a going concern. Each scenario should be distinct so that, to the extent possible, analysis related to each scenario is not duplicative.

Section 234.3(a)(3)(iii)(C) requires a designated FMU's risk management framework to include plans for the designated FMU's recovery or orderly wind-down that identify criteria that could trigger the implementation of the recovery or orderly wind-down plans. In this regard, CLS believes that once a service has been deemed "non-critical" by the designated FMU in its recovery or orderly wind-down plan, the designated FMU should have the discretion to exercise its own judgment as to whether or not it will continue such non-critical service, provided that the financial consequences are not material with respect to its ability to operate the critical service. Further, while CLS agrees that it is useful to identify criteria that could trigger the implementation of a recovery or orderly wind-down plan, ultimately the relevant facts and circumstances in a given situation should dictate whether it is appropriate to trigger the plan. This determination should ultimately be made by the designated FMU's management at the relevant time, based on its assessment of the situation at such time, working with its regulators and other stakeholders. Inflexible triggers, such as capital levels, may have adverse unintended consequences, such as precluding a designated FMU that has a viable recovery opportunity available to it from electing that alternative because it has hit a wind-down trigger.

CLS recognizes its own decision to commence a wind-down, for example, would be triggered at a point that cannot be defined solely in quantifiable (*i.e.*, monetary) terms, as the actual trigger would be the point at which CLS determines that there is no reasonable prospect of raising financing from its shareholders or third parties and/or its Members will not continue to participate in its service on a financially sustainable basis, in either such case to facilitate a recovery. A monetary threshold may be misleading in this context, because if CLS's shareholders have indicated a willingness to recapitalize, it would be inappropriate to trigger a wind-down of CLS's service.

The requirement in §234.3(a)(3)(iii)(D), that a designated FMU's risk management framework include rules, procedures, policies and any other tools that the designated FMU would use in a recovery or wind-down, addresses scenarios that may potentially prevent a designated FMU from being able to provide its critical operations and services as a going concern. CLS would like to highlight that, while some tools, such as loss allocation, may be relatively prescriptive, the application of certain other tools, such as expense reduction or refinancing, will be heavily reliant on the facts and circumstances at the time of distress and therefore may not fit well into a designated FMU's "rules, policies and procedures".

As to the requirement in §234.3(a)(3)(iii)(F) that a designated FMU's plans for its recovery or orderly wind-down include procedures for informing the Board, as soon as practicable, if the designated FMU is considering initiating its recovery or orderly wind-down plan, CLS points out that some tools,



such as loss allocation, will be triggered automatically pursuant to *ex ante* agreements. With respect to such tools, while the Board would be informed of their use as soon as practicable, this notification may be contemporaneous with or *after* their use (regulators would, of course, have had access to the *ex ante* agreements). Other tools that are more discretionary in nature, such as expense reductions, may also be used in the ordinary course of business as part of prudent management.

As a general comment to the requirement that a designated FMU's risk management framework include plans for the designated FMU's recovery or orderly wind-down, CLS believes that a designated FMU's regulator should have the discretion to determine whether a recovery plan *and* an orderly wind-down plan is required for a particular designated FMU, as well as the scope of any such recovery and/or orderly wind-down plan(s).

Q.3.1 Should an annual or longer minimum frequency be established for the proposed “periodic review” of the designated FMU’s comprehensive risk-management framework? Commenters should discuss the anticipated costs or benefits of any suggested minimum frequency. Alternatively, should individual minimum frequencies be established for each particular designated FMU, given the design or type of designated FMU?

CLS believes the Board should not be overly prescriptive with respect to §234.3(a)(3), which requires a designated FMU to review its comprehensive risk-management framework periodically. A designated FMU is required to have formal governance processes under §234.3(a)(2), including definite review frequencies for all risk framework components. The Proposed Rules also define standards for models in multiple sections, including daily, monthly, and annual validation and testing requirements. General standards for review frequencies across all elements of a comprehensive risk-management framework under §234.3(a)(3) may be duplicative and potentially contradict other proposed standards.

With respect to the recovery or orderly wind-down element of a designated FMU's risk management framework, because *ex ante* agreements with relevant stakeholders are central to a designated FMU's recovery or orderly wind-down plans, and these agreements take time to amend or to draft, negotiate and discuss with stakeholders and regulators, “periodic reviews” of plans with respect to recovery or orderly wind-down should be undertaken no more frequently than every other year, assuming there is no interim material change in the designated FMU's risk exposure. Furthermore, CLS takes the view that it is appropriate for the update of recovery or orderly wind-down plans, as required by §234.3(a)(3)(iii), to occur every other year, as this would align such review with the public disclosure mandated by §234.3(23)(v).

Proposed §234.3(a)(4) (Credit risk)

Given that the particular circumstances will dictate how a designated FMU manages replenishing any financial resources that it may employ in a stress scenario, CLS believes that the Board should



allow for some flexibility in §234.3(a)(4)(vi)(B), which requires a designated FMU to establish explicit rules and procedures in this regard. CLS suggests that the language in §234.3(a)(4)(vi)(B) be revised as follows:

*“[Establishes rules and procedures that] describe **generally** the designated financial market utility’s process to replenish any financial resources that the designated financial market utility may employ during a stress event, including a participant default, **which may vary depending on the circumstances of the stress event.**”*

Proposed §234.3(a)(7) (Liquidity risk)

With respect to the standards proposed in §234.3(a)(7), CLS believes that further clarity is required. A designated FMU can test its assumptions using models, but should not conduct tests that involve use of participant funds (other than in *de minimis* amounts). CLS suggests that in respect of the required testing, it be made clear that such testing should not be done in a way which causes disruption to the designated FMU’s members and participants. Furthermore, a designated FMU cannot test scenarios that are heavily reliant upon specific facts and circumstances, such as all business risk scenarios.

CLS would like to note that further clarity is warranted with respect to §234.3(a)(7)(ii), which requires a designated FMU to maintain sufficient liquid resources in all relevant currencies to effect same-day and, where applicable, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of significantly different potential stress scenarios that includes the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the designated FMU. The Board should consider that a designated FMU may not have the authority to demand detailed information on participants’ affiliates, particularly for affiliates in peripheral lines of business. The scope with respect to affiliates should be clarified or removed.

Further clarity is also requested with respect to §234.3(a)(7)(iv), which requires a designated FMU to evaluate and confirm, at least annually, whether its providers of committed arrangements have sufficient information to understand and manage the provider’s associated liquidity risks, and that the provider has the capacity to perform as required under this commitment, as well as with respect to §234.3(a)(7)(v), which requires a designated FMU to maintain and test its procedures and operational capacity for accessing each type of liquid resource at least annually. As noted above, required testing should not cause disruption to the designated FMU’s members and participants, or to the broader financial markets.

Section 234.3(a)(7)(vi)(B) requires a designated FMU to conduct a comprehensive and thorough analysis of its existing stress scenarios, models, and underlying parameters and assumptions on at least a monthly basis (and more frequently when products cleared or markets served experience high volatility or become less liquid, or when the size or concentration of positions held by the designated FMU’s participants increases significantly). CLS suggests generalizing the proposed



standard. However, as the monthly review requirement may not be appropriate for all models or all types of designated FMUs, the Board should not be overly prescriptive with respect to these standards.

Proposed §234.3(a)(13) (Participant default)

As to §234.3(a)(13), which requires a designated FMU to test and review its default procedures, including any close-out procedures, at least annually or following material changes to the rules and procedures, CLS believes clarification is needed with respect to the testing requirements, as noted above. The scale and extent of the required testing should not be so significant as to cause disruption to the designated FMU's members and participants, or to the broader financial markets. A designated FMU can test its assumptions using models or by conducting periodic simulations in its systems, but the scale and extent of the required testing should not require the use of participant funds (other than *de minimis* amounts) or unnecessarily stress the designated FMU's critical service(s).

Proposed §234.3(a)(15) (General business risk)

Section 234.3(a)(15)(ii) requires that a designated FMU, in addition to holding financial resources required to manage credit risk and liquidity risk, maintain a viable plan (approved by the board of directors and updated at least annually) for raising additional equity before the designated FMU's equity falls below an amount that is at all times sufficient to ensure a recovery or orderly wind-down of the designated FMU's critical operations and services.

CLS agrees that it is important for a designated FMU to monitor and manage its general business risk. However, CLS notes that if a designated FMU, or the market as a whole, experiences distress or sudden losses, the designated FMU may face considerable challenges in its efforts to raise additional capital. Even *ex ante* agreements to provide capital (debt or equity) typically provide, as a prerequisite, that the recipient's business is stable. It would be very difficult to raise capital in a stress situation and, furthermore, shareholders would not be predisposed to making binding pre-commitments of further capital beyond the investments they have already made. Accordingly, *ex ante* agreements to provide capital cannot be considered a reliable recovery tool and do not alleviate the concern that parties may refuse to provide funding to a distressed designated FMU where they have no unconditional legal obligation to do so.

Instead of requiring that the designated FMU maintain a viable capital raise plan, CLS takes the view that the designated FMU should seek to ensure at all times that all regulatory capital and liquidity requirements are met and will, if necessary, increase capital and/or liquidity if any shortfalls occur or are projected to occur. This would include a refinancing plan in the form of a loan from one member or a consortium of members in order to maintain operations and liquidity while business activity is stabilized and an orderly equity recapitalization can be executed. The capital and liquidity levels should be routinely reviewed and monitored, and reported to the designated FMU's board of



directors on an historical and current actuals basis plus on a forecast basis over the short and medium-to-longer term horizons.

Q.15.1 Should the Board set a minimum amount of liquid net assets funded by equity that is different from the six-month minimum international standard, such as three or nine months of current operating expenses? Should the Board set the requirement based on the risk profile of the designated FMU? If so, what factors should the Board consider and what would be the effects of such an approach?

CLS believes six months should be a guide. The designated FMU should be able to use the capital cushion if necessary and, if it drops below the six-month minimum, the designated FMU should be given sufficient time to replenish its capital cushion. In setting a minimum amount of liquid net assets funded by equity, the Board should consider the designated FMU's business activity, its cost and revenue profile, as well as the specific timeframe assessed by the individual designated FMU to execute its own wind-down. The longer the notice period the designated FMU is required to comply with to wind down, the more capital is required by the designated FMU.

Q.15.2 Should the Board require a designated FMU that is part of a larger legal entity to take into account, when calculating the cost to implement its recovery or orderly wind-down plans, recovery or wind-down scenarios in which other business lines in the legal entity or the legal entity itself may also face an adverse business environment? To prepare for such scenarios, should the designated FMU include in its calculation of recovery or wind-down costs more than its normal business share of any shared support and overhead costs?

Yes, a designated FMU should factor into its recovery or orderly wind-down plan scenarios and cost calculations any adverse environment that may be faced by the other business lines within the legal entity, or by the legal entity itself.

Q.15.3 For designated FMUs that are part of a larger legal entity, the Board considered the alternative of requiring the designated FMU to hold liquid net assets funded by equity that are specific to the FMU itself to meet the requirement, but believes that it would likely be difficult to implement in practice. Are there any reasonable methodologies for determining which of the liquid net assets and equity held at the legal entity level belong to a particular business line?

It is difficult to determine the capital specific to a designated FMU when the designated FMU is part of a larger legal entity. Also, in insolvency it may not be possible to ring-fence assets within a legal entity; hence, considering a designated FMU to be separately capitalized when that capital is subject to risks within the entity as a whole, may be misleading. The designated FMU should consider a separate legal entity for the designated FMU's activities.



Proposed §234.3(a)(17) (Operational risk)

CLS certainly considers cyberattack scenarios in its business continuity planning. However, CLS agrees with the Board that, as noted in the commentary to the Proposed Rules, in the near term meeting the requirement in §234.3(a)(17)(vii)(B) to be prepared for a two-hour recovery time could present significant challenges for a designated FMU in the case of certain extreme but plausible cyberattack scenarios, particularly if such cyberattacks are widespread. CLS supports the Board addressing with designated FMUs through the supervisory process reasonable approaches to cyberattacks within the context of the evolving risk and technological environment.

Q.17.1 What types of changes to a designated FMU's current systems, policies, procedures, and controls will be necessary to reasonably ensure that its critical information technology systems can recover and resume operations no later than two hours following disruptive events caused by cyberattacks?

Depending on the exact nature of the potential disruptive event being prepared for, implementing sufficient systems, policies, procedures, and controls to reasonably ensure a designated FMU's critical information technology systems can recover and resume operations no later than two hours following a cyberattack could take considerable effort. Substantial changes to a designated FMU's production infrastructure to speed total recovery to within stated recovery time objectives would be required, potentially including further replication of already replicated and redundant resources.

Q.17.2 What are reasonable estimates of the costs and other challenges associated with these changes?

The costs of such changes could be significant, including the costs associated with creating additional replicas of existing production infrastructure and systems.

Proposed §234.3(a)(19) (Tiered participation arrangements)

Q.19.1 What, if any, risks do tiered participation arrangements pose to a payment system? How would a payment system assess these risks?

CLS supports the view that a designated FMU needs to understand the risks associated with the relationships between direct participants and their customers (indirect participants), in order to be able to understand and assess what risks, if any, the tiered arrangements may present to the designated FMU, its system/service and other participants. However, CLS does not maintain a legal contractual relationship with third-party users of the CLS settlement service, which limits CLS's influence on the commercial relationships between such third parties and the CLS Members that provide them with third-party services.

CLS believes that a designated FMU's responsibility should be to ensure that its direct participants have sufficient information from the designated FMU to assess their relationships with their



customers and evaluate the risks presented by the relationship in the context of the participants' overall risk management policies and procedures. A designated FMU may not have sufficient information about a relationship, and should not be required to prescribe and apply (and to assess compliance against) requirements regarding a direct participant's management of its relationship with its customers. The direct participant's regulator or supervisor is better situated to do this and could facilitate detailed and focused discussions with participants (both direct and indirect) regarding their participation in a designated FMU. This discourse could be a part of such supervisors' regular supervision of such participants in their jurisdictions. Such an effort would complement the efforts of the designated FMU in providing participants with sufficient information to understand and manage their risks with respect to participation in the designated FMU.

Q.19.2 What types of information would be helpful to assess the risks posed by indirect participants to a designated FMU? Is it feasible for a payment system to collect this information?

CLS does not maintain a legal contractual relationship with third party users of the CLS settlement service, which limits its influence on the commercial relationships between such third parties and the CLS Members that provide them with third party services. However, to guide participants' understanding and facilitate the assessment of risks related to tiered participation, CLS has developed Third Party Best Practices based on bilateral and multilateral discussions with CLS Members, third parties, regulators, and CLS executive management. CLS believes that systemic risk is reduced if large financial institutions settle payment instructions as CLS Members, and therefore the Third Party Best Practices include a risk-based recommendation for the conversion of large third-party users of the CLS settlement service to CLS Members. The Third Party Best Practices are publicly available on the CLS corporate website.

Q.19.3 How, if at all, should the Board define the threshold for identifying indirect participants responsible for a significant proportion of transactions processed by the designated FMU?

CLS has determined its own triggers, but these may not be relevant or appropriate for any other designated FMUs. CLS's view is that the Board should not be too prescriptive in defining a standard threshold, as thresholds and appropriate tolerances may vary across individual designated FMUs.

Q.19.4 How, if at all, should the Board define the threshold for identifying indirect participants whose transaction volumes or values are large relative to the capacity of the direct participants through which the indirect participants access the designated FMU?

CLS has determined its own triggers, but it should be up to individual designated FMUs, in light of their business models, to identify appropriate thresholds for them. CLS's view is that the Board



should not be too prescriptive in defining a standard threshold, as thresholds and appropriate tolerances may vary across individual designated FMUs.

Q.19.5 How often should a designated FMU review the potential risks from tiered participation arrangements?

CLS's view is that designated FMUs should review their frameworks for managing risks associated with tiered participation arrangements, including defined thresholds, in line with the periodic review standards under §234.3(a)(3). CLS believes that the Board should not be too prescriptive in defining a standard review frequency as the appropriate review frequency may vary by individual designated FMUs in light of their respective business models.

Proposed § 234.3(a)(23) (Disclosure of rules, key procedures, and market data)

Q.23.1 Should the Board require information about fees and discount policies to be part of the designated FMU's public disclosure framework? Why should the Board not require disclosure of fees and discount policies?

With respect to the requirement in §234.3(a)(23)(iii), CLS believes that high-level information should be provided publicly, such that a reader can understand the principles and rationale of the pricing charged by the designated FMU. The Board should not be too prescriptive in its requirements, however, as elements of pricing models may be subject to change and certain information relevant to the calculation of prices may be proprietary.

* * *

We appreciate this opportunity to comment on the Proposed Rules and remain available to answer any questions that the Board may have concerning this comment letter.

Sincerely,

David W. Puth
Chief Executive Officer

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