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Via Email

Philippa Cohen
Bank of England
20 Moorgate
London
EC2R 6DA

Re: CLS Bank International's Response to the Bank of England's Consultation Paper, "Draft Code of Practice and Supervisory Statement relating to governance in recognised payment system operators"

Dear Ms. Cohen:

CLS Bank International ("CLS") welcomes the opportunity to submit these comments in response to the consultation paper, "Draft Code of Practice and Supervisory Statement relating to governance in recognised payment system operators," September 2016 (the "Consultation Paper") from the Bank of England (the "Bank").

CLS was established by the private sector to mitigate settlement risk (loss of principal) associated with the settlement of payments relating to foreign exchange transactions and is the operator of a financial market infrastructure ("FMI") that is the predominant settlement system for foreign exchange transactions (the "CLS System"). The CLS System is the world's largest multicurrency cash settlement system, providing payment-versus-payment settlement in 18 currencies directly to 66 participants ("members"), some of which provide access to the CLS System for over 21,000 third party institutions.

CLS is an Edge Act corporation organized under the laws of the United States and is regulated and supervised by the Federal Reserve. The CLS System was designated in the United Kingdom in 2002 by the Bank for the purposes of the EU's Settlement Finality Directive 98/26/EC, as amended, and is designated or recognized for the purposes of comparable finality legislation in many other jurisdictions. Additionally, in July 2012, CLS was designated a systemically important financial market utility by the United States Financial Stability Oversight

Council, and has been specified by HM Treasury as a recognized inter-bank payment system under the Banking Act 2009.

Furthermore, the 18 central banks whose currencies are settled in the CLS System (including the Bank) have established the CLS Oversight Committee, organized and administered by the Federal Reserve.¹ The CLS Oversight Committee operates in accordance with the Protocol for the Cooperative Oversight Arrangement of CLS.² As a systemically important FMI, CLS is also subject to the April 2012 CPSS-IOSCO Principles for financial market infrastructures (the “PFMI”), as applicable to payment systems.

CLS strongly supports the goals of the Consultation Paper. Good governance is vital to the successful management of risks in payment systems and other market infrastructures. Indeed, CLS has deployed significant effort and resources to refine and enhance its own governance arrangements with this goal in mind. CLS’s current governance arrangements are mandated by applicable law and by the organizational and constitutional documents of the CLS group entities. In addition, on an ongoing basis, CLS adheres to the Swiss Code of Best Practice for Corporate Governance, the UK Corporate Governance Code, as well as laws, rules, and regulations applicable to systemically important FMIs, Edge Act corporations, and bank holding companies subject to regulation and supervision by the Federal Reserve, as required.

Scope of applicability

The Consultation Paper sets out detailed proposals for governance standards intended to apply to a subset of recognised payment system operators (“RPSOs”). While many of these requirements are unlikely to differ materially from those proscribed pursuant to the cooperative oversight arrangements described above, application of another set of standards would subject CLS to an additional set of governance standards, while remaining responsible for resolving and satisfying any gaps that arise as a result of regulatory mismatch. To the extent that this approach is replicated in other jurisdictions, CLS will potentially be subject to conflicting requirements that could compromise the objectives of cooperative oversight.³

As such, CLS submits that the Bank should take a flexible approach to RPSOs that are already subject to international cooperative oversight as well as the relevant governance standards

¹ In addition to the European Central Bank, the CLS Oversight Committee also includes five other Eurosystem central banks, bringing the total to 23 central bank members.

² See http://www.federalreserve.gov/paymentsystems/files/cls_protocol.pdf.

³ Section 9 of the Protocol for the Cooperative Oversight Arrangement of CLS notes, “In particular, the participating central banks seek to promote a consistent oversight approach that:

- A. Achieves comprehensive oversight of the overall CLS system;
- B. Enhances oversight efficiency by minimizing burden on CLS and the duplication of effort by the participating central banks;
- C. Fosters consistent and transparent central bank communications with CLS;
- D. Fosters transparency among the participating central banks regarding the development and implementation of applicable policies; and
- E. Supports fully informed judgments when participating central banks make their independent yet interdependent oversight assessments and decisions vis-à-vis CLS.”

suitable for the RPSO's circumstances. In particular, CLS believes that cross-border RPSOs that are already subject to collective oversight arrangements in which the Bank participates should be exempted from the proposed requirements. Indeed, in the Consultation Paper, the Bank proposes to exempt certain RPSOs, noting "...the code will not apply to a recognised payment system that is operated by a recognized clearing house or central securities depository (CSD), given they are or will be subject to other requirements (eg EMIR and CSDR)."⁴

Should the Bank be unwilling to contemplate flexibility regarding the scope of exemption as proposed above, CLS submits that, at a minimum, the proposed code of practice (the "code") and Supervisory Statement ("SS") should recognize the effective role performed by cooperative oversight arrangements. The code and SS should explicitly note the intent to avoid implementing a regulatory scheme which would duplicate (or potentially contradict) requirements applicable to a cross-border RPSO subject to cooperative oversight arrangements in which the Bank directly participates. Furthermore, absent such flexibility, CLS submits the below additional comments for the Bank's consideration.

Composition of the board

CLS agrees that a board must be sufficiently balanced and independent and that this is essential to good governance. However, depending on the RPSO's circumstances, a prescriptive requirement for a fixed minimum percentage of independent directors appointed to the board could be too rigid and lead to counterproductive outcomes if skills and industry experience are compromised. Ultimately, the goal is to have a strong, engaged, skilled and independent board to oversee the RPSO's operations and management. Setting inflexible targets for the composition of all boards in the sector, without taking into account individual circumstances, could undermine the goals of the Consultation Paper.

CLS's existing board governance arrangements

CLS has invested significant time and effort in refining its governance structure. CLS believes that the current composition of its board is appropriately balanced, and its governance arrangements explicitly consider managing conflicts of interest. The CLS board possesses a broad range of knowledge and skills, including a detailed understanding of the finance industry and the vision and role of the CLS System. In addition, the board has specialist expertise and experience in areas of public interest, technology, risk management and finance.

CLS's governance arrangements clearly specify the roles and responsibilities of the board (including specific requirements for non-executive and independent directors) and CLS executive management, providing for documented lines of reporting and accountability. The

⁴ See p.3 of the Consultation Paper

CLS board is responsible for the ultimate direction, support and oversight strategy for CLS as a whole, as well as for governance and compliance arrangements and relevant control functions.⁵

In the owner-user model where the RPSO is owned and operated by its members (such as CLS), the term “independence” may mean not only “non-executive directors,” but also directors that are not employed by, or affiliated with, a shareholder – these are also known as “Outside Directors.” CLS’s Organizational Regulations require that at least four Outside Directors⁶, including the Chairman, serve on the CLS board. In addition to the requirement that an Outside Director serve as Chairman of the CLS board, there is a strong preference for Outside Directors to chair board committees and in certain cases (such as the Audit and Finance and Risk Management Committees), it is a requirement that the committee chairperson be an Outside Director. Further, all CLS board committees are required to have at least one Outside Director.⁷

The CLS board is subject to annual review by the Nominating and Governance Committee (“NGC”)⁸, which assesses its composition and qualifications (including skills, knowledge and experience) to ensure that the CLS board is compliant with the requirements set forth in its constitutional documents and to review and determine its optimal composition. Furthermore, the Organizational Regulations and supporting governance documentation (such as CLS’s Directors’ Handbook as well as the Directors’ Code of Conduct) apply to all CLS directors and provide additional guidance regarding the responsibilities of the CLS board and committees, including information regarding fiduciary duties as well as conflicts of interest. All CLS directors must attest at least annually as to their understanding and compliance with the Directors’ Code of Conduct, including disclosure of business and industry affiliations. Every CLS director receives annual review and training on the Directors’ Code of Conduct, including on conflicts of interest.

Proposed amendments to board composition

Given CLS’s owner-user model, it is uniquely challenging to identify truly independent directors (who would also qualify as Outside Directors) with the appropriate and relevant skill sets detailed above. CLS believes it currently has a sufficiently balanced and highly capable board that is appropriately representative of the interests of shareholders and broader financial markets that rely on its services. However, a minimum one-third or one-half independent director requirement would dilute and potentially even weaken the robust governance arrangements that CLS has developed and refined.

Furthermore, in the context of a global, cross-border payment system such as CLS, it is important that national standards be adopted in line with internationally agreed standards (such

⁵These governance arrangements are detailed in CLS’s PFMI Disclosure Framework, available at: <https://www.cls-group.com/About/CG/Pages/CorePrinciples.aspx>.

⁶ Outside Directors must also meet additional specific criteria for independence as provided in the Organizational Regulations, aligned with certain criteria in Regulations O and Y of the Board of Governors of the Federal Reserve System.

⁷ The list of CLS board members is available at: <https://www.cls-group.com/About/Pages/BoardofDirectors.aspx>.

⁸ The NGC is a CLS board committee consisting of at least four (and no more than eight) non-executive directors and at least one Outside Director with experience, skills and knowledge in corporate governance and related applicable laws, regulations and best practices.

as the PFMI) as well as the cooperative oversight arrangement under which CLS is supervised and regulated. As noted above, if an RPSO is subject to multi-jurisdictional cooperative oversight arrangements that include the Bank, those arrangements should be the appropriate mechanism for addressing such standards. If other designating jurisdictions were to follow the Bank's example and implement their own governance requirements, there is potential for conflicting national requirements (or conflicts with the international standard), the result of which could ultimately compromise the objectives of cooperative oversight.

As such, CLS urges the Bank to reconsider applying a rigid requirement for a minimum percentage of the board to be comprised of independent directors, especially with respect to CLS's unique nature. The Bank should retain flexibility whilst also considering the cooperative oversight arrangement under which CLS is supervised and regulated, as this has proven to be an effective mechanism to ensure a streamlined and efficient system for enabling central banks, including the Bank, to discharge their domestic responsibilities.

If, however, despite the above arguments, the Bank insists on applying this prescriptive requirement as proposed, CLS would urge the Bank to consider an extensive phase-in period (no less than five years) for those RPSOs that will need to make significant changes to their governance arrangements in order to become compliant with this new standard. An extensive phase-in period is critical for mitigating the risks associated with significant disruptions to an RPSO's governance arrangements that would otherwise occur.

Other comments

Systemic risk manager

CLS is keenly aware of its role as a systemically important FMI and in line with the requirements of the PFMI, has governance arrangements that promote the safety and efficiency of the payment system and support the stability of the broader financial system. Given the criticality of the CLS System's operations as well as the cooperative oversight arrangements described above, CLS by its nature must assume a global perspective with respect to financial stability. This inherently requires equanimity with respect to individual jurisdictions (including the UK) and aligns with the requirements of the PFMI. As such, CLS recommends that, at a minimum, the Bank reconsider explicit references to only UK financial stability as currently drafted in the SS.

Participants defined as both direct and indirect participants

Footnote 1 in the draft SS states, "In this document, references to 'participants' should be taken to refer to direct participants and, where relevant, indirect participants." Where practicable and appropriate, CLS will of course consider indirect participants but notes that, specifically from a governance perspective, this may not be appropriate or even feasible given the scale in

question. As noted above, to date, approximately 21,000 third parties have access to the CLS System.

CLS does not maintain a contractual relationship with these indirect participants and therefore is limited in the extent to which it can engage with, or impose requirements on them. As such, CLS recommends additional clarity and qualifying language be added from the outset to differentiate expectations and requirements with respect to direct vs indirect participants in an RPSO.

Second independent director to hold the chair to account

As discussed above, the NGC advises the CLS board on governance matters and provides oversight of vetting and nominating director candidates and the efficacy of CLS's corporate governance practices (such as committee composition, governance documents, board self-evaluation and director induction and education). For purposes of ensuring accountability, the CLS board undertakes a self-assessment process annually, overseen by the NGC, including a review of the CLS board's performance as a whole and that of the committees. Individual directors are also subject to self-assessments and reviews are conducted by individual committee chairs. During this annual review process, the entire CLS board has an opportunity to review and provide feedback on the chair's performance. Furthermore, on an annual basis, the chair of the CLS board is subject to election (or re-election) by the rest of the board members.

The NGC, as well as the entirety of the CLS board, have taken on the role of holding the chair to account. CLS believes this is a more robust approach than assigning such responsibilities to a single director, independent or otherwise. As such, CLS would urge the Bank to take a flexible approach to assessing RPSO compliance with this requirement and consider alternative, more robust, accountability models.

Ensuring members of the executive are provided appropriate information

Section 5.1(3) of the draft code contains a requirement that, "The *board* must ensure that the members of the *executive* of a RPSO...are provided with the appropriate information and support to discharge their duties." CLS believes that the board is responsible for the ultimate direction, oversight and supervision of the RPSO, whereas the executive is responsible for undertaking business and operational activities and conducting day-to-day management. As such, the board should not be tasked with ensuring the executive are "provided with appropriate information," and CLS recommends that Section 5.1(3) be adjusted accordingly to reflect the board's advisory and oversight function.

Independent performance assessment of the board

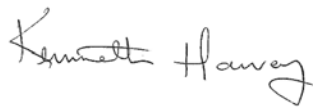
CLS agrees that regular performance assessments are critical for good governance. As discussed above, on an annual basis, the CLS board undertakes internal assessment processes overseen by the NGC. The CLS board is also subject to periodic internal and external governance reviews. One aspect of this is a committed biannual review of CLS board governance practices by an independent third party, which includes a review of the CLS board's structure, overall performance and directors' qualifications and performance.

CLS believes that these activities adequately demonstrate comprehensive and thorough performance management. CLS would welcome further clarification on the Bank's expectations with respect to "regular independent performance assessments," but would caution the Bank against being overly prescriptive with respect to the frequency, scope and specifics of such reviews.

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CLS appreciates the opportunity to respond to the Consultation Paper and would be happy to discuss, or further develop, any of these comments with the Bank.

Sincerely,



Kenneth Harvey

cc: Paul Riordan, Chairman - CLS Nominating and Governance Committee
Rick Sears, Deputy Chairman - CLS Nominating and Governance Committee
David Puth, Chief Executive Officer, CLS Bank International
Dino Kos, Head of Regulatory Affairs, CLS Bank International
Michael Preston, Director, CLS Bank International
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