CLS®
CLS Bank International

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Jonathan Faull
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European Commission
1049 Brussels
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Via Email: markt-nonbanks@ec.europa.eu

Re: Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks

Dear Mr. Faull:

CLS Bank International ("CLS") welcomes the opportunity to share its views on the European Commission's (the "Commission") *Consultation on a Possible Recovery and Resolution Framework for Financial Institutions other than Banks* (October 2012) (the "Consultation Paper"). Thank you for the opportunity to submit these comments.

As the Commission is aware, CLS is a special purpose corporation established by the private sector as a payment versus payment ("PvP") system (the "CLS System") to mitigate settlement risk (loss of principal) associated with the settlement of payments relating to underlying foreign exchange ("FX") transactions (i.e., FX contracts, NDF contracts and OTC credit derivative contracts). It is the predominant settlement system for FX transactions and provides a PvP settlement service for 17 currencies. These currencies represent a substantial majority of the total daily value of FX transactions traded globally.

CLS was created as a result of the collaborative efforts of central banks and financial institutions headquartered in several sovereign jurisdictions. It is organized under the laws of the United States, but English law governs the Rules of the CLS System. The CLS System has also been designated or recognized for the purposes of comparable finality legislation in many of the jurisdictions in which it operates, including in the United Kingdom in 2002 by the Bank of England for the purposes of the EU Settlement Finality Directive 98/26/EC (the "Settlement Finality Directive").

Over the years, CLS has grown consistently with the FX market to mitigate settlement risk, which is generally considered to be the primary risk in FX transactions. Today, CLS serves over 60 Settlement Members, all of which are financial institutions subject to prudential supervision and

regulation, and thousands of 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.

General Comments

CLS recognizes the significant contribution of the Commission in providing guidance for the effective resolution and recovery of non-bank institutions. Moreover, CLS agrees with the Commission's statement that "payment systems are a major channel by which shocks can be transmitted across domestic and international financial systems and markets . . . [c]onsequently, it is critical to the proper functioning of the financial sector and for financial stability that payment systems are robust and secure." Consultation Paper, §5.1.

Regulation of Payments Systems

The Consultation Paper provides that "[g]iven the vital nature of payment systems, and their specific relationship with and oversight by central banks, it is doubtful whether payment systems should merit further consideration in this context." Consultation Paper, §5.1. CLS concurs that payment systems are sufficiently regulated and subject to oversight by central banks and, therefore, further consideration in the context of the Commission's framework is unwarranted. For example, CLS, as an Edge corporation, is regulated and supervised by the Federal Reserve under a program of ongoing supervision and is also subject to heightened regulation by the Federal Reserve due to its designation as a systemically important financial market utility by the United States Financial Stability Oversight Council. In addition, the central banks whose 17 currencies are settled via the CLS System have established a cooperative oversight arrangement for the CLS System (the CLS Oversight Committee) as a mechanism for the fulfillment of their responsibilities to promote safety and efficiency. CLS Bank must also comply with conditions of designation imposed by the various jurisdictions in which it has been "designated" in order to benefit from statutory finality protections in those jurisdictions, including the European Union. Lastly, the CLS System is specified by HM Treasury as a recognized inter-bank payment system under the Banking Act 2009 and is therefore subject to direct supervision by English regulatory authorities. CLS also observes that, in light of the depth and breadth of understanding that a Financial Market infrastructure's (an "FMI") primary supervisor or regulator will have regarding an FMI, it is preferable for an FMI's primary supervisor or regulator to function as the FMI's home resolution authority and that, where possible, there should be an assumption that the primary supervisor or regulator will be the resolution authority.

Scope of Remaining Comments

CLS recognizes that the focus of the Consultation Paper is on central counterparties ("CCPs"), central securities depositories ("CSDs"), and insurance companies, rather than payment systems such as CLS. Consultation Paper, §3.1 at FN 21 ("references to FMIs in this paper are thus to be read as referring to CCPs and CSDs"). CLS supports the Consultation Paper's bifurcated approach to CCPs/CSDs and payment systems because payment systems differ substantially from CCPs/CSDs in their business models as well as their respective regulatory and risk profiles. Given these fundamental differences, CLS believes that it is important to ensure that any future recovery and resolution regime adequately distinguishes among FMIs. Consultation Paper, §3.2.1, Question 4.

Cooperation and Coordination Among Authorities

The Consultation Paper, at §3.2.1(h), Question 25, queries the "key elements and main challenges to take into account for the smooth resolution of an FMI operating cross-border?" CLS maintains that international coordination and cooperation among FMIs' regulators, in cases where the FMI is acting in its capacity as operator of a system or as a participant in another FMI, is fundamental to an FMI's ability to continue its operations uninterrupted in times of distress. This is particularly important in the context of FMIs that operate in several jurisdictions and should be undertaken both prior to and during a resolution or recovery.

Allocation of Losses

With respect to the allocation of losses by CCPs and CSDs, the Consultation Paper asks whether "resolution tools based on contractual arrangements [can] be effective and compatible with existing national insolvency laws?" Consultation Paper, §3.2.1(f), Question 23. Various methods of allocating losses are described, including "pre-funding" a loss by applying loss allocation haircuts to the initial or variation margin that participants normally have to provide to CCPs, or by other contractual arrangements that might apply after the loss has arisen. Consultation Paper, §3.2.1(b).

CLS has concerns regarding the potential imposition of loss allocations outside of the framework memorialized in an FMI's rules, which represent the consensus reached by an FMI's regulators, participants, and other relevant stakeholders. If the resolution authority has the authority to allocate losses in addition to those set forth in the FMI's rules, such power would be inconsistent with, and exceed, its powers in other areas (it cannot, for example, require other types of creditors to absorb losses). The ability of a resolution authority to impose such loss allocations is likely to serve as a disincentive to participation in FMIs (whether directly as a member, or indirectly as a third party participant), since participants would have concerns regarding possible exposure to liabilities that they have not had the opportunity to previously analyze and assess when considering the merits of participating in a specific FMI. The resulting disincentives to participate in FMIs, if implemented, would be contrary to the expressed preference of the regulatory community to increase participation in FMIs in order to mitigate systemic risk.

Amendments to Existing Legislation

The Consultation Paper at §3.2.1(a), Question 3, asks "[d]o you think that existing rules which may impact a CCP's or CSD's resolution (such as provisions on collateral or settlement finality) should be amended to facilitate the implementation of a resolution regime for CCPs/CSDs?" CLS observes that serious consideration of amendments to finality legislation is warranted to ensure that finality and other statutory protections continue after the commencement of a resolution plan, whether an FMI is a participant in a system protected by finality legislation (such as the Settlement Finality Directive) or the designated system itself. This approach would support an FMI's fundamental goal "to continuously provide services to the rest of the financial system by facilitating the conclusion and central handling of transactions." Consultation Paper, §3.2.1(e). Moreover, the CPSS-IOSCO *Principles for financial market infrastructures* (April 2012), at 3.1.10, state that "[a]n FMI should establish rules, procedures, and contracts related to its operations that are enforceable when the FMI is implementing its plans for recovery or orderly wind-down." An efficient way to achieve enforceability of recovery or wind-down plans may be through the coordinated amendment of finality legislation applicable to FMIs worldwide.

Application of Finality Legislation to Insurance Companies

Section 4 of the Consultation Paper applies to systemically important insurance companies and CLS notes that insurance companies do not meet the definition of a “participant” set forth in the Settlement Finality Directive. The Commission may wish to consider amendments to the Settlement Finality Directive that would allow insurance companies to potentially qualify as participants in designated systems, assuming that all other requirements for participation were fulfilled.

Transfer to a Bridge Institution

The Consultation Paper refers to the establishment of a bridge institution as a particularly useful tool for resolving a failed FMI. Consultation Paper, §3.2.1(f)(a). Although it does so solely with respect to CCPs and CSDs, CLS wishes to highlight that in a bridge institution scenario, there would exist numerous operational, financial and risk-related issues related to such a transfer, in addition to potential legal issues resulting from designations for settlement finality purposes in various jurisdictions. In order to maximize the likelihood of a successful transfer in a short period of time, extensive planning and international cooperation is required.

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Please do not hesitate to contact me if you have any questions regarding this submission.

Sincerely,

David W. Puth
Chief Executive Officer