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January 22, 2016

Via E-mail

Board of Governors of the Federal Reserve System  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)

**Re: Notice and Request for Comment  
Docket No. OP-1521**

Ladies and Gentlemen:

CLS Bank International ("CLS") welcomes the opportunity to comment on the Notice and Request for Comment issued by the Board of Governors of the Federal Reserve System (the "Board") (Docket No OP-1521) (the "Proposal"). The Proposal from the Board and, under delegated authority, the Federal Reserve Banks (collectively, the "Federal Reserve") describes the ORSOM (Organization; Risk Management; Settlement; Operational Risk and Information Technology (IT); and Market Support, Access, and Transparency) rating system, which the Federal Reserve intends to use in reviews of financial market infrastructures ("FMIs") subject to the Board's supervisory authority.

CLS very much welcomes a clear, standard, and transparent rating system for comprehensive and consistent supervisory assessments of FMIs that is clearly tied to applicable Federal Reserve regulations and guidance, specifically Regulation HH, which in turn is based on the international guidance of the Principles for Financial Market Infrastructures ("PFMI"). The comments below are directed to specific considerations where CLS believes the Proposal could benefit from further clarification or adjustment.

## **I. Background**

CLS was established by the private sector, in cooperation with a number of central banks, and operates a payment-versus-payment ("PvP") system to mitigate what is generally considered to be the primary risk in foreign exchange ("FX") transactions, which is loss of principal associated with the settlement of payments, or "settlement risk."

CLS operates the world's largest multicurrency cash settlement system for FX and provides a PvP settlement service for 18 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 18,000 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.



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.<sup>1</sup> Additionally, the 18 central banks whose currencies are settled in CLS have established the CLS Oversight Committee,<sup>2</sup> 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.

In July 2012, CLS was designated a systemically important financial market utility (“DFMU”) by the Financial Stability Oversight Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”). The Federal Reserve is CLS’s “Supervisory Agency” (as defined by the Dodd Frank Act), and CLS is subject to the risk management standards set forth in Regulation HH, including the advance notice process for DFMUs contained therein.

## II. Specific Comments on the Proposal

### a. Category: Organization

CLS broadly agrees with the considerations evaluated under the Organization category of the Proposal; however, CLS recommends additional clarity is needed with respect to the statement that, “This category also considers the relationships among the FMI's stakeholders and their influence on the FMI's business strategy.” CLS suggests the addition of qualifying language that will clearly define and limit the scope of assessment to relevant stakeholders.

Additionally, the Federal Reserve may consider referencing Regulation HH §234.3(a)(3), and specifically the italicized language (added for emphasis), which provides that: “The designated financial market utility has governance arrangements that – (i) Are clear, transparent, and documented; (ii) Promote the safety and efficiency of the designated financial market utility; (iii) *Support the stability of the broader financial system, other relevant public interest considerations such as fostering fair and efficient markets, and the legitimate interests of relevant stakeholders, including the designated financial market utility's owners, participants, and participants' customers...*”

#### i. Subcomponent: Board and Management Oversight

CLS broadly agrees with the considerations evaluated under the Board and Management Oversight subcomponent of the Organization category of the Proposal, which is generally aligned with the relevant statutes, regulations, and guidance indicated. However, CLS suggests clarifying the statement that, “Specific considerations in this regard include the board's effectiveness in setting strategic objectives....”

The critical role of the board in setting an FMI's objectives is explicitly constrained by the above-mentioned language in Regulation HH §234.3(a)(3). As an alternative, and in the interest of clearly stipulating the basis for this assessment, the Federal Reserve should consider referencing Regulation HH §234.3(a)(21)(ii) and (iii), which provide that a DFMU “(ii) Has clearly defined goals and objectives that are measurable and achievable, such as minimum service levels, risk-management expectations, and business priorities; and (iii) Has policies and procedures for the regular review of its efficiency and effectiveness....”

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

<sup>2</sup> 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 of the CLS Oversight Committee.



ii. **Subcomponent: Internal Audit**

The Proposal states that an internal audit function should “...provide a rigorous and unbiased assessment of the FMI's risk appetite and risk exposure...” CLS notes that an FMI's board establishes its risk appetite as required under Regulation HH §234.3(a)(2)(iv)(F).<sup>3</sup> The role of an internal audit function is to help an organization accomplish its objectives by providing independent, objective evaluations, and improving the effectiveness of risk management, control, and governance processes.<sup>4</sup> As such, the internal audit function evaluates an FMI's risk exposures and controls (the risk profile) in the context of the FMI's risk appetite as established by its board.

CLS therefore suggests revising the Proposal as follows; “An FMI should have an effective internal audit function with sufficient resources and independence from management to provide a rigorous and unbiased assessment of the FMI's risk profile and risk exposure, including financial and operational risk, as well as the effectiveness of risk management and controls.”

b. **Category: Risk Management**

CLS suggests that amendments to the Risk Management category, as described below, should be made to align the standards against which an FMI is assessed with respect to this category.

i. **Recovery/Orderly Wind-down and Capital Plan**

The Risk Management category rating “... assesses the FMI's ability to implement a recovery or orderly wind-down of its operations and the viability of its capital plan.” CLS suggests that, from a practical perspective, the best way to “assess” implementation of recovery or orderly wind-down would be to focus on the development and maintenance of a credible recovery and orderly wind-down plan in accordance with the regulatory expectations and requirements as applicable to each FMI.

ii. **Access to Assets**

The Risk Management category rating “...considers the FMI's ability and practices in safeguarding its own assets and those of its participants, and the FMI's ability to ensure those assets are accessible at all times with minimum losses.” However, in CLS's view, it is not appropriate to assess an FMI's ability to “ensure” access to assets at all times. In certain well known, publicly-disclosed circumstances, access to assets will not be possible at all times (for example, RTGS systems have certain known and specified closing hours during which a participating FMI would not be able to access its central bank account). Additionally, Regulation HH contemplates that access to assets may not be feasible at all times and therefore requires DFMUs to regularly assess and mitigate risks associated with access to assets, whether the FMI's own assets or those of its participants. CLS suggests this language in the Proposal be amended to align with Regulation HH §234.3(a)(7)(viii), which requires that a DFMU, “Establishes rules and procedures that explicitly – (A) Address potential liquidity shortfalls that would not be covered by the designated financial market utility's liquid resources and avoid unwinding, revoking, or delaying the same-day settlement of payment obligations...”

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<sup>3</sup> Regulation HH §234.3(a)(2)(iv)(F) requires that, “The board of directors establishes a clear, documented risk-management framework that includes the designated financial market utility's risk-tolerance policy...”

<sup>4</sup> As defined by the Institute of Internal Auditors (<https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Definition-of-Internal-Auditing.aspx>)



### iii. Direct and Indirect Participant Risks

The Risk Management category rating provides for an assessment of "...the FMI's awareness of, and control over, the risk that its participants' customers and other FMIs indirectly introduce." CLS agrees that it is critical for FMIs to be aware of risks that indirect participants introduce; however, the assessment focus should be limited to material risks. Accordingly, CLS suggests that this language in the Proposal be amended to align with the requirements of Regulation HH §234.3(a)(19) that, "...the designated financial market utility identifies, monitors, and manages the *material risks* arising from arrangements in which firms that are not direct participants in the designated financial market utility rely on the services provided by direct participants to access the designated financial market utility's payment, clearing, or settlement facilities, whether the risks are borne by the designated financial market utility or by its participants as a result of their participation....(emphasis added)."

In addition, there are circumstances in which FMIs may not be able to "control" risks, including those associated with indirect participants or other FMIs. As "control" is an undefined term in the Proposal, in the interest of consistency and clarity, CLS suggests amending the language in the Proposal to align with the relevant sections of Regulation HH noted below:

- Regulation HH §234.3(a)(3)(i): "Risk-management policies, procedures, and systems that enable the designated financial market utility to identify, measure, monitor, and manage the risks that arise in or are borne by the designated financial market utility, including those posed by other entities as a result of interdependencies..."
- Regulation HH §234.3(a)(19): "...the designated financial market utility identifies, monitors, and manages the material risks arising from arrangements in which firms that are not direct participants in the designated financial market utility rely on the services provided by direct participants to access the designated financial market utility's payment, clearing, or settlement facilities, whether the risks are borne by the designated financial market utility or by its participants as a result of their participation. The designated financial market utility (i) Conducts an analysis to determine whether material risks arise from tiered participation arrangements; (ii) Where material risks are identified, mitigates or manages such risks; and (iii) Reviews and updates the analysis conducted under paragraph (a)(19)(i) of this section the earlier of every two years or following material changes to the system design or operations or the environment in which the designated financial market utility operates if those changes could affect the analysis conducted under paragraph (a)(19)(i) of this section."

### c. Category: Settlement

CLS agrees that settlement finality is critical; however, CLS suggests that amendments to the Settlement category, as described below, should be made to align the standards against which an FMI is assessed with respect to this category.

#### i. Ensuring Settlement "as expected"

The Settlement category "focuses on the risk-management tools that an FMI uses to ensure settlement takes place *as expected*...(emphasis added)." CLS believes that the language "as expected" merits clarification; FMIs cannot, and were not designed to, ensure that settlement will occur under all circumstances. In contrast, settlement will only take place if the necessary requirements are met, as set forth in the rules and other relevant documents of the FMI. CLS, for example, is not a counterparty to any underlying transactions, does not guarantee the settlement of



any payment instruction submitted for settlement, and will only settle payment instructions that pass applicable risk management tests.<sup>5</sup> In addition, Regulation HH §234.3(a)(8) requires each FMI's rules to specify permissible points in time that allow for amendments or revocations (for example, the CLS rules explicitly allow the revocation of payment instructions in certain circumstances). Accordingly, it is expected that revocations will take place and therefore settlement will not occur in these cases.

#### ii. Ensuring Settlement Finality

In CLS's view, it is not appropriate to assess an FMI's ability to "ensure" settlement finality. CLS agrees that the point at which settlement is final and irrevocable is of critical importance, as settlement without finality may introduce unintended, uncertain, or unmanageable credit or liquidity risks for an FMI, its participants, and their customers, which may also create or amplify systemic risk.<sup>6</sup> The point of final settlement is defined by an FMI, and is an explicit requirement for DFMUs as noted in Regulation HH §234.3(a)(8), which states, "The designated financial market utility clearly defines the point at which settlement is final and the point after which unsettled payments, transfer instructions, or other settlement instructions may not be revoked by a participant." However, no FMI has the ability to "ensure" settlement finality, even where the law is clear. Settlement finality is a legal construct and, as such, CLS suggests the assessment be made consistent with the relevant standard expressed in Principle 1 of the PFMI, which is "...a high degree of certainty for each material aspect of an FMI's activities in all relevant jurisdictions."

#### d. Category: Operational Risk and IT

CLS broadly agrees with the considerations evaluated under the Operational Risk and IT category of the Proposal, which is generally aligned with the relevant statutes, regulations, and guidance indicated. However, CLS recommends that clarification be provided with respect to the consideration of "interdependency monitoring programs." In the interest of clear and comprehensive guidance, CLS suggests the Federal Reserve align this language with Regulation HH §234.3(a)(3)(i), which requires a DFMU to establish, "Risk-management policies, procedures, and systems that enable the designated financial market utility to identify, measure, monitor, and manage the risks that arise in or are borne by the designated financial market utility, including those posed by other entities as a result of interdependencies."

#### e. Category: Market Support, Access, and Transparency

CLS believes that FMIs should be open to new participants, support market development and operate in a sound and transparent manner. However, it is CLS's view that the Market Support, Access, and Transparency category description in the Proposal is too restrictive and should be revised to further align with the balanced approach set forth in both Regulation HH and the PFMI. For example, the Federal Reserve could consider incorporating language from Principle 18 that states, "An FMI's participation requirements should be justified in terms of the safety and efficiency of the FMI and the markets it serves, be tailored to and commensurate with the FMI's specific risks, and be publicly disclosed. Subject to maintaining acceptable risk control standards, an FMI should endeavour to set requirements that have the least restrictive impact on access that circumstances permit."

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<sup>5</sup> For FX payment instructions, CLS simultaneously settles the two payment instructions, thereby eliminating the risk that one payment is made without the corresponding payment being made.

<sup>6</sup> As discussed in Section 3.8.1 of the April 2012 *Principles for financial market infrastructures*



Additionally, CLS suggests that amendments to the Market Support, Access, and Transparency category, as described below, should be made to align the standards against which an FMI is assessed with respect to this category.

i. Access to, and Use of, FMI Services

It is CLS's view that further clarification and guidance is needed with respect to the consideration of an FMI's efforts "... to ensure fair and open access to, and *use of*, its services....(emphasis added)" As noted above, CLS believes that a balanced approach is required with respect to participation requirements, specifically, as per Principle 18 of the PFMI, "An FMI's participation requirements should be justified in terms of the safety and efficiency of the FMI and the markets it serves, be tailored to and commensurate with the FMI's specific risks." As such, an FMI should endeavor to allow for fair and open access in line with acceptable risk control standards, so as to avoid the possibility of a single participant jeopardizing the stability and resilience of the entire ecosystem.

In addition, CLS, as well as other FMIs, can endeavor to set the least restrictive participation requirements that risk control standards permit. However, ensuring use of the FMI's services is not within the purview or authority of any FMI. While an FMI's strategy and objectives (as discussed in detail above) should align with incentives for participants to use the FMI's services, the actual use of an FMI's services cannot be mandated by the FMI. The ability to mandate the use of an FMI's services rests with regulatory authorities. For example, this is the case with regulatory requirements mandating central clearing of OTC derivatives. With respect to FX transactions, CLS notes that PVP settlement not a mandate but rather a best practice according to the Basel Committee on Banking Supervision's February 2013 *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions*.<sup>7</sup> However, CLS does not have the authority to compel adherence with such regulatory guidance.

ii. Member Monitoring Framework

In the interest of clear and comprehensive guidance, CLS suggests that the Federal Reserve align this language with Regulation HH §234.3(a)(18), which states; "The designated financial market utility has objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access. The designated financial market utility – (i) Monitors compliance with its participation requirements on an ongoing basis and has the authority to impose more-stringent restrictions or other risk controls on a participant in situations where the designated financial market utility determines the participant poses heightened risk to the designated financial market utility; and (ii) Has clearly defined and publicly disclosed procedures for facilitating the suspension and orderly exit of a participant that fails to meet the participation requirements."

iii. Efficiency in Consuming Resources

In CLS's view, the consideration of "the efficiency with which it consumes resources in providing its services" is vague and subjective, as there are no clear standards or requirements against which FMI efficiency in consumption of resources may be assessed. If this consideration is retained, CLS suggests that the Federal Reserve provide additional guidance, including more explicit standards against which FMIs would be assessed, to facilitate a common understanding of an objective standard.

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<sup>7</sup> Implemented in the United States in SR13-24, "Managing Foreign Exchange Settlement Risks for Physically Settled Transactions," issued December 23, 2013.



**f. Category Ratings/Composite Ratings**

The Proposal emphasizes that supervisory assessments and the resulting ratings under ORSOM are not formulaic derivations. CLS appreciates that the ORSOM rating system is designed to allow for supervisory judgement and discretion, both in the assessment conducted under each category in the Proposal as well as the composite rating for each FMI.

As such, to align with the Proposal's objective of, "...facilitat[ing] a clear and logical discussion of the FMI's condition with the FMI's management and board of directors...", CLS suggests that at the time the Federal Reserve delivers its annual assessment to an FMI's management and board of directors, it should also provide explanatory guidance as to the supervisory judgement underlying that annual rating. Such explanatory guidance would be extremely helpful for FMIs as well as align with the Proposal's further objective of being "...easily understood and used by both supervisors and FMIs..."

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

Sincerely,

A handwritten signature in black ink, appearing to read "David Puth". The signature is written in a cursive, flowing style.

David Puth

cc: Dino Kos, Head of Regulatory Affairs, CLS Bank International  
Michele Fleming, Chief Compliance Officer, CLS Bank International  
Lauren Alter-Baumann, Managing Director, CLS Bank International  
Irene Mustich, Associate Director, CLS Bank International