CPSS-IOSCO Principles for financial market infrastructures

Clearstream's response to the consultative report

26 July 2011

Clearstream Banking AG, Frankfurt and Clearstream Banking S.A., Luxembourg (jointly referred to as Clearstream) appreciate the opportunity to comment on the public consultation on the consultative report on the principles for financial market infrastructures issued by CPSS-IOSCO. As a wholly owned subsidiary of Deutsche Börse Group, Clearstream is one of the world's leading suppliers of post-trading services including settlement, safekeeping, and administration of securities, Clearstream welcomes the objective of the consultative report further harmonize at a global-level the existing international standards for central securities depositories (CSDs), and securities settlement systems (SSSs).

The settlement of market transactions and the custody of securities are Clearstream's most important fields of activity. In this environment Clearstream provides two fundamental services:
- International Central Securities Depository (ICSD): As an ICSD it has, over a period of over 40 years, developed a strong position in the international fixed income market. It handles the clearing, settlement and safekeeping of international securities and offers its customers the possibility to use Clearstream Banking as a single point of access for the settlement and custody of internationally traded bonds and equities across 50 markets.
- Central Securities Depository (CSD) for German domestic securities.

(I)CSDs have proven their resilience during the financial crisis, while playing a stabilizing role on the financial markets, in particular in facilitating the movement of collateral between counterparties at a time of severe liquidity stress and in ensuring the availability of global settlement liquidity to the financial centre. This has been a test for the (I)CSDs throughout the world that has proven the appropriate implementation of sound and safe risk management procedures and global best-practice standards. It needs to be ensured that newly introduced international rules and requirements do not affect the safety, efficiency and services innovation of the current post-trading arrangements.

Summary of highlights on the proposed regulation

1. The approach of the consultative report is very CCP risk-centric, which in general terms is less adapted to the SSSs/CSDs. Keeping the new principles separate among the SSSs/CSDs, CCPs and TRs would have been preferred.

2. Principle 2 - The commercial and for-profit business structures that FMIs may have, should not be demonized. Doing so would risk jeopardizing the real benefits and stabilizing factor that well managed FMIs bring to the international economy in supporting international finance and economic activity.

3. Principle 2 - In some countries, like Germany, publicly listed corporations are required to have a two-tier board structure. The principles should acknowledge these national particularities and set clear rules on defining which board is targeted in such cases.

4. Principle 4 - The coverage of credit exposure "fully with a high degree of confidence" is one of the main new requirements that the principles aim to introduce. Strict compliance with this principle at all times would be likely to have a negative impact for International Central Securities Depositories (ICSDs) and CSDs with a banking license.

5. Principle 5 - The entire section on pro-cyclicality should be removed from the consultative report. First, because it might lead to the "stigmatization" of corrective or remedial collateral management actions during periods of crises. In addition, should the (I)CSDs be required to implement collateral policies that are much stricter and conservative than other players (as the section proposes), their ability to compete effectively will be curtailed.
   The ICSDs offer the most relevant collateral management systems globally, and the relevance of such systems to the market's ability to deploy collateral should not be under-estimated in the context of facilitating the goal of stronger financial sector capitalization.

6. Principle 9 – Introduces the "supervised special-purpose institution" form of incorporation for FMIs. Here again the CCP approach is incompatible with (I)CSDs. (I)CSD operating banking type services require the ability to settle in commercial bank money, which allows for settlement in different currencies and in different cash settlement time-zones. All of which results in the operation of cash accounts, cash settlement, deposit taking, loan granting and eventually offering other banking-style value-added services, all of them being services that contribute to enhancing the safety, efficiency and transparency of the securities market.
   It should, in particular, be noted that the multi-currency capacity of the ICSDs to facilitate the securitization of on-balance sheet of financial institution's assets has been

a core feature of financial stability and will remain so, especially in the context of Basle III.

7. Principle 17 - continues to focus primarily on FMI "system availability" aspects, while ignoring staff and workspace availability. Further, business continuity plans are and should be based on impact and not on cause, as the causes are manifold and only the impact matters. Generally, the principle should be closer aligned to ESCB/CESR Recommendation 11 for SSSs.

8. Principle 18 - Requesting for an external legal opinion for each prospective customer or the country in which it is located, is not common practice in our industry, and does not come without a financial cost, which will eventually transpire to customers and the industry as a whole, while not necessarily providing further legal certainty. We strongly suggest reconsidering such an approach.

9. Principle 19 - Requires FMIs to identify and manage risks arising from indirect participants, and to manage the credit and liquidity risks of these indirect participants. We believe (I)CSDs do not have the means nor the authority to impose segregation requirements to its customers that would allow for the identification of the indirect participants' risks, nor should this become a requirement for (I)CSDs in the future as potentially conflicting with: a) banking secrecy laws prevailing in several jurisdictions of the participants, and b) the securities' law applicable to the (I)CSDs, such as in Luxembourg law according to which, participants are treated as owners towards their depositary for the securities deposited on their account with the depositary.

10. Principle 20 –The requirements for the FMI to identify, monitor, and manage link-related risks, should only apply to bilateral links where risk management provisions must, by definition, be made for the regulation of credit claims arising on securities transfers between two SSSs, and not on other forms of links.

Specific comments

Comments on the 'General scope sections – 1.0. and 2.0.'

FMI: definitions, organisation and function

The consultative report proposes (under **1.8**) yet another set of definitions, namely a definition for the Financial Market Infrastructures (FMI), of a CSD (under **1.11** and **Annex H: Glossary**) and of a SSS (under **1.12**). While we are not challenging the relevance of these definitions, it is important to consider that in the absence of a single definition effort in this area of finance, these definitions should only have a guidance value, as definitions are often different from each other and unaligned among the different best-practice regulatory documents. Based on that, we see the need to define "financial institutions" in the sense of the paper and recognize the inclusion of all FMIs under this definition.

Scope of the principles for FMIs

Moreover we have noted that the overall approach of the consultative report is very CCP risk-centric in its approach, which in general terms is less adapted to the SSSs/CSDs, and possibly excessive for the case of the TRs (that have yet to tests their Market Infrastructure relevance). The measures aimed at increasing financial stability resulting from the recent crisis, are pushing the role of CCPs and (I)CSDs in different directions. While CCPs will play an increasing systemically important role as FMI by means of the G20 obligation on firms to clear certain derivatives in their systems, (I)CSDs will not see new settlement flows triggered by financial stability requirements. In fact, perhaps CSDs and ICSDs will see their volumes decrease in the future, due to increased competition for settlement flows and custody business with other financial institutions (such as agent banks) not captured in the scope of these principles. Having separate recommendations for SSSs/CSDs and CCPs proved to be effective over the last years, to the extent of being replicated in Europe under the CESR/ESCB initiative. These separate recommendations guaranteed a regulatory level playing field in the competitive securities landscape.

A separation of the new principles for SSSs/CSDs, CCPs and TRs would have been preferred from our perspective.

As hinted in the previous paragraph, the size and systemic importance of some other players in the securities custody business could take similar roles and functions as those foreseen for the (I)CSDs in this consultative report, we would be interested to better understand which measures are foreseen to allow for a regulatory level playing field among these players in the forthcoming future.

Efficiency as a public policy objective

(I)CSDs thrive for efficiency and to reduce costs for the benefit of the overall financial markets (**1.18**), while maintaining a successful revenue business case (which is important to sustain its operation and investments); all of these elements drive the decision-making of these FMIs.

Regulators should also thrive for these same objectives when formulating new regulatory initiatives, as excessive regulation aimed at absolving from future liability, often leads to overburdening processes, creating inefficiencies and translating in additional costs for the whole industry, hence also increasing risks.

Having said this we believe that there is no need to elevate efficiency to a supervisory condition. There are no clear guidelines on how to measure efficiency and we believe that efficiency of FMIs is best reached by market forces. As much as FMIs pursue efficiency, we feel that FMIs cannot influence their participants to be efficient. Sound operational and comprehensive processing as foreseen in the principles should be sufficient

General applicability of the principles
The classification of FMIs being "systematically important" (1.20) highlights their relevance in the eyes of national authorities. However the presumption that (I)CSDs, SSSs, and CCPs are systematically important because of the role they play, is nevertheless an assertion which would be true world-wide, and not only market by market. The applicability of the principles should be homogeneous at a functional level, otherwise leading to situations of regulatory arbitrage in certain jurisdictions, element that would negatively impact the level-playing field for the provision of services in a cross-border basis.
Should the national regulators classify differently FMIs in their home jurisdictions, this should be based on clear guiding rules to be defined in the principles themselves (e.g. maximum number of participants, FMIs limited to certain clear defined products (e.g. spot agricultural commodities only), FMIs limited in number of transactions a day, or maximum cash amount handled a day).

Overview of the key risks for FMIs
A complete risk averting approach to regulation could be unrealistic, particularly if applicable to only some players in the market. Moreover a complete risk averting approach comes with an important financial cost, and a reduced efficiency for the entire market. Additionally, in averting risks the role of regulators should not be downplayed, all by the contrary, this aim can only be achieved with their increased involvement.

There are already significant requirements – both legal and standard-based, which ensure that critical financial sector infrastructures are protected. In Europe for instance, the FMIs fall under the scope of the Settlement Finality Directive (Directive 98/26/EC) which requires Member States to designate their critical payment and settlement systems and ensure that oversight of all their activities takes place. But rightly decided not to include these under the Directive on the Protection of Critical National Infrastructures (COM(2006) 786) which designates European critical infrastructures, to avoid labelling these with a "critical" tag. Likewise the consultative report should avoid labelling FMI with a "systematically important" tag before such importance is proven. This is particularly relevant for the TRs, whose short life span in Europe has not demonstrated the need for such a label.

We wish to emphasize the paramount need for the treatment of systemically important firms to follow a balanced and comprehensive approach. We believe that the imposition of surcharges on categories of firms judged to be systemic would not be the best way to address the risk, especially were such judgments to be based on simplistic measures such as type of institution alone (as opposed to the functions they undertake). Such an approach would be ineffective and probably counterproductive in pre-defining a list of firms to be subject to the principles.

All in all, the commercial and for-profit business structures that FMIs tend to have, should not be demonized. Doing so would risk jeopardizing the real benefits and stabilizing factor that well managed FMIs bring to the international economy in supporting international finance and economic activity.

Compliance to the rules and regulations is an element very high on the agenda of FMIs, who are undertaking all necessary checks in accordance to their law of reference.
The consultative report proposes a substantially strengthened set of principles, risk management obligations and transparency/disclosure requirements. We note however that the frequency in which compliance to these principles is to be assessed remains very vague. While we tend to assume that compliance is to the maintained on an on-going basis, we would recommend that further precision be brought as to the periodicity of the assessments that the regulatory authorities should undertake on the FMIs. As there needs to be a specific role of surveillance by the policy makers to emerging sources of systemic risk across the financial sector and not just at firm level.

Comments on section '3.0. Principles for financial market infrastructures'

Principle 1: Legal basis
An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each aspect of its activities in all relevant jurisdictions.

In general terms, today's legal construction in the most European jurisdictions does already provide legal certainty, and does not leave much room for unforeseen legal situations. These principle 1 rules, should leverage on existing legal structures and serve as a model mainly for developing markets.

The requirements under **3.1.4** to "to obtain well-reasoned and independent legal opinions or analyses" for each aspect of FMI activities is not common practice in our industry today, and does not come without a heavy cost to the FMIs which will eventually transpire to customers and the industry as a whole, while not necessarily providing further legal certainty. We strongly suggest to reconsider such an approach. It also need to be understood, that full legal opinions need to take care for all different aspects of law. In any event, the preparation of such "full size" opinions takes substantial time and due to the volatility of the underlying laws, this principle can only be considered as a moving target.

The same is true for **3.1.9**, which requires the FMI to validate its legal agreements in the jurisdiction of a participant declared in default or insolvent.

Principle 2: Governance
An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

Governance of complex global firms needs to be more in-depth and better attuned to their risk profiles and business models. Moreover it needs to be internationally consistent and coordinated through well functioning mechanisms. In many jurisdictions the governance arrangements are different from the more Anglo-Saxon style governance, the principles should cater for these governance styles as well.

As a general remark, the commercial and for-profit business structures that FMIs often have should not be demonized. Doing so would risk jeopardizing the real benefits and stabilizing factor that well managed FMIs bring to the international economy in supporting international finance and economic activity.

More specifically on the governance arrangements based on principle 2, while we do not challenge the importance of transparency, under point **3.2.1.**, full and comprehensive disclosure of the governance arrangements at all levels to all public seems to be too far reaching. Lines of responsibility and accountability need to be restricted to high-level organizational charts of the board and/or the executive management members. Excessive disclosure could also be in contradiction with the data privacy rules applicable in several modern jurisdictions, particularly true in Europe.

3.2.2. Supporting the public interest is indeed a very broad concept. While we do not challenge the importance of fostering fair and efficient markets as well as maintaining the safety and efficiency of the FMI and promoting financial stability (all principles that dictate our activities today) for the overall public interest, before enforcing such a requirement to FMIs it would be important to consult on the assessment methodology used as a basis for such a requirement to be judged as observed.

The difference of governance structures is acknowledged under 3.2.4., without bringing further clarity on the way to address these differences In some countries, for publicly listed corporations a two tier approach for the board is mandatory (this is true for Germany and Austria, among others) or a possible legal concept (like in the case of Luxembourg). As a consequence of this, there are some clear rules on the split of duties by national (corporate) law which need to be taken into account in the drafting of the principles. Therefore, it need to be clear, which board is targeted in such cases and sometimes an appropriate wording to take care for national laws need to be put in place.

The notion of independence, under 3.2.8. is very difficult to precise, particularly in larger financial groups. Moreover, if the definition of what is an "independent board member" shall be determined by local rules, hence be different in all jurisdictions opening the way for different treatments according to the country of incorporation, before enforcing such a requirement on FMIs, it would be important to publicly consult on the assessment methodology by which such a requirement will be judged as observed.
A common understanding of the concept of "independent" may bring governance harmonization among FMIs by making clear what is understood as an external board member (perhaps understood as "not a shareholder", "not a client", "not an employee", or "not employed by an FMI shareholders"), having said this, such a tight criteria would make it very unlikely to find suitable and knowledgeable candidates for the role.

As a matter of fact, under a two tier governance approach there cannot be an independent member in the executive board. The implementation of risk-management framework is often placed into the responsibility of the executive board and there is no power at the level of the supervisory board for that. Also direct access of certain functions to the supervisory board by circumventing the executive board is often in contradiction with the local law. Furthermore, the roles related to fixing the strategy vary with regard to the degree of involvement of the supervisory board.

The above is particularly true for all items listed under 3.2.7, under German law, such requirements clearly fall in the responsibility of the executive board, if not related to the executive board itself (for items (b) and (c)). This also is true for the direct reporting line of the chief risk officer to a non-executive director on the board as expressed in 3.2.12.

Under 3.2.9. it is indicated that "further, policies and procedures should also include regular reviews of the board's performance and that of each individual member on a regular basis", we have difficulties to see how an implementation of the self-performance review and performance measurement by the board should function in practice. We do not belief, that this will add any benefit but will face substantial practical implementation problems. We therefore think that implementation of a proper remuneration system based on some clear cornerstones (e.g. like those given in CRD III) and related disclosure requirements would be more appropriate. (this is also applicable to point 3.2.7)

Governance of complex global firms needs to be more in-depth and better attuned to their risk profiles and business models. It needs to be internationally consistent and coordinated. As an example CBL and CBF are commercial companies indirectly owned at 100% by a listed company, Deutsche Börse AG, which is not a participant.
Therefore, by the very effect of company law, compliance with this principle can only be but limited. Moreover, committees proposed under 3.2.9 might in such groups be placed on a consolidated level (i.e. the level of the mother company) instead of the single entity level.

Principle 3: Framework for the comprehensive management of risks
An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

As stated in the general comments, we cannot see an FMI being obliged to set incentives to their participants and their customers to manage and contain their own risks. In this regard, we favour the previous approach stated in the "Recommendations for Securities Settlement Systems", where each FMI was responsible of monitoring its own risk exposures.

We therefore propose to rephrase "key consideration 2" more in line with the following:

An FMI should encourage its participants to behave in line with the FMI's rules and regulations and should have measures in place to enforce such behaviour in order to minimize the overall risk.

Having said this, it remains unclear to us how an FMI can set incentives to participants to manage their own risks, as required under point 3.3.5. Such a requirement is also pulling compliance of customers into the sphere of the FMI, leading to an unwarranted rule enforcement situation. We therefore propose to rephrase 3.3.5 along for the lines expressed above.

In general terms, all institutions involved in the trading and post-trading value chain (investors, banks, market infrastructures, etc.) and not just the (I)CSDs should be included in the sanctioning regimes. As FMIs in principle do not have (direct) influence on the clients of its participants.

This principle also introduces the requirement for FMIs (under **3.3.6**) to consider the risks that may arise from interdependencies, and particularly the risks that the FMI bears from and poses to other entities. This risk approach being quite novel, further precisions should be provided on the way in which such interdependence risk can be monitored, assessed and managed. Particularly as the (I)CSDs do not have the means to access the market information to assess risks relating to interdependencies. Should this requirement be retained for the future, some very precise examples of how FMIs should cope with this principle would need to be provided, to clarify how observance could be met.

A final consideration in relation to the proposed approach of setting incentives to participants and their customers, is the fact that such a holistic risk approach, could hinder the relation with the FMI customers as it would lead to discussions with the less observing customers (discussion which are more suited to the regulatory authorities) and demands for incentives from well performing clients and therefore would be a door opener to conflicts.

Principle 4: Credit risk
An FMI should effectively measure, monitor, and manage its credit risk from participants and from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. A CCP should also maintain additional financial resources to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the [one/ two] participant[s] and [its/their] affiliates that would potentially cause the largest aggregate credit exposure[s] in extreme but plausible market conditions.

Under the evidence that there has not been any system failure among FMIs during the recent financial market crisis, (I)CSD's current structure has proven its resilience during the crisis, while playing a stabilizing role on the financial markets. For the most, (I)CSDs have facilitated the movement of collateral between counterparties at a time of severe liquidity stress and in ensuring the availability of global settlement liquidity to the financial centres. Such a role could be achieved through a well managed and controlled flexibility of the FMI during that period, perhaps this would not have been possible under a stringent requirement of full collateralization.

On defining the sources of credit risk under **3.4.2.**, the concept of "potential future exposure" should not apply to intraday cash loans granted by (I)CSDs to participants for the purpose of purchasing securities. "Potential future exposure" is relevant for transactions where credit exposure fluctuates over time according to the movement of market factors.

On managing credit risk under **3.4.5.**, it is mentioned that "A payment system, CSD, and SSS should cover its current and, where it exists, potential future exposure to each participant fully

with a high degree of confidence using, as a rule, collateral and, exceptionally, equity capital (after deduction of the amount dedicated to cover general business risk)".
The coverage of credit exposure "fully with a high degree of confidence" is one of the main new requirements that the principles aim to introduce.

While in principle we agree to the need to collateralize credit exposures to participants to a high degree, we disagree to the full collateralization requirement in all case and before further understanding is received with regards to many of the credits risk concepts introduced in this consultative report. This is partially due to unclear definitions (e.g. missing definition of "liquid net assets") and the non-existing link between equity (funding) and assets (liquidity).
Settlement cycles are composed of a variety of technical, legal and practical issues to harmonize cash and securities flows across markets, currencies and settlement locations / settlement agents.
The above mentioned elements might develop into a matter of operational problems:
(a) on the securities settlement side (e.g. technical problems in the settlement applications at any settlement location) to late or even non-receipt of funds at the intended settlement date or
(b) on the cash side (not caused by the settlement party) to late or non-receipt of funds at the targeted date (e.g. technical problems at Target-2, different holiday rules, problems in the time zones, etc.)

Self-Collateralization of securities purchased using the credit facilities might be a possibility to alleviate the full collateralization requirement in some cases, but not in all and usually does not cover the exposure in full:
(a) Based on the law in some countries like Germany it is assumed, that in principle the securities deposited by a bank belong to its customers if not explicitly stated differently. Furthermore, securities clearly marked as client assets cannot be taken as collateral for cash obligations of the settlement institution in debit unless explicitly agreed upon upfront.
(b) In order to reflect changes in market prices, haircuts will be applied which lead to a coverage of less than 100 %.
(c) Some securities processing institutions – including SSSs/CSDs operate in the custody and settlement chain and settle high volumes of securities not owned by themselves and in line with (a) and (b) in many cases not eligible for collateralization.

In the relation towards highly creditworthy governmental counterparties including central banks and similar institutions their own legal framework does not allow to provide collateral for receiving loans. As such, if for technical reasons such institutions cannot fulfil its settlement obligations in time, the settlement would fail and potentially – due to the magnitude of their open market transactions – impact on the markets might be severe.

SSSs and (I)CSDs granting loans to their clients, in our view, should be subject to solvency rules as laid down in the Basel Committee on Banking Supervision (BCBS) rules on banking supervision (solvency rules) as well as being obliged to adequate quantitative liquidity rules.

We clearly agree that regarding the SSS- or CSD-services more stringent business rules should be applied related to the scope of credit business than a generic freedom to grant credit as any "regular" bank.

Liquidity is core for SSSs and (I)CSDs and therefore a clear definition of liquid assets is needed. To our understanding, liquid assets in this sense cannot be limited to liquid securities and cash held at central bank but must include
(i) Receivables to related parties which operate a centralized liquidity management for a group
(ii) Receivables to commercial banks as a network of commercial banks is the basis for settlement in commercial bank money.

European (I)CSDs with access to banking services cover the vast majority of settlement transactions and international assets services and their market share is growing. These (I)CSDs have – in general – a sound capital basis and are operating to reasonable low fees and still with a substantial income and a good liquidity situation. These (I)CSDs offering banking services are subject to the whole set of European banking and capital requirements regulation, including the provisions in relation to the provision of credit to its customers. This principle should not be incompatible with the banking license FMIs could have.

Moreover in order to implement 3.4.5., FMIs would require receiving further precisions in relation to the understanding of what is meant by "high degree of confidence" and "prudent haircuts". Perhaps a confidence level should be favoured for FMIs subject to these principles as is the case for CCPs.

In any case, there need to be some freedom for FMIs to grant uncollateralized (short term) credit to highly credit worthy clients like central banks or central governments / government agencies of highly rated countries, on the basis of a proper risk analysis.

We therefore propose the following framework:

1. Require the application of solvency rules similar to the BCBS "Basel" framework.
2. Limit uncollateralized credit to overnight only
3. Restrict uncollateralized credit to central government, central banks, international organizations and multilateral development banks, which under the "Basel" framework receive a zero risk weight
4. Allow for uncollateralized credit to other counterparties having a risk weight of not more than 20 per cent under the "Basel" solvency framework up to the overall maximum of available unencumbered financial assets.

With regards to the contingency planning for uncovered credit losses mentioned under 3.4.16., the following requirement is proposed: "An FMI should analyse and plan for how it would address any potential residual credit exposures, adopt rules and procedures to implement such plans and make these rules and procedures transparent to participants. This should also include providing details on how potentially uncovered credit losses would be allocated,

including in relation to the repayment of any funds an FMI may borrow from liquidity providers."
We fully support the requirement for FMIs to establish contingency planning for extreme circumstances. However, as much as plans could be shared and discussed with Regulators and Supervisors, their disclosure to participants should not be made mandatory.

Principle 5: Collateral
An FMI that requires collateral to manage its or its participants' credit risk should accept collateral with low credit, liquidity, and market risk. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

In relation to the acceptable collateral under **3.5.2.**, the requirement for FMIs to "avoid wrong-way risk by not accepting collateral that would likely lose value in the event that the participant posting the collateral defaults" is challenging.
We would strongly suggest that this requirement be re-written to soften it up because the avoidance (or elimination) of correlation risk on collateral is hardly achievable, or at least at a reasonable cost. This is, of course, not related to any collateral which is issued by the counterparty itself, but towards other constructs of collateral where the relation to the client is not that obvious.

An important share of the collateral provided by the participants to the (I)CSDs consists of senior bonds (or non-subordinated bonds) issued by investment-grade financial institutions. Considering that, typically, the vast majority of the participants to an FMI are these investment-grade financial institutions, there is clearly an element of correlation risk inherent on the collateral pool of the (I)CSDs. Should the (I)CSDs be required to avoid or eliminate correlation risk as a matter of principle, they would be forced to restrict the universe of eligible collateral to securities issued by the most creditworthy sovereigns because, as evidenced during episodes of systemic crisis, even securities issued by high-grade corporates and supranationals show some degree of positive correlation to financial institutions.

In our view, a much more realistic and practical objective would be to require that FMIs have robust processes in place to manage and mitigate correlation risk on collateral. To expect the (I)CSDs to fully "avoid wrong way risk" would be to impose a very high additional cost on them, and on the market as a whole.

The inclusion of "extreme price moves", when valuing collateral under **3.5.3.**, in the calculation of haircuts is not an economically reasonable proposition and will surely lead to increased costs to participants due to excessive over-collateralization resulting from this requirement.

Similarly to what mentioned under 3.4.5., points **3.5.1.** and **3.5.3.** require for FMI implement "prudent haircuts" and haircuts procedures to be "independently validated" at least on a yearly basis. However little precision is given about the way in which "Independently validated" or "prudent haircuts" are to be understood. In our opinion, it would be unacceptable to force the (I)CSDs to seek external validation for internal procedures.

Regarding avoiding concentration of collateral under 3.5.4., it is required for FMIs to avoid the concentration of holdings of certain assets. However the principle should take into consideration the role that (I)CSDs have as custodians. Whereas clearing members have to deliver collateral to secure their obligations to a CCP, participants to (I)CSDs already have their securities deposited with them. Therefore, it does not make sense to attempt to restrict the holdings of certain (possibly) low-quality assets but to restrict their usage (or concentration) as collateral.

We therefore suggest rephrasing this passage as follows:

3.5.4. An FMI should restrict the usage of securities deemed to be illiquid and / or of low credit quality ~~avoid the concentration of holdings of certain assets,~~ because of potential concerns about the ability to liquidate the assets quickly without significant price effects. An FMI could manage the concentration of such assets when used as collateral ~~holdings~~ by establishing concentration limits or imposing concentration charges. Concentration charges would penalise participants for using ~~maintaining holdings of~~ certain illiquid and / or low credit quality assets beyond a specified threshold as established by the FMI. Further, concentration limits and charges should be constructed to prevent participants covering a large share of their exposures with the most risky assets acceptable. These limits should be periodically stressed by an FMI to determine their adequacy.

We have identified substantial problems with regards to the requirement to limiting pro-cyclicality set under 3.5.5., which calls for "an FMI should appropriately address pro-cyclicality in its collateral arrangements. In this context, pro-cyclicality typically refers to changes in risk management practices that are positively correlated with business or credit cycle fluctuations and that may cause or exacerbate financial instability, "to the maximum extent that is practical and prudent, an FMI should establish stable and conservative haircuts that are calibrated to include periods of stressed market conditions in order to reduce the need for pro-cyclical adjustments."

This entire section on pro-cyclicality should be removed from the consultative report. First, because it might lead to the "stigmatization" of corrective or remedial collateral management actions during periods of crises. In addition, should the (I)CSDs be required to implement collateral policies that are much stricter and conservative than other players (as the section proposes), their ability to compete effectively will be curtailed.
The ICSDs offer the most relevant collateral management systems globally, and the relevance of such systems to the market's ability to deploy collateral should not be under-estimated in the context of facilitating the goal of stronger financial sector capitalization.

There is no concrete evidence that collateral arrangements of FMIs were significant contributors to financial instability in recent crisis. On the other hand, there is a number of high-profile, well-documented cases where the actions of certain prime brokers led to the downfall of major investment banks.

Finally, we would also like to draw the attention of the CPSS-IOSCO committees , that FMIs will still require in the future the flexibility (or be imposed with the obligation in certain jurisdictions) to grant loan without collateral to highly credit worthy clients, such as central banks.

Principle 6: Margin

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

As mentioned in the introductory remarks, we favour the previous approach to have separate recommendations for SSSs/CSDs and CCPs, hence will not comment on CCP related principles.

Principle 7: Liquidity risk

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

It is customary to FMI to effectively measure, monitor, and manage their own liquidity risk. Principle 7 under point **3.7.1.**, introduces however the requirement for FMIs to manage the liquidity risk between their participants.
It seems hard to assume a liquidity risk obligation in the case of payments due between third parties, or participants of a CSD. Considering the example where client A does not deliver cash, securities of client B are also not delivered and there is no liquidity risk for the CSD as such.

In relation to point **3.7.2.**, the FMI who is granting credit on the basis of pledged collateral (pledge, lien, etc.) should not be seen as exposed to a liquidity risk in so far that it can be assured that such collateral can be mobilized to generate liquidity from markets and/or central banks. Robust and efficient cross border mechanisms have to be elaborated and defined to remedy to existing shortfalls to mobilize in a crisis situation such collateral where and when needed.
As also mentioned under 3.7.10 hereunder, in a crisis scenario, the reliability of any committed and uncommitted 'pre-arranged ' funding resources are highly questionable, whereas the available collateral is what matters in so far it can be swiftly transferred to generate liquidity in a crisis situation. We therefore question the validity of stress scenarios to obtain an

appropriate level of 'committed' liquidity to be available which in return will be withdrawn from providers in a crisis situation.
In a 'non-crisis' situation uncommitted lines have proven to be reliable and sufficiently abundant to remedy to liquidity shortfalls. We agree that such uncommitted lines should nevertheless be complemented by own liquid assets which by nature however are limited.

On the requirement to maintaining sufficient liquidity resources under 3.7.10., we note that the consultative report suggests for pre-arranged funding arrangements to have to exclude uncommitted lines (e.g.: money market lines and overdraft lines). Committed lines to be at disposal of an FMI and readily available within market stress situations is highly questionable and henceforth not to be considered more reliable than money market lines (uncommitted lines), therefore the cost involved in having sufficient committed lines at disposal is not justifiable.

Further in relation to 3.7.10., the testing of access to funding – as also foreseen under Basel III – is not seen as useful. In the case a stress test is successful, that does not mean, access is feasible in crisis situations. Furthermore, test-sale of assets with good quality for which there is demand, but no supply (e.g. BUNDs), can be sold easily but potentially not been purchased back and therefore future liquidity positions are put at risk. On the other hand, tests of liquidity access when there is already more than sufficient liquidity available do not sound reasonable to us. This is creating additional liquidity which needs to be placed on the market and is creating placement, concentration and market risk and potentially has a negative impact on other supervisory ratios like solvency.

Finally also in relation to 3.7.10., any pre-arranged funding arrangement (such as central bank access) will be part of the liquidity resources, which is not compatible to the requirement of it being non-double counting.

Section 3.7.11. forces FMIs to have adequate access to private-sector liquidity resources. We believe that for liquidity risk management purposes, the FMI should have enough discretion to decide on its own sources of liquidity, a mandatory portion of central bank eligible collateral available seems to go against this principle. Consequently, we do not agree to have a mandatory requirement to maintaining sufficient liquidity resources being eligible for central bank credit, particularly in the in case access to central banks is available.

Principle 8: Settlement finality
An FMI should provide clear and certain final settlement, at a minimum, by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

Finality of settlement ensures that transactions will, at some point, be complete and not subject to reversal even if the parties to the transaction go bankrupt or fail. The assurance of this principle is ensured in Europe by the Settlement Finality Directive (SFD), which readily requires all systems to clearly define such rules. Principle 8 should be duly aligned to the SFD rules currently applicable in Europe

Principle 9: Money settlements
An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

It should be acknowledged that the multi-currency capacity of the ICSDs to facilitate the securitization of on-balance sheet financial institution's assets has been a core feature of financial stability and will remain so, especially in the context of Basle III.
Taking account, in particular, of the requirement of Basle III to transform on-balance sheet assets and bearing in mind a) the limited investment capacity of many domestic markets and b) the incremental cost that emerging capital requirements will impose on currency swap agreements, the goal of financial stability requires, amongst other things, the capability to distribute securitized obligations to global investors, a service provided by the (I)CSDs via their banking capabilities.

The consultative report defines central bank and commercial bank money settlement in sections 3.9.1. to 3.9.5. Nevertheless, we see a couple of open questions – also applicable to section 3.9.6. – as follows:
Currently in Europe most (I)CSDs settle the cash leg of their operations on accounts opened in the books of central banks, whether these are dedicated accounts or standard accounts directly opened in the books of a notified cash settlement system (such as Target2).
However, it may not always be practicable to use the central bank of issue as the single settlement agent. This is true for the cash settlement of non-domestic currencies, as well as the participation of institutions that have no direct access to central bank accounts. In other cases the recourse to commercial bank money, would be the choice of the participant

This is stipulated under point 3.9.2., "an FMI should conduct its money settlements using central bank money, where practical and available", however this principle does not elaborate on the fact that where both central and commercial bank facilities are offered, the choice should be at the sole discretion of the participant.

While the consultative report defines central bank and commercial bank money settlement, under 3.9.1.,it is important to provide certainty that all forms of exchange of cash via central banks are effectively included, namely:

- direct cash settlement between two client accounts at the central bank,
- cash settlement via a trustee account of the FMI,
- settlement via an FMI's account acting as principal.

Clarification is particularly relevant in light of what stated under 3.9.2. that indicates that "only direct accounts with the central bank (not via the FMI)" are relevant for conducting its money settlements using central bank money.

Furthermore, the classification for settlement involving two central banks linked via the FMI and potential time lacks between the two legs during which the cash is located on accounts at the FMI need to be clarified

Finally, specifically for the EURO, clarification is important as determine which should be considered as the central bank of issue.

We believe there is also room for clarification in relation to the statements under 3.9.3. and 3.9.2., that consider that "cash exchanged via the central bank account of the FMI is a direct claim of the client on the FMI but not using a commercial bank (other than the FMI).

Principle 9 under 3.9.6. seems to introduce a new quality of settlement in the books of an FMI. Based on our comments above, the intended solution under 3.9.6. seems to consider a third quality of "cash". As current market practices only distinguish between central bank money settlement and commercial bank money settlement (either in the books of the CSD or a third party settlement institution), we cannot see the additional benefit of introducing this as a specific settlement quality.

Principle 9 under 3.9.6. backs the "supervised special-purpose institution" form of incorporation as a way for the FMI to settle payment obligations, a special-purpose form that would restrict the provision of cash accounts to participants and favour funding in central bank money.
While we can endorse some aspects of this approach, the main purpose (I)CSD of banking type services is in fact the ability to settle in commercial bank money which allow for settlement in different currencies and in different cash settlement time-zones. All of which results in the operation of cash accounts, cash settlement, deposit taking, loan granting and eventually offering other banking-style value-added services, all of them being services that contribute to enhancing the safety, efficiency and transparency of the securities market.
Here again, the consultative report should make further differentiation of the distinctions that exist among FMIs, particularly with regards to(I)CSDs and take into consideration and acknowledge that other payment forms may serve the same market efficiency purposes.

Principle 10: Physical deliveries
An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.

No comments.

Principle 11: Central securities depositories
A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

As already mentioned under principle 1 in 3.1.4., and mentioned in the upcoming principle 20. Principle 11, under **3.11.3.** also requires that a full review of all link agreements be undertaken. This is not common practice in our industry today, and does not come without a heavy toll to the FMIs aim of efficiency and a financial cost, which will eventually transpire to customers and the industry as a whole, while not necessarily providing further legal certainty. We strongly suggest your CPSS-IOSCO committees to reconsider such an approach.

Principle 11 on CSDs (and principle 14 on segregation and portability) sets under **3.11.5.** the legal arrangements to protect the assets and positions of a participant's customers in a CSD in order to achieve the benefits of segregation and portability.
While the concept of "segregation and portability" is mainly a CCP one, most (I)CSDs currently provide to its customers the tools necessary to allowing the segregation of securities belonging to the customer of a participant, and therefore facilitating the portability of customer holdings, should the participant default, to another participant.
(I)CSD customers have the technical means to segregate at wish, nevertheless (I)CSDs do not have the means to impose segregation requirements to its customers, nor should this become a requirement for (I)CSDs in the future.

Principle 11 under **3.11.6,** tries to set the framework of "other" activities which an FMI could undertake and suggests that one way to address the risk associated to these "other activities" may be for the FMI to separate legally the other activities. We strongly oppose to this proposal. The integrity of the business – if undertaken – is the current strength of the business model. Contrary, we suggest to limit to additional tools that may be necessary to address these risk and enhance the description of that further like: "Such tools may be general guidelines to limit the business and the incurred risk in an adequate manner (e.g. short term business only, in relation to its participants only, etc.) and the application of (parts of) the relevant banking rules to such business in an appropriate manner."

The principle introduces the notion of links among CCPs and CSDs. From a CSD perspective a CCP is nothing else than another participant in its system. We therefore do not see the need for specific provision on the services of a CSD towards a CCP. Should the consultative report wish to handle the relation between CCPs and CSDs, this should rather be mentioned under the "access" provision in principle 18, and therefore propose to delete key consideration 6 and section 3.11.7.

Principle 12: Exchange-of-value settlement systems

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

No comments.

Principle 13: Participant-default rules and procedures

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

Principle 13 sets as key objectives of the default rules and procedures the following cases:
(a) ensuring timely completion of settlement even in extreme but plausible market conditions;
(b) minimizing further losses at the FMI, other participants and the customers of the defaulting participant;
(c) limiting disruptions to the market;
(d) providing a clear framework for accessing FMI liquidity facilities as needed; and
(e) managing and closing out the defaulting participant's positions and liquidating any applicable collateral in a prudent and orderly manner.

The public disclosure requirements set under 3.13.6., defines the measures that an FMI may take in a default event. It is required that FMI make available to the public: (a) the circumstances in which action may be taken; (b) who may take those actions; (c) the scope of the actions which may be taken, including the treatment of both proprietary and customer positions, funds and assets; (d) the mechanisms to address an FMI's obligations to non-defaulting participants; and (e) the mechanisms to help address the defaulting participant's obligations to its customers.
While we do not challenge the importance of transparency, the above full and comprehensive disclosure of the default arrangements at all levels to all public seems to be too far reaching. This information is currently available to the customers and the regulators who are the concerned recipients.

Principle 13, under 3.13.7 requires the FMI to establish a program to test and review periodically its participant-default procedures to ensure that they are both practical and effective.
We can see the relevance of periodical tests of default procedures, we believe that FMIs do not have the means to request such tests from their customers.
Regulatory authorities have a role to play in this regard, as they are better placed to request the users of a FMI to periodically test their own default procedures to ensure that they are both practical and effective, and inform the FMI accordingly.

Principle 14: Segregation and portability

A CCP should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

As mentioned in the introductory remarks, we favour the previous approach to have separate recommendations for SSSs/CSDs and CCPs, hence will not comment on CCP related principles.

Principle 15: General business risk

An FMI should identify, monitor, and manage its general business risk and hold sufficiently liquid net assets funded by equity to cover potential general business losses so that it can continue providing services as a going concern. This amount should at all times be sufficient to ensure an orderly wind-down or reorganisation of the FMIs critical operations and services over an appropriate time period.

Maintaining sufficient equity capital is indeed a key aspect of the FMI risk management mechanisms, principle 15 under 3.15.6. introduces the requirement to "hold, at a minimum, equity capital at normal times equal to [six, nine, or twelve] months of expenses"
Considering that for banks the equity capital ratio is set at 15 % of 3 years average gross income, we would wish to request further clarification for such a requirement. In any event the equity capital charges should not exceed the six months of expenses.

Furthermore the rule to avoid double regulations in this same paragraph, is not clear. The statement on duplicative regulation should rather state: "in case the risk is covered by international risk based capital standards or risk charge under the banking rules as defined by BCBS, these are treated as being a substitute in order to avoid double regulation."

Further precision need to be introduced to the concept of "cash-equivalent" under 3.15.7 in order to describe properly, and in order to avoid, that bank balances are not counted.

Principle 15 under key consideration 5, introduces the requirement to "maintain a viable plan for (a) raising additional capital should its equity capital approach or fall below the minimum; and (b) if the FMI is unable to raise new capital, achieving an orderly wind down or reorganisation of its operations and services"
While the requirement appears acceptable from an initial review, we can only but argue that such a rule is not optimal nevertheless.

For those FMIs unable to establish a viable capital plan to avoid systemic disruption, captions 3.15.8. to 3.15.10., establish the condition in which the FMI could achieve an orderly wind-down or reorganization of its critical operations and services in a way that avoids any systemic disruption to the markets. We believe such a requirement is excessive, unless the capital shortage situation is effectively recurrent over an extended period of time.

In this regard we draw your attention to the benefits that the incorporation as a credit institution has for (I)CSDs, as these are subject to the Basel II rules. As a consequence strict capital requirements for credit, market and especially operational risk are readily in place, as well as the monitoring of the equity needs on a continuous basis.

Principle 16: Custody and investment risk
An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

With regards to investing participant assets, under 3.16.4., the consultative report requires that FMI may make investment decisions on the cash or securities from it participants only further to fully disclosing to its participants a risk-management strategy for investing such assets.
While we do not challenge the importance of transparency, the above full and comprehensive disclosure of the FMI treasury investment, be it of the participant assets or others to all public seems to be too far reaching. This information could be available to the customers and the regulators who are the concerned recipients.

Principle 17: Operational risk
An FMI should identify all plausible sources of operational risk, both internal and external, and minimise their impact through the deployment of appropriate systems, controls, and procedures. Systems should ensure a high degree of security and operational reliability, and have adequate, scalable capacity. Business continuity plans should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale disruption.

Principle 17 is much more specific and stringent as the recommendations 8 and 11 of the respective CCP and SSS sets of recommendations. Having said this, the principle continues to focus primarily on "systems' availability" and ignores staff and workspace availability, although it recognizes supplier availability.

Explanatory note 3.17.4 requires FMIs to "seek to comply with commercial standards regarding business continuity and industry's best practice", whilst we have no issue with this, as we are in practice doing this informally, further clarification would be required to on how to document this formally in the future in order to demonstrate observance. We raise awareness once more that overly extensive documentation and heavy process bears costs and reduce efficiency.

Explanatory note 3.17.8 requires that an FMI should formally and explicitly commit to service level targets and performance standards regarding operational reliability. This includes e.g. recovery time objectives and availability times. Whilst we agree to the value of disclosing such metrics, it should not be required to formally include such targets into contractual service level agreements with customers, as they are by definition targets which may not always be met depending on the circumstances.

Principle 17, under note **3.17.12.,** requires that:
1) FMI's business continuity plans should cover "wide-scale" disruptions, while there is no definition of the understanding of "wide-scale". We would suggest deleting this phrase, as explanatory note **3.17.13** (see below) already describes such requirement as those "events that could impact both their primary and secondary site".
2) Requires that the FMI consider both internal and external threats and weights and assessed the impact of each threat identified. This requirement will practically impossible to achieve, as the number of threats can never be exhaustive. Further, business continuity plans are and should be based on impact and not on cause, as the causes are manifold and only the impact matters.
3) It is also suggested that an FMI's business continuity plan may need to include measures that prevent disruptions. This requirement goes against the commonly used impact-based approach and would require FMIs to include for additional elements such as: physical security, information security and internal control measures into the business continuity plan, which is not practicable. All these elements can be, and are, part of the control of risks framework, and should not belong to the business continuity plan.

Principle 17, under note **3.17.13.,** requires that:
1) A secondary site should be located at an appropriate geographical distance, meaning it should in principle not be affected by an event that affects the primary site, with the exception of some very specific threats, such as a coordinated (terrorist) attack. As mentioned earlier, this wording is more accurate than "wide-scale" above. This also confirms the argument that distance or a 3rd site does not protect against coordinated (terrorist) attacks.
2) If the diversity of the risk profiles of the primary and secondary sites are not sufficient in "all" scenarios, then a third site should be considered. The common sense alternative would rather be to change the secondary site rather than to add a third site with the significant increase of costs for the FMI and the overall market. Further, the reference to "all" scenarios should be tempered as the consultative report make reference to exception cases, as the one for coordinated attacks (see 1) above).
3) An FMI should consider alternative arrangements to allow processing of time-critical transactions in extreme circumstances that none of the FMI's sites are operational. As mentioned under the " general comments" section of our response, a complete risk averting approach is unrealistic and does come at a cost. This requirement is contradictory and unachievable, if "none" of the sites are operational (be it the 1st, the 2nd, the 3rd or even the 4th site) and considering the assertion that you cannot protect against targeted attacks (see above), there is no possible way that an FMI could consider alternative arrangements to allow processing of transactions in extreme circumstances. So this requirement should be removed.
4) Operations should be resumed within 2 hours, although ideally backup systems should commence processing immediately. While we do not challenge the two-hours recovery time objective, we believe the consultative report should consider following a more prudent approach as the one used in the ESCB/CESR recommendations wording, which includes an

important additional sentence: "depending on the nature of the problems, recovery may take longer".
5) The principle requires that settlement before the end of the day should be ensured in extreme conditions. While we do not challenge the relevance of this objective, if a serious adversity occurs 5 minutes before the end of the settlement day, this objective would probably not be achieved. We therefore believe the consultative report should following more flexible approach in its wording, such as "depending on the moment in time of the problem, recovery may take longer".
6) In extreme conditions, an FMI may resume operations with some data loss. This means, if not extreme, there should be no data loss. This is in contradiction with the requirement (in the same text) to define recovery point objectives. Recovery points are the times you define to take backups. If a disaster occurs between recovery points, you lose data as of the last recovery point.

Principle 17, under note **3.17.14.,** requires that if an FMI has global importance or critical linkages to other FMIs, it should set up, test and review appropriate cross-system or cross-border crisis management arrangements. While we acknowledge the relevance of periodical cross-system or cross-border crisis management arrangements, we believe that FMIs (or an FMI alone) do not have the means to request such tests.
Regulatory authorities have a role to play in this regard, as they are better placed to request these tests in their respective jurisdictions and in coordinating cross-border tests. Similar market-wide exercises are currently undertaken in the UK, the consultative report may want to inspire itself from this example.

Principle 17, under note **3.17.15.,** requires that:
1) An FMI should simulate "large-scale disasters". Please refer to our comments in relation to the term "wide-scale disruptions" above.
2) The FMI's employees, participants and service providers should be thoroughly trained to execute the business continuity plan and should be regularly involved in the testing. Whilst Clearstream invites customers to participate in tests, at their own will, we believe that FMIs should not be responsible (nor have the means) to train customers or service providers in BCP arrangements.
3) An FMI should consider the need to participate in industry-wide tests. As mentioned above regulatory authorities, rather than FMIs, have a role to play in organizing such tests. The consultative report may want to inspire itself from countries, such as the UK, US and Sweden, where the regulators, and/or market authority and/or the market associations organize this.

Principle 18: Access and participation requirements
An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

Principle 18 under 3.18.1. requires for FMIs to "ensure that its participants and linked FMIs have the requisite operational capacity, financial resources, legal powers, and risk-management expertise." While indeed a thorough due diligence process is applicable today to new customers, neither "operational capacity" nor "risk-management expertise" is something that can be checked today without internationally recognized benchmarking standards to judge on such elements.
In today's global financial market, it should also be taken into account that 'participation requirements' not based on globally applicable objective rules could lead to the subjective exclusion of prospective customer in detriment of the aims of these principles.

However the topic of the legal assessments mentioned under 3.1.4. and 3.11.3., is once more raised under 3.18.5 under the requirement for the FMI to consider the risks that participants may pose to the FMI and other participants. The requirement for FMIs to establish "legal opinions or other arrangements that ascertain that possible conflicts of laws issues would not impede participation of the applicant". Requesting for an external legal opinion for each prospective customer or the country in which it is located is not common practice in our industry, and does not come without a financial cost, which will eventually transpire to customers and the industry as a whole, while not necessarily providing further legal certainty. We strongly suggest your CPSS-IOSCO committees to reconsider such an approach.

We relate to the comment made earlier in principle 11, regarding the links among CCPs and CSDs. From a CSD perspective a CCP is nothing else than another participant in its system. We therefore do not see the need for specific provision on the services of a CSD towards a CCP.

Principle 19: Tiered participation arrangements
An FMI should, to the extent practicable, identify, understand, and manage the risks to it arising from tiered participation arrangements.

On tiered participation arrangements, such as the sub-custodian agreements that the (I)CSDs generally have, the requirement to request legal opinions for each jurisdiction is readily common practice.

We draw your attention that the requirements set under 3.19.2., that defines "indirect participants as "a type of relationship with entities that are not bound by the rules of the FMI, but whose transactions are recorded, cleared, or settled by or through the FMI." We understand this indirect participation approach to be mainly CCP relevant rather than CSD related. We therefore stress once more the importance to differentiate clearly the understanding of indirect participation among the different FMIs.

In Europe a definition of indirect participant already exists within the sphere of the CSD's rules, and particularly under the Settlement Finality Directive (SFD). This body of law considers in its 'compendium of definitions in community law' [1] an indirect participant to be "a credit institution (...) with a contractual relationship with an institution participating in a system executing transfer orders (...) which enables the abovementioned credit institution to pass transfer orders through the system"

The SFD also provides that "a Member State may decide that for the purposes of this Directive an indirect participant may be considered a participant if it is warranted on the grounds of systemic risk and on condition that the indirect participant is known to the system".
Confirming the important role that regulators have to play in supervising tiered participations arrangements, which the consultative report intends to shift to the sphere of the FMI's responsibilities.
Principle 19 should not go beyond these provisions by imposing to obtain knowledge of indirect participants in order to implement the principle requirements.

In addition to the above, the consultative report should try to leverage on the conclusions reached in other international fora, such as the Hague Convention, the Geneva Securities Convention (Unidroit), or in Europe the prospected Securities Law Directive.
These legislative efforts recognise the 'securities account provision' to be one of the most important functions of a CSD. If a CSD is considered as an account provider it will remain responsible and liable towards the account holder. In its turn the account holder could be an account provider, who in its turn will be responsible and liable towards its own account holders (or tiered participants under principle 19). This 'account provision/account holder' structure guarantees the liabilities at each respective level with no adverse effect in terms of investor protection. We believe this internationally applicable model should prevail.

On the more specific requirements of principle 19, under 3.19.3., it requires FMIs to identify and manage risks to the extent possible arising from indirect participants. While under 3.19.4 it requires FMIs to managing credit and liquidity risks of indirect participants. We believe that gathering information "on the proportion of payment, clearing, and settlement activity that is conducted by direct participants on behalf of indirect participants." is potentially conflicting with banking secrecy laws prevailing in several jurisdictions of participants, and may contradicts provisions of the securities law applicable to the (I)CSDs, such as in Luxembourg law, according to which participants are owner of the securities deposited on their account with the (I)CSDs
As earlier mentioned, under principle 11, most (I)CSDs currently provide to its customers the tools necessary to allowing the segregation of securities belonging to the customer of a participant, and therefore facilitating managing credit and liquidity risks of indirect participants.

[1] Please refer to page 15 of the link hereafter:
http://ec.europa.eu/internal_market/financial-markets/docs/certainty/communitylaw_en.pdf

CSD customers have the technical means to segregate at wish, nevertheless (I)CSDs do not have the means nor the authority to impose segregation requirements to its customers, nor should this become a requirement for (I)CSDs in the future.

Currently the only obligation imposed on customers is to identify account as proprietary or non-proprietary, and this in those jurisdictions that do not default account property assumptions (e.g.: an account will be considered as non-proprietary by default according to the German Securities Deposit Act except if otherwise explicitly notified in writing)

Based on the above, we find the enforceability of these requirements to be a problem from a FMI perspective. While we do not challenge the importance of managing third-party risks, regulatory authorities have a role to play in this regard, as they are better placed to request the users of an FMI to use the account segregation tools available for this purpose.

Principle 20: FMI Links
An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.

For the purpose of bringing further clarity to this principle, let us spell-out once more the difference what is understood as a link:

"A link between two SSSs consists of a set of procedures and arrangements for the cross-border transfer of securities through book-entry process. A link takes the form of an omnibus account opened by an SSS (the investor SSS) in another SSS (the issuer SSS).

<u>Direct links (unilateral, bilateral)</u>
The link between two SSSs is unilateral when it is used only for the transfer of securities registered in one system to another and not vice versa. A bilateral link between two SSSs means that a single agreement regulates the transfers of securities from any of the systems.

A direct link implies that no intermediary exists between the two SSSs, and the operation of the omnibus account opened by the investor SSS is managed either by the investor SSS or the issuer SSS.

In an operated direct link, a third party (i.e. a custodian) opens and operates an account in the issuer SSS on behalf of the investor SSS. The responsibility for the obligations and liabilities in connection with the registration, transfers and the custody of securities must remain legally enforceable only between the two SSSs.

Relayed links
Relayed links are contractual and technical arrangements for the transfer of securities involving at least three securities settlement systems (SSSs): the "investor" SSS, the "issuer" SSS and the "intermediary" SSS."[2]

Having clarified our understanding of what a link is among SSSs/CSDs, let us comment on the specific Principle.

Principle 20 under **3.20.6** requires for CSD to CSD links that "any credit extensions between (I)CSDs should be covered fully by high-quality collateral and be subject to limits" and the footnote completes this text with "In exceptional cases, other adequate collateral may be used to secure credit extensions between (I)CSDs subject to the review and assessment by the relevant authorities."
In relation to this requirement, we would like to highlight that the substance of the credit-oriented elements in this principle 20 refers to risks arising on the operation of cross-system settlement links. These elements of the principle appear to deal first and foremost with bilateral links rather than with unilateral links.

Therefore the provisions of this principle only apply to bilateral links where risk management provisions must, by definition, be made for the regulation of credit claims arising on securities transfers between the two SSSs. In the case of unilateral links - whether direct, operated or relayed - the "investor" SSS acts only as a participant in the remote "issuer" SSS. The regulation of credit claims arising from securities movements lies predominantly or even exclusively with the "issuer" or remote SSS according to the rules under which finality is achieved in that system.
Credit risk which may arise in the issuer SSS to which the "investor" SSS is linked in a unilateral link arrangement is addressed in the proposed principle 4, and more accurately in the ESCB CESR Recommendation 9.

Principle 20 under **3.20.7** requires for CSD to CSD links to provide "adequate segregation and portability of securities" in the event that one becomes insolvent.
As mentioned earlier under principle 11, on the legal arrangements to protect the assets and positions of a participant's customers in a CSD in order to achieve the benefits of segregation and portability. The concept of "segregation and portability" is mainly a CCP one, most (I)CSDs currently provide to its customers the tools necessary to allowing the segregation of securities belonging to the customer of a participant, and therefore facilitating the portability of customer holdings, should the participant default, to another participant.
CSD customers have the technical means to segregate at wish, nevertheless (I)CSDs do not have the means to impose segregation requirements to its customers, nor should this become a requirement for (I)CSDs in the future.

2 ECB clarification on the types of links, under:
http://www.ecb.int/paym/coll/coll/ssslinks/html/index.en.html

Finally, regarding the links among CCPs and (I)CSDs, we relate once more to the comment made under principle 11, by which under a CSD perspective a CCP is nothing else than another participant in its system. We therefore do not see the need for specific provision on the services of a CSD towards a CCP. Should the consultative report wish to handle the relation between CCPs and (I)CSDs, this should rather be mentioned under the "access" provisions in principle 18.

Principle 21: Efficiency and effectiveness
An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.

No comments.

Principle 22: Communication procedures and standards
An FMI should use or accommodate the relevant internationally accepted communication procedures and standards in order to facilitate efficient recording, payment, clearing, and settlement across systems.

No comments.

Principle 23: Disclosure of rules and key procedures
An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

Further to some previous comments in relation to the transparency and disclosure requirements, we would like to draw the attention to the fact that (I)CSDs are currently already subject to publishing the following best practice and other compulsory information:

- BIS Disclosure framework for securities settlement systems
- Pillar III Disclosure Report according to the Basel II framework
- ECSDA Disclosure framework
- Questionnaire of the Association of Global Custodians
- European Code of Conduct-related:
    - Unqualified independent assurance report on the Self-assessment Report
    - Fee Schedule
    - General Terms and Conditions
- Statement on Auditing Standards (SAS) No. 70 by the American Institute of Certified Public Accountants (AICPA), soon to be replaced by the new SSAE 16 reporting standard.

To the above disclosure requirements, will need to be added the many requirements set in this consultative report. You will certainly appreciate that before, new disclosure requirements are imposed to FMIs, particularly to (I)CSDs, some world-wide standardization and harmonization work needs to be undertaken in this domain and this at global scale.
Many disclosure requirements are aimed at providing information on specific aspects, but all of them have common characteristics, that often lead to a very large degree of duplication of information, efforts and resources in the information to be made available.

Principle 23 under 3.23.4 requires the FMI to take a disciplinary role in the financial market. It states that "an FMI is well placed to observe the performance of participants and should promptly identify those participants that do not adequately understand its rules, procedures, and risks of participation. In such cases, an FMI should notify the senior management within the participant institution and, in cases of significant potential risk, notify the appropriate regulatory, supervisory, and oversight authorities"
We are of the opinion that in most of cases, any such occurrences are due to the customer not adequately understanding (I)CSDs rules, procedures etc., we do not deem appropriate to fulfil a policeman role before the customer effectively becomes a problem. In which case, indeed measure will be taken to ensure to exclude this participant.

Principle 23 under 3.23.5 requires the FMI to provide "descriptions of priced services for comparability". Comparability among CSD services is not always an easy task, due to the fact that the services (I)CSDs provide are not equal among providers. This element should be kept in mind when considering such a principle.

The principle requires under 3.23.6, for FMIs to provide additional information as needed to further enhance the understanding of the activities and operations of the FMI. This general information, may include "the names of direct participants in the FMI", while this element is common practice in many markets, exclusions of this principle should the envisaged for those jurisdictions where banking secrecy laws apply.

Principle 24: Disclosure of market data
A TR should provide timely and accurate data to relevant authorities and the public in line with their respective needs.

As mentioned in the introductory remarks, we favour the previous approach to have separate recommendations for SSSs/CSDs and CCPs, hence will not comment on Trade Repositories' related principles.

Annexes A to H

The consultative report proposes under Annex F the following considerations:

1) A regulator, supervisor or overseer of an FMI may want to establish expectations for an FMI's critical service providers in order to support an FMI's overall safety and efficiency. Whilst this would appear beneficial at first sight for FMIs, as it would resolve issues relating to the enforcement of standards on service providers, the question remains on which authority should enforce this requirement, as the FMI does not have the authority nor the means. Regulator should have a role to play in this regard, although in this case as well, the problem might be that the regulator of the FMI, might not be in a position to regulate the service provider (e.g.: an IT or telecom provider, which are not regulated by the financial market authorities.
The consultative report might want to bring solutions to these problems, prior to its implementation, or limiting this requirement to the financial markets only would already be an improvement.

The consultative report proposes (**Annex H: Glossary**) yet another set of definitions, While we are not challenging the relevance of these definitions, it is important to consider that in the absence of a single definition effort in this area of finance, these definitions should only have a guidance value, as definitions are often different from each other and unaligned among the different best-practice regulatory documents.

For any further details or clarifications, please contact:

Mathias Papenfuß
Member of Clearstream Executive Board
Phone +49 69 2 11-1 59 77
Fax +49 69 2 11-61 59 77