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28<sup>th</sup> September, 2012

***Delivered Electronically***

Secretariat  
Committee on Payment and Settlement Systems  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland  
Sent *via* email to: [cpss@bis.org](mailto:cpss@bis.org)

Secretariat  
Technical Committee  
International Organization of Securities Commissions  
C/ Oquendo 12  
28006 Madrid  
Spain  
Sent *via* email to: [fmi@iosco.org](mailto:fmi@iosco.org)

**Re: CPSS-IOSCO Recovery and Resolution Consultative Report.**

The Global Financial Markets Association (“**GFMA**”)<sup>1</sup> welcomes the opportunity to submit comments to the Committee on Payment and Settlement Systems (“**CPSS**”) and the Technical Committee of the International Organization of Securities Commissions (“**IOSCO**”) (collectively, “**CPSS-IOSCO**”) regarding the Consultative Report on Recovery and Resolution of Financial Market Infrastructures (the “**Recovery and Resolution Report**”).<sup>2</sup> As noted in the Recovery and Resolution Report, financial market infrastructures (“**FMI**s”) play an essential role in the global financial system, and any disorderly failure of an FMI could lead to significant, systemic disruptions in the financial markets. The GFMA agrees, therefore, that “ensuring that FMIs can continue to perform critical operations and services as expected in a financial crisis is . . . central to the recovery plans [FMIs] formulate and the resolution regimes that apply to them.”<sup>3</sup> We strongly support CPSS-IOSCO’s efforts to outline the features of an effective recovery and

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<sup>1</sup> The Global Financial Markets Association (GFMA) brings together three of the world’s leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, visit <http://www.gfma.org>

<sup>2</sup> Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, *Recovery and Resolutions of Financial Market Infrastructures*, July 2012.

<sup>3</sup> See Resolution and Recovery Report, p. 1.

resolution regime for FMIs, and we are pleased to submit comments in response to the issues raised in the Recovery and Resolution Report.

As a preliminary matter, we note that the Institute of International Finance (“*IIF*”) and the International Swaps and Derivatives Association (“*ISDA*”) are also submitting comments on the Recovery and Resolution Report which relate specifically to central counterparties (“*CCPs*”) in the global derivatives markets. We generally support the comments of ISDA and the IIF and, although some of our comments do apply to CCPs, we have generally focused on recovery and resolution mechanisms as they relate to the FMIs responsible for the clearing and settlement of cash securities, rather than CCPs, to avoid duplication of effort.

For purposes of this letter, references to recovery mean those mechanisms utilized to stabilize an FMI and restore its financial strength and viability when the FMI comes under severe stress and to ensure continued provision of critical operations and services. References to resolution mean those processes established to deal with the wind-down of an FMI without severe systemic disruption and without exposing taxpayers to loss while preserving systemically important functions.

## INTRODUCTION

In April 2012, CPSS-IOSCO released its Principles for Financial Market Infrastructures (the “*Principles*”).<sup>4</sup> The Principles make significant advances in promoting effective risk management and a stronger global infrastructure so that FMIs operate safely and efficiently under normal circumstances as well as in times of severe market stress. Consistent with the Principles, most FMIs have rules and procedures that would mitigate the effects of financial shocks and participant defaults. FMIs are thus less likely to reach the point of total insolvency than other types of financial institutions. At the same time, if an FMI insolvency were to occur, the repercussions of that event throughout the financial system could be severe. Given the critical role FMIs play in the financial markets, it is imperative that effective recovery and resolution mechanisms exist to avoid, or at least mitigate, the failure of an FMI.

We agree that the basic principles reflected in the Financial Stability Board’s (“*FSB*”) Key Attributes of Effective Resolution Regimes for Financial Institutions (the “*Key Attributes*”) provide an important conceptual framework for the resolution of FMIs. As we discuss more fully below, we believe the following additional considerations are essential to the implementation of these Key Attributes in the context of FMIs:

- *Interconnectedness of FMIs and other market participants.* Any resolution and recovery plan for an FMI must consider interconnections between, and the potential repercussions of an FMI failure on the stability of, other FMIs, other financial institutions and the financial system in general. As a result, resolution and recovery planning should involve not only the FMI and its regulators, but also its participants and the other FMIs to which it is linked, to ensure that regulators understand these potential repercussions and that any resolution and recovery plan swiftly preserves or replaces central functions and minimizes a broader destabilization of critical infrastructure.

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<sup>4</sup> See Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions, Principles for financial market infrastructures, April 2012.

- *Preservation of the FMI's systemically important or critical functions through management, administration or conservatorship.* A statutory management, administration or conservatorship approach to the resolution and recovery for an FMI may be essential in appropriate circumstances. Such an approach should be viewed as an *alternative* to otherwise applicable insolvency law only when resolution of the FMI pursuant to such insolvency law would have serious adverse effects on stability of the financial system. Administrative powers should include the authority to act swiftly to (i) assume control of the entity (and dismiss senior management responsible for its failure), (ii) transfer the entity's systemically important services (and related assets and liabilities) to private-sector purchasers or a bridge entity in a manner that ensures uninterrupted continuity of such services and (iii) liquidate the entity and its remaining assets and liabilities in an orderly fashion. Such an approach will only be successful if (i) the manager, administrator or conservator has both sufficient expertise and sufficient authority to make critical decisions quickly, and (ii) the continued operation of the systemically important or critical functions of an FMI would not require market participants to expose themselves to credit risk of the insolvent FMI without appropriate new safeguards.
- *Cooperation across multiple jurisdictions.* Where multiple resolution authorities may claim jurisdiction over a single FMI, including as a result of different jurisdictions of formation of its affiliates, these authorities should agree in advance as to which authority has primary jurisdiction and how to ensure that its determinations have finality in other jurisdictions. Jurisdictional disputes will magnify the effects of a failure by delaying recoveries for other affected parties and creating uncertainty that may overhang the market for an extended period.
- *Triggers for resolution rather than recovery.* Although triggers for the resolution of an FMI rather than recovery should be determined by the appropriate regulator, the most critical considerations are the FMI's prospects for raising additional capital and for obtaining adequate liquidity to make continued operation feasible, the FMI's insolvency or the likelihood of insolvency, the lack of a private market sector solution and the inability to put the FMI through a normal insolvency without threatening financial stability. Such considerations apply whether or not the FMI is of a type that takes on credit risk of its participants.
- *Legal mandates requiring use of the FMI.* When participants are required to use an FMI pursuant to a legal mandate, such as a clearing or reporting obligation, relevant authorities should be prepared to take swift action to amend or relieve that legal mandate to the extent necessary to maintain market liquidity, minimize regulatory risk to those affected by the FMI insolvency, and avoid conditions in which market participants would have to choose between increasing exposures to the credit risk of the insolvent FMI or exiting the market.
- *Loss allocation.* Loss allocation should be governed by principles emphasizing predictability and parity. In other words, participants should not be exposed to losses, or required to provide new support, in ways that are not consistent with the rules of the FMI, the waterfall, and general principles of insolvency; and comparably

situated participants should be treated comparably, even when disparate treatment would be more convenient. A resolution authority should not have the ability to require additional money from FMI members to fund the continuing operations of an FMI. “Tear ups” would never be appropriate with regard to cash equity transactions. Losses resulting from operational failures, including fraud, rather than from participant defaults, should be borne by the holders of the FMI’s equity. Loss allocation should not be structured to provide advantages to first movers who withdraw liquidity from the FMI at a critical time.

- *Transfers and bridge facilities.* Although the GFMA supports resolution and recovery plans that would involve the ability to transfer open positions quickly to an alternative or bridge facility, any such transfer should only be done as long as the economic and legal rights of market participants can be effectively preserved.
- *Moratoriums on payment.* Although we recognize that moratoriums on payment may in some circumstances preserve an FMI’s assets pending resolution, we are concerned that moratoriums may undermine confidence and make it difficult to maintain continuity of the FMI. We do not believe these should be a core aspect of the resolution process.
- *Termination rights.* In general, FMI participants should not be stayed or prohibited from exercising early termination rights under relevant agreements and the rules of the FMI during resolution or insolvency. However, where an FMI’s contracts are transferred to another FMI or a bridge facility, FMI participants should not be permitted to terminate their contracts solely by reason of the resolution authority’s appointment.
- *Resolvability assessments.* In evaluating recovery or orderly wind-down plans for FMIs, supervisors should focus on identifying (and identified) barriers to recovery, including any vulnerabilities resulting from organizational structure.

In framing our comments, we have not commented on each specific question asked by CPSS-IOSCO in the Recovery and Resolution Report, but instead have focused on detailing our views on how a recovery and resolution regime would respond to the principles and concerns outlined above.

## DISCUSSION

### **A. Interconnectedness of FMIs and other market participants.**

Any resolution and recovery plan for an FMI must consider interconnections between, and the potential repercussions of an FMI failure on the stability of, other FMIs, other financial institutions and the financial system in general. For example, FMIs function as the centralized hub for other critical functions, and accordingly the failure of an FMI may cut off communications between other parts of the financial markets and expose other FMIs to financial losses or losses of functionality. As a result, resolution and recovery planning should involve not only the FMI and its regulators, but also its participants and the other FMIs to which it is linked, to ensure that regulators

understand these potential repercussions and that any resolution and recovery plan swiftly preserves or replaces central functions and minimizes a broader destabilization of critical infrastructure.

Given the complexity of the global financial markets, it is impossible to identify in advance all of the possible consequences of the failure of an FMI. The following, however, should be considered:

- Regulators should be aware of which other FMIs connect to a particular FMI, the reasons for those connections, whether alternative resources are available to those other FMIs and the possible effects of the loss of those connections;
- Regulators should also be familiar with other service providers (if any) that offer comparable functionality, their ability to manage a large-scale migration to their platforms, and the speed at which such a migration could be accomplished;
- Regulators should understand which service providers to the FMI are critical to its continued functioning and consider how to ensure uninterrupted provision of such services during a resolution procedure;
- Regulators should be sensitive to circumstances that create heightened risk of contagion throughout the financial system, such as cross-collateralization or cross-netting across FMIs, significant exposures of systemically important financial institutions (SIFIs) to the FMI, and potential effects on regulatory capital for SIFIs and other entities with credit exposure to the FMI; and
- Regulators should consider the potential spillover effects of even a short-term disruption to the continued functioning of an FMI, including a decrease in value to financial assets held in custody, direct losses on participants and their customers, and a reduction in credit generally.

## **B. Statutory Management/Administration/Conservatorship.**

The Recovery and Resolution Report poses a number of questions regarding statutory management, administration, and conservatorships, including whether there are circumstances under which a statutory management, administration, or conservatorship could offer an appropriate process within which to ensure continuity of critical services. A statutory management, administration or conservatorship approach to the resolution and recovery process for an FMI may be essential in certain circumstances, but will only be successful if (i) the manager, administrator or conservator has both sufficient expertise and sufficient authority to make critical decisions quickly, and (ii) the continued operation of the FMI would not require market participants to expose themselves to credit risk of the insolvent FMI without appropriate new safeguards.

Many FMIs, such as central securities depositories (“*CSDs*”), are monopolies. As a result, orderly resolution may well require some form of administration to preserve the function of the FMI in the market, because if the FMI were allowed to stop functioning it might cause severe disruptions in the financial markets as a whole. Any effective resolution regime must, therefore, provide mechanisms allowing an administrator to quickly take the necessary steps to ensure that the FMI continues to perform its critical operations and services during the resolution process. In addition,

because FMIs have very specialized operations that require significant technical knowledge and expertise to manage, the administrator would have to be highly qualified, knowledgeable, and capable of making complex decisions rapidly. In that respect, regulators should have identified in advance a panel of potential administrators—some or all of whom may be internal to the FMI itself—that have the background and expertise to identify and implement actions that will be required in the first hours and days of an insolvency proceeding to prevent significant market disruption. Moreover, resolution authorities should be strongly encouraged to appoint administrators or conservators that are already familiar with an FMI's general recovery and resolution plan. Finally, as we discuss later, any statutory management, administration, or conservatorship process would have to be harmonized across jurisdictions so that conflicting resolution mechanisms would not hinder the administrator's ability to operate the FMI across all jurisdictions in which the FMI operates.

The Recovery and Resolution Report also asks whether there are any powers beyond those of a standard insolvency practitioner that a statutory manager, administrator, or conservator would require during the resolution of an FMI. As explained above, an effective resolution regime for FMIs would provide the administrator with the authority to exercise its discretion to make important decisions very quickly. In addition, any administrator or similar officer must have the ability—and be required to—consult with the FMI's participants about proposed measures, the continuing functions of the FMI and the potential long-term impact on participants, insofar as practicable given time constraints. Finally, any transfer of the FMI's operations to a statutory management, administration, or conservatorship should only be done under circumstances in which the participants' rights and obligations, and the legal status of transactions or information held within the FMI, would not be substantially varied.

### **C. Cooperation among multiple jurisdictions**

An orderly resolution or recovery process for an FMI with operations in multiple jurisdictions will require cooperation among the resolution authorities in those jurisdictions. To the extent key functions of the FMI are performed through an affiliated group of entities, some of which may be formed in jurisdictions other than the home jurisdiction of the FMI, it is essential that the resolution process encompass all such entities in a single process, and that all applicable jurisdictions agree to respect the determinations of the primary jurisdiction. During the financial crisis, we have seen circumstances in which courts in two jurisdictions claimed jurisdiction over a dispute, rendered conflicting judgments, and refused to enforce each other's judgments—leaving market participants with no clear form of redress. Where multiple resolution authorities may claim jurisdiction over a single FMI, including as a result of different jurisdictions of formation of its affiliates, these authorities should agree in advance as to which authority has primary jurisdiction and how to ensure that its determinations have finality in other jurisdictions. Jurisdictional disputes will magnify the effects of a failure by delaying recoveries for other affected parties and creating uncertainty that may overhang the market for an extended period.

### **D. Triggers for Resolution rather than Recovery.**

In general, we agree with the provisions of Section 4.5 of the Resolution and Recovery Report, which relates to a determination that the FMI has no reasonable prospects of sustaining or recovering viability. Although triggers for the resolution of an FMI rather than recovery should be determined by the appropriate regulator, the most critical considerations are the FMI's prospects for

raising additional capital and for obtaining adequate liquidity to make continued operation feasible, the FMI's insolvency or the likelihood of insolvency, the lack of a private market sector solution and the inability to put the FMI through a normal insolvency without threatening financial stability. Such considerations apply whether or not the FMI is of a type that takes on credit risk of its participants.

**E. Legal Mandates Requiring Use of the FMI.**

In certain circumstances, market participants may be required, pursuant to a legal mandate, to use a certain FMI. For example, this will likely be the case in the derivatives market when all standard over-the-counter ("OTC") derivatives are required to be cleared through a CCP. While moving standard OTC derivatives to a CCP will, in theory, reduce counterparty risk under normal market conditions, it could ultimately have the opposite effect if the CCP is under significant stress. In such instances, regulators should offer relief from the legal mandates in order to maintain market liquidity, minimize regulatory risk to those affected by the FMI insolvency, and avoid conditions in which market participants would have to choose between increasing exposures to the credit risk of the insolvent FMI or exiting the market altogether.

**F. Loss Allocation and Treatment of Equity Owners.**

Loss allocation should be governed by principles emphasizing predictability and parity. In terms of predictability, participants should not be exposed to losses, or required to provide new support, in ways that are not consistent with the rules of the FMI (which should expressly address loss allocation), the waterfall, and general principles of insolvency. As an example, resolution authorities should not have the power to require additional money from the FMI's members to fund the continuing operations of the FMI during the resolution process. In terms of parity, comparably situated participants should be treated comparably, even when disparate treatment would be more convenient.

The Recovery and Resolution Report raises questions regarding the concepts of "tear-ups" and whether they are ever an appropriate loss allocation arrangement prior to the resolution of a CCP. We note that this question relates specifically to CCPs and, therefore, will be addressed in further detail by ISDA and the IIF as it relates to derivatives. From a securities clearing vantage point, however, "tear-ups" would never be an appropriate recovery or resolution tool.

Losses resulting from operational failures, including fraud, rather than from participant defaults, should be borne first by the holders of the FMI's equity. Where an FMI is owned on a mutual (or *quasi*-mutual) basis, the same principles should apply. The members, like shareholders, would stand to lose their initial investment. Loss allocation should not be structured to provide advantages to first movers who withdraw liquidity from the FMI at a critical time. Instead, we believe that losses should be allocated based, in large part, on the nature of the loss. For example, losses arising from an operational, financial, or business failure of the FMI, or its owner, should accrue through the ownership and control structure, without reference to default procedures. Such situations are much closer to a typical insolvency of a public utility. In that circumstance, the owners of the FMI should stand to lose control of the FMI through the resolution procedure, with the resolution authority able to sell, merge, or otherwise change the ownership structure of the FMI while simultaneously preserving the positions of the participants.

### **G. Transfer and Bridge Facilities.**

The Recovery and Resolution Report identifies as an important resolution tool the transfer of the systemically important or critical functions of a failing FMI to a solvent third party or, on an interim basis, a bridge institution. We generally agree that these measures could prove critical in certain circumstances to, for example, avoid the exercise of termination and liquidation rights as well as to ensure continuity of other systemically important or critical functions, such as payment processing and settlement of transactions. We note, however, that any such transfer should only be done if the rights of market participants can be effectively preserved. This will help participants (many of which may also be SIFIs) avoid increasing counterparty risk as well as provide advance legal certainty regarding the rules governing the rights of an FMI's participants in a resolution proceeding.

### **H. Moratorium on Payments.**

Another issue raised in the Recovery and Resolution Report relates to the circumstances under which a suspension of payments to unsecured creditors may be appropriate when resolving an FMI. In our opinion, there should be no moratorium on payments that would prevent continuity of an FMI. The rules of the FMI should be followed closely in all circumstances. This is vital to providing market confidence and should not be varied under any foreseeable circumstances—except perhaps a catastrophic shut-down of the entire market. Accordingly, if an FMI enters into liquidation, then the usual liquidation procedures and priorities should apply.

### **I. Termination Rights.**

Although the question of early termination rights has the most relevance with respect to CCPs, as a general rule, a participant should not be stayed or prohibited from exercising early termination rights arising under relevant agreements and FMI rules with respect to financial contracts with an FMI in resolution or insolvency. However, if necessary to preserve systemically important or critical functions for an FMI subject to resolution, the resolution authority must have the power to transfer such contracts to a bridge entity or another FMI (including for these purposes a recapitalized FMI depending on the regime in the applicable jurisdiction) or retain such contracts in the failed FMI, subject to the usual anti-cherry-picking limitations (all contracts of the participant must be transferred or all retained) and non-discrimination against cross-border participants.

Any such transfer, if it occurs, should be done within the period of one day foreseen by Key Attribute 4.3, with proper notice to the affected participants. The participant should be stayed from terminating by reason of the resolution authority's appointment (or the insolvency of the FMI) as foreseen by the Key Attributes until it has notice of whether its contracts have been transferred. Thereafter, if its contracts have not been transferred (and thus remain in the failed FMI), the participant should be permitted to exercise its termination rights. If its contracts are transferred to the bridge or other acquirer, neither the appointment of the resolution authority nor the insolvency of the FMI should be considered a default of the bridge or successor FMI that would give either party the right to terminate its transferred contracts. This limitation would not affect any subsequent default by the bridge or successor FMI, such as a payment or delivery default, or an insolvency event.



**J. Resolvability Assessment.**

Each FMI's supervisors should routinely (ideally annually) assess its plans for recovery or orderly wind-down and require that the FMI proactively address any vulnerabilities that would increase its risk of a disorderly failure. We believe that identifying those aspects of an FMI's operations that would impede recovery or orderly wind-down, and working with the FMI to address those aspects prior to an insolvency, will help reduce the risk that the insolvency of the FMI would lead to broader systemic harm. In particular, we note the following considerations:

- Each FMI will have unique issues that depend on its functions and its interconnectedness with other FMIs and financial institutions, as well as its operations, agreements, credit exposures, management, systems and employees;
- Ownership structures may be a source of strength, or alternatively may be likely to impede additional capital raising at a time of crisis, and should be fully understood;
- Access to liquidity is a critical aspect of both recovery and orderly wind-down;
- Commingling of infrastructure and banking functions make resolvability more complex, as do other arrangements that effectively intertwine infrastructure functions with non-FMI functions;
- Failure to maintain appropriate separateness between affiliated entities may make it difficult or impossible to untangle their affairs;
- To the extent the FMI relies on third-party providers for essential aspects of its operations, the possible loss of relationships with those third-party providers may impede recovery or orderly wind-down;
- The departure of employees with key knowledge may have comparable effects to the loss of key third-party providers;
- Systems failures or vulnerabilities may be unresolvable within critical time frames;
- Feedback effects from other FMIs or financial institutions adversely effected by the insolvency may amplify the crisis or disrupt anticipated recovery plans; and
- Jurisdictional disputes, or lack of cross-border cooperation and coordination, as they apply to both FMIs and other financial institutions, may interfere with the ability to execute recovery or orderly wind-down plans.

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Thank you again for the opportunity to comment on the Recovery and Resolution Report. We would be pleased to discuss any of these comments in further detail, or to provide any other

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assistance that would help facilitate your review and analysis. If you have any questions, please do not hesitate to contact the GFMA Executive Director, Ms. Vickie Alvo ([valvo@gfma.org](mailto:valvo@gfma.org)).

Yours sincerely,

A handwritten signature in cursive script that reads "Simon Lewis". The signature is written in black ink on a white background.

Simon Lewis

Chief Executive, GFMA