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The Financial System and
Major Operational Disruption FSM Team
Room 4/16
HM Treasury
1 Horse Guards Road
London
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Ladies and Gentlemen:

We are writing on behalf of the CLS Group, and on behalf of its two subsidiaries CLS Services Ltd. ("CLS Services"), a company organized in the United Kingdom, and CLS Bank International, an Edge corporation organized under the laws of the United States ("CLS Bank"). The CLS Group welcomes the opportunity to respond to and comment upon the paper entitled "The financial system and major operational disruption" dated February 2003 issued by HM Treasury (Cm5751) (the "Treasury Paper").

The CLS Group is acutely aware of the importance of having good arrangements in place to maintain the resilience of the global financial system during major operational disruption. The CLS Group agrees with the position set forth in the Treasury Paper that the main responsibility for responding to a major operational disruption's effect on the financial system can only realistically rest with the private sector. The CLS Group has implemented very robust contingency plans to ensure business continuity in the event of natural or manmade disasters. CLS Bank, as a critical market infrastructure, has been

working very closely with the Federal Reserve Bank of New York to address issues raised by the Federal Reserve in its White Paper. CLS Services is an active member of the Foreign Exchange Joint Standing Committee's operations sub-group focusing on technical operational issues within the foreign exchange and international money markets, including contingency planning.

Background on the CLS Group

CLS Bank is a special purpose bank organized under Section 25A of the US Federal Reserve Act, as amended (the "Edge Act"), and, as such, received its charter from the Board of Governors of the Federal Reserve System. The CLS Group is owned by 67 of the world's largest financial institutions and was organized to provide a continuous linked settlement service for the settlement of payment instructions relating to foreign exchange transactions. The service that CLS Bank provides to its Members eliminates the temporal risk (or so-called "Herstatt" risk) associated with the settlement of foreign exchange transactions. CLS Bank has received robust legal opinions from counsel in each jurisdiction in which a Settlement Member is organized or has its headquarters confirming the finality of instructions settled across the books of CLS Bank. Each Settlement Member of CLS Bank agrees, pursuant to a Settlement Member Agreement governed by New York law, to be bound by the CLS Bank Rules and Member Handbook, which are governed by the laws of England and Wales.

CLS Bank has its office in New York City and, as mentioned, is regulated by the Board of Governors of the Federal Reserve System through the Federal Reserve Bank of New York. CLS Bank has entered into a Master Services Agreement with CLS Services pursuant to which CLS Services provides a number of services to CLS Bank, including back office operations. CLS Services is organized under the laws of England and Wales and has its offices in London. The CLS settlement system has been designated by the Bank of England under the Regulations implementing the EU Settlement Finality Directive (SFD). It has also been designated by the Bank of Canada, the Australian Ministry of Finance and the Monetary Authority of Singapore under appropriate local legislation.

For each of the currencies eligible for settlement through CLS Bank, CLS Bank maintains an account at the corresponding Central Banks. All payments related to settlements that are received by or paid out of CLS Bank go through the applicable Central Banks accounts and Real Time Gross Settlement (RTGS) systems. Accordingly, CLS Bank is a part of a robust, global payment network that has already incorporated important contingency protections covering both concentrated regional disruptions and catastrophic events.

To put the significance of CLS Bank in context, CLS Bank currently settles an average of 80,000 payment instructions a day, comprising a US dollar equivalent in excess of US\$800 billion. Since it began offering its settlement service on 9 September 2002, CLS Bank has settled 6 million instructions, representing a US dollar equivalent of US\$70 trillion.

One of the significant aspects of the CLS settlement system is that while settlement of payment instructions is done on a gross basis across the books of CLS Bank in New York City, the funding of the resulting payment obligations is done on a net basis. Experience has shown that because of netting, a relatively small amount of value paid into the system (in the order of US\$20 billion equivalent) can settle an enormous amount of payment instructions (so far upwards of the equivalent of US\$1 trillion on CLS Bank's highest value days). The liquidity and operational benefits of such netting would be of great value in the event of any operational disruption. It is an important feature of the CLS settlement service that, in connection with settlement, CLS Bank only receives and disburses Central Banks funds. Accordingly, it is clear that timely access to those Central Bank funds and related payment systems is critical.

General Response to the Treasury Paper

The CLS Group welcomes the publication of the Treasury Paper, as it highlights the importance of contingency planning, outlines the legislative tools currently available, and recognises the fundamental importance of leaving it to the private sector to respond in recovery scenarios.

The core question posed by the Treasury Paper is whether, in principle, it would be useful to have new legislation to help promote order in the financial system in the face of major operational disruption. CLS Bank believes that the CLS settlement service which it offers and the legal framework supporting that service – in and of itself – makes a significant positive contribution to the ability of the foreign exchange community to respond quickly and effectively in the case of a major operational disruption. Pursuant to the CLS Documents, many of the most important participants in the global foreign exchange community have bound themselves to a single set of rules for the settlement of payment instructions relating to the settlement of foreign exchange transactions. CLS Bank believes that the CLS Documents are robust and notes that they are supported by legal opinions in all 18 jurisdictions wherein a Settlement Member of CLS Bank is organized or headquartered. The CLS Documents already contain provisions relating to the obligations of the parties in the event of *force majeure* or settlement disruption.

The CLS Documents also contain explicit provisions governing the failure of one or more of its Settlement Members to perform under the terms of the CLS Documents, whether due to *force majeure* or otherwise, including provisions on the interest rates and compensation to be paid for delays in making payments. CLS User Groups have already agreed a best practice for the applicable interest rates and compensation to be paid for delays in settling. Similarly, the agreements that CLS Bank has with its Liquidity Providers include provisions governing the inability of a party to perform due to *force majeure*. The contractual arrangements that CLS Bank has with the applicable Central Banks also contain provisions related to extending the opening hours for payment systems and the adjustment of the settlement period. CLS Bank already has in place robust contingency procedures with each of its Central Banks.

The Treasury Paper correctly notes that the financial system is highly dependent on information and that in a crisis the normal mechanisms through which information flows could be unavailable. This is an area in which the CLS settlement system makes a unique and important contribution. CLS Bank provides an infrastructure for the collection of information and the prompt communication of information among CLS management and operations, CLS Bank Settlement Members and Central Banks. This infrastructure constitutes an important vehicle for market co-operation to resolve difficulties on both a bilateral and multilateral basis.¹ Accordingly, it is vital that in the event of a major market disruption, CLS Bank and CLS Services have access to the best methods of communication available and prompt access to contingency sites. It is also critical that all sites from which CLS Bank and CLS Services operate be secure in times of crisis. CLS Bank and CLS Services would welcome any assistance that the authorities could provide to ensure such access at a time when communications and transportation may be severely restricted.

The Treasury Paper notes that the limitations of any new legislation should acknowledge the international nature of the financial system. This limitation is critically important to CLS Bank. Since CLS Bank is organized and regulated in the United States but has delegated many operational functions to CLS Services in London, it is vitally important that any legislation enacted in the United Kingdom provide absolute certainty as to whether it would apply to CLS Services. The issue is raised in paragraph 5.19 of the Treasury Paper, where it states that the laws being considered would apply to “actions that took place in the UK”. The case of CLS Bank is potentially ambiguous on its face, since operations occur in London but settlement occurs across in the books of CLS Bank in New York City. The preferable approach would be to make clear that such legislation does not apply to CLS Services leaving it to U.S. legislation and the Federal Reserve to make any necessary legislative provisions applicable to CLS Bank. Clearly any action proposed by the authorities in London should be taken in consultation with the Federal Reserve Bank of New York and perhaps the wider Central Banks community. If anything, the Treasury Paper does not go far enough in recognizing the international impact of any proposed suspensive or directional powers.

Legal certainty is a critical component to the effectiveness of the CLS settlement system. Accordingly, it is crucial that CLS Bank and CLS Services be given as much advance notice as possible of any action to be taken under existing legislation (e.g., the declaration of a bank holiday under the Banking and Financial Dealings Act 1971) or any proposed legislation.

¹ On 25th March, CLS Bank and CLS Services experienced their first major service disruption. While the event itself was regrettable, it did provide first hand experience for co-ordinating a disruption involving 52 Settlement Members located in 18 jurisdictions and involving seven currencies and their respective Central Banks. The disruption was successfully managed under the existing CLS Bank Documents and an industry “best practice” that had been implemented relating to compensation, which is now being reviewed.

Specific Responses to the “Key Broad Questions” set forth in the Treasury Paper

The CLS Group would like to respond as follows to the “key broad questions” addressed in the Treasury Paper:

3b Is there more that could usefully be done by the private sector to strengthen the contingency provisions in contracts and other legal instruments? Is there a role for the authorities in assisting with this?

CLS Bank has included within its legal documentation with its Settlement Members and in its legal documentation and operating guidelines with the Central Banks with whom it maintains accounts contingency protections that it believes are adequate to deal with major disruptions. The CLS Group does not believe that there is a role for the authorities in assisting with this to the extent that such provisions would directly affect CLS Bank’s contracts and other legal instruments.

The CLS Group defers to each of CLS Bank’s Settlement Members to determine in light of its own circumstances whether there is a role for the authorities that will assist the Member meeting their obligations under its legal arrangements with CLS Bank. However, CLS Bank points out that the CLS settlement system has been carefully designed to provide the CLS services to its Settlement Members under the legal regime in each applicable jurisdiction. Any changes in the applicable legal regimes might adversely affect the operation of the current CLS Bank Rules or adversely affect finality and would have to be reviewed carefully with local counsel. In particular, any change in the bankruptcy law governing a CLS Bank Settlement Member that had the effect of introducing a clawback or other similar provision or any uncertainty as to the applicability of any such provision, would require close scrutiny.

One of the lynchpins in the CLS settlement system is the certainty provided by the CLS Bank Documents that if each of CLS Bank’s Settlement Members performs, settlement will be completed with finality. Any change in law, however well intentioned, that adds uncertainty as to a Settlement Member’s obligation to perform under the CLS Documents in accordance with their respective terms calls into question the certainty and finality that those documents now provide.

3c Is there more that could usefully be done by the private sector to strengthen market co-operation? Is there a role for the authorities in assisting with this?

The CLS Bank settlement service provides a classic example of the private sector being called upon to address a systemic industry risk. The ability of CLS Bank to offer its unique settlement service to its Membership has only been made possible through the support and encouragement of the CPSS

Subgroup on Foreign Exchange Settlement Risk of the Bank for International Settlements and the Central Banks representing the seven currencies that are currently eligible for settlement in CLS Bank.² Such support will continue to be vitally important to the continued success of CLS Bank. By the same token, it underscores the importance of any action taken by regulators in one jurisdiction being coordinated with actions being taken by regulators in the other jurisdictions.

The CLS Group supports and encourages market co-operation and CLS Bank itself provides a significant example of and vehicle for such cooperation. As the shareholders of the CLS Group represent a significant share of the foreign exchange market, the CLS Group constitutes an important forum where ideas can be exchanged and actions taken to mitigate the consequences of a serious market disruption. The CLS Group does not believe that, from its perspective, there is a role for the authorities in assisting in strengthening such market cooperation; however, the CLS Group would also be supportive of initiatives that CLS Bank's Settlement Members thought might be useful to strengthen market co-operation.

4a In principle, would it be useful to have new legislation to help promote order in the financial system in the face of major operational disruption?

The CLS Group defers to CLS Bank's Settlement Members to propose what, if any, new legislation might be helpful in promoting order in the financial system in the face of major operational disruption, with the caveat that any legislation proposed would have to be carefully reviewed by the industry prior to its enactment to make sure that it did not adversely impact on the performance of CLS Bank's Settlement Members under the CLS Bank Documents. It is, for instance, vitally important to CLS Bank that the relevant Central Banks are always in a position to credit CLS Bank's settlement account and that they be able to communicate that information to CLS Bank promptly. It is also critical that once such information is communicated to CLS Bank that the credit be irrevocable and final.

4b Have you any comments on: how new legislation might address risks; the possible disadvantages and limitations of new legislation; and the general constraints on the use of new legislation?

The CLS Group again defers to CLS Bank's Settlement Members to comment on how new legislation might address risks. We do, however, note again that any new legislation would have to be carefully scrutinized to make sure that it did not adversely affect the operation of the CLS settlement system. There would be a clear disadvantage to the foreign exchange community if the result of new legislation were to compromise the legal obligation of CLS Bank Settlement Members to perform in accordance with the terms of the CLS Bank

² The Australian dollar, Canadian dollar, euro, Japanese yen, Swiss franc, UK pound sterling, and US dollar.

Documents or if the new legislation were to introduce uncertainty in that regard. The CLS Group endorses the limitations and constraints set forth in paragraph 6.28 of the Treasury Paper; namely, that any new powers should never be used in a purely financial crisis; should only be used in extreme circumstances; only with the support of the markets; and only if the overall benefits of doing so outweighed the costs. Any action taken would also have to be consistent with any action taken by the Federal Reserve and any other applicable Central Banks. It is critical that any legislation not add additional uncertainty to the uncertainty already implicit in a disaster scenario. It is vitally important that any powers exercised not have unanticipated consequences on the existing and highly complex legal arrangements represented by the CLS Bank Documents and the agreements CLS Bank has with the Central Banks. It is critical that the finality of settlement under the CLS Bank Rules not be impaired or threatened in any way.

4c If new legislation were to be sought, are the suspension and direction powers the right choices? Are there any other types of legislation that might be useful to help promote order in the financial system?

Since the CLS Group is not proposing any specific category of legislation at this time, it does not offer a specific response to this question.

6l Do you support the idea of a suspension power, subject to the constraints of paragraph 6.28?

The CLS Group does not support any power to suspend financial obligations that would affect the ability or obligation of a CLS Bank Settlement Member to comply with its obligations to CLS Bank under the CLS Bank Documents. Any such suspension might have an adverse affect on the global settlement of foreign exchange transactions involving multiple currencies. Where CLS Bank can foresee the possibility of such an adverse affect, it might require action under the CLS Bank Rules to suspend the affected Settlement Members or currencies as a prophylactic measure. Such measures would be taken in consultation with the relevant Central Banks. Accordingly, any measure enacted that would suspend obligations would have to be reviewed very carefully to see what, if any, affects such suspension might have in practice on the operation of the CLS settlement system.

7f Do you support the idea of a direction power, subject to the constraints of paragraph 7.29?

The CLS Group does not support any power to direct financial infrastructure that would affect the ability or obligation of a CLS Bank Settlement Member affected thereby to comply with its obligations to CLS Bank under the CLS Bank Documents or that would affect the ability or obligation of CLS Bank to comply with its obligations to its Settlement Members. Any such direction might have an adverse affect on the global settlement of foreign exchange transactions. Where CLS Bank can foresee the possibility of such an adverse affect, it might require action under the CLS Bank Rules to suspend the affected

Settlement Members or currencies as a prophylactic measure. Accordingly, any measure enacted that would suspend obligations would have to be reviewed carefully to see what, if any, affects such suspension would have on the operation of the CLS settlement system. To the extent that CLS Services is, itself, part of the financial infrastructure, the CLS Group does not see a useful role for the authorities to directly intervene in the operations of CLS Services or CLS Bank.

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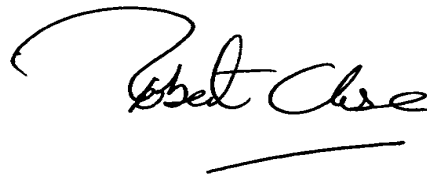
In conclusion, there are three items that are important to the CLS Group. First, that the Central Banks are always in a position to credit CLS Bank's settlement account promptly and with finality; second, that communication links between CLS Bank, CLS Services, CLS Bank's Settlement Members and the Central Banks not be adversely affected by a disaster; and third, that CLS Services in the UK receive the utmost logistical support and security for its infrastructure and communications links to enable it to continue its activities even in the event of a major disaster.

The CLS Group believes that the consultation called for in the Treasury Paper constitutes a very constructive exercise that should contribute significantly to any legislative proposals. The continuing leading position of London in the International Financial Markets generally, and the Foreign Exchange Markets particularly (a strong element in the rationale for CLS Services to be domiciled in London), place significant stresses on the legal and regulatory structure in the United Kingdom. We look forward to an opportunity to comment on any proposed legislation prior to its enactment.

Yours sincerely,



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