

**FSB consultation on the Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions, Annex to the Key Attributes: Client Asset Protection in Resolution**

**AFTI and FBF contribution**

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**I. Introduction**

**Association Française des Professionnels des Titres ("AFTI")** is the French association representing the post- trade industry. All 100 members of AFTI are players in the securities market and back office functions: **banks, investment firms, FMIs etc., acting in France and more generally in Europe.**

**The French Banking Federation (FBF)** represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, *i.e.* more than 390 commercial, cooperative and mutual banks. They employ 373,000 people in France and around the world, and serve 48 million customers.

AFTI and FBF fully support the FSB initiative to introduce appropriate resolutions plans for non-Bank financial institutions as they play an increasing role in the operation and sustainability of financial markets and potentially concentrate high volumes of activities. Thus, in a number of circumstances, recovery & resolution plan are to be developed with the objectives to identify practical, economically viable solutions with no unintended effects on the whole range of market participants.

As the voice of the French banks and post-trade market players, we would like to make specific comments on the elaboration and the implementation of resolution plans as well as on the annex to the FSB consultation document related to the protection of assets.

Our recommendations are issued in one hand from the perspective of custodians regulated as banks and providing a vast range of securities services (local and global custody, depositary function and asset servicing, issuers services, etc.), and on the other hand, as representatives of part of the non-banking sector in particular FMI's since Euroclear France and L.C.H Clearnet SA are AFTI members.

We therefore think we have a large expertise on the topics addressed by the FSB document and a real added-value on the comments we address and seem us well-balanced.

## II. General comments

First of all AFTI & FBF fully agree with the FSB on the fact that non-bank entities considered as potentially systemic should put in place recovery and resolution plans which are comprehensive, transparent and reliable enough to cover any situation which could threaten the maintenance of service they offer. Such an approach requires having a clearer definition of what can be considered as systemic entities (the market size, the range of functions performed and services offered, as well as the geographic presence in several countries or geographic zones can constitute objectives criteria for identifying such entities).

Secondly, there must be a strong consistency between the principles regarding the elaboration of recovery plans which is a key concern managed currently by CPSS/IOSCO and the principles regarding the elaboration of resolutions plans managed by the FSB. Starting from this assumption, we consider the following recommendations should be taken into account to reach the final objective which is, for the FSB and CPSS/IOSCO, to set up an efficient and coherent general framework at the global level.

Thirdly, the content of the resolution plans should not be larger than the content of the recovery plans. This means that resolutions plans should be focused only on the core functions that should be preserved in extreme situations and that would require the triggering of the resolution solutions. These critical core functions are to be identified on an ex-ante basis at the regulatory level for each broad category of non-bank entity, with a strong implication of their members / participants and not at their own discretion. In addition, these core functions need to be isolated in a way that allow to transfer them in an appropriate structure where they could be managed by the resolution authority independently from other services which are not critical for the maintenance of the stability of financial markets. Consequently any failure of a non-bank entity that would result from non-core activities should not lead to the activation of resolution solutions.

Finally, a clear distinction should be made between the different types of non-bank-entities, in accordance with their specific role and risk profile. A "one-fit-all approach" or adoption of tools that would be relevant to one category of one non-bank entity only would result in failing the key objectives of financial policy makers with regard to resolution of systemic structures. Any source of credit exposures is to be analysed in details for each entity with a clear description of the operations creating these exposures and how they are to be appropriately mitigated.

Regarding the protection of assets; first of all, we would like to express that we are in favor of any initiative that allows to further clarify that client asset protection is effective and consistent, wherever the assets are located and how they are used. In this respect, we welcome the report and are globally in phase with the general approach adopted by the FSB.

As a reminder, AFTI & FBF contributed to the IOSCO report published on «Recommendations Regarding the Protection of Client Assets» (the «IOSCO Report») in February 2013 and considered it as a constructive supplement of what have been already done through the G-20 political push to ensure that protection of client assets in case of resolution should remain a high priority. A significant level of transparency and clarity is also a key priority: on one side for investors that need to be aware of the level of risk associated to their investment choices; on the other side for regulators in order to facilitate an orderly management of extreme situations where relevant.

We also would like to make a number of comments to explain more specifically how some recommendations should apply and to ensure that provisions are not misinterpreted at the end and do not lead to the adoption of principles which are not relevant and may even impede the smooth application of the protection principles.

In terms of transparency, clarity and certainty should be a key priority. At the same time, where a high level of transparency is delivered to clients and allows them to better understand, but also monitor the types of products and operations in which their assets may be invested in, this information should be considered as a real safeguard and thus should not lead to the disclosure of information which has no added-value for investors. Similarly, further transparency should allow avoiding imposition of additional measures such as restrictions or bans for certain of operations. Investors should have the opportunity to benefit from these kinds of operations to enhance the performance of their investments when they consider that these are acceptable in view of their own personal objectives.

As mentioned in the consultative document, the objective to preserve client asset protection in case of resolution should be considered in conjunction with other ones that may result from extreme situations. In any case this principle should not result in creating systemic risks (as failure of some intermediaries or contagion effects to other market participants and/or jurisdictions) that may endanger the stability of the whole financial system and markets.

On the prompt access to assets in case of resolution, we are of the opinion that this principle should not lead to the imposition of inappropriate constraints on intermediaries in term of liability. Everyone should be aware that, in most cases, any delay in the restitution of assets is mainly due to the constraints imposed at the local level in insolvency laws.

In this respect, we urge the FSB to reflect more in the guidance the results of the IOSCO survey on the different existing regimes for the protection, Distribution and/or transfer of client Asset conducted in March 2011.

This survey has highlits

In case of cross-border investments, which are performed at the demand of investors themselves and not at the own initiative of the intermediary, it should not be asked to intermediaries (especially custodians) to substitute themselves to prompt restitution mechanisms and consequently introduce a restitution obligation even if the assets have not been previously returned to the intermediary.

Finally considerations on client asset protection should be reviewed in conjunction with other regulatory initiatives to make sure a high level of consistency prevails and that no conflicting nor duplicative approaches are finally adopted.

### **III. Detailed contribution**

#### **A) Key attributes on the resolution plans**

**In response to Question 1**, we fully support an approach consisting to better specify the applicable principles depending of the different category of FMIs. Indeed, some part of the guidance hardly fit with all FMIs' categories. This is why, we believe that the content of the FMI' resolution plans should be based on a thorough analysis of critical services performed by each category of FMIs.

In addition, the content of the resolutions plans -which should consist primarily to identify the critical services to protect-have to be consistent with the content of the recovery plans. .Our view is that the identification of these critical services should not be left to the FMI Board decision only and should be determined in accordance with regulations locally applicable to these FMIs. Indeed, it is not acceptable that the discretion of the FMI may fully apply in such situations. A minimum framework defining different types of scenarios is to be established on ex-ante basis with appropriate safeguards.

Once critical functions identified, FMIs should be able to isolate them in case of resolution from other functions in order to restrict properly the resolution process to functions that need to be maintained and/or transferred to another entity in such a situation.

**In response to Question 2**, we agree that a clear distinction should be made between the different types of non-bank-entities, in accordance with their specific role and risk profile. Any source of credit exposures is to be analysed in details for each entity with a clear description of the operations creating these exposures and how they are to be appropriately mitigated. This being said differently resolution tools should not be limited to the specific case of CCPs with reference to the use of VMs and IMs (with a certain level of haircutting) as these protection measures are not in place for other non-bank-entities such as CSDs which could provide critical services presenting credit or liquidity risks. In this respect, we welcome the FSB's position regarding FMIs licensed as banks that should be still subject to "a resolution regime that includes the elements and delivers the objectives set out in this Annex".

**In response to question 3**, AFTI & FBF fully support the statutory objectives of effective resolution, namely pursuing financial stability and allowing for the continuity of critical functions without losses for taxpayers. In general, the principles defined at the FSB level should provide for transparency requirements in order to ensure appropriate information to all stakeholders in relation to the FMI. Although, we acknowledge that a resolution plan may be specific and that any decision from authorities will have to be tailored to the actual situation of the concerned FMI, some degrees of transparency is necessary for participants to assess their risks in using and participating in FMIs.

**In response to Question 4**, as highlighted in our response to the CPSS/IOSCO consultation on FMIs' recovery plans, we do not see clearly why FMIs operated and/or owned by central banks should be excluded from the scope of the resolution regimes for FMI. It is fundamental to introduce standards with equivalent effects for those entities. At minimum, the report should explain what kind of measures with equivalent effects than those deployed for private structures should be developed and that central banks will have to implement for the FMIs they manage.

**In response to Question 5**, we consider that reducing or writing down variation and initial margins are resolution tools that could be activated only under very specific circumstances and in particular in the case where the FMI services are extremely critical. In all cases, only the resolution authority should have the power to enforce implementation of such mechanisms.

**In response to Question 6**, AFTI & FBF are of opinion that principles regarding close-out netting should be recognized even in resolution. Close-out netting is a widely used mechanism in financial markets that contributes to effective crisis management and stability of the markets.

**Regarding Question 8**, we consider that for each type of non-bank entity, the effective entry into resolution should be clearly specified. Indeed, for the specific case of FMIs, the frontier between recovery and resolutions phases may be blurred contrary to the case of banking institutions for which recovery and resolution situations are clearly distinguished.

**In response to question 9**, we stress that loss allocation rules should never be determined by the FMI on its own but they should be drafted together with, at least, all respective authorities and with all participants. These rules should be fully transparent to all clients and indirect clients of the FMI.

**In response to Question 10**, considering the transfer of critical functions to a solvent third party or bridge institution, it may be worth to keep in mind that we may have for OTC derivatives a mandatory clearing with a sole CCP clearing those products (for example, since ESMA may declare the clearing mandatory as soon as a first CCP will be agreed).

**In response to Question 16** and in line with our comments related to the question 1, we believe that maximum certainty and transparency of the resolution planning is necessary for members to be able to assess their risk. Members need to know which tools could be triggered in case of insolvency and to what extent they could be asked to contribute.

It also means that a minimum framework defining different types of scenarios is to be established and disclosed on an ex-ante basis. If an FMI enter into a resolution phase, participants should be associated to the resolution authority decision.

**In response to Question 17**, we suggest to pay more attention to the issue regarding supervisory cooperation mechanisms that should be further assessed for FMIs considered as systemically important regarding their market size, the functions performed and the range of services offered, and their geographic presence in several countries or geographic zones

**In response to Questions 18, 19, 20 and 21**, the definition of resolution plans for systemic FMIs should not be in contradiction with principles retained for the resolution of banking institutions that may be themselves participant of FMIs. In this respect, the FMIs' participants should keep access to the services performed by FMIs when this condition is required by the banking resolution authority.

## **B) Annex relating to the protection of clients 'assets**

**In response to Question 34**, we agree that the FSB consultative document and the IOSCO report are complementary in their role and in terms of scope. We acknowledge that the specific case of resolution require further attention as this type of extreme situations may have substantial impacts on the protection of client assets. At the same time, it should not be forgotten that the resolution of an FMI should happen very scarcely and that this type of scenario would certainly require the implementation of exceptional measures that would be taken according to the ad-hoc context and with the primary objective to avoid contagion and very negative impacts on the global stability of markets and the real economy.

In these conditions the review of guidance to be applied in case of resolution should not result in the introduction of new rules which are not justified in view of the probability they have to be effectively implemented and of the risk that an exceptional situation will have to be addressed with exceptional means going beyond normal principles defined on an ex-ante basis.

**In response to Question 35**, whereas we admit that the FSB consultative document covers a various number of aspects (as segregation and use of protection funds) and types of operations (as securities and re-use of assets), we do not consider that it makes a clear distinction between the different types of firms that may be involved in these operations. As already highlighted in the response to the IOSCO report, the use of the generic term «firm» may cover a vast range of entities as broad as custodians, depositaries, brokers-dealers, prime brokers, banks acting as agents and even central securities depositaries themselves in some cases. The specificities of each of these market participants, that may vary strongly, should be taken into consideration when adopting more well-defined rules that have to be consistent with the roles performed by each of them.

In this respect, we urge the FSB to take into account IOSCO survey on the different regimes for the protection, Distribution and/or transfert of client Asset conducted in March 2011

As an illustration, a Central Securities Depository holds for its participants and for the issuers part or entirety of the issuance, without the need to sub-deposit; a depository bank for a UCITS fund holds the entirety of a given UCITS assets and controls the asset manager's investment decisions; a custodian holds only a part of client's assets, without knowing which part and is obliged to sub-deposit the assets with another custodian or with a CSD. The obligations of those three types of securities intermediaries are not the same and consequently their liabilities cannot be defined in the same way.

**In response to Question 36** on the objectives of the FSB consultative document, as a preliminary remark, AFTI & FBF would like to remind that it was globally in phase with the objectives presented in the IOSCO report, notably that:

- an intermediary should maintain accurate and up-to-date records of client assets, with clear information on the precise nature, the amount, the location and the ownership status of the assets
- an intermediary should provide a statement to each client on a regular basis, as well as on the request of the client
- an intermediary should understand the foreign regime of the jurisdiction where the assets are located (where relevant), notably through the performance of appropriate and regular due diligences on the sub-custodians they select
- an intermediary should ensure a high level of transparency and clarity to its clients, but only on a ex-post basis.

At the same time, AFTI and FBF clearly stated that, when it is asked to an intermediary to understand the legal frameworks of jurisdictions where the assets are located, it should not result in requiring to the intermediary to produce ex-ante advice on these frameworks as intermediaries are not authorised to make some investment decisions as such. In addition the intermediary should not as a consequence be subject to a liability regime which supersedes the local framework with some restitution obligations that would apply systematically whatever the client's investment decisions and the associated risks.

More specifically, on the objectives of the FSB consultative document, we are of the opinion (as mentioned previously) that the prompt access to assets in case of resolution should not give rise to additional liabilities for the intermediaries, notably in terms of restitution of assets. Would such an approach be retained, it may endanger the financial stability of the intermediary itself whereas it has a sound and resilient financial profile.

In addition, we would like to take the opportunity of this question to remind that AFTI/FBF has always promoted further harmonisation of securities laws and insolvency rules, as notably underlined in its response to the IOSCO report. However, the Unidroit Convention is a very high level instrument that is compatible with as good as all systems worldwide and that in reality proposes that securities, by virtue of credit of a securities account should be treated as cash (liability) and not securities. This is a pre-financial crisis manner of considering securities law and therefore cannot be viewed as the right approach in terms of harmonization for securities law

For the same reasons, the principles to be applied in such an extreme situation should be balanced with other parameters observed in the resolution phase.

**In response to Question 37** on the definition of «client assets», AFTI/FBF welcomes that the FSB provides a definition of client assets which is much detailed than the one presented in the IOSCO report. However AFTI/FBF has still a number of comments of this definition:

- In view of the definition retained by IOSCO, it is not clear whether derivative products are included or not. We are in favor of the exclusion of these instruments as they are actually contracts between both parties and not securities that are credited/debited from securities accounts. This is the approach which has been retained in the AIFMD (and in the upcoming UCITS V Directive) for the definition of assets which can be held in custody or not. Derivatives are excluded from assets in custody and are classified in the «other assets» for which the depositary is required to perform an oversight function. We are against the inclusion of cash that is on the bank's balance sheet and that is covered, in many jurisdictions, by a guarantee fund due to its fungibility nature. Furthermore, forcing banks to reimburse cash immediately in the case of a stress event is a source of additional systemic risk. We agree with the FSB approach on the exclusion of assets which have been delivered as collateral in transfer title. As these assets do not belong any more to the clients, they cannot be included in the assets held by the client, including in a resolution phase.
- We would also appreciate some explanation on the point 2.1(iv) "assets arising from transactions entered into by a firm on behalf of a client": what type of transactions is concerned? Is it about transactions that are not yet settled?
- Some global regulations already provide a clear, simplified and harmonised classification of clients. In particular in Europe, the MIFID distinguishes three main clients profiles :
  - Retail clients
  - Professional clients
  - Eligible counterparties

Such classification could be retained in the guidance to consider especially the intermediaries' obligations on information.

**In response to Questions 38 and 39** on transfer powers and portability, we believe that such measures should be considered very carefully in view of the potential issues associated with such an option. In theory this type of solution may appear as a sound one to maintain the provision of services instead of returning them to the clients.

Such solutions have been retained in the EMIR regulation in the EU for contracts which are centrally cleared in CCPs. However, right now in the effective implementation phase of these measures, it clearly appears that provisions are to be further analysed between the industry and regulators as very concrete issues result from the portability requirements.

For assets which are held in custody, exercise of transfer powers by resolution authorities cannot be envisaged without prior contractual arrangements between entities and authorised by the national laws. Indeed, the IOSCO survey of march 2011 has pointed out that today a vast majority of local regimes (particularly the trustee regimes and the custodial regimes) does not allow the transfer of clients asset except on a case- by- case basis and with the prior consent of the client<sup>1</sup> (see chapter 4 related to the post-insolvency treatment of client assets). In this respect, AFTI& FBF consider that the national laws should provide more clarification regarding the possibility for the resolution authority to exercise a bulk transfer of the clients assets, as:

- Transfers of assets cannot be implemented without prior relevant developments in IT systems and in account structures, especially if volumes to be handled are significant the difficulties to perform the transfer itself in the resolution phase should not be underestimated as a number of preliminary controls and checks should be conducted. As an

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<sup>1</sup> See paragraph on Transfer of client assets page 18 of the IOSCO survey of Regimes for the Protection , Distribution and/or Transfer of Client Assets published in March 2011.

illustration, where assets are to be migrated from one intermediary to another in a «business as usual» environment, such an exercise is to be planned properly with a succession of key steps and intermediary controls. risks considerations are also to be taken into consideration. Even if pre-arrangements exist between some entities, it should be possible for any of them to approve or not such a transfer in case of resolution. As mentioned previously market participants which are in a sound financial situation should not be endangered by unintended contagion effects that would stem from too far-reaching measures.

- There is legal uncertainty regarding the irrevocable nature of such transfers Clients cannot exercise their individual choice in the transfer of their assets to a solvent investment firm

In addition, on a practical point of view, such a transfer implies that the bridge institution is able to offer the same services (even bespoke ones?) to the transferred clients and in the same vein it means that fees should be slightly the same (it should be kept in mind that the transfer will be done without the consent of the client).

Finally, the development of such «back -up solutions» would certainly have a significant cost due to the developments of tools and resources required to ensure a good functioning of such transfers and portability between different entities.

**In response to Question 40 and 41**, we are in phase with the FSB approach and we believe that the guidance should not be more prescriptive. As mentioned previously we are in favor of a high level of transparency and clarity and we consider that disclosure associated with proper segregation of assets should be considered as a full protection tool. This principle fully applies to securities and lending operations and is more relevant than purely restricting or banning these types of transactions that may enhance the efficiency and profitability of client assets. Once again investors should only enter in operations that they fully understand and which are in adequacy with their own investment and risk objectives, provided that they are properly informed on the risk profile of these operations.

As indicated in the IOSCO report, AFTI supports a legal framework which preserves the ownership rights of clients, instead of granting claims or entitlements.

On re-use, disclosure to clients is also highly recommended, especially where some assets are pledged in favor of an intermediary (e.g. a prime broker). In any case such an option should be allowed only with an ex-ante waiver on asset protection granted by the client itself to this intermediary. In addition, the liability on the assets which have been pledged should lie with the intermediary which can re-use these assets and with any other one, as the custodian which has been appointed for holding of the client assets.

As a matter of principle, we are opposed against the possibility of reuse or re-hypothecation if the collateral taker has not received title transfer before using the collateral securities on the market.

**In response to Questions 42 and 43** on records and disclosure requirements in relation to securities lending and re-hypothecation, we have the same comments as those mentioned in the previous paragraph. We also like to underline that a certain number of market practices already promote a high level of disclosure to investors and regulators.

**In response to Questions 44 and 45** on consistency of this guidance with the FSB report on Securities Lending and Repos issued in November 2012, we welcome the FSB concern on the necessity to achieve this kind of consistency between various regulatory initiatives. However we suggest that the comparison is made with the latest FSB Report on Securities Lending and Repos issued in September 2013, where the FSB has defined its final recommendations on this workstream.



As indicated previously in answer to Question 40 and 41, we consider that no restrictions should be introduced for this type of operations provided that the collateral taker has received title transfer before using the collateral securities on the market. We believe that this approach, coupled with a high level of transparency, is the most effective way to ensure a high level of safety on these operations.

**In response to Question 46** on cross-border issues, we fully agree that extensive cooperation and exchanges of information between home and host authorities are crucial in a resolution process. The existence of ex-ante arrangements are also essential to anticipate a number of relevant solutions that may be implemented in case of resolution and above identify the type, nature and level of information that will be required to have the full picture in case of resolution.

**In response to Questions 47 and 48**, we still agree that a high level of disclosure is a key element to ensure an effective protection of assets and to facilitate the management of a resolution situation. In this respect we agree that intermediaries may be required to provide some information on the assets they hold on behalf of clients, with some elements on segregation, re-use and re-hypothecation and cash re-investment (as mentioned previously).

However intermediaries should not be required to conduct a detailed analysis on how assets of clients would be impacted in case of resolution, with specific information on for instance :

- the effect of correlated failures,
- the effect of foreign laws on the asset protection,
- how shortfalls in client assets and resultant client claims are treated in the resolution,
- cooperation and sharing agreements between relevant foreign authorities in respect of a resolution situation.

Intermediaries cannot be asked to provide information that is to be assimilated to legal opinions. This is the client's responsibility to get such opinions from relevant entities, and only on their demand.

In addition it is not possible for an intermediary to provide the information on the various elements mentioned above on an individual basis, i.e. depending on the portfolio and the specific risk profile of each client.

Finally, as a resolution would be an extreme situation where exceptional measures are to be undertaken, it is not possible to anticipate which right answers could be implemented. Decisions would be taken by the resolution authorities that would have to adapt the solutions to the specific context where the resolution takes places.