August 25, 2010

Re: The Federal Reserve's Authority over Clearinghouses

Dear Chairman Gensler:

It was a pleasure to meet you at the conclusion of the CFTC/SEC Roundtable on Clearing and Listing of Swaps and Security-Based Swaps held last Friday, August 20. I am writing to elaborate on our brief conversation about my remarks at the Roundtable that the Board of Governors of the Federal Reserve System (the Fed) needs a seat at the table in discussions about systemic risk in the clearinghouses, including systemic risk issues raised by the conflict of interest rules, because of the Fed's overall authority in this area.

The Fed plays a central role under the Dodd-Frank Act in the regulation of systemic risk in the clearinghouses.

First, it is the supervisor of the major dealer banks that are the principal owners, members and users of the clearinghouses. Dodd-Frank establishes the Fed as the systemic risk regulator of bank holding companies with $50 billion or more in assets, section 165(a), and any systemically important nonbank financial institution so designated by the Financial Stability Oversight Council (the Council), section 113(a).

Second, the Fed can extend discount window privileges to a clearinghouse in "unusual or exigent circumstances" under section 806(b), subject to any conditions it prescribes, which could include conditions relating to risk management systems.

Third, the Fed may object to any rules promulgated by the SEC and the CFTC with respect to systemically important clearinghouses, in which case the Council resolves the conflict. Under section 804 of the Act, the Council may vote to designate a "financial market utilit[y]" as "systemically important."[1] Section 803(6)(A) contains a broad definition of the term "financial market utility" which includes clearinghouses.[2] Section 805(a)(2) provides that the CFTC and the SEC can "prescribe regulations, in consultation with the Council and the Board of Governors, containing risk management standards." If the Fed is unsatisfied with the risk management standards promulgated by the CFTC and the SEC, it may object, and the CFTC or the SEC then has 60 days to respond.[3] After such a response the Council may vote to require the CFTC or the SEC "to prescribe such risk management standards as the Council determines is necessary."[4]

It was abundantly clear from the discussion at the Roundtable that the conflict of interest rules promulgated by the CFTC and the SEC under sections 726 and 765 will have a direct bearing on the systemic risk of the clearinghouses (and ultimately on that of their participants). The Fed thus has the power to critically shape these rules in its capacity as primary regulator of large bank holding companies and systemically important nonbank financial institutions, and as lender of last resort. In principle, it could prohibit the institutions it supervises from taking part in any clearinghouse it considers too risky. The Fed could also deny discount window access to such a clearinghouse—a critical need without which a clearinghouse would not be viable. The clearinghouse would thus need to assure itself far in advance of any need for window access that its risk management systems would satisfy Fed concerns.

Given the Fed's significant, if not dominant, role as the chief systemic risk regulator, together with its experience and expertise, it would be inadvisable for the CFTC or the SEC to act on issues relevant to clearinghouse risk, including conflict of interest rules, without the Fed's input, or propose rules that the Fed objected to. Moreover, it is extremely unlikely that the Council would act in a way that would be inconsistent with the Fed's position.

The Committee on Capital Markets Regulation has advocated fundamental consolidation of the regulatory structure to avoid the difficulties posed by this potential clash in agency jurisdiction created by Dodd-Frank.[5] Unfortunately, this has not been done. The Committee has also taken the view that the Fed should have the last word on control of systemic risk in the clearinghouses due to its long experience with these issues and specific expertise.[6] In effect, Dodd-Frank has implemented this recommendation by giving the Fed in practice the ultimate power to shape the clearinghouse rules bearing on systemic risk.

Sincerely,

Hal S. Scott
President & Director
Committee on Capital Markets Regulation

cc:
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Timothy F. Geithner, Secretary of the United States Department of the Treasury
Mary L. Schapiro, Chairman of the Securities and Exchange Commission

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 804(a)(1).
[2] This is made even clearer because the Act defines the term "designated clearing entity" to mean "a designated financial market utility that is a derivatives clearing organization." *Id.* § 803(3).
[3] *Id.* § 805(a)(2)(B)–(D).
[4] *Id.* § 805(a)(2)(E).
[5] *See* Comm. on Capital Mkts. Regulation, The Global Financial Crisis: A Plan for Regulatory Reform 203 (May 2009); Comm. on Capital Mkts. Regulation, Recommendations for Reorganizing the U.S. Financial Regulatory Structure (Jan. 2009).
[6] Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking member, S. Comm. On Banking, Hous. & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Agric., Nutrition & Forestry 4 (Apr. 26, 2010).