Overview

In this report, FedFin assesses Title VIII of the Dodd-Frank Act, which establishes a new regulatory framework for “financial market utilities” and systemically-significant payment, settlement and clearing activities. The final language limits the Federal Reserve’s authority if the SEC or CFTC are now regulating an entity or activity, but the new framework still gives the FRB significant influence and establishes a tough new risk-management, conduct, capital and supervisory regime. The Financial Stability Oversight Council will designate financial market utilities (FMUs) and designated activities, with this process public – in sharp contrast to the one established for other entities subject to systemic regulation.¹

Like the overall systemic-risk framework, this part of Dodd-Frank is effective upon enactment, meaning that changes for covered entities and activities could ensue very quickly. Which these are of course remains to be determined, but major clearing houses, payment-service providers, foreign-

exchange clearing entities, OTC derivatives clearinghouses or exchanges and tri-party repurchase agreement activities are all likely on the list for potential designation. Once so designated, profound changes in operations would result even if parts of an FMU or entities previously engaged in a designated activity are now regulated by the banking agencies, SEC or CFTC.

In return for this burden of regulation, FMUs receive access to the Federal Reserve, affording them payment-and-clearing services through the System that are often provided at lower cost than those from private vendors. Any private companies previously offering these services to entities likely to be designated FMUs will thus experience significant competitive pressure. FMUs also gain access to the FRB’s discount window and other emergency support, making them for the first time eligible for emergency liquidity assistance that some believe make designated FMUs “too big to fail.” However, the FRB sought these provisions out of fear that failure to intervene in a liquidity crisis affecting the payment, settlement and clearing system could have profound and adverse macroeconomic implications. For example, the Board provided then-unprecedented amounts of discount-window support after September 11, 2001 to keep the payment system operating, but it was only able to do so quickly because the firm most immediately involved was a bank. Now, the board may intervene for any FMU. FMUs could also be resolved in the new systemic liquidation framework.2

Analysis

All of the provisions detailed below were effective upon enactment (July 21, 2010).

A. Definitions

1. Financial Market Utility

This term means any person that manages or operates a multilateral system for transferring, clearing, or settling payments, securities, or other financial transactions among or between financial institutions and the entity itself. It does not include:

- designated contract markets, registered futures associations, swap data repositories, and swap execution facilities registered under the Commodity Exchange Act or those national securities exchanges, national securities associations, alternative trading systems, security-based swap data repositories, and swap execution facilities registered under the Securities Exchange Act of 1934, solely by reason of their providing facilities for comparing data on the terms of settlement of securities or futures transactions effected on the exchange or by means of any electronic system operated or

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controlled by such entities, although this exclusions applies only with respect to the activities that require the entity to register; and

- a broker, dealer, transfer agent, or investment company, or any futures commission merchant, introducing broker, commodity trading advisor, or commodity pool operator, solely by reason of functions performed as part of brokerage, dealing, transfer agency, or investment company activities, or solely by reason of acting on behalf of a financial market utility or a participant in connection with furnishing services to FMU participants or the use of FMU services, provided that these do not constitute critical risk management or processing functions of the financial market utility. These terms are not defined and will likely need to be clarified through FRB regulation.

2. **Payment, Clearing, or Settlement Activity**

This means an activity carried out by one or more financial institutions to facilitate the completion of financial transactions, but does not include any offer or sale of a security or any quotation, order entry, negotiation, or other pre-trade or execution activity. The law also details activities covered by the overall definition (e.g., calculation and communication of unsettled transactions).

3. **Financial Transactions**

For the definitions above, the term “financial transaction” includes:

- funds transfers;
- securities contracts;
- contracts of sale of a commodity for future delivery;
- forward contracts;
- repurchase agreements;
- swaps;
- security-based swaps;
- swap agreements;
- security-based swap agreements;
- foreign exchange contracts;
- financial derivatives contracts; and
- any similar transaction that the Council determines to be a financial transaction for purposes of this title.

**B. Regulation**

FMUs and systemically-significant activities are generally to be regulated by their primary regulator e.g., the SEC, CFTC, bank supervisor or FRB. If several agencies govern an entity, then they are to agree among themselves
on a primary supervisor and, if they cannot, then the Financial Stability Oversight Council (FSOC) will do so.

1. **Designation**

On a non-delegable basis and by a two-thirds vote with an affirmative Treasury one, the FSOC will name systemic FMUs and payment, settlement and clearing activities. Criteria include:

- aggregate value of processed transactions;
- aggregate exposure;
- inter-connectedness;
- impact of failure; and
- any other factors deemed appropriate.

As with the designation of systemic financial companies, those made here can be rescinded under a process detailed in law. However, in contrast to the treatment of systemic firms, designations for systemic FMUs or activities here would be made only following a process (which does not permit judicial appeal) including public notice and comment unless a designation is an emergency one. The FSOC may demand the information it needs to make this determination and it and the FRB may also require ongoing reports from designated FMUs or activities. With an affirmative vote of the FSOC, the FRB can issue rules on these record-keeping and reporting requirements, coordinating with the primary supervisor. All of this information is protected from disclosure.

2. **Rules**

Consulting the FSOC and primary supervisors, the FRB is to issue rules or orders for systemic institutions on their risk management and conduct. The SEC or CFTC may do the same for entities they supervise, although the FRB could deem them insufficient and, following a process, the FSOC would then side with the FRB or other regulators if they cannot resolve their differences. The law details what these standards should be (e.g., collateral and margin requirements, capital standards for FMUs) and limits the degree to which they can override standards set by the SEC and CFTC.

3. **Advance Notice**

FMUs must notify their supervisor sixty days in advance of any significant change in their own rules of operation, with the supervisors (in consultation with the FRB) to set the terms of these notices. Within sixty days of receipt of this notice, a supervisor can object to a rule change and block it if desired. The change may go forward if not objected to or commented upon in sixty days, although the agency may extend this period for novel or complex changes. FMUs could change rules without this notice in emergency situations, although supervisors could then review and reverse these changes.
4. **Common Risk-Management Framework**

   The CFTC and SEC must coordinate with the FRB to establish a common framework for designated activities and their risk management within one year of enactment. A report to Congress on this is required.

5. **Examination**

   Supervisors will need at least annually to examine FMUs to assess factors detailed in law. Service providers to FMUs are also subject to examination. The FRB is to be consulted in these examinations and may participate in them.

   Examinations are also mandated by primary supervisors for designated activities, with supervisors allowed to delegate these to the FRB. The Board is also given back-up examination power over these activities.

6. **Enforcement**

   Supervisors can enforce these standards for FMUs and activities under provisions applicable to insured depositories. The Board may recommend enforcement actions to the primary supervisor, with binding arbitration by the FSOC if the primary supervisor rejects the FRB’s recommendation. If the FRB finds that there is risk of “substantial harm,” it can issue an enforcement action on its own against an FMU after consulting with the supervisor and upon an affirmative FSOC vote.

   With regard to activities, a supervisor can ask the FRB to enforce its orders and the FRB also has back-up enforcement power, although an affirmative vote of the FSOC is required to use it.

C. **Federal Reserve Services**

   The law broadens those to whom the FRB can provide payment services to include FMUs. Discount and other borrowings from the FRB are also permitted for FMUs under “exigent circumstances” under a process detailed in law. The FRB can pay earnings on balances held by FMUs in the same manner as now done for depository institutions and exempt or modify reserve requirements for them.