May 19, 2011

Via electronic delivery

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave., N.W.
Washington, D.C. 20551

Attention: Comments

Re: Notice of Proposed Rulemaking Regarding Financial Market Utilities (Docket No. R-1312; RIN No. 7100-AD71)

Dear Ms. Johnson:

The Clearing House Association L.L.C. ("Association") and The Clearing House Payments Company L.L.C. ("PaymentsCo." and, together with the Association, "The Clearing House")[1] appreciate the opportunity to provide comments to the Federal Reserve Board of Governors ("Board") in response to its Notice of Proposed Rulemaking ("Proposed Rule") regarding the Board's authority under Section 805 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") to prescribe risk management standards for financial market utilities ("FMUs") designated as systemically important under Section 804 of the DFA (each, a "Designated FMU").[2] The Proposed Rule also proposes the standard for determining when a Designated FMU must provide advance notice of a proposed change to its rules, procedures, or operations, as required under Section 806(e) of the DFA.

[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Association is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs, and white papers—the interests of its owner banks on a variety of systemically important banking issues. PaymentsCo. provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the funds transfer, automated clearing house, and check image payments made in the United States. For additional information, see The Clearing House's Web page at www.theclearinghouse.org.

[2] 76 Fed. Reg. 18445 (April 4, 2011).

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SUMMARY

The Clearing House supports the purposes of Title VIII of the DFA and, specifically, the Board's efforts to regulate systemic risk in payment systems. As indicated in our response to the Financial Stability Oversight Council's proposed rule regarding its authority to designate FMUs as systemically important, The Clearing House believes that only the largest interbank payment systems pose the type of systemic risk contemplated in the DFA; and the Board's proposal to adopt the Committee on Payment and Settlement Systems ("CPSS") Core Principles for Systemically Important Payment Systems (the "Core Principles") reinforces this belief.[3] The Clearing House responds to the Proposed Rule with the following comments:

1. The proposed risk management standards demonstrate that the automated clearing house ("ACH") clearing arrangements should not be considered to be systemically important.
    - The proposed risk management standards would prohibit a settlement unwind; however, the Federal Reserve Banks provide for a settlement unwind for ACH transactions, and a settlement unwind for ACH transactions is recognized in Article 4A of the Uniform Commercial Code.
    - Prohibiting the unwinding of transactions would require fundamental change to the nature of ACH transactions.
    - Providing for same day settlement finality for transactions that are not themselves considered to be final payment (*e.g.*, ACH credit and debit transactions) contributes little to controlling actual risk and instead risks increasing moral hazard.
2. The proposed standards go beyond the risk management objectives of Title VIII of the DFA.
    - Standards related to efficiency are not contemplated by the DFA, and determining Designated FMUs' performance against such efficiency standards is better done in the competitive marketplace than in the halls of government.
3. The proposed definition of materiality should be crafted more narrowly and the rule review process should provide for more streamlined reviews of most rule changes.

[3] *See* CPSS Core Principles (January 2001), available at www.bis.org/publ/cpss43.pdf.

- The rule review process needs to balance the need for review of rules that change the fundamental risk profile of a Designated FMU against the inefficiency and burden on both the FMU and the Board of requiring a lengthy prior review of routine changes.
- A narrower definition of materiality would target those changes that may materially affect the nature and level of risk presented by the Designated FMU, without targeting changes intended to improve service operations.
- An expedited review process would avoid unnecessary delays for the vast majority of rule changes and operational changes that may pose little or no risk to financial stability.

DETAILED COMMENTS

1. The proposed standards demonstrate that ACH clearing arrangements should not be considered systemically important.

The Proposed Rule would adopt the ten principles in the Core Principles that are designed to promote safety and efficiency in systemically important payment systems. The Board, as the relevant Supervisory Agency, would then apply those standards to payment systems that are Designated FMUs. The Proposed Rule would require that payment systems that are Designated FMUs "meet or exceed the risk-management standards."[4] The Board states that it would "interpret and apply the proposed standards consistent with its interpretation and application of those standards under its existing [Payment System Risk ("PSR")] policy."[5] Several proposed standards, while appropriate risk controls for truly systemically important payment systems, are generally inapplicable (or have no relevance) to payment systems such as ACH clearing arrangements that do not carry an expectation of settlement finality. Specifically, the standards proposed in Section 234.3(a)(3)-(5) should not apply to ACH clearing arrangements. These risk management standards would require that:

(3) The payment system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the payment system operator and the participants and which provide appropriate incentives to manage and contain those risks.

[4] Proposed Rule § 234.3(b).

[5] 76 Fed. Reg. at 18447.

(4) The payment system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.

(5) A payment system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.[6]

These three standards, together with Section 234.3(a)(7) on security and operational reliability are the heart of the risk management standards for systemically important FMUs. While The Clearing House strongly supports these standards for systemically important payment systems and believes that the standards in Sections 234.3(a)(3)-(5) should be incorporated into any final rule establishing risk management standards for Designated FMUs, The Clearing House believes that these standards and their importance for systemically important FMUs demonstrate that ACH clearance and settlement systems should not be subject to the standards and should not be Designated FMUs.

As noted in The Clearing House's comment letter on the designation of FMUs, credit transactions on ACH systems, such as PaymentsCo.'s electronic payments network ("EPN"), do not carry the expectation of finality that is characteristic of other electronic payment transactions subject to Article 4A of the U.C.C. ("Article 4A"). First, Article 4A does not apply to "any funds transfer any part of which is governed by the Electronic Funds Transfer Act of 1978 [(the 'EFTA')],"[7] and the EFTA covers consumer transfers of funds "processed by automated clearinghouse."[8] Therefore, for consumer ACH credit payment transactions (e.g., salary and benefit payments), the bank receiving the payments should have no expectation that such payments are final until settlement for the payments is actually completed. In addition, under Section 4A-405(d), ACH credit payments are not subject to the receiver finality rule under which a beneficiary's bank cannot recover payments made to a beneficiary because the bank itself does not receive payment. Thus, the finality guarantee in Article 4A does not apply to ACH credit transactions. Without this expectation of finality, receivers of ACH credit transactions cannot immediately rely on the liquidity of an ACH credit transaction to discharge other obligations outside of the ACH system.

The potential systemic effect of ACH debit transactions is even more limited because of finality expectations. ACH debit transactions are returnable as a matter of right. All ACH debit

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[6] Proposed Rule §§ 234.3(a)(3)-(5).

[7] U.C.C. § 4A-108.

[8] 15 U.S.C. § 1693a(6).

transactions can be returned on the banking day after the settlement day essentially for any reason and disputed consumer debit entries can be returned for an extended period. For example, POS entries can be returned for up to 60 days after the settlement date. More significantly, if a bank has failed, the Federal Deposit Insurance Corporation ("FDIC"), as receiver, is likely to stop paying debit transactions in the pipeline that have not been paid prior to the cutoff hour established by the institution. Even for transactions received before the cutoff, the FDIC could, although it generally does not, return all of the debit transactions received on the day of the failure.

Consistent with the lack of finality in the underlying transaction, settlement for ACH transactions, in the end, has always been based on unwinding transactions that cannot be settled. This type of unwind is a fundamental part of settlement for the ACH networks, including EPN and the Federal Reserve Banks' FedACH Service ("FedACH"). These ACH networks remove a defaulting participant's transactions in the event that the defaulting participant has insufficient funds to settle all of the transactions from the settlement.[9] This settlement practice helps the ACH networks to provide affordable retail payments to merchants and consumers, and the risk of unwinding payments is well understood by participants in the ACH networks. Prohibiting the ACH networks from unwinding transactions would require fundamental changes to the ACH settlement process and would significantly change the nature of ACH payments themselves. The ACH system was designed as a batch-processed, relatively low dollar value payment system that provides a low cost means of making these payments. Providing for an unwind in the event of an inability to complete settlement is consistent with this design and purpose. Changing the nature of ACH payments to provide for same day finality would encourage the use of the ACH for higher dollar value transactions and lead to other changes in security and controls that would fundamentally change the nature of the ACH system and significantly increase the cost of processing small dollar value transactions through the ACH. Such a cost increase could provide an incentive to return to currently less efficient paper-based payments, particularly in the case of the growing volume of ACH check conversion transactions.

a. *Application of the proposed standard in Section 234.3(a)(3) would render impractical and, in effect, abolish ACH transactions.*

Based on the Core Principles, it appears that the standard proposed in Section 234.3(a)(3) would not be met. The Core Principles state that Core Principle III would

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[9] *See* Federal Reserve Bank Operating Circular 4, § 11.1, available at http://frbservices.org/files/regulations/pdf/operating_circular_4_010111.pdf; *see also* EPN Rules, § 7.7.5.3, available at http://www.epaynetwork.com/cms/documents/001748.pdf.

not be met “if it is possible for payments that have already been made to be unwound in the event of a participant failure.”[10] This standard appears to assume that the communication of payment related information constitutes the making of a payment. While this standard makes sense where the party receiving the payment is relying on the payment system to settle all payments processed through the system, it does not where there is no such expectation. The overbroad application of such a requirement to payments that themselves do not provide for settlement finality—the most obvious example of which are checks and ACH payments—would render impractical and, in effect, abolish those payments. There is no evidence that any such result was contemplated by Congress in adopting Title VIII.

More specifically, the requirement in Section 234.3(a)(3) for a payment system to have procedures for managing credit and liquidity risks has no application where the system never assumed credit and liquidity risks in the first place by committing to pay funds that it had not received and where the payment system participants expect to manage their own credit and liquidity risks. Where these participant risks are within the range of risks that banks manage for other purposes, such as the credit and liquidity risks contemplated by national bank lending limits, there is no reason to shift these risks to the payment system.[11] For example, where daily exposures between counterparties in a payment system such as EPN are on the order of magnitude that may arise from counterparties elsewhere, such as loans, it is both reasonable to expect the system participants to manage those risks and unreasonable to require the payment system to manage those risks.[12]

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[10] Core Principles § 7.3.6.

[11] *See* 12 U.S.C. § 84.

[12] While the liquidity risk on a failed payment is similar to the liquidity risk on a failed loan repayment, the credit risk on the payment is inherently less to the extent that the bank receiving the payment retains the right to recoup any funds made available to the payee from the payee, as is typically the case with respect to ACH payments.

b. *Section 234.3(a)(4) imposes a same day finality requirement, that conflicts with the basic structure of an ACH debit transaction.*

The standard proposed in Section 234.3(a)(4) again assumes that an unwind option is not available and, thus, requires final settlement on the day of value. To meet the standard proposed in Section 234.3(a)(4), the Core Principles state that "[a]chieving final settlement by the end of the day is the minimum standard."[13] The Core Principles further provide that "[s]ettlement cannot be considered final until there is no further possibility that [the payment] will be unwound, because all conditions have been satisfied." While this date might be considered to be the value date for ACH credit entries, ACH debit entries are not final until the collecting bank no longer has a right of return.[14] The rules governing the ACH provide that the collecting, or receiving, depository financial institution has at least until the next business day after the settlement day to return an ACH debit item.[15] Therefore, ACH debit entries would not be final before the end of the settlement day for purposes of proposed Section 234.3(a)(4). Although it would be theoretically possible to split ACH debit entries apart from ACH credit entries and settle them on a separate net basis for each type of transaction so that "finality" could be achieved for ACH credit entries on the same day, neither the magnitude of the risks posed by these transactions nor the language of Title VIII warrant such a requirement.[16]

c. *Section 234.3(a)(5) is, at minimum, inapplicable to FMUs that do not take on credit or liquidity risk.*

This principle requires a payment system to be able to complete settlement in the event of the single largest participant's inability to settle. The CPSS discussion accompanying the Core Principles requires that "a system that combines multilateral net settlement with [deferred net settlement] needs to be protected against liquidity risk arising from an inability to settle on the part of one or more participants . . . by ensuring that additional financial resources are available to meet this contingency."[17] However, as in the case of subsections (a)(3) and (a)(4), unless the system has taken on responsibility for ensuring settlement or the counterparty exposures exceed the credit and liquidity exposures that participants are accustomed to managing in

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[13] Core Principles § 7.4.4.

[14] *See* U.C.C. § 4-214.

[15] *See* NACHA Operating Rules, Appendix 4, Part 4.1, available at http://www.achrulesonline.org/.

[16] According to NACHA statistics in 2010 there were 9.26 billion ACH debit transactions and 6.36 billion ACH credit transactions.

[17] Core Principles § 7.5.10.

other lines of business, it is neither necessary nor appropriate to require a system take on this type of responsibility. In the case of the ACH system, to do so would threaten the existence of the ACH as an alternative to costly and resource-intensive large value payment systems.

For the risk standard proposed in Section 234.3(a)(5) to make practical sense, the nature of ACH debit transactions would have to change fundamentally and the right to return the transactions would have to be abolished. Because ACH debit transactions are initiated by the receiver of the transaction and there is no means for the receiver to verify current account balances, this right is critical to protect the account-holding banks that receive ACH debit entries from the initiation of charges to their accounts that they are unable to recover from an account holder.

The foregoing comments do not suggest in any way that The Clearing House believes that the standards in proposed Sections 234.3(a)(3)-(5) are inappropriate for systemically important FMUs. To the contrary, although The Clearing House believes that these standards are at the heart of risk management for systemically important payment systems, the nature of the standards themselves demonstrates that it is inappropriate for the ACH to be designated as a systemically important FMU.

2. <u>The proposed risk management standards would exceed the statutory objectives under the DFA</u>.

The Board has requested comment on whether the proposed standards achieve the statutory objectives provided in the DFA: (1) to promote robust risk management, (2) to promote safety and soundness, (3) to reduce systemic risks, and (4) to support the stability of the broad financial system.[18] The Clearing House believes that the proposed standards would, in some cases, exceed these statutory objectives. Specifically, proposed Sections 234.3(a)(8), (9), and (10) address system operating issues that while they could, in practice, affect levels of risk are not themselves risk issues. These standards are that:

(8) The payment system should provide a means of making payments that is practical for its users and efficient for the economy.

(9) The payment system should have objective and publicly disclosed criteria for particpation, which permit fair and open access.

(10) The payment system's governance arrangements should be effective, accountable, and transparent.

While these standards may express desirable goals for payment systems generally, they do not specifically address the risks contemplated by Title VIII. For example, under Section

[18] 12 U.S.C. § 5464(b).

234.3(a)(8), any judgments as to whether or not a particular form of payment is practical or economically efficient will be highly subject and speculative when made *ex ante* and, in the longer run, must be determined by market choices. A payment system that appears to be practical and efficient on paper will not be either practical or efficient if customers will not use it. These judgments as to practicality and efficiency are better left to market forces than incorporated into risk management standards.

Similarly, under Section 234.3(a)(9), it is not clear how the criteria for access to participation in a payment system relates to the risks contemplated by Title VIII, particularly when the Federal Reserve Banks offer competing payment services that are open to all depository institutions. Payments systems can range from (a) proprietary structures designed to offer and clear a single type of payment under the terms offered by a single service provider to (b) groups of financial institutions that have organized to clear a specific type, or types, of payments among them. While the participation criteria for these systems could be an issue for competition law, it is difficult to see how criteria could directly affect the risks that such systems present to the financial system, which is the focus of Title VIII.

Section 234.3(a)(10) addresses governance. While the results of governance, in terms of the decisions made or the structure of the payment system, may directly affect the risks that a system presents, the governance structure itself does not present such risks. As noted above, payment systems include proprietary payment services and groups of institutions. They may or may not be publicly traded companies. Each type of organization will have a different governance structure designed to function for its type of organization. Again, these judgments are better left to the participants and the markets than undertaken by regulators under an expansive reading of the purposes of Title VIII.

Finally, The Clearing House is particularly attuned to the risk of adopting standards that exceed the statutory objectives of Title VIII in light of the consultative report issued by the CPSS and the International Organization of Securities Commissions ("IOSCO") in March 2011, which revises the standards applicable to systemically important payment systems, central securities depositories, securities settlement systems, central counterparties, and trade repositories.[19] The Board has indicated that it will "seek comment on the adoption of revised standards for Designated FMUs under section 805(a) of the [DFA] based on the new international standards." The revised standards include a principle for "managing general business risk." The Clearing House believes that adopting the international standards in full has the potential to encroach even further on the authority and business judgment of private-sector FMUs in areas that are not directly related to the risks posed by the FMUs and contemplated by Title VIII.

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[19] *See* CPSS-IOSCO Principles for Financial Market Infrastructures, Consultative Report (Mar. 2011), available at www.bis.org/publ/cpss94.pdf.

3. The proposed definition of materiality should be drafted more narrowly and should provide for expeditious review.

Title VIII provides for 60 days' advance notice to the applicable Supervisory Agency of proposed changes to rules, procedures, or operations that could materially affect the nature or level of risks presented by a Designated FMU. While the authority granted by this provision is broad, regulatory experience with similar prior notice requirements has shown that they can be cumbersome both for the regulator and for the regulated entity. Unless administered carefully, such requirements invite micro-management by the regulator and impair the ability of the regulated entity to respond to competition and changing market conditions. In this regard, The Clearing House believes that it is important to recognize that while, in some respects, Title VIII represents a codification of concerns that have been studied for two decades, payment systems have functioned effectively during that period, and throughout the recent global financial panic, without any such prior notice requirements.[20] Accordingly, The Clearing House believes that the prior notice requirement should be applied narrowly to ensure that the advance notice requirement proposed in Section 234.5 target only those "proposed change[s] to rules, procedures, or operations changes that could . . . materially affect, the nature or level of risks presented by the designated [FMU]."[21] Without such a narrow focus, the Board will, no doubt, be inundated with notices of proposed changes that will slow the rule review process and delay important implementations.

For example, The Clearing House believes that the Proposed Rule overreaches the statutory purpose of ensuring sound risk management by requiring advance notice of changes that "affect the performance of clearing, settlement, or payment functions *or* the overall nature or level of risk presented by the designated financial market utility."[22] The purpose of the Section 806(e) requirement is to provide the Supervisory Agencies, as defined by the DFA, with advance notice of changes to the level of risk posed by the Designated FMU. This purpose is clear from the statutorily required contents of the notice, which are codified in the Proposed Rule: (1) "the nature of the change and *expected effects on risks* to the designated [FMU], its participants, or the market," and (2) "how the designated financial market utility *plans to manage any identified risk*."[23] Changes implemented by the Designated FMU that relate to the broad category of performance, as opposed to risk, are more appropriately vetted in the

[20] Such requirements have existed for securities and for commodities clearing systems prior to enactment of the Commodity Futures Modernization Act.

[21] 12 U.S.C § 5465(e)(1)(A).

[22] Proposed Rule § 234.5(c)(1) (emphasis added).

[23] *See* 12 U.S.C. § 5465(e)(1)(C) and Proposed Rule § 234.5(a)(2) (emphasis added).

competitive marketplace. The Clearing House believes that the language relating to the "performance of clearing, settlement, or payment functions" should be deleted from the final rule.

Accordingly, The Clearing House believes that the Board should adopt a narrower definition of materiality that targets, as required by statute, only those categories of change that materially and significantly affect the nature and level of risk presented by the Designated FMU. The Proposed Rule identifies at least two categories of changes that would materially affect the nature or level of risks presented that may have nothing to do with risk at all. Changes affecting the "scope of services" may not be risk-based changes. More likely, such changes are intended to improve participant experience or competitive position. The Clearing House believes that it is beyond the scope of systemic risk regulation, as contemplated in the DFA, for the Board to force a delay in implementing business-related changes; particularly in a competitive market in which the Federal Reserve Banks offer the competing alternative. In addition, as discussed above, changes affecting "governance" may not be risk-based changes. Judgments concerning governance rules, procedures, or operations are better left to the participants and the markets than regulators.

Finally, even within these limitations, The Clearing House believes that the term "materially" is subject to widely differing interpretations. Title VIII is intended to address systemic risks. Most changes in levels of risk to individual institutions will not affect the overall stability of critical markets, financial institutions or the broader financial system. The Clearing House believes that the Board should interpret the term "materially" narrowly so as to only require prior review of truly significant changes. Similarly, The Clearing House believes that the corresponding exclusion in Section 234.5(c)(3)(ii) should be applied broadly.

Even if the Board interprets the term "materially" narrowly, there would be changes to rules, procedures, or operations where there is uncertainty as to the need for prior review. The Proposed Rule provides for a 60-day review period and, with respect to proposed changes that raise novel or complex issues, the Board may extend the review period for an additional 60 days. Moreover, the Proposed Rule provides that the Board may require the Designated FMU to provide additional information, after which the Board has 60 days to review the additional information. Delaying the implementation of changes from 60 to 180 days unduly prolongs the change process unless the change poses truly systemic concerns.

To speed the review period for changes that are not truly of systemic concern, The Clearing House believes that an expedited review to determine whether a full 60-day or longer review is necessary. The Board should provide a 10-day period in which it would make an initial determination as to whether a proposed change is material. If the Board determines that a proposed change is not material, it would notify the FMU and the 60-day review period would not apply. We believe that this process will both ease the Board's burden of reviewing

Designated FMU rule changes and speed Designated FMUs' time to market with product and service enhancements that do not materially affect the nature or level of risk presented by the Designated FMU.

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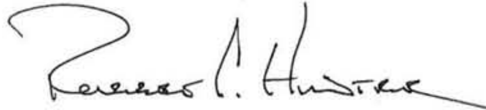
Thank you for your consideration and review of our comments. If you have any questions or wish to discuss The Clearing House's comments, please do not hesitate to contact me at (336) 769-5314.

Yours very truly,



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