The Clearing House
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April 25, 2013

Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Robert deV. Frierson, Esq.
Secretary

Re: Docket No. R-1455
RIN No. 71-AD 94
Regulation HH—Accounts for Financial Market Utilities

Governors:

The Clearing House Payments Company L.L.C. ("The Clearing House")[1] is pleased to comment on the Federal Reserve Board's ("Board") proposal[2] to amend its Regulation HH[3] to implement the provisions of section 806(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[4] Section 806(a) provides that the Board may authorize a Federal Reserve Bank to establish an account for a financial market utility ("FMU") that has been designated as systemically important by the Financial Stability Oversight Council ("FSOC") and provide specified priced services to the FMU "subject to any applicable rules, orders, standards, or guidelines prescribed by the Board." The Clearing House has been designated as systemically important by FSOC on the basis of its operation of the Clearing House Interbank Payments System ("CHIPS"®).[5]

[1] Established in 1853, The Clearing House is the United States' 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 Clearing House 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 automated clearing-house, funds transfer, and check-image payments made in the U.S. Its affiliate, The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers, the interests of its member banks on a variety of systemically important banking issues. See The Clearing House's web page at www.theclearinghouse.org.

[2] 78 Fed. Reg. 14,024 (Mar. 4, 2013).

[3] 12 C.F. R. pt. 234.

[4] 12 U.S.C. § 5465(a).

[5] *See*, Financial Stability Oversight Council, *2012 Annual Report* at 145.

The Clearing House Association L.L.C. : 450 West 33rd Street : New York, NY 10001
Phone 212.613.0100 : Fax 212.613.0184 : www.theclearinghouse.org

Under the proposed rule an FMU would apply for an account, and the Board would authorize the appropriate Reserve Bank to open the account subject to any restrictions, limitations, or requirements that the Board may impose on the account or Reserve Bank's provision of services.[6] The Reserve Bank would have an on-going obligation to ensure that the arrangement does not create undue credit, settlement, or other risks.[7]

In order to qualify for Reserve Bank accounts or services, an FMU must, in the Reserve Bank's judgment:

(1) be in generally sound financial condition;

(2) be in compliance with all requirements regarding financial resources, liquidity, participant default management, and other aspects of risk management;

(3) be in compliance with all Federal Reserve orders and policies, operating circulars, and other requirements regarding Reserve Bank accounts and services; and

(4) demonstrate on-going ability to meet all of its obligations under its agreement with the Federal Reserve, even in cases of market stress or participant default.[8]

In addition the Board or Reserve Bank may "request" that the FMU provide information or verification of compliance with conditions imposed on the account,[9] and the Board will consult with the FMU's primary supervisor (which may be the Board itself) before authorizing the account and afterward to ensure compliance with mandatory conditions.[10]

Reserve Banks will reserve the right to close the account.[11] Because FMUs do not have regular access to the discount window, daylight overdrafts will not usually be permitted, and FMUs must have the resources to promptly repay any inadvertent daylight overdrafts in its account.[12]

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[6] Proposed 12 C.F.R. § 234.6(a)

[7] *Id.* § 234.6(b)

[8] *Id.*

[9] *Id.* § 234.6(c).

[10] *Id.* § 234.6(d).

[11] *Id.* § 234.6(e).

[12] 78 Fed. Reg. at 14,025-26.

The Board also proposes that accounts for FMUs will earn interest, generally at the rate that depository institutions earn on their Reserve Bank accounts.[13]

SUMMARY

The Clearing House suggests that the Board's proposal should be revised to address the following issues:

1. The proposed sharing of confidential supervisory information about FMUs with the business operations of the Federal Reserve Banks is unacceptable. The Board should keep this information confidential and instead certify to the Reserve Banks that the FMUs are in compliance with applicable standards and requirements.

2. The Board should declare that any accounts established under Regulation HH are covered by the safe harbor of 12 U.S.C. § 4405.

3. Federal Reserve Bank accounts should not be mandatory for FMUs.

The Clearing House also believes that the provisions of proposed Regulation HH regarding the payment of interest appear reasonable.

DETAILED COMMENTS

1. The proposed sharing of confidential supervisory information about FMUs with the business operations of the Federal Reserve Banks is unacceptable. The Board should keep this information confidential and instead certify to the Reserve Banks that the FMUs are in compliance with applicable standards and requirements.

The Board states that the purpose of the provisions it has proposed is to "facilitate the use of Reserve Bank accounts and services by a designated FMU in order to reduce settlement risk and strengthen settlement processes, while limiting the risk presented by the designated FMU to the Reserve Banks."[14] In particular, "the proposed terms and conditions are designed to provide the Federal Reserve with sufficient information to assess a designated FMU's ongoing condition as it pertains to the FMU's ability to settle promptly and to manage its settlement process and Reserve Bank

[13] Proposed 12 C.F.R. § 234.7.

[14] 78 Fed. Reg. at 14,025.

account(s) safely."[15] Thus the Board's proposal clearly contemplates that sensitive supervisory and financial information concerning an FMU would be freely provided to the Reserve Bank.

This aspect of the proposal creates serious difficulties for FMUs. The Federal Reserve Banks are significant providers of financial services to banks and other financial institutions. In 2011 the Federal Reserve Banks earned $478.6 million from these services.[16] This is of particular concern to The Clearing House because the Reserve Banks' service offerings directly parallel the services that The Clearing House offers to its member banks and other financial institutions, with the Fedwire funds-transfer service competing with CHIPS®, and FedACH competing with The Clearing House's Electronic Payments Network. The Clearing House and the Reserve Banks are extremely competitive, with relatively close market shares for each of these services. Because of these facts, The Clearing House regards the Federal Reserve Banks as its primary competitors.

Since we have been designated as systemically important, our relationship with the Federal Reserve has changed dramatically. We now have a full-time team of examiners who are privy to every detail of our operations: they see minutes of all meetings, meet regularly with senior management, and have access to all financial statements as well as our strategic business plans—all of which would be of great value to our competitors. We can share all of this very sensitive information with our examiners because the Board has provided assurances that the information will not be shared with our competitors at the Reserve Banks. The Board is now proposing to breach this confidence—to share confidential exam materials with the commercial side of the Reserve Banks so that they can "assess" our "ongoing condition" and determine whether they wish to continue to hold an account for us or provide financial services. While it may seem that the account services of the Reserve Banks are a very different line of business from the Reserve Banks' payment services like Fedwire, that is not in fact the case. If The Clearing House were to open a Reserve Bank account to manage our CHIPS® settlement, we would have to use Fedwire to pay the participants with a positive final position—indeed, we use Fedwire for that purpose today. Thus the Reserve Banks' Wholesale Product Office, which operates Fedwire, could have access to our examination information under the Board's proposal.

This is unacceptable. Confidential examination material should never be shared with the examinee's competitors—there can be no exceptions to this rule. Instead of sharing confidential information, the Board should do its own evaluation of an FMU and then certify to the Reserve Bank that the FMU meets all of the requirements set out in

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[15] *Id.*

[16] Board of Governors of the Federal Reserve System, *98th Annual Report, 2011* at 135.

the Board's rule and also meets whatever conditions that the Board has imposed on the FMU's access.

2. The Board should declare that any accounts established under Regulation HH are covered by the safe harbor of 12 U.S.C. § 4405.

As noted above, the purpose of providing Reserve Bank accounts and services to FMUs is to "reduce settlement risk and strengthen settlement processes."[17] The Reserve Banks have, of course, provided settlement services to payment systems and other "settlement arrangements" for decades and have offered accounts to these arrangements as part of the settlement service. If the payment system is not itself organized as a bank or other institution eligible for Reserve Bank accounts, the settlement account is typically structured as an account held by the Reserve Bank for the joint benefit of the "settlers," and the payment system designated as the "settlement agent" having exclusive authority to give the Reserve Bank instructions regarding the account.[18] Under this arrangement, the balance of the account is not an asset of the payment system or settlement agent, but the Reserve Bank's obligation to pay the settlers.

If the payment system obtains a direct Reserve Bank account, that account will be an obligation of the Reserve Bank to pay the balance of the account to the payment system, and thus the payment system's asset. This could significantly increase risk to the settlement arrangement by making the balance in the account subject to garnishment, attachment, and similar actions on the part of the system's creditors—actions that could seriously disrupt the settlement process. In addition, with the settlement account an asset of the payment system operator, the payment system would have to hold credit balance accounts for the system's participants, which would represent the system's liability to the participants, and the balance of those credit balance accounts would then be subject to garnishment, attachment, and similar actions on the part of the participants' creditors—actions that could also disrupt the settlement process.

In order to eliminate this concern, the Board should state as part of Regulation HH that any accounts covered by the regulation (and the corresponding credit balance accounts that the FMU would hold for the participants) would be exempt from garnishment, attachment, or similar process because any such action would amount to a "stay, injunction, avoidance, moratorium, or similar proceeding or order" that would "limit or delay application of otherwise enforceable netting contracts" and thus prohibited under 12 U.S.C. § 4405. Without this kind of assurance, few if any FMUs will want to shift to these accounts.

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[17] 78 Fed. Reg. at 14,025.

[18] *See, e.g.,* Federal Reserve Bank Operating Circular No. 12, §§ 3.1, 6.1.

3. Federal Reserve Bank accounts should not be mandatory for FMUs.

As pointed out in the previous section, payment systems and other settlement arrangements have managed without their own Reserve Bank accounts for decades. Settlement accounts are held in the name of the banks that are the payment systems' settlers, and that arrangement provides certain legal protections for payment systems and their participants. Because of this, FMUs should not be forced to shift the current arrangements to their own accounts under Regulation HH. While there is nothing in the Federal Register notice to indicate that the Board or Reserve Banks will try to force FMUs to make the conversion to Regulation HH accounts, the Board should be clear when it publishes its final rule that there is no intention to require FMUs to shift current arrangements to the new Regulation HH accounts.

4. The provisions of proposed Regulation HH regarding the payment of interest appear reasonable.

Proposed section 234.7 of Regulation HH would allow the Reserve Banks to pay interest on balances maintained by an FMU at the same rate paid to depository institutions or at another rate authorized by the Board. This provision merely implements the provision of section 806(c) that "[a] Federal Reserve Bank may pay earnings on balances maintained by or on behalf of a designated financial market utility in the same manner and to the same extent as the Federal Reserve Bank may pay earnings to a depository institution under the Federal Reserve Act."[19] This provision appears reasonable, and The Clearing House supports it.

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We hope these comments are helpful. If you have any comments, please contact me at 212-612-9234 or joe.alexander@theclearinghouse.org.

Very truly yours,

Joseph R. Alexander
Senior Vice President, Deputy
General Counsel, and Secretary

[19] 12 U.S.C. § 5465(c).