

March 31, 2014

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

Re: Docket No. R-1477, RIN No. AD 7100 AE-09  
Regulation HH

Docket No. OP-1478  
Policy on Payment System Risk

Governors:

The Clearing House Payments Company L.L.C. (“PaymentsCo”) and The Clearing House Association L.L.C. (“Association” and, together with PaymentsCo, “The Clearing House”)<sup>1</sup> are pleased to comment on the Board’s proposals to (i) amend its Regulation HH,<sup>2</sup> which, among other things, sets risk-management standards for financial market utilities (“FMUs”) that have been designated as systemically important by the Financial Stability Oversight Council (“FSOC”) under section 804 of the Dodd-Frank Act<sup>3</sup> and (ii) amend its Policy on Payment System Risk (“PSR Policy”),<sup>4</sup> which applies to other payment systems (such as Fedwire) that the Board regards as systemically important. In both cases, the Board proposes to adopt the *Principles for Financial Market Infrastructures* (“PFMI”), which were adopted in 2012 by the Bank for International Settlements’ Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”).<sup>5</sup> The PFMI were conceived as a successor to a number of standards that had been adopted over the years, including CPSS’s *Core Principles for Systemically Important*

---

<sup>1</sup> 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. Its affiliate, 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 automated-clearing-house, funds-transfer, and check-image payments made in the United States. See The Clearing House’s web page at [www.theclearinghouse.org](http://www.theclearinghouse.org) for additional information.

<sup>2</sup> 79 Fed. Reg. 3666 (Jan. 22, 2014) (proposing to amend 12 C.F.R. pt. 234).

<sup>3</sup> 12 U.S.C. § 5463.

<sup>4</sup> 79 Fed. Reg. 2838 (Jan. 16, 2014).

<sup>5</sup> The PFMI are available at <http://www.bis.org/publ/cpss101a.pdf>.

*Payment Systems* (“Core Principles”),<sup>6</sup> which forms the basis of the standards that the Board previously adopted for Regulation HH and the PRS Policy.

The Clearing House has a significant interest in these proposals. PaymentsCo has been designated as a systemically important FMU by FSOC by reason of its operation of the Clearing House Interbank Payments System (“CHIPS”)<sup>7</sup> and is thus subject to Regulation HH. PaymentsCo and its predecessors have operated CHIPS continuously since 1970, making CHIPS one of the oldest funds-transfer systems operating and The Clearing House one of the world’s most experienced funds-transfer system operators. The Clearing House pioneered many of the risk-control measures that have become standard throughout the world, including bilateral net credit limits (1984), sender net debit caps (1985), and a collateralized loss-sharing arrangement to ensure settlement even if the participant with the highest net debit cap were to fail suddenly at its highest possible net debit position (1990). CHIPS was compliant with the Lamfalussy standards, the first international standards on payment-system risk, before the Lamfalussy Report<sup>8</sup> was issued, and since then, CHIPS has moved beyond these standards to provide real-time final settlement to all payment messages that it releases.

Our comments are thus informed by more than 40 years’ experience in successfully operating a high-value funds-transfer system and dealing with all of the risk-control issues that arise from managing such systems. This experience has led The Clearing House to consistently support well-thought-out international standards for managing the risks that arise from the operation of public- or private-sector financial market infrastructures.

## SUMMARY

1. In general, The Clearing House supports the proposed amendments to Regulation HH and the PSR Policy. Nonetheless, we recommend that certain of the principles be revised or eliminated.

2. There are serious difficulties with the Board’s proposed Principle 19—tiered-participation arrangements.

(a) The proposal misapprehends the relationship between an FMU’s participants and their correspondent banking customers.

---

<sup>6</sup> Available at <http://www.bis.org/publ/cpss43.pdf>.

<sup>7</sup> *FSOC 2012 Annual Report* at 146-50, available at <http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2012%20Annual%20Report.pdf>. CHIPS transmits and settles payment orders in U.S. dollars for some of the largest and most active banks in the world. On an average day, CHIPS transmits and settles over 400,000 “payment messages” worth an aggregate of \$1.51 trillion. It has been estimated that CHIPS carries a very high percentage of all international interbank funds transfers that are denominated in U.S. dollars.

<sup>8</sup> *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (Nov. 1990).

(b) The Board has not adequately articulated the risks that these relationships pose to an FMU.

(c) Correspondent relationships of CHIPS participants do not present any risk to CHIPS, other CHIPS participants, or to PaymentsCo.

(d) PaymentsCo is not a self-regulatory organization. Any regulation of the relationship between a CHIPS participant and its customers should be done by bank supervisors, not PaymentsCo.

(e) Principle 19 raises serious conflict-of-interest issues and would require substantial and costly efforts to shield aggregate data to avoid antitrust concerns for a bank-owned organization.

(f) If the Board wishes to capture true tiered-participation arrangements, it should amend the rule to limit its application to participants that are actual participants of the FMU.

3. Principle 15—General business risk

(a) The Clearing House generally supports the proposed requirement that FMUs identify, monitor, and manage general business risk. We also support the requirement that FMUs plan for orderly resolution and wind down, but believe that these should take into account viable alternatives to an FMU's services.

(b) The required capital plan should be reviewed every three years rather than annually.

(c) The liquid-assets requirement also appears generally reasonable, but should be clarified to remove unnecessary expenses.

(d) The requirement for equity capital requires clarification.

4. Principle 2—Governance

(a) The Clearing House generally supports the Board's proposals on governance. However, we do not support a requirement that an FMU support "other public interest considerations," and do not support a requirement that the board have one or more public-interest directors.

5. Principle 23—Disclosure of rules, key procedures, and market data.

(a) The Clearing House generally supports public disclosure of key rules and procedures.

(b) The Clearing House strongly opposes requiring private-sector FMUs to disclose their prices publicly.

6. Principle 22—Communication procedures and standards

(a) The Clearing House supports this principle as currently outlined in the Board’s proposal.

7. Principle 21—Efficiency and effectiveness

(a) The Clearing House believes that the Board has not given sufficient weight to market judgments regarding an FMU’s efficiency and effectiveness.

8. Effective dates

(a) If the Board adopts the proposal without change, it must delay the effective date until 18 months after publication of the final rule in the Federal Register.

#### DETAILED COMMENTS

**1. In general, The Clearing House supports the proposed amendments to Regulation HH and the PSR Policy. Nonetheless, we recommend that certain of the principles be revised or eliminated.**

As noted at the outset of this letter, The Clearing House supports reasonable, well-thought-out international standards for both private- and public-sector financial market infrastructures. As the Board notes, most of the principles that are set out in the PFMI have been carried over from the Core Principles, which The Clearing House has strongly supported in the past,<sup>9</sup> and which CHIPS has consistently observed over the years.<sup>10</sup>

Many of the changes that the PFM<sup>11</sup> makes are useful clarifications of existing practice. Other changes, for example the requirement to maintain sufficient liquid assets and the requirement that an FMU develop and maintain plausible recovery and wind-down plans, appear to be reasonable.<sup>11</sup> Some clarification would be in order, and

---

<sup>9</sup> See, e.g., comment letter of The Clearing House Association L.L.C. on the Board’s proposal to adopt the Core Principles for its PSR Policy (Jul. 27, 2004).

<sup>10</sup> See, e.g., CHIPS self-assessment under the Core Principles, available at <https://www.theclearinghouse.org/~media/Files/Payco%20Files/CHIPS%20Core%20Principles%20Self%20Assessment.pdf>.

<sup>11</sup> But see below at pages 14-15 for our thoughts on how that requirement should be calculated.

certain of the burdens associated with managing that policy could be reduced. Other proposals, however, are ambiguous about what would actually be required; the current wording could be interpreted in ways that would result in unnecessary burdens or seem to be aimed at risks that either do not exist or exceed the scope of the Board's authority under Title VIII of the Dodd-Frank Act. This is particularly true for Principle 19—Tiered-Participation Arrangements.

One problem that runs throughout the proposal is that it is one uniform set of standards that are to be applied to all designated FMUs, however disparate those may be. While the Board notes that certain of the principles apply only to certain kinds of FMUs (e.g., Principle 14 applies only to central counter parties), this does not take into account material differences that can be found among the same kinds of systems.

The balance of this letter will provide comments on individual principles.

2. **There are serious difficulties with the Board's proposed Principle 19—tiered-participation arrangements.**
  - (a) **The proposal misapprehends the relationship between an FMU's participants and their correspondent banking customers.**

Proposed 12 C.F.R. § 234.3(a)(19) provides that

[a] designated financial market utility identifies, monitors, and manages the material risks to the designated financial market utility arising from arrangements in which firms that are not members in the designated financial market utility rely on the services provided by direct participants to access the designated financial market utility's payment, clearing, or settlement facilities.

The proposed regulation itself does not define the term *direct participant* or explain what kind of relationships are intended to be covered by this rule, but the Federal Register notice explains that “[t]iered participation arrangements occur when other firms (indirect participants) rely on the services provided by direct participants to use the designated FMU's central payment, clearing, or settlement facilities.” Because

[i]ndirect participants are not bound by the rules of the designated FMU, but their transactions are cleared or settled through the FMU by way of a direct participant that has a contractual relationship with the FMU . . . the transactions of indirect participants may pose credit, liquidity, operational, and other risks to the FMU . . . , these risks can affect the safety and soundness of the FMU and pose systemic risk to other market participants and FMUs.<sup>12</sup>

---

<sup>12</sup> 79 Fed. Reg. at 3684.

The proposed rule does not explain what an FMU must do to meet the requirements, but the Federal Register notice makes some suggestions: “a designated FMU can set expectations in its membership agreements with its direct participants regarding information on transactions undertaken on behalf of their customers in order to evaluate the proportion of customer business relative to the direct participant’s proprietary business.”<sup>13</sup>

These contract provisions are designed to allow the FMU to require some fairly extensive information collection from participants:

In order to determine whether it faces material risks arising from tiered participation, a designated FMU could gather basic information on indirect participants in order to identify (a) the proportion of activity that direct participants conduct on behalf of indirect participants, (b) direct participants that act on behalf of a material number of indirect participants, (c) indirect participants with significant volumes or values of transactions in the system, and (d) indirect participants whose transaction volumes or values are large relative to those of the direct participants through which they access the FMU. A designated FMU’s analysis would also benefit from identifying material dependencies between direct and indirect participants that might affect the FMU. For example, the FMU could determine whether a large proportion of the transactions processed by the designated FMU originates from indirect participants and, as a result, creates a material dependency on the operational or financial performance of a few direct participants.<sup>14</sup>

In our letter commenting on the PFMI as originally proposed by CPSS and IOSCO, we noted our opposition to treating bank customers as “indirect participants” of an FMU simply because the bank may execute a customer’s order by sending a corresponding payment order through the FMU:

A bank (other than a beneficiary’s bank) that receives a funds-transfer payment order from a customer will execute that payment order by sending a corresponding payment order to another bank, either the beneficiary’s bank or a subsequent intermediary bank. In doing this, the bank will have a number of options, and the choice of a particular FMI will be based on a number of factors that may change from time to time, even minute to minute. In any case, the risk to the bank arises not from its participation in an FMI, but from its correspondent relationship, and banks have evolved techniques for dealing with this risk, including balance checks and explicit evaluations of their customers’ creditworthiness.

---

<sup>13</sup> *Id.* at 3684-85.

<sup>14</sup> *Id.* at 3685.

On the receipt side, receiving banks or their customers may expect to receive payments from other banks through an FM or otherwise, and failure to receive a payment may cause problems for the customers. Nevertheless, payments fail every day for reasons that are largely unrelated to the FMI (e.g., insufficient balances or credit lines, violations of economic-sanctions laws, attachment or garnishment,) and it follows therefore that an FMI should not intervene in these relationships.<sup>15</sup>

Unfortunately, these problems were not corrected in the final PFMI, and the Board's proposal appears to perpetuate these problems, especially as evidenced by the reference noted earlier to "information on *transactions undertaken on behalf of their customers* in order to evaluate *the proportion of customer business relative to the direct participant's proprietary business*" (emphasis added).

There are serious difficulties in treating ordinary correspondent banking relationships as tiered-participation arrangements and subjecting them to the kinds of regulatory controls that the proposal contemplates.

First, the proposal seriously misapprehends the relationship between an FMU, its participants, and their customers. On CHIPS, our participants' customers do not have any kind of access to CHIPS, and we categorically reject the notion that these customers should in any way be classified as participants—even "indirect" participants—of CHIPS. Rather CHIPS participants use CHIPS, along with Fedwire and SWIFT and other systems to execute their customers' payment orders. The choice of which payment system to use (or indeed whether any payment system should be used) is almost always at the discretion of the bank, not the customer, and the FMU has no say in that matter.

While the Board acknowledges that "there are limits to the extent to which a designated FMU can influence direct participants' commercial relationships with their customers," it goes on to say that "the FMU should not ignore risks that can significantly affect its operations"<sup>16</sup> without specifying how these relationships could give rise to any risk to an FMU.

**(b) The Board has not adequately articulated the risks that these relationships pose to an FMU.**

In its justification for this rule, the Board states that tiered-participation arrangements "*may pose credit, liquidity, operational, and other risks to the FMU,*" and that if these risks are not effectively managed, they "*can affect the safety and*

---

<sup>15</sup> Clearing House comment letter on CPSS-IOSCO *Consultative Report on Principles for Financial Market Infrastructures* at 10 (Jul. 28, 2011).

<sup>16</sup> 79 Fed. Reg. at 3684.

soundness of the FMU and pose systemic risk to other market participants and FMUs.”<sup>17</sup> The Board’s solution to this problem is to suggest information-collection requirements that will be very burdensome to both FMUs and their participants—and, as noted below, may result in the disclosure to competitors of very sensitive competitive information that has never before been collected. Yet the Board’s descriptions of the potential risks that these information collections are designed to uncover are extremely vague:

- “material dependencies between direct and indirect participants that *might affect* the FMU,”
- “material dependency on the operational or financial performance of a few direct participants,”
- “the dependencies and risk exposures inherent in tiered-participation arrangements *can present risks* to the designated FMU and its smooth functioning and the broader financial markets.”<sup>18</sup>

There is no effort, however, to demonstrate how these supposed risks could actually affect an FMU or its participants. Compare this to our own analysis, below, which is based on a concrete analysis of how CHIPS operates and how these participants interact with their customers, and demonstrates that there is no risk to CHIPS, CHIPS participants, or PaymentsCo.

**(c) Correspondent relationships of the CHIPS participants do not present any risk to CHIPS, other CHIPS participants, or to PaymentsCo.**

We do not believe that CHIPS, CHIPS participants, or PaymentsCo bear any significant risk from our participants’ relationships with their correspondent customers.

Many large CHIPS participants have extensive correspondent networks and can execute payment orders using book transfers that do not go through CHIPS or any other system. This is not a risk to CHIPS, but is a strength of the payment system as a whole because it provides for alternative routing and avoids concentration risk. Furthermore, there is natural de-risking evident in these extensive correspondent networks because all of the major bank that are not CHIPS participants typically maintain correspondent relationships with three or more CHIPS participants and, as a normal course of business, allocate their volume among those participants, minimizing any meaningful concentration risk.

Both statute<sup>19</sup> and most correspondent-banking agreements give CHIPS participants a great deal of leeway in how they execute their correspondent customers’

---

<sup>17</sup> *Id.* at 3684.

<sup>18</sup> *Id.* at 3685 (emphasis added).

payment orders, including the choice of funds-transfer system. The participants are under no obligation to use CHIPS and will use any system—or no system—in an effort to route the payment through the most efficient means.

The fact that participants use CHIPS to execute their customers' payment orders does not present any risk to CHIPS because the method for determining a participant's opening position requirement is based on all of the bank's volume through CHIPS. This requirement is recalculated weekly and therefore takes account of changes in volume and captures all of the payment orders that the bank is sending on behalf of all of its customers and on its own behalf. The liquidity requirements of the system resulting from customer transactions are incorporated into the calculation and no additional information on the bank's relationships is required to manage risks to CHIPS or its participants.

Moreover, CHIPS participants are well aware of the risks that they run from the potential failure of another CHIPS participant. CHIPS regularly conducts liquidity risk simulations in which various stress scenarios test the potential failure of one or more banks to meet their funding obligations, and the results of these scenarios are shared with individual participants so that they can see which payments would not be made as a result of the failure, including payments made in execution of customer payment orders. In other words, CHIPS participants know that they and other CHIPS participants use CHIPS to execute their customers' payment orders and can anticipate the risks that might arise from that fact.

**(d) PaymentsCo is not a self-regulatory organization and should not interfere with CHIPS participants' relations with their customers.**

PaymentsCo is not a self-regulatory organization that exercises regulatory authority over its members, and nothing in Title VIII indicates that designation as a systemically important FMU is intended to convert a designated firm into one.

CHIPS provides a medium for banks to send payment orders on their own behalf or to execute payment orders received from their customers and provides a mechanism for settlement of the sender's obligation to pay the amount of the payment order to the receiving bank. PaymentsCo does not incur any credit or liquidity risk from any participant in any of its payment services and thus incurs no risk from the relationships that the participants have with their customers.

PaymentsCo is not—and should not be—in any position to govern or interfere with the relationship between a CHIPS participant and its customers. CHIPS participants are responsible for managing their relationships with their customers, including setting reasonable credit limits to ensure that the customers have the liquidity to allow the participants to execute the payment orders they receive from the customers in a timely

---

<sup>19</sup> See U.C.C. § 4A-302.

fashion. Whether these facilities are being extended in a responsible manner is not something that PaymentsCo is in a position to judge, and it would not be appropriate for PaymentsCo to interfere with its CHIPS participants' relationships with their customers. The participants' supervisors are in a better position to regulate these relationships, and it is clear that the supervisors can and do review these relationships and insist on responsible risk management on the part of the banks they regulate.

**(e) Principle 19 raises serious conflict-of-interest issues and would require substantial and costly efforts to shield aggregate data to avoid antitrust issues for a bank-owned organization.**

As noted above, the proposal contemplates that an FMU will

gather basic information on indirect participants in order to identify (a) the proportion of activity that direct participants conduct on behalf of indirect participants, (b) direct participants that act on behalf of a material number of indirect participants, (c) indirect participants with significant volumes or values of transactions in the system, and (d) indirect participants whose transaction volumes or values are large relative to those of the direct participants through which they access the FMU.<sup>20</sup>

These data would give an FMU a complete picture of each participant's relationship with its most important customers. But given the critical role that the proposed rule gives to the board of directors in the FMU's risk management,<sup>21</sup> it is clear this information will have to be made available to the board and that the board will have to be involved in analyzing the data and making decisions based on that analysis. Consequently, when the board is made up of representatives of the member banks, those banks will acquire information on each other's most significant relationships, raising significant conflict-of-interest and antitrust risks, unless we endeavor to aggregate or otherwise mask data, which may undermine what the Board is trying to accomplish in making an FMU's board of directors responsible for supervising the FMU's risk management.

Principle 19 also appears to require FMUs to encourage indirect participants who are large relative to their direct participants to move to a larger direct participant or become direct participants themselves. But considering that the banks that would be normally be considered large enough to manage these relationships are all PaymentsCo members and that banks that would normally be considered too small to manage at least some of these relationships are likely to be nonmembers, compliance with this requirement could appear to third parties as an effort by an FMU to favor its owner banks, which might raise some risk of costly antitrust litigation inappropriately

---

<sup>20</sup> 79 Fed Reg. at 3685.

<sup>21</sup> See proposed 12 C.F.R. § 234.3(a)(2); 79 Fed. Reg. at 3670-72.

challenging the FMU's efforts to comply with the regulation. Even absent those antitrust considerations, this requirement certainly presents serious conflicts of interest for the operator of a bank-owned system.

Encouraging direct participation by our participants' larger customers would not necessarily be a better option as these relationships may pose their own risks that will have to be identified and managed.

- (f) If the Board wishes to capture true tiered-participation arrangements, it should amend the rule to limit its application to banks that are actual participants of the FMU.**

The Clearing House recognizes that there may be risks that arise from situations in which a participant relies on another bank for settlement. But even in these cases, the risk can be mitigated by restricting the settling bank's ability to withdraw its agreement to settle or requiring the nonsettling participant to have back-up settlement arrangements.

If the Board wishes to capture these kinds of arrangements, we suggest that it replace the current language dealing with direct and indirect participants with language such as this:

*Tiered-participation arrangements occur when some financial institutions ("indirect" or "nonsettling" participants) have access to the FMU infrastructure for sending and receiving payment orders or other transactions, but rely on the services of other participants ("direct" or settling" participants) for settlement of those transactions.*

*In practice, this would describe a situation in which an indirect or nonsettling participant would be known by the FMU, would have an agreement binding it to the FMU's rules, and would often have a direct connection to the FMU. This would be in contrast to the situation in which a financial institution sends payment orders to another bank that is a FMU's participant expecting that the participant may execute its payment orders by sending them through the FMU. In these cases, the participant's financial institution customer is not known by and has no legal obligation to the FMU. In cases such as this, the participant's customer is not considered to be an indirect participant, and these situations are not intended to be covered by Principle 19.*

- (g) We oppose the adoption of Principle 19 as currently drafted.**

For these reasons, we believe that proposed section 234.3(a)(19) is overbroad, imposes unnecessary burdens, and attempts to solve a problem that does not exist. We strongly urge the Board not to adopt it as currently drafted.

- (h) Questions on Principle 19**

*Q.19.1. What, if any, risks do tiered participation arrangements pose to a payment system? How would a payment system assess these risks?*

Systems like CHIPS that do not extend credit to their participants and regularly recalculate their participants' liquidity requirements based on actual transaction flows do not face any risk from tiered-participation arrangements.

*Q.19.2. What types of information would be helpful to assess the risks posed by indirect participants to a designated FMU? Is it feasible for a payment system to collect this information?*

If the system does not face any risks from so-called indirect participants, there should be no need to collect information on these arrangements.

*Q.19.3. How, if at all, should the Board define the threshold for identifying indirect participants responsible for a significant proportion of transactions processed by the designated FMU?*

The Board should make it clear that it agrees that systems that do not extend credit to their participants and regularly recalculate their participants' liquidity requirements based on actual transaction flows do not face any risk from tiered-participation arrangements.

*Q.19.4. How, if at all, should the Board define the threshold for identifying indirect participants whose transaction volumes or values are large relative to the capacity of the direct participants through which the indirect participants access the designated FMU?*

Before identifying any threshold for "indirect participant" transaction volume, the Board should first determine whether these arrangements present any real risk to a payment system. As noted, the Board should determine that systems that do not extend credit to their participants and regularly recalculate their participants' liquidity requirements based on actual transaction flows do not face any risk from tiered-participation arrangements. Such systems should not be required to establish thresholds.

*Q.19.5. How often should a designated FMU review the potential risks from tiered participation arrangements?*

An FMU that does not bear any risk from its participant's or their customers has no risk from tiered-participation arrangements and should not be expected to review the nonexistent risks on any schedule.

### 3. Principle 15—General business risk

Proposed section 234.3(a)(15) provides that an FMU must identify, monitor, and manage the risks of loss arising from its business that are not related to participant default, including losses from poor business strategy, ineffective operations, operating expenses, and other risks, including legal risk. As part of the requirement, an FMU must maintain at a minimum, sufficient liquid net assets funded by equity to cover the greater of (i) the cost to implement its recovery or orderly wind-down plan to address general business losses, and (ii) six months of current operating expenses.

The proposal also requires an FMU to hold equity in the form of common stock, disclosed reserves, and other retained earnings, that is at all times greater than or equal to the required amount of unencumbered liquid financial assets. An FMU must have a capital plan for raising equity in case its capital falls below minimum levels.

Finally, an FMU must have plans for recovery from general business losses and orderly wind down should recovery not prove feasible.

- (a) The Clearing House generally supports the proposed requirement that FMUs identify, monitor, and manage general business risk. We also support the requirement that FMUs plan for orderly resolution and wind down, but believe that these should take into account viable alternatives to an FMU's services.**

We agree that FMUs should understand what risks they face and should undertake steps to monitor and manage those risks. We also agree that FMUs should have robust recovery and wind-down plans in place in case they do face serious financial reversals. It is important, however, that these plans be calibrated to take into consideration the existence of viable alternatives should recovery or wind down be required (e.g., Fedwire as a substitute for CHIPS). A requirement that recovery and wind-down plans ignore a basic fact would be unrealistic and overly burdensome to the FMU.

- (b) The requirement for a capital plan should be reviewed every three years rather than annually.**

Proposed section 234.3(a)(15)(iii) provides that an FMU must maintain “a viable plan, approved by the board of directors and updated at least annually, for raising additional equity before the designated financial market utility's equity falls below the amount required” to ensure recovery or orderly wind down.

We do not believe that it is necessary for the board to review the capital plan annually. In the absence of material changes to the capital position of the FMU or materially changed circumstances in the capital markets, the rote review of the plan would serve no useful purpose. The plan should, of course, be reviewed whenever

there is any material change in the FMU's financial position, or if material changes in capital markets would require material changes in the plan. Except in those circumstances, it should be sufficient for the board to review the plan every three years.

One important aspect of any plan for raising capital will be to seek additional capital contributions from the owners. For bank-owned systems, this can present a problem in that the banks may be required to obtain permission from their primary supervisors, which may not be forthcoming or which may take a significant amount of time to obtain.

When becoming owners of an FMU, banks usually have to obtain permission from their supervisors, which will often condition approval on limiting the investment to the initial contribution. Additional contributions—even voluntary contributions—may require additional permission from the supervisor, which may take time.

**(c) The liquid-assets requirement also appears generally reasonable, but should be clarified to remove unnecessary expenses.**

Proposed section 234.3(a)(15)(A) states that an FMU:

(A) Holds unencumbered liquid financial assets, such as cash or highly liquid securities, that are sufficient to cover the greater of—

(1) The cost to implement the recovery or wind down plan to address general business losses as required under § 234.3(a)(3)(iii) and [sic]

(2) Six months of current operating expenses or as otherwise determined by the Board.

As an opening matter, we believe that it is reasonable that an FMU hold liquid assets that would be necessary to cover its recovery or wind-down plan, and that the FMU should plan on six months' runway for that plan to take effect. We therefore agree that the FMU should have sufficient liquid assets to continue operations for six months. However, the formula that the Board uses may overstate the amount that would be required.

The proposed regulation itself does not specify how current operating expenses are to be calculated, but the Federal Register notice does provide some detailed guidance:

When calculating its current operating expenses, the designated FMU is expected to consider its normal business operating expenses. These expenses are those that are typically categorized as either "cost of sales" or "selling, general, and administrative expenses" on the designated FMU's income statement. Therefore, these costs may exclude, among

other items, depreciation and amortization expenses, taxes, and interest on debt.<sup>22</sup>

There are different ways of describing expenses on a firm's income statements. One common way is to list various expense items, such as compensation and benefits, communications and technology costs, occupancy, marketing costs, and travel and related expenses. Many of these expenses are irrelevant to actually running the system. For example, if an FMU suffers serious losses and must restructure to recover or wind down, it will likely eliminate or significantly reduce travel and marketing expenditures. The recovery plan may also call for shedding business lines and could also result in dismissing or furloughing some employees. Thus requiring an FMU to keep on hand liquid assets to fund all of the FMU's current operations at the current rate of spending would overstate the amount actually needed. We suggest that the Board make this point clear by revising proposed section 234.3(a)(15)(A) as follows:

(A) Holds unencumbered liquid financial assets, such as cash or highly liquid securities, that are sufficient to cover the greater of—

(1) The cost to implement the recovery or wind down plan to address general business losses as required under § 234.3(a)(3)(iii) ~~and~~ or

(2) Six months of current ~~operating~~ expenses *required to operate the FMU's essential facilities*, or as otherwise determined by the Board.

**(d) The requirement for equity capital requires clarification.**

**Proposed** section 234.3(a)(15)(B) provides that an FMU must hold "equity, such as common stock, disclosed reserves, and other retained earnings, that is at all times greater than or equal to the amount of unencumbered liquid financial assets that are required to be held under paragraph (a)(15)(i)(A) of this section"

It is not clear what the Board intends by requiring equity at least equal to the amount of the required liquid assets. Does this mean simply that the amount of equity on the liability side of the balance sheet must be at least equal to the amount of liquid assets on the asset side of the balance sheet (a way of ensuring that the liquid assets are "funded by equity")?<sup>23</sup> Or does it mean that the equity must be in addition to the liquid assets? In other words, does it mean that in calculating equity an FMU must subtract the liquid assets from the asset side of its balance sheet before subtracting liabilities from asset?<sup>24</sup>

---

<sup>22</sup> 79 Fed. Reg. at 3682.

<sup>23</sup> I.e., equity = assets – liabilities.

<sup>24</sup> I.e., equity = assets – liquid assets – liabilities.

We believe that requiring an FMU to hold equity in addition to the required liquid assets is overkill. The Board should clarify in the final rule that this means that the amount of equity on the liability side of the balance sheet must be at least equal to the amount of liquid assets on the asset side of the balance sheet.

**(e) Questions on Principle 15**

*Q.15.1. Should the Board set a minimum amount of liquid net assets funded by equity that is different from the six-month minimum international standard, such as three or nine months of current operating expenses? Should the Board set the requirement based on the risk profile of the designated FMU? If so, what factors should the Board consider and what would be the effects of such an approach?*

As noted above, The Clearing House believes that six months is a reasonable standard, so long as the definition of what constitutes the expenses to be recovered is amended as suggested above.

*Q.15.2. Should the Board require a designated FMU that is part of a larger legal entity to take into account, when calculating the cost to implement its recovery or orderly wind-down plans, recovery or wind-down scenarios in which other business lines in the legal entity or the legal entity itself may also face an adverse business environment? To prepare for such scenarios, should the designated FMU include in its calculation of recovery or wind-down costs more than its normal business share of any shared support and overhead costs?*

We think that it is reasonable to treat the service that caused an FMU to be designated as systemically important as a separate division of the company and require liquid assets and capital to be earmarked for that service so that the company's other services are not taken into account when calculating these requirements.

Whatever is done, the Board should ensure that Reserve Bank services are treated in an equal manner. For example, if the Board determines that all of an FMU's services must be included in the minimum asset and capital requirements, then FedACH and the Reserve Banks' other services must be included in determining the equivalent liquid-asset and capital requirements to be included in the pro forma Reserve Bank balance sheets that are used in calculating the private-sector adjustment factor.

*Q.15.3. For designated FMUs that are part of a larger legal entity, the Board considered the alternative of requiring the designated FMU to hold liquid net assets funded by equity that are specific to the FMU itself to meet the requirement, but believes that it would likely be difficult to implement in practice. Are there any reasonable methodologies for determining which of the liquid net assets and equity held at the legal entity level belong to a particular business line?*

As noted above, we believe that it is reasonable to treat the service that caused an FMU to be designated to be treated as a separate division with capital and liquid

assets dedicated to it. This could be done by having separate pro forma balance sheets and P&L statements for the service, and we do not believe that this would be difficult to do. Again, the Board should ensure that the requirements that private-sector FMUs are required to meet should be imposed on the equivalent Reserve Bank service.

#### 4. Principle 2—Governance

Proposed section 234.3(a)(2) provides that an FMU must document clear and transparent governance arrangements, including board composition; responsibility of the board for risk management; qualification of senior managers; authority, resources, and independence of the risk-management function; and authority, resources, and independence of internal audit. The proposed rule also specifically provides that governance arrangements should be designed to promote the safety and efficiency of the FMU, the stability of the broader financial system, and “other relevant public interest considerations” (e.g., fostering fair and efficient markets and legitimate interests of legitimate stakeholders).

Proposed section 234.3(a)(2)(iv)(D) requires that a majority of the board of directors to be independent directors, i.e., “not executive, officers, or employees” of the FMU or its affiliates. There is no requirement for a public-interest director who is not affiliated with any of the FMU’s owners or participants, although the Board does ask whether it should impose such a requirement.

- (a) The Clearing House generally supports the Board’s proposals on governance. However, we do not support a requirement that an FMU support “other public interest considerations,” and we do not support a requirement that the board have one or more public-interest directors.**

We agree with the general requirements on responsibility of the board for risk management; qualification of senior managers; authority, resources, and independence of the risk-management function; and authority, resources, and independence of internal audit.

We have serious concerns about requiring an FMU to promote broader public-interest considerations, however they may be defined. While § 805(b)(4) of the Dodd-Frank Act<sup>25</sup> specifies financial stability as a goal of FMU risk-management standards, there is no mention of broad, undefined public-interest considerations, an extremely vague concept that could undermine the essential character of a private-sector system. This would actually be detrimental to the public interest.

The economy benefits enormously from having a private-sector alternative to the central bank’s funds-transfer system. A private-sector system focuses exclusively on the needs of its participants. As a result, the participants get excellent service and fast response to their changing needs. When a public-sector system faces continuous

---

<sup>25</sup> 12 U.S.C. § 5464(b)(4).

competition from a private-sector system, it is forced to match the private-sector system in both performance and service quality. This competition forces both systems to be better than either would likely be if there were only one funds-transfer service in the country.

We agree that the majority of the board should be independent of management. We do not believe that outside public-interest directors should be required. The purpose of these directors would be to speak for the broader public-interest considerations that the Board refers to in its proposal. As noted above, we believe that the Board should not impose any requirements on private-sector FMUs to support broader public-interest considerations, and there is no need for directors whose principal task is to take on this responsibility.

**(b) Questions on Principle 2.**

*Q.2.1. Should the Board specify in the rule text "other relevant public interest considerations" for a specific type of or even for a particular designated FMU?*

No. The Board should omit any reference to other relevant public-interest considerations.

*Q.2.5. Should the designated FMU's board of directors be required to have a committee of the board of directors that only has audit responsibilities to which the audit function reports and a risk committee of the board of directors that only has risk-management responsibilities to which the risk management function reports? Alternatively, should the designated FMU's audit and risk-management functions be required to report directly to the entire board of directors?*

This should be left to the discretion of the FMU. It should be clear that the audit and risk-management committees can be composed of audit and risk-management professionals who are not necessarily board members so long as there is reporting to the board.

*Q.2.6. What additional guidance should the Board provide to a designated FMU's board of directors in order to identify a "major decision" that must be disclosed to relevant stakeholders under the rule?*

There are different kinds of major decisions, and the stakeholders who are entitled to disclosure will differ depending on the kind of decision taken. For example, changes to the system's rules will have to be disclosed to participants and the public under Principle 23. Changes in major procedures, such as the adoption of a new format will also have to be disclosed to participants, who will then notify their major customers and counterparties. Changes in connection and security procedures will also be disclosed to participants, but should not be disseminated to the general public for security reasons. Major corporate decisions, such as the decision to merge or

consolidate with another company, would be shared with the owners, but may or may not have to be disclosed to the participants in the system.

In short, who should be informed of a major change is often difficult to articulate in advance, but common sense usually dictates who should be informed of any particular change. Thus we do not believe that additional guidance would be helpful.

## **5. Principle 23—Disclosure of rules, key procedures, and market data**

Proposed section 234.3(a)(23) would require public disclosure of all rules and key procedures (including default rules) and information sufficient to allow participants to have an accurate understanding of the risks, fees, and other material costs of participation. Proposed section 234.3(a)(23)(iv) incorporates CPSS-IOSCO's *Disclosure Framework for Financial Market Infrastructures*.

### **(a) The Clearing House generally supports public disclosure of key rules and procedures.**

The Clearing House supports public disclosure of rules and most key procedures. Public disclosure of rules is especially apt in jurisdictions in which the rules of an FMU can be binding on remote parties who are not participants.<sup>26</sup> Nevertheless, certain procedures, including connectivity requirements and security procedures, should not be publicly disclosed because this information could help hackers and other unauthorized persons gain access to the system.

We support limited release of market data, such as the total volume that the system processes. We oppose public release of data about the volume processed by individual participants.

### **(b) The Clearing House strongly opposes requiring private-sector FMUs to disclose prices publicly.**

Private-sector systems are not public utilities or common carriers whose rates are subject to government approval and must be listed in published tariff schedules. As private-sector systems they should be permitted—even encouraged—to negotiate prices freely with participants and potential participants in order to compete with one another. In order for the market to work properly, these negotiations need to be confidential.

All participants and potential participants know what prices they pay or will pay and therefore know the material costs they incur as a result of participation. Thus the

---

<sup>26</sup> See, e.g., N.Y. U.C.C. § 4-A-501(2).

intent of this provision is accomplished without the need for public disclosure of sensitive pricing information.<sup>27</sup>

**(c) Question about Principle 23.**

*Q.23.1. Should the Board require information about fees and discount policies to be part of the designated FMU's public disclosure framework? Why should the Board not require disclosure of fees and discount policies?*

The Board should not require disclosure of fees and discount policies for the reasons stated above.

**6. Principle 22—Communication procedures and standards**

This principle requires an FMU to use or accommodate internationally accepted communication procedures, messaging standards, and reference data standards that provide a common set of rules across systems for exchanging messages and allow a broad set of systems and institutions in various locations to communicate efficiently and effectively.

An FMU may meet this requirement by supporting systems that translate or convert internationally accepted procedures and standards into those used by the FMU. The Board notes that “[d]esignated FMUs subject to the Board’s authority already use, or at minimum accommodate, the relevant internationally accepted communications procedures.”<sup>28</sup>

**(a) The Clearing House supports this principle as currently outlined in the Board’s proposal.**

The Clearing House’s principal concern with this section of the PMFI was that it could have been used to force systems to use a particular format, such as the ISO 20022. We are gratified that the Board has made clear that this is not its intent, and that the proposal as explained by the Board gives FMUs the flexibility to design their formats to allow participants to map from one commonly used system to another, e.g., SWIFT to CHIPS or Fedwire and *vice versa*.

**7. Principle 21—Efficiency and effectiveness**

Section 234.3(a)(21) provides that an FMU must be efficient and effective in meeting the requirement of the participants and the markets it serves, have clearly

---

<sup>27</sup> This reasoning does not apply to public-sector systems, however. Section 11A of the Federal Reserve Act, 12 U.S.C. § 248a, requires the Board to publish a list of prices for Reserve Bank services. Congress clearly made the decision that a public-sector entity should be required disclose its fees for reasons of public accountability. These reasons do not apply to private-sector entities.

<sup>28</sup> 79 Fed. Reg. at 3686.

defined goals and objectives that are measurable (e.g., service levels), and review its efficiency and effectiveness periodically.

**(a) The Clearing House believes that the Board has not given sufficient weight to market judgments regarding an FMU's effectiveness.**

The Clearing House believes that the Board has not given sufficient weight to the judgment of the market when evaluating the efficiency and effectiveness of private-sector systems.

The Board defines efficiency as “what an FMU chooses to do, how it does it, and the resources required by the designated FMU to perform its functions,” and effectiveness as “whether the designated FMU is meeting its goals and objectives, which include the requirements of its participants and the markets it serves.” But an FMU that does not meet “the requirements of its participants and the markets it serves” will not be able survive in the market. Its participants will move to other systems. An FMU that does not meet its objectives efficiently, as the Fed defines that term, will not be able to keep its expenses to the level at which the prices it must charge for its services can compete in the market. Moreover, the Board’s reference to “public policy goals” is, as noted above, inappropriate.

We therefore believe that the Board should either drop this requirement, or redefine efficiency and effectiveness in terms of market judgments.

**8. Effective dates**

The Board proposes to make most of the principles effective 30 days from the date that the final rule is published in the Federal Register. The effective date for selected rules (relating to orderly recovery and wind-down plans, minimum liquidity and capital requirements, and tiered-participation arrangements) would be six months after publication.

**(a) If the Board adopts the proposal without change, it must delay the effective date until 18 months after publication of the final rule in the Federal Register.**

A 60-day period will only work if FMUs are expected to anticipate that the Board will adopt the new rules without substantial change and begin compliance efforts well in advance of the effective date. It is not realistic to expect FMUs to begin their compliance efforts until after the final rule is published and be able to compliance within six months.

As noted above, we regard the proposed rules regarding tiered-participation arrangements to be ill-advised and believe that the Board should not—and will not—adopt this requirement as drafted. It would make no sense for any FMU to begin costly

compliance efforts before the Board issues a final rule on this point. If the Board, despite these reasoned arguments, goes forward with principle 19, we would require 18 months to complete our compliance efforts.

**9. Differences between Regulation HH and Principle 19.**

The Board has adopted a somewhat different approach in adopting the PFMI for Regulation HH and the PSR Policy: it proposes to adopt the PFMI wholesale for its PSR Policy, but adapts the PFMI's principles into the regulatory language for Regulation HH. This leads to some differences in language between the regulation and the PSR Policy, which could, in turn, lead to the conclusion that the Board intends different results for the two sets of FMUs. We don't think that the Board intends this,<sup>29</sup> but the Board could avoid this implication by using the same language for both.

\* \* \* \* \*

We hope these comments are useful. If you have any questions, please contact me at 212-612-9234 or [ioe.alexander@theclearinghouse.org](mailto:ioe.alexander@theclearinghouse.org).

Very truly yours,



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

---

<sup>29</sup> See letter from Louise L. Roseman to James D. Aramanda (May 23, 2014).