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January 21, 2016

BY ELECTRONIC DELIVERY

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Proposed ORSOM Supervisory Rating System; Docket No. OP–1521

Dear Mr. Frierson,

The Clearing House Payments Company L.L.C. ("The Clearing House")[1] respectfully submits this comment letter in response to the notice and request for comment issued by the Board of Governors of the Federal Reserve Systems ("FRB" or "Board") regarding its proposed "ORSOM" supervisory rating system (the "Proposal").[2] The Board would use the "ORSOM" rating system in its supervision of financial market infrastructures ("FMIs"), including financial market utilities ("FMUs") that the Financial Stability Oversight Council designates as systemically important under Title VIII of the Dodd-Frank Act ("designated FMUs").[3] The Clearing House appreciates the Board's efforts to develop a framework that can be used to, among other things, "facilitate a clear and logical discussion of the FMI's condition with the FMI's management."[4] However, we have concerns regarding specific aspects of the Proposal, as well as several recommendations to improve it.

I. Executive Summary

On November 13, 2015, the Board published a notice and request for comment on a proposed "ORSOM" supervisory rating system for FMIs, which the Board anticipates implementing in 2016. The "ORSOM" rating system would be used to assess an FMI with respect to five rating categories:

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[1] Established in 1853, The Clearing House is the nation's oldest payments company and banking association. The Clearing House is owned by 21 of the largest commercial banks in America, which employ 1.4 million people domestically and hold more than half of all U.S. deposits. The Payments Company within The Clearing House clears and settles approximately $2 trillion daily, representing nearly half of the U.S. volume of ACH, wire and check image transactions. The Clearing House Association is a nonpartisan advocacy organization within The Clearing House that represents, through regulatory comment letters, amicus briefs and white papers, the interests of its owner banks on a variety of systemically important bank policy issues.

[2] Supervisory Rating System for Financial Market Infrastructures, 80 Fed. Reg. 70211 (Nov. 13, 2015).

[3] Under the Dodd-Frank Act, the Board has authority to supervise certain FMUs that provide payment, clearing and settlement services and that the Financial Stability Oversight Council designates as systemically important. Note that FMUs are a subset of FMIs, which is a broader term that includes payment systems, central securities depositories, securities settlement systems, central counterparties, and trade repositories. In addition to its authority to supervise designated FMUs under the Dodd-Frank Act, the Board has supervisory authority over certain other FMIs, such as FMIs operated by state member banks or bank holding companies, as well as those operated by the Reserve Banks (e.g., the Fedwire Funds Service).

[4] 80 Fed. Reg. 70211, 70212.

- (O) Organization
- (R) Risk Management
- (S) Settlement
- (O) Operational Risk and Information Technology (IT)
- (M) Market Support, Access, and Transparency.

While The Clearing House appreciates the Board's effort to create a consistent framework for assessing FMIs, we have concerns regarding the Proposal. In particular, we believe that in certain ways the Proposal would create new obligations for FMIs that go beyond existing regulatory requirements. We do not believe that it is appropriate for a supervisory rating system to function in such a manner. In addition, while we believe that some flexibility is necessary for an effective rating system for a category of entities that vary in numerous ways, we have concerns about the impact that excessive supervisory judgment and discretion may have on the rating an FMI receives. The Clearing House also has a number of other recommendations that we believe would improve the Proposal. These issues are addressed in further detail below.

II. The Clearing House's Comments

A. Comments Regarding Consistency with Existing Regulatory Expectations

1. Independent Assessments

With respect to the "Organization" category, the Board states that "[t]his rating also evaluates the effectiveness of the FMI's governance program for risk models and its use of independent validation mechanisms to validate the FMI's model methodologies and output."[5] The Clearing House recognizes the importance of independent validation of certain risk models that FMIs use, however we have concerns about the potential overly broad interpretation of the independent validation component. Specifically, we are concerned it could be interpreted to apply to a variety of analytics that an FMI may use that are outside the scope of the risk-management framework set forth in Regulation HH (e.g., revenue models) and for which independent validation is unnecessary. The Clearing House believes that it would be more appropriate for this component to apply to those "model methodologies and output" that have a material impact on an FMI's overall risk, and we urge the Board to tailor the framework accordingly.

2. Risk Introduction

With respect to the Risk Management category, the Board states that this rating "assesses the FMI's awareness of, and control over, the risk that its participants' customers and other FMIs indirectly introduce." The Clearing House understands this statement to relate to the risk management requirements that are referenced in Section 234.3(a)(3)(i) in Regulation HH.[6] This view is based on the

[5] *Id.* at 70213

[6] Specifically, 12 C.F.R. § 234.3(a)(19) states that "[t]he designated financial market utility identifies, monitors, and manages the material risks arising from arrangements in which firms that are not direct participants 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, whether the risks are borne by the designated financial market utility or by its participants as a result of their participation. The designated financial market utility— (i) Conducts an analysis to determine whether material risks arise from tiered participation arrangements;

Board's statement that the ORSOM rating system "is designed to ... be clearly tied to relevant Federal Reserve regulations and guidance ..."[7] The Clearing House requests that the Board confirm this understanding and clarify that this component does not create additional supervisory expectations for designated FMUs outside of Regulation HH.

3. Relevant Industry Guidance

The Board states that "[a]nalysis of the issues considered under each category should be consistent with Regulation HH, the PSR policy, and relevant guidance, such as supervision and regulation (SR) letters and guidance of the Federal Financial Institutions Examination Council (FFIEC)."[8] With this in mind, the Board has identified examples of "relevant statutes, regulations and guidance" for each of the ORSOM categories. The references are sometimes vague however, such as in the list for the "Operational Risk and IT" category, which refers to "FFIEC and relevant industry guidance." The Clearing House encourages the Board to specifically identify the "relevant industry guidance" to which it is referring.

4. Management Responsiveness

In its explanation of the "Board and Management Oversight" category, the FRB states that "[t]his rating evaluates how effectively the board of directors and senior management guide and manage the FMI, and ensure that the FMI operates in a safe and sound manner ..."[9] The FRB further states that "specific considerations in this regard include management's responsiveness to supervisory concerns."[10] The Clearing House understands this statement to refer to issues that the Board identifies and that the FMI agrees to address. We request the FRB confirm that this understanding is correct, and that an FMI would not be deemed unresponsive where it disagrees with the Board's finding and pursues a formal appeal/disagreement process. In addition, we note that the Board and Management Oversight category appears to create a new standard outside of Regulation HH. In particular, the Board states that "[t]his rating component also evaluates the board's effectiveness at establishing the FMI's objectives, strategy, and risk tolerances, and management's effectiveness at ensuring that the FMI's activities are consistent with them." This appears to be a new standard that is not based on the content of Regulation HH.

5. Market Support, Access and Transparency

The Board states that this category evaluates the FMI's "efforts to support the markets they serve." While we recognize that this concept is included in the Principles for Financial Market Infrastructures, we believe it is unnecessary. By definition, systemically important FMIs clearly serve their market. That they effectively serve their market is what makes them systemically important, and the fact that a FMU is designated indicates that it is highly effective. For these reasons, we believe that

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(ii) Where material risks are identified, mitigates or manages such risks; and (iii) Reviews and updates the analysis conducted under paragraph (a)(19)(i) of this section the earlier of every two years or following material changes to the system design or operations or the environment in which the designated financial market utility operates if those changes could affect the analysis conducted under paragraph (a)(19)(i) of this section."

[7] 80 Fed. Reg. 70211, 70212.

[8] *Id.* at 70212.

[9] *Id.* at 70213.

[10] *Id.*

the Board's evaluation of market support and access is unwarranted and that the Board should refine this category to focus on an FMI's transparency.

That being said, to the extent that the Board does not agree and believes it is necessary to evaluate market support and access as part of this category, The Clearing House believes that certain clarifications are necessary. The Board states that the Market Support, Access, and Transparency category "focuses on, among other things, "the FMI's efforts ... to ensure fair and open access to, and use of, its services ..."[11] The Board notes that relevant regulations include Regulation HH § 234.3(a)(18), which states that "[t]he designated financial market utility has objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access." The Clearing House understands this ORSOM category to relate to concerns regarding improper anticompetitive behavior, such as decisions to exclude an entity that are made for illegitimate, anticompetitive reasons. We note however, that there may be legitimate restrictions on participation in an FMI (e.g., eligibility requirements that are designed to protect the safety and soundness of the FMI and its participants). We encourage the Board to clarify that FMIs would not be penalized for limiting participation for such legitimate reasons and that the "fair and open" access standard applies with respect to the specific market the FMI serves (e.g., financial institutions that make large value funds transfers).

The Proposal also states that "analysis under this category should consider, among other things ... the efficiency with which [an FMI] consumes resources in providing its services ..." We note that this standard is vague and believe that it could be interpreted in an overly broad and problematic way. Moreover, it does not appear to be based on the requirements of Regulation HH. Accordingly, we question the appropriateness of its inclusion in the ORSOM rating system and encourage the Board to remove it from the final version of the rating system.

B. Comments Regarding Potential for Excessive Supervisory Discretion

1. Supervisory Judgment

The Board states that "the weight prescribed to either a category or a category's components is a matter of supervisory judgment and expertise, and may differ among FMIs." The Clearing House recognizes that the assessment of an FMI's compliance with Regulation HH requires some supervisory judgement and discretion, however, we do not believe that customized weighting is appropriate for similarly situated FMIs (i.e., those FMIs of similar size and type). The Clearing House believes that the ORSOM rating system will only be effective if it is applied uniformly to such FMIs and ask the Board to confirm this will be the case.

Further, the Board states that "[a]n FMI's rating should ... take into account the FMI's responsiveness to supervisory concerns and the *sustainability* of any measures that the FMI has implemented to address those concerns, both in terms of long-term viability and demonstrated effectiveness."[12] The Clearing House believes it is essential that the Board provide FMIs with a clear understanding of the objective criteria against which they will be assessed, and that the supervisory judgment incorporated into an ORSOM rating should be based on clearly articulated standards. The clear communication of criteria and standards to FMIs will allow them to better satisfy the Board's

[11] *Id.* at 70214.
[12] *Id.* (emphasis added).

supervisory expectations. Accordingly, The Clearing House believes that the Board should define the term "sustainability."

2. Composite Rating Scale

The Board states that the composite rating "should not represent a formulaic combination of its category ratings, such as an arithmetic average."[13] While The Clearing House recognizes that there are benefits to allowing for such flexibility, we have concerns about the impact that excessive supervisory judgment and discretion may have on the rating an FMI receives. The Board states, for example, that "[t]he weight prescribed to either a category or a category's components is a matter of supervisory judgment and expertise, and may differ among FMIs."[14] As noted above, The Clearing House believes that the Board should provide FMIs with a clear understanding of the objective criteria against which they will be assessed, and we believe that this principle should extend to the relative weight prescribed to the ORSOM categories and category components.

C. Other TCH Comments

1. Frequency of Examinations/ORSOM Ratings

The Board states that the ORSOM rating system will be used to determine an annual ORSOM rating, which will be conveyed to an FMI's management and board of directors. The Clearing House believes that an annual rating framework will in many instances provide FMIs with insufficient time to respond to and address the supervisory feedback that they have received. The Clearing House encourages the Board to adopt a longer examination cycle, particularly with respect to those FMIs (i) that received a 3 or better in their previous ORSOM rating; and/or (ii) that are also examined under the FFIEC's MDPS supervisory program. In addition, with respect to the latter category, we encourage the Board to coordinate its ORSOM examination schedule with the FFIEC such that an FMI that is also an MDPS is examined and receives a rating under each framework in alternating years.

2. Audit as a Component of the Organization Category

The Organization category contains two subcomponents: (i) Board and Management Oversight, which "addresses the organization and conduct of the FMI's board of directors and senior management"; and (ii) Internal Audit, which "reflects the ability and independence of the FMI's internal audit function to assess risk and to inform the board and management."[15] The Board notes that while there are two subcomponents to this category, an FMI's assessment under the subcomponents will be reflected in a single category rating. We recognize that internal audit is a component of the governance standard in Regulation HH. However, The Clearing House believes that an FMI's audit functions should be assessed in a separate and distinct category for purposes of the ORSOM rating system because of internal audit's overall importance and the unique nature of its independence from an FMI's management and other operations.

[13] *Id* at 70215.
[14] *Id.* at 70212.
[15] *Id.* at 70213.

3. Adequate Disclosure of Rules and Procedures

In its discussion of the Market Support, Access, and Transparency category, the Board states that this category will consider the adequacy of an FMI's disclosure of its "rules, procedures, and relevant information about its operations." The Clearing House encourages the Board to clarify that FMIs are not expected to disclose proprietary or otherwise confidential information, and that an FMI's treatment of such information as non-public and confidential will not negatively impact the FMI's rating in this category.

4. Category Rating Scale

The Clearing House believes that certain standards described in the rating scale require clarification. For example, it could be argued that the identification of only one matter requiring immediate attention would cause an FMI to receive a 4 ("Marginal") under the proposed category rating scale. Specifically, the second prong of the definition of a 4 ("Marginal") rating provides that "[t]he FMI should correct one or more of the issues identified immediately, dedicated supervisory monitoring of the FMI's remediation efforts is needed, and supervisory action is likely."[16] We believe that the language of the second prong should clarify that it relates only to the types of issues that are referenced in the first prong (i.e., "issues of substantial issues of concern with respect to the category's supervisory guidance"). We also believe that a similar clarification is warranted with respect to the definition of a 3 ("Fair") rating.[17]

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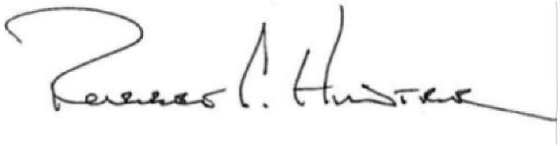
Thank you for the opportunity to comment on the Proposal. If you have any questions or wish to discuss The Clearing House's comment letter, please do not hesitate to contact me using the contact information provided below.

Yours very truly,



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[16] *Id*. at 70215.

[17] *Id*. The second prong of the definition of a 3 rating provides that "the FMI should correct one or more of the issues identified within a defined period, dedicated supervisory monitoring of the FMI's remediation efforts is likely needed, and supervisory action may be needed." We believe that the Board should clarify that the second prong relates only to the types of issues that are referenced in the first prong of the definition.