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Dodd-Frank Title VIII: The Devil is in the Details

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Introduction

Almost suffocated within the 848 pages[1] of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act")[2] are the paltry 20 pages of Title VIII, Payment, Clearing, and Settlement Supervision ("Title VIII"). Title VIII has gone largely unnoticed primarily because it appears, on its face, to deal solely with arcana only relevant to financial market utilities (e.g., The Depository Trust Company). To be sure, Title VIII grants the Board of Governors of the Federal Reserve System ("FRB"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") sweeping new powers over financial market utilities. Separately, however, and hidden in plain view, is a massive and expansive grant of new authority over activities that are critically important to a broad swath of financial institutions – broker-dealers, hedge funds,[3] and investment companies in particular. Specifically, the newly established Financial Stability Oversight Council ("Council") may designate certain payment, clearing, or settlement activities as systemically important (or likely to become so), a designation that clears the way for the FRB, the SEC, and the CFTC to exercise new rulemaking, examination, and enforcement authority over any financial institution engaged in the activity. This new authority could revamp the way many critical market functions are performed today, leading firms to reconsider existing business models.

Background

According to Section 802 of the Act, Congress was compelled to address the payment, clearing, and settlement area because, among other things:

> Enhancements to the regulation and supervision of systemically important financial market utilities and the conduct of systemically important payment, clearing, and settlement activities by financial institutions are necessary – (A) to provide consistency; (B) to promote robust risk management and safety and soundness; (C) to reduce systemic risks; and (D) to support the stability of the broader financial system.

Title VIII appears to be a direct response to the stresses in settlement, clearance, and payment processes that the FRB and other regulators around the globe witnessed during the financial meltdown in 2008. To accomplish Congress's goals, Title VIII provides the FRB, the SEC, and the CFTC with tremendous new authority to promulgate risk management standards for designated financial market utilities, ***and*** to set standards for the conduct of systemically important payment, clearing, and settlement activities of financial institutions. Title VIII defines "financial institutions" to include, among other market participants, broker-dealers, investment advisers, investment companies, and futures commission merchants. Broadly speaking, in determining payment, clearing and settlement activities that are or are likely to become systemically important, the Council is required to consider, among other factors deemed appropriate by the Council: (i) the aggregate monetary value of transactions carried via such activities; (ii) the aggregate exposure of financial institutions engaged in such activities to their counterparties; (iii) interdependencies of such activities with other financial market utilities or payment, clearing, or settlement activities; and (iv) the effect that a failure or disruption of such activities would have on critical markets, financial institutions, or the broader financial system. Appendix A contains a flowchart detailing the process by which certain financial institution activities will be subject to heightened risk management rules and standards, lists the relevant payment, clearing, and settlement activities covered by Title VIII, and defines the key terms used in Title VIII.

Key Issues for Broker-Dealers, Hedge Funds, and Investment Companies

It is not yet clear how the FRB, SEC, and CFTC will exercise their new Title VIII authority over designated financial activities. However, the statute expressly states that the regulators must consider "international standards" when promulgating risk management standards under the authority granted in Title VIII. The primary source for international standards in the payment, clearance, and settlement area is the joint working group between the Bank for International Settlements ("BIS") Committee on Payment and Settlement Systems ("CPSS")[4] and the Technical Committee of the International Organization of Securities Commissions ("IOSCO"). CPSS and IOSCO jointly announced early this year that they had "launched a comprehensive review of their existing standards for financial market infrastructures such as payment systems, securities settlement systems and central counterparties."[5] Existing CPSS/IOSCO standards for securities settlement systems address several issues, including stock lending and central counterparties.[6]

As shown in Appendix A, Title VIII specifically addresses activities involved in the completion of financial transactions, such as repurchase agreements and "securities contracts." It is unclear whether "securities contracts" will be defined to include stock lending arrangements, but the phrase is defined in other federal statutes to include stock lending agreements.[7] A decision by the Council to subject important stock lending functions (including repo arrangements) to enhanced risk management rules and standards could have a dramatic impact on certain markets. For example, enhanced collateral or margin requirements in the repo or stock loan markets could cause frictions within the existing bilateral, tri-party, and conduit contractual relationships among market participants.

Indeed, the Federal Reserve Bank of New York ("NYFRB") has been keen to revamp many aspects of the tri-party repo market since the demise of Bear Stearns and Lehman Brothers in 2008. Although many of the changes sought by the NYFRB have already been addressed by the NYFRB

Payments Risk Committee's private sector Task Force on Tri-Party Repo Infrastructure, Title VIII would give the FRB (along with the SEC and CFTC) the express statutory authority needed formally to effectuate many of the proposed changes.[8] Of particular note, the NYFRB has requested public comment on the idea of requiring a central counterparty in the tri-party repo markets.[9] The idea of encouraging the use of central counterparties has also been discussed by the SEC in connection with the stock lending markets.[10]

Conclusion

Financial market participants – especially broker-dealers, hedge funds, and investment companies – would be wise to monitor the implementation of Title VIII carefully. Depending on how the Council defines systemically important activities – and how the FRB, SEC, and CFTC decide to interpret and apply their new authority – significant changes could be on the horizon for key markets.

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[1] U.S. Government Printing Office version.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. 111-203 (111th Cong. 2d sess. 2010).

[3] Title IV of the Dodd-Frank Act requires hedge fund advisers managing over $150 million or more in assets to register as "investment advisers," and Title VIII expressly applies to registered investment advisers because they are included within the definition of "financial institution" covered by Title VIII.

[4] The BIS is "an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks." *See About BIS*, www.bis.org/about/index.htm. BIS' CPSS "serves as a forum for central banks to monitor and analyse developments in payment and settlement arrangements as well as in cross-border and multicurrency settlement schemes. The chairman of the CPSS is William C. Dudley, President of the Federal Reserve Bank of New York." *See* BIS Press Release, *CPSS-IOSCO Working Group on the Review of the "Recommendations for Central Counterparties"* (Jul. 20, 2009), www.bis.org/press/p090720.htm.

[5]*See* BIS Press Release, *Standards for Payment, Clearing and Settlement Systems: Review by CPSS-IOSCO* (Feb. 2, 2010), www.bis.org/press/p100202.htm. According to CPSS/IOSCO, "[t]here are three sets of standards involved, namely: the 2001 Core principles for systemically important payment systems, the 2001/2 Recommendations for securities settlement systems, and the 2004 Recommendations for central counterparties." *Id.*

[6]*See* Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, *Recommendations for Securities Settlement Systems* (Nov. 2001), http://www.bis.org/publ/cpss46.pdf.

[7]*See, e.g.*, Federal Deposit Insurance Act, 12 U.S.C. § 1000(e)(8)(D)(ii); U.S. Bankruptcy Code, 11 U.S.C. § 741(7).

[8]*See* The Federal Reserve Bank of New York, *Tri-Party Repo Infrastructure Reform*, White Paper, at 1 (May 17, 2010), www.ny.frb.org/banking/nyfrb_triparty_whitepaper.pdf. According to the NYFRB: "A key

focus of the recommendations is to reduce reliance by market participants on intraday credit provided by tri-party repo agents. Other complementary recommendations are designed to foster improvements to credit and liquidity risk management practices of market participants, enhance market transparency, and decrease the likelihood and mitigate the negative effect of default by a large cash borrower." *Id.*

[9]*Id.* at 19; The Federal Reserve Bank of New York, *Tri-Party Repo Infrastructure Reform*, Appendix II, Tri-Party Repo Infrastructure Reform Task Force Report, at 9, 27 (May 17, 2010), www.ny.frb.org/banking/nyfrb_triparty_whitepaper.pdf.

[10]*See* Transcript of Securities Lending and Short Sale Roundtable, at 120-163, 177, 191-195 (Sept. 29, 2009), www.sec.gov/news/openmeetings/2009/roundtable-transcript-092909.pdf (discussion of central counterparties for stock lending by the members of the third and fourth panels, SEC Commissioners, and SEC Chairman Schapiro).

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