

Financial Stability Oversight Council Begins the Process of Designating Systemically Important Financial Market Utilities

If you are not a large bank holding company, what are the odds that you will be considered to be significant enough to be subject to the new regime of systemic regulation? Speculation is increasing regarding how many companies will be designated as significant nonbanks under Title I of the Dodd-Frank Act ("Act") and be regulated as systemically significant by the Federal Reserve Board and the FDIC. The Financial Stability Oversight Council ("Council") has now opened a second front in the Dodd-Frank Act's mandate to identify systemically significant companies by issuing an advance notice of proposed rulemaking ("ANPR") regarding the designation of entities that operate multilateral financial clearing systems that are deemed to be systemically significant for purposes of a regulatory structure mandated under Title VIII of the Act. Far more so than in Title I, Congress deferred to the regulators in deciding what actions should be taken to seek to prevent such systems from triggering significant financial instability. Depending on the approach that is taken by regulators, implementation of Title VIII may have a significant impact on the activities of both systemically important clearing systems as well as financial institutions that have high levels of transactions with such systems.

Title VIII has received relatively little attention to date. It broadly establishes, without much definition, comprehensive regulation of systemically important financial market utilities ("FMUs") and their significant financial institution participants. Title VIII provides broad flexibility to the regulators to supervise the operations of FMUs and take enforcement action against them. See *Dechert LLP Analysis of Financial Regulatory Reform Legislation for American Bankers Association* http://www.aba.com/RegReform/RR_TitleMenu.htm for a discussion of Title VIII.

Under Title VIII, an FMU is a party that manages or operates a multilateral system for the purposes of transferring, clearing or settling payments, securi-

ties, or other financial transactions among financial institutions or between financial institutions and the system. The term is defined to exclude a range of parties, including national securities exchanges, registered futures exchanges, and registered swap execution facilities.

As with Title I, Congress set forth a number of factors that the Council is to consider in determining whether an FMU's payment, clearing or settlement activities are, or are likely to become systemically important. Systemic importance is deemed to be present where the failure or disruption of an FMU or the conduct of its payment, clearing or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among

financial institutions or markets and as a result threaten the stability of the U.S. financial system. The Council generally must provide an FMU advance notice of its proposed designation and an opportunity to object.

Once an entity is designated as a systemically important FMU, it will become subject to a range of regulatory oversight. That will include compliance with regulatory risk management standards. While this is yet undefined, presumably it will potentially cover capital requirements, back-up facilities, risk management and a range of oversight that banks and bank holding companies are accustomed to. The bottom line is that the law is so broad that it gives federal regulators a free hand to design system specific standards to seek to reduce risk associated with payment, clearing or settlement activities that can impact the economy generally. A systemically important FMU will also be required to provide prior notice of proposed changes to its rules procedures, or operations which could materially affect the nature or level of risks associated with the FMU. This raises the question of whether regulators will impose restrictions on FMU investments, the range of acceptable participants, permissible activities, and impose technology requirements. FMUs will also be subject to enforcement action by regulatory authorities.

Moreover, financial institutions (subject to certain activity threshold levels) that engage in specified activities with an FMU will also be subject to regulatory risk management standards in regard to those activities. Thus, there could be a regulatory scheme imposed on FMU participants, counterparties, vendors and others which are covered by the threshold limitations established by the Council. Financial institutions are broadly defined to include depository institutions, brokers or dealers, investment companies, insurance companies, investment advisers and companies engaged in activities that qualify as financial under section 4 of the Bank Holding Company Act.

The ANPR requests comments, among other things, on:

- What quantitative and qualitative information the Council should use to measure the factors specified in Title VIII for the designation of a systemically important FMU, and how should such information be incorporated into the determination?
- How should the Council weight the considerations for a systemically important determination?
- How should the Council measure and assess the

aggregate value of transactions processed by an FMU?

- How should the Council measure and assess the aggregate exposure of an FMU?
- How should the Council identify, measure and assess the effects of relationships, interdependence and other interactions of FMUs?
- How should the Council assess whether failures or disruptions to an FMU could potentially threaten the financial system of the U.S.?
- What factors should the Council consider in distinguishing between a systemically important FMU and a financial institution that is very substantially engaged in a systemically important payment, clearing or settlement activity?

Comments are due by 30 days from publication in the Federal Register.

At this stage, we draw several preliminary conclusions:

- Potential FMUs and financial institutions that conduct significant levels of transactions through an FMU have important operational interests at stake under Title VIII.
- Such companies should consider weighing in during the comment process that has just commenced and participate in the development of the regulatory record.
- Comments should focus on the thresholds that are to be established for the designation of systemically important FMUs and their significant participants, and the minimal range of regulation that is necessary for a functioning market place.
- Companies that may be considered to be systemically important FMUs should begin to identify and engage talent and resources that are familiar with federal regulatory approaches to transferring, clearing or settlement operations and begin identifying operational, legal and economic issues.

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This update was authored by Thomas P. Vartanian (+1 202 261 3439; thomas.vartanian@dechert.com) and Robert H. Ledig (+ 1 202 261 3454; robert.ledig@dechert.com).

Practice group contacts

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David L. Ansell

Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

David J. Harris

Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Robert H. Ledig

Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

Thomas P. Vartanian

Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com



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