

*For Immediate Release*

**Hal S. Scott Releases Letter to CFTC Chairman Gensler  
Urging Major Federal Reserve Input to CFTC Rules on  
Conflicts of Interest in Derivatives Clearinghouses**

**CAMBRIDGE, Mass., September 15, 2010**—Hal S. Scott, Director of the Committee on Capital Markets Regulation, today released his August 25 letter to Gary Gensler, Chairman of the Commodities Futures Trading Commission, reiterating his proposal that the CFTC and the SEC closely consult the Federal Reserve on conflicts of interests affecting the nation's OTC derivatives clearinghouses because these rules could affect the riskiness of the clearinghouses.

“The Fed’s broad powers and roles under Dodd-Frank affect virtually every important CFTC and SEC regulatory and rulemaking activity affecting clearinghouses, including conflict of interest rules,” said Mr. Scott, who also is the Nomura Professor of International Financial Systems at Harvard Law School. He noted that the Fed’s mandates under the Dodd-Frank Act empower the central bank to:

- supervise the major dealers who are the principal owners and users of clearinghouses;
- open the discount window privileges to clearinghouses under unusual circumstances—subject to conditions which could include those relating to their risk management systems, and;
- object to any rules promulgated by the SEC and the CFTC regarding systemically important clearinghouses, forcing the Financial Stability Oversight Council to resolve the dispute.”

Given these broad, immense powers, he added “it is inconceivable to me that an agency whose rulemaking and systemic risk moderating activities are certain to come under close Fed scrutiny would not want to take the Fed into its confidence on conflict of interest rules. A failed important clearinghouse would be the financial equivalent of Chernobyl. This is no time in our history for regulatory turf battles. I ardently hope that Chairman Gensler and his staff at CFTC, as well as their counterparts at the SEC, are coming to precisely that conclusion.”

Mr. Scott’s August 25 letter to Chairman Gensler follows on the next page.

# COMMITTEE ON CAPITAL MARKETS REGULATION

August 25, 2010

The Honorable Gary Gensler  
Chairman  
Commodity Futures Trading Commission  
3 Lafayette Centre  
1155 21st Street NW  
Washington, DC 20581

Re: The Federal Reserve's Authority over Clearinghouses

Dear Chairman Gensler:

It was a pleasure to meet you at the conclusion of the CFTC/SEC Roundtable on Clearing and Listing of Swaps and Security-Based Swaps held last Friday, August 20. I am writing to elaborate on our brief conversation about my remarks at the Roundtable that the Board of Governors of the Federal Reserve System (the Fed) needs a seat at the table in discussions about systemic risk in the clearinghouses, including systemic risk issues raised by the conflict of interest rules, because of the Fed's overall authority in this area.

The Fed plays a central role under the Dodd-Frank Act in the regulation of systemic risk in the clearinghouses.

First, it is the supervisor of the major dealer banks that are the principal owners, members and users of the clearinghouses. Dodd-Frank establishes the Fed as the systemic risk regulator of bank holding companies with \$50 billion or more in assets, section 165(a), and any systemically important nonbank financial institution so designated by the Financial Stability Oversight Council (the Council), section 113(a).

Second, the Fed can extend discount window privileges to a clearinghouse in "unusual or exigent circumstances" under section 806(b), subject to any conditions it prescribes, which could include conditions relating to risk management systems.

Third, the Fed may object to any rules promulgated by the SEC and the CFTC with respect to systemically important clearinghouses, in which case the Council resolves the conflict. Under section 804 of the Act, the Council may vote to designate a "financial market utilit[y]" as "systemically important."<sup>1</sup> Section 803(6)(A) contains a broad definition of the term "financial market utility" which includes clearinghouses.<sup>2</sup> Section 805(a)(2) provides that the CFTC and the SEC can "prescribe regulations, in consultation with the Council and the Board of Governors, containing risk management standards." If the Fed is unsatisfied with the risk management standards promulgated by

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 804(a)(1).

<sup>2</sup> This is made even clearer because the Act defines the term "designated clearing entity" to mean "a designated financial market utility that is a derivatives clearing organization." *Id.* § 803(3).

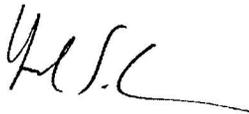
the CFTC and the SEC, it may object, and the CFTC or the SEC then has 60 days to respond.<sup>3</sup> After such a response the Council may vote to require the CFTC or the SEC “to prescribe such risk management standards as the Council determines is necessary.”<sup>4</sup>

It was abundantly clear from the discussion at the Roundtable that the conflict of interest rules promulgated by the CFTC and the SEC under sections 726 and 765 will have a direct bearing on the systemic risk of the clearinghouses (and ultimately on that of their participants). The Fed thus has the power to critically shape these rules in its capacity as primary regulator of large bank holding companies and systemically important nonbank financial institutions, and as lender of last resort. In principle, it could prohibit the institutions it supervises from taking part in any clearinghouse it considers too risky. The Fed could also deny discount window access to such a clearinghouse—a critical need without which a clearinghouse would not be viable. The clearinghouse would thus need to assure itself far in advance of any need for window access that its risk management systems would satisfy Fed concerns.

Given the Fed’s significant, if not dominant, role as the chief systemic risk regulator, together with its experience and expertise, it would be inadvisable for the CFTC or the SEC to act on issues relevant to clearinghouse risk, including conflict of interest rules, without the Fed’s input, or propose rules that the Fed objected to. Moreover, it is extremely unlikely that the Council would act in a way that would be inconsistent with the Fed’s position.

The Committee on Capital Markets Regulation has advocated fundamental consolidation of the regulatory structure to avoid the difficulties posed by this potential clash in agency jurisdiction created by Dodd-Frank.<sup>5</sup> Unfortunately, this has not been done. The Committee has also taken the view that the Fed should have the last word on control of systemic risk in the clearinghouses due to its long experience with these issues and specific expertise.<sup>6</sup> In effect, Dodd-Frank has implemented this recommendation by giving the Fed in practice the ultimate power to shape the clearinghouse rules bearing on systemic risk.

Sincerely,



Hal S. Scott  
President & Director  
Committee on Capital Markets Regulation

cc: Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System  
Timothy F. Geithner, Secretary of the United States Department of the Treasury  
Mary L. Schapiro, Chairman of the Securities and Exchange Commission

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<sup>3</sup> *Id.* § 805(a)(2)(B)–(D).

<sup>4</sup> *Id.* § 805(a)(2)(E).

<sup>5</sup> See COMM. ON CAPITAL MKTS. REGULATION, THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 203 (May 2009); Comm. on Capital Mkts. Regulation, Recommendations for Reorganizing the U.S. Financial Regulatory Structure (Jan. 2009).

<sup>6</sup> Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking member, S. Comm. On Banking, Hous. & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Agric., Nutrition & Forestry 4 (Apr. 26, 2010).