XI. *The Payment, Clearing, and Settlement Supervision Act of 2010: Mitigating Systemic Risk Through Consolidated Regulatory Supervision*

A. Introduction

Enacted as Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[1], the Payment, Clearing, and Settlement Supervision Act of 2010 (the "PCSSA")[2] addresses a broad range of payment, clearing, and settlement activity in the wake of the financial crisis of 2007-09. With the purpose of "mitigat[ing] systemic risk in the financial system and promot[ing] financial stability,"[3] the PCSSA grants authority to the newly created Financial Stability Oversight Council (the "Council")[4] and broadens the authority of several Federal regulatory agencies, including the Board of Governors of the Federal Reserve System (the "Board of Governors" or the "Fed").[5] The PCSSA enhances the Fed's role in the supervision of standards and conduct in the nation's payment clearing, and settlement system (the "PCS System").[6]

Although "[t]he Dodd-Frank Act addresses critical gaps and weaknesses in the U.S. regulatory framework, many of which were revealed by the recent financial crisis,"[7] gaps in the statutory framework and inefficiencies in regulatory jurisdiction "undermine its effectiveness."[8] The PCSSA and Dodd-Frank, generally, remain silent on the "shadow" banking system, which certain academics, the

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank].
[2] Payment, Clearing, and Settlement Supervision Act of 2010, 12 U.S.C. § 5461 (2010) [hereinafter PCSSA].
[3] *Id.* § 5461(b) (listing the purposes of the PCSSA).
[4] Brian D. Christiansen & William J. Sweet, Jr., *Supervision of Payment, Clearing and Settlement*, SKADDEN COMMENTARY ON THE DODD-FRANK ACT, Jul. 9, 2010, at 1, http://www.skadden.com/newsletters/FSR_Supervision_of_Payment_ Clearing_and_Settlement.pdf.
[5] PCSSA, *supra* note 2, §§ 5462-72.
[6] *Id.*
[7] *Implementation of the Dodd-Frank Act Before the S. Comm. on Banking, Housing and Urban Affairs*, 112th Cong. (2011) (statement of Ben S. Bernanke, Chairman, Federal Reserve).
[8] Int'l Monetary Fund [IMF], Monetary and Capital Markets Department, Financial Sector Assessment Program: United States of America, *Technical Note: Consolidated Regulation and Supervision*, 10-11 (July 2010).

International Monetary Fund, and others believe to have played an important role in the crisis.[9] Furthermore, "as new constraints applicable to large regulated institutions push more activity into the unregulated sector," regulators will need to strengthen "prudential supervision of payments, clearing and settlement systems."[10] Because the PCSSA moves toward consolidating regulatory supervision in the Fed and empowers the Council to "recommend significant changes in regulation, if such changes are deemed necessary for financial stability,"[11] regulators now may have the authority necessary to mitigate systemic risk effectively.[12]

B. The Payment Clearing and Settlement System

1. Defining the Payment, Clearing, and Settlement System

The PCS System refers to the methods by which parties, including individuals, businesses, financial institutions, and banks, transfer wealth committed to counterparties in transactions in order to complete those transactions.[13] Although parties like large financial institutions engage in various activities to facilitate many types of transactions,[14] historically banks, particularly Federal Reserve banks,

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[9] Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 1 (Nat'l Bureau of Econ Research, Working Paper), *available at* http://ssrn.com/abstract=1676947; *see* IMF, *supra* note 8, at 7-8; Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, Comments on "Regulating the Shadow Banking System" at the Brookings Panel on Economic Activity (Sep. 17, 2010).

[10] Tarullo, *supra* note 9, at 1.

[11] Gorton & Metrick, *supra* note 9, at 1.

[12] *See id.* at 1; IMF, *supra* note 8, at 5.

[13] *See generally* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS, 83-99 (2005) (explaining the functions and purposes of the Federal Reserve System and the Federal Reserve in the U.S. payment system).

[14] *See, e.g.*, Gorton & Metrick, *supra* note 9, at 2-3 (arguing that large financial institutions and cash-rich non-financial companies use investment banks or broker-dealers as "banks" in the repo market); *see also* PCSSA, *supra* note 2, at § 5462(7)(B) (including in the definition of "financial transaction," among other transactions, "funds transfers," various types of securities contracts, "repurchase agreements," various types of swaps, and "any similar transaction that the [Financial Stability Oversight] Council

have acted as the primary financial intermediaries transferring demand debt among parties.[15] Once-typical transfer services include check processing, wire transfers, securities clearing, and various forms of credit.[16] The speed, frequency, and size of transactions as well as the risk associated with the temporal delay between the time a party commits itself to a transaction and the time a counterparty receives the object of that commitment make relying on party-to-party exchange of currency unattractive relative to services provided by financial intermediaries.

2. Advantages of the PCS System: Practical Efficiency, Managing Risk

In this way, financial intermediaries provide services to sellers and buyers of goods, services, and financial assets that make transactions more practicable and efficient, while also assuming the risk that a party to a transaction may become insolvent before the transaction settles.[17] For example, widget Distributor A ("A") in

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determines to be a financial transaction"), § 5462(7)(C) (including in the definition of "financial activities," among other activities, "the movement of funds," "the management of risks and activities associated with continuing financial transactions," "the final settlement of financial transactions," and other similar functions that the Council may determine.").

[15] *Compare* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 84, 85 (asserting that "most of the payments underlying [the sale or purchase of "goods, services, or financial assets"] flow between depository institutions, a large number of which maintain accounts with the Reserve Banks" and that "[t]he Federal Reserve plays a vital role in both the nation's retail and wholesale payments systems"), *with* Gorton & Metrick, *supra* note 9, at 3 (concluding that "shadow banking [has] grow[n] so much" in recent years based, in part, on an index comparing the rapid growth of broker-dealer assets relative to the growth of commercial bank assets).

[16] *Compare* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 85 (listing Reserve Bank retail and wholesale services), *with* PCSSA, *supra* note 2, at § 5462(7)(C) (defining payment, clearing, and settlement activities broadly), *and* GARY GORTON, QUESTIONS AND ANSWERS ABOUT THE FINANCIAL CRISIS, PREPARED FOR THE U.S. FINANCIAL CRISIS INQUIRY COMMISSION, (2010, *available at* http://online.wsj.com/public/resources/documents/crisisqa0210.pdf (asserting that "bank liabilities [like "sale and repurchase agreements"] . . . [had] not been quantitatively important historically").

[17] PCSSA, *supra* note 2, at § 5461(a)(1) (find that financial intermediaries "may reduce risk for [financial market] participants and the broader

Albuquerque may purchase widgets from Manufacturer B ("B") in Baltimore for $1,000,000. B ships the widgets and awaits payment from A. Relying on the $1,000,000 it expects to receive from A, B rushes to purchase materials from Supplier C ("C") in Cincinnati and Supplier D ("D") in Detroit.

Considering only issues related to cash payment for goods, a stable PCS System benefits market participants in several critical ways.[18] Even in the simple hypothetical presented above, the speed, frequency, and size of transactions make party-to-party exchanges highly inefficient. Absent the contemporary system, if A were to pay B using cash, A would have to take physical possession of $1,000,000 to deliver to B by some method agreeable to both parties. Without financial intermediaries, the transaction would require time to settle. Assuming B had no other source of currency sufficient to cover the cost of materials, B could not pay C or D until B received payment from A, limiting B's productivity. Furthermore, the size of the transaction could make obtaining and delivering actual currency slow, risky, and impractical because banks would have to make cash available to the transacting parties and those parties would have to handle enough currency to cover the transaction. The amount of currency held by or available to a market's participants would limit its liquidity.

Perhaps more importantly, in the hypothetical system, a market participant would face "liquidity . . . and credit problems that could disrupt its clearing and settlement activities."[19] Absent financial intermediaries, B would assume the risk that A could become insolvent before the transaction settles. B would be reluctant to transact with A without careful assurances about A's solvency. [20] C and D likewise might need to assess the risk of both B and A's

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financial system); *see* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 84-85 ("The Reserve Banks settle payment transactions efficiently by debiting the accounts of the depository institutions making payments and by crediting the accounts of depository institutions receiving payments.")

[18] PCSSA, *supra* note 2, at § 5461(a)(1) (finding that "the proper functioning of the financial markets is dependent upon safe and efficient arrangements for the clearing and settlement of payment, securities, and other financial transactions").

[19] BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 85.

[20] Operating with an analogous rationale leading up to the financial panic of 1907, "banks and clearinghouses refused to clear checks drawn on certain other banks." *Id.* at 83.

insolvency prior to settlement. Even if B were to assume the cost of such determinations, in the event that A were to become insolvent prior to settlement, B, C and D, would bear losses. B might factor that risk of loss into the price it charges A.[21] Therefore, the risk of insolvency before settlement would impose transaction costs on market participants and destabilize the underlying market.

Today, however, transfers of actual currency "account for only a small proportion of the total dollar value of all monetary transactions."[22] Instead, individuals, businesses, financial institutions, and banks typically rely on the banking system, particularly depository institutions and the Federal Reserve, to provide services to transfer noncash payments.[23] That is, some financial intermediary, typically a depository institution, likely stands in for each participant in the hypothetical transaction. "[B]y debiting the accounts of the depository institutions making payments and by crediting the accounts of depository institutions receiving payments"[24] payment, clearing and settlement conducted through financial intermediaries eliminates the inefficiencies associated with transferring currency. Reliance on financial intermediaries also shifts the risk of insolvency before settlement from market participants to those intermediaries, but noncash payment methods create risk even in an interbank payment context.[25] Like the hypothetical market participants, depository institutions face similar practical concerns and liquidity and credit risks.[26] For example, during the financial panic in 1907

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[21] During the "Free Banking" Era preceding the National Banking Act of 1863, the real value of a bank note relative to its face value depended on the issuing bank's stability. *See* Hugh Rockoff, *The Free Banking Era: A Reexamination*, 6 J. MONEY CRED. & BANKING 141, 143 (1974).

[22] BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 87.

[23] *Id*. at 89 ("While cash is convenient for small-dollar transactions, for larger-value transactions individuals, businesses, and governments generally use checks or electronic fund transfers."); *cf.* GORTON, *supra* note 1616 (arguing that institutional investors and other nonfinancial firms use repo agreements as the functional equivalent of checking accounts to safely earn interest on "deposits" in excess of the amount insured by the FDIC.). See Gorton & Metrick for their critique of the Dodd-Frank Act.

[24] BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 84-85.

[25] PCSSA, *supra* note 2, § 5461(a)(2) ("Financial market utilities that conduct or support multilateral payment, clearing, or settlement activities may reduce risks for their participants and the broader financial system, but such utilities may also concentrate and create new risks . . . .").

[26] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 85.

prior to Congress's creation of the Federal Reserve system, banks and private clearinghouses refused checks drawn on certain other banks, which contributed to the failure of otherwise solvent banks and instability in the greater economy.[27]

Throughout the nineteenth and twentieth centuries, similar financial panics severely disrupted the national economy and Congress sought to curtail such disruptions through federal regulation of the PCS System as early as 1913.[28] In that year, Congress passed the Federal Reserve Act to address problems that contributed to the Crisis of 1907.[29]

3. Features of the PCS System

To address the public's lack of confidence in banks' ability to act as financial intermediaries servicing transactions,[30] the Federal Reserve Act "provide[s] for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."[31] Because the Federal Reserve is the U.S. central bank, it is considered "immune from liquidity problems . . . and credit problems" that historically caused banking panics.[32] Thus, the Federal Reserve, primarily through the Reserve Banks, acts as the primary financial intermediary servicing transactions between banks.[33] The Federal Reserve

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[27] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 83.
[28] *Id*. at 1.
[29] The Federal Reserve Act, Pub. L. No. 43, 38 Stat. 251, (codified as amended in scattered sections of 12 U.S.C.) (establishing "Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes").
[30] *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 1-2 (arguing that Congress passed the Federal Reserve Act, spurred by proposals from the National Monetary Commission, which Congress established in response to the Crisis of 1907); *see also* GORTON, *supra* note 16, at 1-4.
[31] The Federal Reserve Act, *supra* note 29.
[32] BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 85.
[33] *See id.* at 85 ("The Federal Reserve plays a vital role in both the nation's retail and wholesale payments systems, providing a variety of financial services to depository institutions.").

thereby performs an important role in the world's largest payment system,[34] and by extension, in the international payment system.[35]

Federal Reserve banks process "interbank checks, checks not drawn on the institution at which they were deposited," providing a centralized method for exchanging the checks and moving funds.[36] Depository institutions, however, also clear checks through private arrangements.[37] The Federal Reserve also developed jointly with the private sector a nationwide mechanism that processes credit and debit transfers electronically known as the automated clearinghouse ("ACH").[38] More recently, "the Reserve Banks began a cross-border ACH service."[39] "The Fedwire Funds Service provides a real-time gross settlement system . . . to initiate electronic funds transfers that are immediate, final, and irrevocable,"[40] while "[t]he Fedwire Securities Service provides safekeeping, transfer, and settlement services for securities issued by the Treasury, federal agencies, government-sponsored enterprises, and certain international organizations."[41]

These traditional bank services alone, however, paint an inaccurately narrow picture of banking, and thereby the PCS System, for at least three reasons.[42] First, these services primarily involve just one side of a bank's balance sheet because each involves "depositors transfer[ing] money to the bank, in return for a checking or savings account that can be withdrawn at any time" or parties making those withdrawals.[43] A bank also typically loans funds to borrowers,

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[34] BD. OF GOVERNORS OF THE FED. RESERVE SYS., *supra* note 13, at 84 ("The U.S. payment system is the largest in the world," and "[t]he Federal Reserve therefore performs an important role as an intermediary in clearing and settling interbank payments").
[35] *See id*. at 88-99.
[36] *See id*. at 90, 90-91.
[37] *Id.* at 90.
[38] *Id.* at 93.
[39] *Id.*
[40] *Id.* at 94.
[41] *Id.* at 95-96.
[42] *See* Gorton, *supra* note 16, at 2 (defining banking as "creating short-term trading or transaction securities backed by longer term assets"); Gorton & Metrick, *supra* note 9, at 2 (arguing that "there has been a major shift in the source of transaction media away from demand deposits" and that "innovation and regulatory changes" among other things "led to the decline of the traditional banking model").
[43] Gorton & Metrick, *supra* note 9, at 2.

holding the loans as assets on its balance sheet.[44] Second, since the time federal deposit insurance was capped at $100,000 large institutions and cash-rich non-financial companies have sought "safe, interest-earning, short-term investments" akin to demand deposits through the shadow banking system financed by off-balance-sheet lending.[45] Thus, by participating in the repo market broker-dealers can meet this demand and act as banks in the shadow banking system.[46] Third, "[r]epo and checks are both forms of money."[47] Whether in the traditional banking system or the shadow banking system, the possibility of a run on the "banks" poses systemic risk and destabilizes the PCS System.

C. The Legislative Landscape Governing the Payment, Clearing, and Settlement System

1. Regulation Before the PCSSA

Since the enactment of the Federal Reserve Act, Congress has continued to recognize the importance of a stable PCS System in maintaining the health of the greater economy and addressed systemic risk in the PCS System in legislation throughout the twentieth century.[48] During this time, Congress has amended the Federal Reserve Act and passed further legislation, clarifying and supplementing the Federal Reserve Act's mandate to address national economic and financial policy.[49] Motivated by the financial crisis of 2008, Congress recently sought to "mitigate systemic risk in the financial system and promote financial stability" by enacting the PCSSA.[50]

Prior to the financial crisis in 2007-09 and the enactment of the PCSSA in 2010, regulation reflected "the basic contours [of the U.S. financial system] drawn during the Great Depression."[51] On one side of the banking-commerce divide, the "'invisible hand' of market

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44 *Id.* at 2.
45 *Id.* at 2.
46 *Id.* at 3.
47 Gorton, *supra* note 16, at 2.
48 *See id*. at 1-2.
49 *Id*. at 83-84.
50 PCSSA, *supra* note 2, at § 5461(b).
51 IMF, *supra* note 8, at 5.

discipline" tempered "innovation and regulatory arbitrage."[52] On the other, "stringent regulation and supervision" offset the moral hazard of retail deposit-taking institutions' access to "the federal financial safety net."[53] Without the PCSSA's broad authorization, the Fed "has had to supervise payments systems based on a mixture of its supervisory authority over certain systems providers and its right to impose conditions on the use of Federal Reserve Bank settlement services by other systems."[54]

2. How the PCSSA Changes the Regulatory Framework

The PCSSA moves away from an atomistic understanding of firms, beginning with a statement of Congressional findings regarding the role of the payment, clearing, and settlement system in ensuring market safety and efficiency, the system's relationship to market risk, and the importance of regulating and supervising the system.[55] Congress found the regulatory and supervisory enhancements to be 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."[56] Consistent with these findings, the purpose of the PCSSA is to "mitigate systemic risk in the financial system and promote financial stability" by 1) authorizing the Board of Governors to promote uniform standards for managing risk and conduct in the PCS System, 2) enhancing the Board's role in supervising the risk management standards for systemically important market utilities, 3) strengthening the liquidity of systemically important market utilities, and 4) enhancing the Board's role in supervising the risk

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[52] *Id.* at 7-8, 9.
[53] *Id.*
[54] Financial Institutions Advisory & Financial Regulatory Group, Shearman & Sterling LLP, *Obama Administration Submits Additional Legislation to U.S. Congress*, CLIENT PUBLICATION, Jul. 29, 2009, at 3, http://www.shearman.com/files/Publication/399cbdd6-ca4a-4842-8bee-08a69388cbae/Presentation/PublicationAttachment/8c9c7e24-f091-464c-89be-28a2975f93af/FIA-072909-Obama-Administration-Submits-Additional-Legislation-to-U.S.-Congress.pdf.
[55] PCSSA, *supra* note 2, at § 5461(a) (listing Congress's findings).
[56] *Id.*, at § 5461(a)(4)(A)-(C).

management standards for systemically important payment, clearing, and settlement activities by financial institutions.[57]

To achieve this purpose, Congress through the PCSSA charges the Council with determining whether a financial market utility or payment, clearing, or settlement activity is, or is likely to become "systemically important."[58] The PCSSA permits the Council to consider any factor it deems appropriate in designating a "financial market utility or payment clearing or settlement activity" as "systemically important."[59] In making the determination, the Council will consider the following guidelines explicit in the PCSSA: "aggregate monetary value of transactions processed or carried out; aggregate exposure to counterparties; relationships, interdependencies or other interactions with other financial market utilities or payment, clearance or settlement activities; and effect failure or disruption of the utility or activity would have on critical markets, financial institutions, or the broader financial system."[60]

The PCSSA "provides for the supervision of systemically important financial market utilities and payment, clearing and settlement activities conducted by financial institutions" by assigning a greater supervisory role to the Board of Governors.[61] The PCSSA "defines a 'financial market utility' as 'a person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person,'" excluding several types of entities.[62] In consultation with the Council and the primary regulatory agency of the designated market utility, the Board of Governors will prescribe risk management standards to "promote robust risk management; promote safety and soundness; reduce systemic risks; and support stability of the broader financial system."[63] The PCSSA also authorizes the U.S. Commodity Futures Trading Commission (the "CFTC") and the U.S. Securities and Exchange Commission (the "SEC") to prescribe regulations for market utilities under their respective regulatory

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[57] *Id*.
[58] PCSSA, *supra* note 2, at § 5463(a)(1).
[59] PCSSA, *supra* note 2, at § 5463(a)(2).
[60] Christiansen & Sweet, *supra* note 4, at 1.
[61] Christiansen & Sweet, *supra* note 4, at 1.
[62] *Id.*; *see also* PCSSA, *supra* note 2, at § 5462(6)(A). For entities that the definition explicitly excludes, see PCSSA, *supra* note 2, at § 5461(6)(B).
[63] *Id.* at 2; *see also* PCSSA, *supra* note 2, § 5464.

supervision.[64] The Board of Governors, however, has authority to review these standards to "prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States."[65]

The PCSSA empowers the Board of Governors to "authorize a Federal Reserve Bank to establish and maintain an account for a designnated financial market utility" and provide certain services to the market utility to the extent that the Reserve Bank can provide to a depository institution.[66] The PCSSA further empowers the Board of Governors to authorize a Federal Reserve bank to provide "discount and borrowing privileges only in unusual or exigent circumstances," upon a vote of the Board of Governors, and "upon a showing by the designated financial market utility that it is unable to secure adequate credit accommodations from other banking institutions."[67] Furthermore, "[t]hose privileges are available to all designated financial market utilities, not just those that are banks or bank holding companies."[68]

D. Conclusion

The PCSSA fits in the post-Dodd-Frank regulatory framework as a source of macro prudential oversight intended to mitigate systemic risk posed by payment, clearing, and settlement market utilities and activities. Through the Act, Congress empowers regulators to designate systemically important market utilities and activities and to promote uniform standards to regulate them. The PCSSA represents a step toward eliminating simultaneous statutory gaps and overlapping regulatory regimes. Its lack of specificity and silence on the shadow banking system make its impact on activities along the regulatory periphery uncertain. Although Congress through the PCSSA's broad grant of authority enhances the ability of Federal regulators to supervise the PCS System, predicting whether and to what extent regulators will achieve the Act's objectives remains difficult absent agency or further legislative interpretation of the Act.

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[64] PCSSA, *supra* note 2, at § 5464(a)(2).
[65] *Id.* at § 5464(a)(2)(B).
[66] *Id.* at § 5465(a).
[67] *Id.* at § 5464(b)
[68] Christiansen & Sweet, *supra* note 4, at 3.
[69] Student, Boston University School of Law (J.D. 2012).