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**Resolving central counterparties after Dodd–Frank:
Are they eligible for “orderly liquidation”?**

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[Summary: The disorderly failure of a central counterparty clearinghouse (CCP) could lead to severe systemic disruptions, potentially impairing the effective operation of financial markets. To avoid such disruptions, we need effective mechanisms to provide for the resolution of a failing clearinghouse if recovery is not possible.]

The payment, clearing, and settlement systems that support financial markets are critical to the efficient functioning of the financial system. Although sometimes referred to as the “plumbing” of the financial system, these little-appreciated infrastructures may be more accurately described as “the central nervous system” of a market economy.

* This paper is preliminary and should not be cited or quoted without the authors’ permission. The views expressed in this paper are solely those of the authors and do not necessarily reflect the views of the Federal Reserve Bank of Chicago, the Board of Governors of the Federal Reserve System or their staff. David DeCarlo co-authored this article while he was an intern in the Financial Markets Group at the Federal Reserve Bank of Chicago. He now works at the Federal Reserve Bank of New York. The authors welcome all comments.

[Page 1 pullout: “When the crisis hit, regulatory options for responding to distress in large, non-bank financial companies left policymakers with a no-win dilemma: either prop up failing institutions with expensive bailouts or allow destabilizing liquidations through the normal bankruptcy process” --

Sheila C. Bair, former chair, Federal Deposit Insurance Corporation.ⁱ

A specialized form of financial market infrastructure—the central counterparty (or CCP) clearinghouse—is widely used in modern securities and risk transfer markets. Central counterparty clearing provides a foundation for centralized risk management (including multilateral netting, collateralization, and loss mutualization) and efficient data processing (such as trade registration, reporting, and risk monitoring). However, central clearing also concentrates risk. Interposing a CCP as the “buyer to all sellers” and “seller to all buyers” in a market may make the CCP a *single point of failure* that could propagate systemic shocks through global financial markets in a crisis.

What if a CCP fails? Paul Tucker, a former Deputy Governor of the Bank of England, recently noted that this “is a huge issue.”ⁱⁱ The disorderly failure of a CCP could lead to severe systemic disruptions, potentially impairing the effective operation of financial markets. To avoid such disruptions, we need effective mechanisms to provide for the resolution of a failing clearinghouse if recovery is not possible.

BOX

International policy developments

In the wake of the 2009 Financial Crisis, the Group of Twenty charged the Financial Stability Board (FSB) with responsibility for monitoring and assessing the implementation of internationally agreed regulatory reforms. Among other things, the

FSB has issued standards for the resolution of financial institutions, including specific guidance regarding the application of those standards to financial market infrastructures (see http://www.financialstabilityboard.org/publications/r_141015.pdf).

In addition, the Committee on Payments and Market Infrastructure (CPMI), formerly known as the Committee on Payment and Settlement Systems (CPSS), and the International Organization of Securities Commissions (IOSCO) recently published a report on the resolution of financial market infrastructures, including clearing and settlement infrastructures (see <http://www.bis.org/cpmi/publ/d121.pdf>).

END BOX

In 2010, Congress enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act. Title II of Dodd–Frank provides for a new “orderly liquidation authority” for the resolution of certain non-bank financial companies. In this paper, we discuss whether a systemically important CCP would be eligible for orderly liquidation. If a failing U.S. CCP qualifies as a “financial company” and meets the other requirements of Title II, it may be resolved by the Federal Deposit Insurance Corporation (FDIC) under the new resolution authority. If not, it would be resolved under the Bankruptcy Code or other applicable law.

Orderly liquidation of non-bank financial companies under Dodd–Frank

Title II of Dodd–Frank authorizes the Secretary of the Treasury to appoint the FDIC as receiver for a non-viable financial company under the conditions set forth in the statute and applicable regulations. Among other things, Dodd–Frank section 203(b) requires the Treasury Secretary to initiate orderly liquidation proceedings if, after consultation with the President, the Secretary determines that:

- A financial company is “in default or in danger of default”;

- The failure of the company and its resolution under the Bankruptcy Code (or other applicable law) “would have serious adverse effects on financial stability in the United States”;
- A “viable private sector alternative” to orderly resolution is not available to prevent the company’s default;
- The effect on “creditors, counterparties and shareholders of the financial company and other market participants” of a Title II resolution is “appropriate given the impact . . . on financial stability in the United States”;
- Orderly resolution of the company “would avoid or mitigate . . . adverse effects” on the company’s stakeholders, taking into consideration financial stability concerns, the cost to the U.S. Treasury and other factors; and
- The company qualifies as a “financial company.”

To determine whether a company qualifies as a financial company for this purpose, we look to the definition set forth in Dodd–Frank Act section 201(a)(11) and related provisions of U.S. law.

With certain exceptions not relevant to our discussion, a company is defined as a financial company under Title II only if it is incorporated or organized under U.S. law (federal or state) and is: a bank holding company as defined in section 2(a) of the Bank Holding Company Act of 1956; a nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the Federal Reserve); or a company that is “predominantly engaged in activities” that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956. In addition, certain subsidiaries of the foregoing entities may themselves be financial companies. We consider each of these possibilities in turn.

General conditions for orderly liquidation under Title II

First, no systemically important U.S. CCP is a bank holding company or a subsidiary of a bank holding company. Second, no U.S. CCP is a nonbank financial company

supervised by the Federal Reserve under Dodd–Frank section 201(a)(15). This result arises from the statute’s incorporation by reference of the definition of “U.S. nonbank financial company” under Dodd–Frank section 102(a)(4)(B), which expressly excludes “derivatives clearing organizations” (the term for CCPs regulated by the Commodity Futures Trading Commission [CFTC]) and “clearing agencies” (the term for CCPs regulated by the Securities and Exchange Commission [SEC]). Therefore, no derivatives clearing organization or clearing agency is a nonbank financial company supervised by the Federal Reserve for purposes of either Title I or II of Dodd–Frank. This is consistent with the general regulatory framework of Dodd–Frank, which assigns primary supervisory authority over U.S. CCPs to the CFTC and SEC, not the Federal Reserve.

Consequently, a U.S. CCP may qualify as a financial company only if it is “predominantly engaged in activities” that the Federal Reserve has determined are “*financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956.*” Moreover, according to Dodd–Frank section 201(b), a company may not be considered a financial company for purposes of Title II “if the consolidated revenues of such company from [activities that are financial in nature or incidental thereto] . . . constitute less than 85 percent of the total consolidated revenues” of the company.” This proviso turns out to be relevant to at least one U.S. CCP because of its corporate structure, but we do not discuss the complicated issues that may arise under the revenue test of section 201(b) in this article.

Is central clearing an activity that is “financial in nature”?

To determine whether a CCP qualifies as a “financial company” for purposes of Title II, we must identify the activities that the Federal Reserve has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act. That turns out to be no simple task. As an initial matter, the reference to section 4(k) of the Bank Holding Company Act in Dodd–Frank Title II is ambiguous when applied to companies – such as CCPs – that are not bank holding companies.ⁱⁱⁱ

The Federal Reserve, which has primary responsibility for interpreting and applying section 4(k), has resolved that ambiguity by adopting a regulation defining the activities that are considered financial in nature for purposes of Title I of Dodd–Frank. Title I imposes enhanced prudential standards on certain “nonbank financial companies,” as separately defined in section 102(a)(6), and subjects those companies to supervision by the Federal Reserve for financial stability purposes.^{iv} The Federal Reserve essentially incorporated the list of Congressionally authorized activities added by the Gramm–Leach–Bliley Act and activities previously approved by the Board for bank holding companies under sections 4(c)(8) and (13) of the Bank Holding Company Act in its Title I determination.

The FDIC, in turn, has determined that the Federal Reserve’s interpretation of the parallel (but not identical) language of Dodd–Frank Title I is “appropriate and consistent with the purposes and goals of Title II” and that “the definition of ‘financial activities’ for purposes of Title II [should] remain as similar as practicable to the definition of ‘financial

activities' for purposes of Title I.”^v The FDIC’s decision to adopt the Federal Reserve’s interpretation of the statutory language in Title I, however, does not completely resolve the problems that arise in determining which activities are “financial in nature or incidental thereto” for purposes of Title II. In particular, the list of activities that are considered financial in nature under the Bank Holding Company Act “evolved piecemeal over the years and reflects both regulatory and statutory political and policy decisions made during those times.”^{vi}

The defining characteristic of central counterparty clearing is counterparty substitution, by means of which the CCP is interposed as a principal to all contracts that are accepted for clearing. Can we find this function listed as an activity that the Federal Reserve has determined to be financial in nature under the Bank Holding Company Act? Not in simple or obvious terms. The list includes “[e]ngaging in investment transactions as principal, including underwriting and dealing in government obligations and money market instruments, investing and trading as principal in foreign exchange and derivatives, and buying and selling bullion.” A CCP, as we have noted, does become a principal to each trade it accepts for clearing. But serving as a central counterparty does not involve underwriting or dealing, as those terms are ordinarily understood. Moreover, central counterparty clearing is a special form of market infrastructure, not the kind of activity that can easily be conceived of as “engaging in investment transactions.” Given these doubts, we think the list of financial activities under section 4(k) is not dispositive, as the other activities on the list are even further from sounding like descriptions of central clearing. While Lubben (2014) concludes that

central clearing is not on the list of financial activities, there is separate precedent supporting the conclusion that clearing is an activity that is financial in nature.^{vii}

The Federal Reserve has previously determined that a CCP for foreign currency transactions performed functions that are permissible for bank holding companies under section 4(c)(8) of the Bank Holding Company Act.^{viii} As we have noted, activities that have been approved by the Federal Reserve for bank holding companies pursuant to section 4(c)(8) are included in the list of activities that are financial in nature for purposes of Title I, and the FDIC has adopted that list for purposes of Title II.

Consequently, it appears that CCPs may be eligible for resolution by the FDIC in orderly liquidation proceedings, assuming that the other requirements of Title II are satisfied. Nevertheless, there are some other reasons to question that conclusion, as we discuss next.

Other issues of statutory construction

Lubben (2014) notes that the CFTC has been given no role in triggering an orderly liquidation under Title II. That certainly seems odd, given that section 203(a)(1) of Dodd–Frank explicitly provides for the SEC to play a key role in determining whether to recommend to the Treasury Secretary that a failing broker-dealer should be subject to orderly liquidation by the FDIC. Dodd–Frank section 203(a)(1) also explicitly provides for the Director of the Federal Insurance Office to play a similar role in determining whether to recommend orderly liquidation of a failing insurance company. The omission of authority for the CFTC or SEC—the primary supervisory authorities for U.S. CCPs—

to play any role in determining whether a failing CCP should be resolved by the FDIC under Title II suggests, as Lubben argues, that Congress may not have intended for CCPs to be resolved in orderly liquidation proceedings.

What, if anything, should we make of the fact that certain CCPs have been designated by the Financial Stability Oversight Council (FSOC) as systemically important “designated financial market utilities” (DFMUs) under Dodd–Frank Title VIII? To date, FSOC has identified five CCPs as DFMUs—the Chicago Mercantile Exchange, Inc., Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, and The Options Clearing Corporation. Some commentators have concluded that a failing DFMU would be subject to orderly liquidation under Title II because the FSOC has made a systemic risk determination as a prerequisite for designation under Title VIII that is effectively identical to the systemic risk determination required under Title II.

That conclusion, however, is not consistent with the language of Dodd–Frank section 203(b), which explicitly requires the Secretary of the Treasury to determine that a failing company qualifies as a financial company. To be sure, a systemic risk determination by FSOC under Title VIII is persuasive evidence that the Secretary of the Treasury would conclude that the failure of a DFMU “would have serious adverse effects on financial stability in the United States,” but that alone is not sufficient to trigger a Title II proceeding, as we have argued here.

Conclusion

Under current circumstances, a U.S. CCP may qualify as a financial company only if it is “predominantly engaged in activities that the Board of Governors has determined are *financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act of 1956*. ...” The Federal Reserve has previously determined that central clearing is an activity that is permissible for bank holding companies and FSOC has designated certain CCPs as systemically important. However, as we have noted, the omission of authority for the CFTC or SEC to play any role in determining whether a failing CCP should be resolved by the FDIC under Title II may suggest that Congress did not intend for CCPs to be resolved in orderly liquidation proceedings. If so, this casts doubt as to whether CCPs are eligible for orderly liquidation and raises the possibility that Chapter 7 of the Bankruptcy Code provides the only mechanism under U.S. law for resolving a systemically important CCP.

Does the Bankruptcy Code provide an adequate procedure for resolving systemically important financial market infrastructures, such as CCPs? Former FDIC Chair Sheila Bair argues that policymakers faced a “no-win dilemma” in responding to financially distressed non-bank financial companies and were forced to “prop up failing institutions with expensive bailouts or allow destabilizing liquidations through the normal bankruptcy process” (see note 1) In response, Congress enacted Dodd–Frank Title II to provide for the orderly liquidation of systemically important non-bank financial companies. For the reasons discussed in this article, however, there is some lingering uncertainty whether U.S. CCPs are eligible for orderly resolution under Title II. As Duffie (2014) notes,

“[r]esolution procedures should be transparent and predictable . . . so that the attendant risks can be better managed and priced into contracts.”^{ix} Moreover, because the disorderly failure of a systemically important clearinghouse could lead to severe systemic disruptions, we should have reasonable certainty about the tools policymakers have to respond to such a crisis.

ⁱ Shelia C. Bair, 2011, “Testimony on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act,” before Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 17, available at: <https://www.fdic.gov/news/news/speeches/archives/2011/spfeb1711.html>.

ⁱⁱ Paul Tucker, 2014, “Are Clearing Houses the New Central Banks?,” Remarks at the Federal Reserve Bank of Chicago, Symposium on OTC Derivatives, Chicago (April 11), p. 2, available at: http://www.chicagofed.org/digital_assets/others/events/2014/annual_over_the_counter_derivatives_symposium/tucker_clearinghouses_new_central_banks_tucker_2014.pdf.

ⁱⁱⁱ Federal Deposit Insurance Corporation, 2013, Definition of “Predominantly Engaged in Activities That Are Financial in Nature or Incidental Thereto,” Federal Register, Vol. 78, No. 111, p. 34716 (June 10, 2013), available at: https://www.fdic.gov/regulations/laws/federal/2013/2013-06-10_final-rule.pdf.

^{iv} Board of Governors of the Federal Reserve System, 2013, Definitions of “Predominantly Engaged In Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company, Federal Register, Vol. 78, No. 66, pp. 20756 et seq. (April 5, 2013), available at: www.gpo.gov/fdsys/pkg/FR-2013-04-05/pdf/2013-07688.pdf.

^v FDIC (2013), p. 34717. We note that Dodd-Frank section 102(a) requires the Federal Reserve to determine which activities “are financial in nature” for purposes of Title I; by contrast, section 201(a)(11) requires a determination regarding activities that are “financial in nature or incidental thereto” for purposes of Title II. However, this distinction has no significance for the discussion in this article.

^{vi} Davis Polk & Wardwell, LLP, 2011, Summary of Federal Reserve Proposed Rule on Definitions Related to Nonbank Financial Companies and Interconnectedness of Systemically Important Firms (February 9), p.1, available at: www.davispolk.com/publications/list?&field_pb_related_services_target_id=49361.

^{vii} Lubben, Stephen J., 2014, “Nationalize the Clearinghouses!,” Seton Hall Public Law Research Paper No. 2458506 (June 24), p. 23, available at: <http://ssrn.com/abstract=2458506> or <http://dx.doi.org/10.2139/ssrn.2458506>.

^{viii} Board of Governors of the Federal Reserve System, 1996, Order Approving a Notice to Engage in Certain Nonbanking Activities and Application to Become a Member of the Federal Reserve System (December 4, 1996), available at: www.federalreserve.gov/boarddocs/press/bhc/1996/19961204/#f9/.

^{ix} Duffie, Darrell, 2014, “Resolution of Failing Central Counterparties,” (December 17), available at: www.darrellduffie.com/uploads/working/DuffieCCP-ResolutionJan2015.pdf.