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Financial Market Utilities: One More Dangerous Concept in Dodd–Frank

Norbert J. Michel, PhD

Abstract

Policymakers have paid too little attention to Title VIII of the 2010 Dodd–Frank Act. Title VIII creates a new regulatory framework for certain payment, clearing, and settlement (PCS) companies. This new regime is similar to the special regulatory framework that Title I of the act created for systemically important financial institutions. One problem is that Title VIII broadens the concept of what constitutes a public utility to include companies in the financial industry. Newly designated PCS firms are now legally referred to as financial market utilities (FMUs), a term that conveys a special status for one segment of financial markets. Title VIII will ultimately restrict competition among financial firms, increase consumer prices, concentrate financial risk, and invite taxpayer bailouts. In its entirety, Title VIII provides yet another reason why Congress should repeal the Dodd–Frank Act.

An underreported problem with the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act is that it broadens the concept of what constitutes a public utility. In particular, Title VIII of Dodd–Frank confers a special status on firms that it identifies as financial market utilities (FMUs).[1] This change marks a dangerous shift in the relationship between government and private markets because it implies that private financial firms cannot—or should not—competitively provide financial services. More broadly, Title VIII expands the regulatory power of the Federal Reserve and other key regulators through a new framework for certain payment, clearing, and settlement (PCS) companies. This new framework is similar to the heightened regulatory regime that Dodd–Frank created for large financial firms referred to as systemically important

Key Points

- Title VIII of Dodd–Frank confers a special status on firms it identifies as financial market utilities (FMUs), marking a dangerous shift in the relationship between government and private financial markets.
- Treating PCS firms as public utilities is anticompetitive and mistakenly implies that the financial industry cannot function unless it remains as currently structured. The FMU status will restrict competition, concentrate financial risk, and raise consumer prices.
- Title VIII authorizes the FSOC to designate specific PCS firms *and* activities as systemically important. Both actions amount to identifying financial firms deemed "too big to fail."
- Designated PCS firms will have access to deposit and payment services with the Federal Reserve. The Fed can also provide discount window borrowing to PCS firms in "unusual or exigent circumstances."
- Title VIII all but ensures that the Fed will be viewed as part of even the nonbank financial sector's PCS system.

This paper, in its entirety, can be found at **http://report.heritage.org/bg3005**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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financial institutions (SIFIs). That framework effectively identifies the companies that regulators deem too big to fail.

While Title VIII does not—yet—impose as heavy a regulatory burden on PCS firms as Title I does on SIFIs, it does provide clear advantages to some PCS companies relative to their potential competitors. For instance, Title VIII gives certain PCS firms explicit access to deposit and payment services, as well as so-called emergency funding, through the Federal Reserve. Title VIII and the FMU designation have further socialized the cost of financial risk-taking and therefore increased the likelihood of future financial crises and bailouts. The anticompetitive nature of the utility concept mistakenly implies that the financial industry cannot function unless it remains structured as it currently exists. Ultimately, Title VIII will restrict competition, lead to higher consumer prices, concentrate financial risk, and invite future taxpayer bailouts. Overall, Title VIII provides yet another reason why Congress should repeal Dodd–Frank.

The following list summarizes the main reasons why Title VIII and the FMU concept are a long-term threat to free enterprise:

- **The public utility concept** is anticompetitive because it allows incumbent firms to protect their profits and dominant positions at the expense of potential rivals.
- **The FMU designation** mistakenly implies that the financial industry cannot function unless the PCS segment remains structured as it currently exists. No financial companies should be isolated from potential competition and technological innovation in this manner.
- **The FMU concept** imposes standardization on markets, thus hindering innovation and competition and threatening the long-term strength and stability of financial markets.
- **The Title VIII FMU designation** has only further socialized the cost of financial risk-taking and, therefore, increased the likelihood of future financial crises and bailouts. Former Federal Deposit Insurance Corporation (FDIC) Chair Shelia Bair notes that certain PCS firms "were drooling at the prospect of having access to loans from the Fed" when Title VIII was being crafted.[2]
- **Based on the history of public utilities, the FMU designation** is likely to restrict competition, concentrate financial risk, and raise consumer prices.

An Overview of the Payment, Clearing, and Settlement (PCS) Systems

U.S. financial markets include a wide variety of PCS systems, many of which interconnect. For instance, retail payment systems, such as bankcard networks, facilitate consumer purchases. Wholesale payment systems, such as the Clearing House Interbank Payments System (CHIPS), typically handle large transactions between financial institutions.[3] However, most retail credit card transactions are ultimately settled via both retail and wholesale systems. Stock market and derivative clearing and settlement largely take place within separate specialized PCS systems.

While payment, clearing, and settlement are technically separate functions, many PCS firms' operations overlap all three. MasterCard, for example, operates a network that performs all three functions in order to facilitate retail purchases. When a consumer swipes his card to buy an item, a series of electronic processes begin. The first process determines the validity of the card, and the last process is the final settlement between the consumer's and the retailer's banks.[4] Thus,

1. Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111–203, 2010, https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf (accessed March 6, 2015).
2. Gretchen Morgenson, "One Safety Net that Needs to Shrink," *The New York Times*, November 3, 2012, http://www.nytimes.com/2012/11/04/business/one-safety-net-that-needs-to-shrink.html (accessed February 26, 2015).
3. For detailed descriptions, see "Retail Payment Systems: IT Examination Handbook," Federal Financial Institutions Examination Council, February 2010, and "Wholesale Payment Systems: IT Examination Handbook," Federal Financial Institutions Examination Council, July 2004. For a brief summary, see Marc Labonte, "Supervision of U.S. Payment, Clearing, and Settlement Systems: Designation of Financial Market Utilities (FMUs)," Congressional Research Service, R41529, September 10, 2012, pp. 5–8.
4. Susan Herbst-Murphy, "Clearing and Settlement of Interbank Card Transactions: A MasterCard Tutorial for Federal Reserve Payments Analysts," Federal Reserve Bank of Philadelphia, October 2013, http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/publications/discussion-papers/2013/D-2013-October-Clearing-Settlement.pdf (accessed February 3, 2015).

payment, interbank clearing, and settlement all occur on MasterCard's network. Securities and derivatives-oriented PCS firms also fulfill these three roles, but they function very differently from retail card networks.

For instance, the Options Clearing Corporation (OCC) is a large PCS firm that *clears* equity derivatives, investments that derive value from securities such as stocks. The OCC is known as a central counterparty (CCP), which means that it steps in to guarantee derivatives contracts for investors. This process ensures that the original buyer of a derivatives contract can ignore whether the original seller will uphold its end of the contract because the CCP takes on that risk. Because it makes this guarantee, the CCP monitors the financial strength of the original buyer and seller and requires both parties to post collateral.[5]

A CCP checks the market price of its derivatives contracts every day and, as necessary, requires additional collateral based on changes in value. Eventually, perhaps months or even years later, the CCP settles the contract.[6] This entire process—submitting a contract to the CCP, along with all collateral requirements and adhering to any CCP rules—is commonly referred to as *clearing* the contract. In January 2015, the OCC cleared an average of almost 18 million contracts *per day*.[7] The OCC is referred to as a "multilateral" clearing agency because many of the parties that clear contracts through the OCC trade multiple contracts with multiple counterparties.[8]

These two examples demonstrate the wide variety of transactions, with varying degrees of complexity, which take place in the PCS system. Dodd–Frank's ostensible purpose is to ensure that problems in the PCS system do not spill over into the broader financial system, even though these companies have had virtually nothing to do with previous crises. To achieve this goal, Title VIII creates a new regulatory regime for certain systemically important PCS firms, and also for firms that undertake so-called systemically important PCS activities. Title VIII authorizes the Financial Stability Oversight Council (FSOC) to designate both these firms and these activities.

An Overview of Title VIII

Title I of Dodd–Frank created the FSOC and gave it the power to designate certain financial companies for heightened regulations under the Federal Reserve. These firms are commonly referred to as systemically important financial institutions (SIFIs). Title VIII of Dodd–Frank is similar to the Title I SIFI framework. Under Title VIII, the FSOC can identify "systemically important" PCS firms for new regulations, and can also force new rules on any PCS firm engaged in systemically important PCS activities. Title VIII also extends certain privileges to systemically important PCS firms via the Federal Reserve.

In layman's terms, systemically important PCS firms are those whose failure the FSOC believes could lead to a financial crisis. Similarly, the FSOC can identify certain PCS *activities* as systemically important if the FSOC believes a disruption in that individual activity could threaten the stability of the financial system.[9] Both aspects of Title VIII are troubling for several reasons.

First, Title VIII allows the Federal Reserve (via the FSOC) to usurp the authority of PCS firms' primary regulators in the name of maintaining financial stability. The Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), primary regulators of some PCS firms prior to Dodd–Frank, are still allowed to prescribe regulations for the respective PCS

5. The collateral is referred to as margin, and the CCP also requires its members to contribute to a reserve fund that covers losses that exceed the margin. See John W. McPartland, "Clearing and Settlement of Exchange Traded Derivatives," Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 267, October 2009, https://www.chicagofed.org/publications/chicago-fed-letter/2009/october-267 (accessed February 3, 2015).
6. These contracts can, and often are, transferred or liquidated before they formally expire.
7. News release, "OCC Announces Average Daily Cleared Contract Volume Declined 5% in January," Options Clearing Corporation, February 2, 2015, http://www.optionsclearing.com/about/newsroom/releases/2015/02_02.jsp (accessed March 9, 2015).
8. Most derivatives traded over the counter (OTC) instead of on exchanges are not cleared through CCPs; instead, they are cleared bilaterally (directly by the buyer and seller of the contract). See Robert R. Bliss and Robert S. Steigerwald, "Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures," Federal Reserve Bank of Chicago *Economic Perspectives* (2006, 4th Quarter), https://www.chicagofed.org/~/media/publications/economic-perspectives/2006/ep-4qtr2006-part2-bliss-steigerwald-pdf.pdf (accessed February 3, 2015).
9. 12 U.S. Code 5462(9), Section 803(9) of Dodd–Frank provides definitions for "systemically important" and "systemic importance." Dodd–Frank does not define "financial stability."

firms they supervise. Now, however, the SEC and the CFTC may do so only in consultation with the FSOC. Ultimately, the Fed can decide whether those regulations "are insufficient to prevent or mitigate significant liquidity, credit, operational, or other risks to the financial markets or to the financial stability of the United States."[10] Should the SEC or the CFTC object to the Fed's proposed standards, a two-thirds vote by the FSOC resolves the dispute.[11] Of course, nothing precludes either the SEC or the CFTC from developing tougher regulations than the Fed would want.

Another problem with Title VIII is that it gives the FSOC a great deal of discretion to determine which activities threaten financial stability. Dodd–Frank broadly defines PCS activities as those "carried out by 1 or more financial institutions to facilitate the completion of financial transactions," and then defines "financial transactions" to include everything from basic funds transfers and foreign exchange contracts, to "any similar transaction" the FSOC decides is a financial transaction.[12] Once the FSOC identifies an activity as systemically important, the Fed can impose rules and regulations on the firms that undertake the activity. This approach dramatically increases federal regulators' power to shape the very structure of the financial industry and, therefore, enhances opportunities for regulatory capture.[13]

Another issue is that Title VIII authorizes the FSOC to identify a new class of financial companies that regulators view as too big to fail.[14] Specifically, Title VIII authorizes the FSOC to "designate those financial market utilities … that the Council determines are, or are likely to become, systemically important."[15] Ostensibly, the term financial market utility (FMU) refers to the largest clearinghouses and other PCS firms, such as those which serve as CCPs.[16] Thus, the term "systemically important FMU" would refer to a specially designated PCS firm.

This systemically important FMU designation sets several dangerous precedents and further entangles the Federal Reserve in financial market regulations. The Fed will now be the primary regulator of any designated FMU that was not previously regulated by either the SEC or the CFTC. Additionally, any designated FMU will now have deposit and payment services with its district Federal Reserve bank, privileges previously reserved for depository institutions. This policy effectively gives designated FMUs a reserve account at the Fed so that they can transfer large dollar payments *directly* instead of relying on private commercial banks.[17] Thus, this

10. 12 U.S. Code 5464(a)(2)(B), Section 805(a)(2)(B).
11. 12 U.S. Code 5464(a)(2)(E), Section 805(a)(2)(E). Title I of Dodd–Frank does not empower the Fed or the FSOC in this manner with respect to systemically important bank and nonbank financial firms.
12. PCS activities are defined in Dodd–Frank, 12 U.S. Code 5462(7)(A), Section 803(7)(A). The definition for PCS activities does exclude the "offer or sale of a security under the Securities Act of 1933 (15 U.S. Code 77a et seq.), or any quotation, order entry, negotiation, or other pre-trade activity or execution activity." 12 U.S. Code 5462(7)(B), Section 803(7)(B) defines these financial transactions as: "(i) funds transfers; (ii) securities contracts; (iii) contracts of sale of a commodity for future delivery; (iv) forward contracts; (v) repurchase agreements; (vi) swaps; (vii) security-based swaps; (viii) swap agreements; (ix) security-based swap agreements; (x) foreign exchange contracts; (xi) financial derivatives contracts; and (xii) any similar transaction that the Council determines to be a financial transaction for purposes of this title."
13. The term "regulatory capture" reflects that individuals who serve as regulators come to identify with the firms they are regulating at least as much as the agencies with which they are employed. The capture theory was originally developed in the seminal work of George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, Vol. 2 (Spring 1971), pp. 3–21. Stigler argued that governments stifle competition because they end up regulating at the behest of firms who capture regulatory agencies.
14. Many of the same criticisms that apply to the FSOC regarding SIFIs under Title I apply to Title VIII. See Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.
15. 12 U.S. Code 5463, Section 804.
16. Title VIII, Section 803(6) defines the term FMU as "any 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." As of this writing, the FSOC has designated eight systemically important FMUs. See "Designated Financial Market Utilities," Federal Reserve Board of Governors, January 29, 2015, http://www.federalreserve.gov/paymentsystems/designated_fmu_about.htm (accessed February 9, 2015). Internationally, the term "financial market infrastructures" is more common.
17. Anna Paulson and Kristin Wells, "Enhancing Financial Stability: The Case of Financial Market Utilities," Federal Reserve Bank of Chicago, *Chicago Fed Letter* No. 279, October 2010, https://www.chicagofed.org/publications/chicago-fed-letter/2010/october-279 (accessed February 3, 2015).

change shifts activity from the private sector and more closely associates PCS activities with a federally backed financial function.

Furthermore, the Fed can now provide "discount window borrowing"—direct (typically short-term) loans from the central bank—to designated FMUs in "unusual or exigent circumstances."[18] At minimum, these changes provide a competitive advantage to specially designated firms. At worst, this new relationship with the Fed invites future taxpayer bailouts. Former FDIC Chair Sheila Bair testified to Congress that granting FMUs access to the discount window "not only gives these firms a real advantage over other 'non' systemic competitors, it opens up taxpayers to potential losses and creates moral hazard." Bair also testified that "Title VIII FMUs will very likely become the new GSEs [government-sponsored enterprises] and a new source of system instability."[19]

Combined, these Title VIII changes all but ensure that the Federal Reserve—and therefore the federal government—will be viewed as part of even the *nonbank* financial sector's PCS system. Just as disconcerting is the fact that Title VIII enshrines the term "financial market utility" in the U.S. Code. This term did not previously exist in U.S. law and it should be removed because it implies that certain financial firms should be treated as public utilities. For the most part, the term "public utility" describes privately owned but extensively regulated companies in a handful of industries. In general, these companies have accepted far-reaching regulations—even of the rate of profit they are allowed to earn—in exchange for exclusive operating privileges.

Public Utilities and FMUs

Encoding the term "financial market utility" into federal law bestows a special status on financial companies because it conflates them with public utilities.[20] This status is particularly dangerous because the term "public utility" is not an objective economic concept. The term is political and, as such, lends itself to broad applications by policymakers who want to extensively regulate and even nationalize private companies. For instance, Michael Lind, co-founder of the New America Foundation, recently argued that basic transactional banking is a public utility:

> When these [industries] are in private hands, these are predatory monopolies, these are oligopolies; they are exacting a tax from every entrepreneur, every business, and their customers. It's actually bad for markets. And the best thing for a market would either be they would be regulated like public utilities or nationalized in some cases. But ... remember that Alexander Hamilton, first Treasury Secretary, called banking a public utility.[21]

It is true that Hamilton argued that a national banking system would be a public utility, but not in the same sense that the term—or banking, for that matter—is currently known. At the nation's founding, the term simply meant that certain things, even government institutions, would be good for the public.[22] In this context, many of the founders argued that institutions such as courts and a monetary system were necessary to create a nation. But broad applications of the term "public utility" were always a source of conflict among the nation's founders.

18. 12 U.S. Code 5465(b), Section 806(b). This credit is separate from the Fed's emergency program provisions in Section 13(3) of the Federal Reserve Act, and it does require a majority vote of the Fed Board of Governors.
19. Bair also recommended that this "unwarranted expansion of the government safety net" be repealed. See "Failing to End 'Too Big To Fail': An Assessment of the Dodd–Frank Act Four Years Later," report prepared by the Republican staff of the Committee on Financial Services, U.S. House of Representatives, 113th Congress, July 2014, p. 81, http://faculty.haas.berkeley.edu/ross_levine/Other/House_Republications_071814_tbtf_report_final.pdf (accessed February 20, 2015.)
20. Internationally, the term "financial market infrastructures" is more common; all of the same criticisms herein apply to that term as well.
21. Russ Roberts, "EconTalk: Michael Lind on Libertarianism," Library of Economics and Liberty, July 22, 2013, video, at the 45:28 mark, http://www.econtalk.org/archives/2013/07/michael_lind_on.html (accessed February 24, 2015).
22. William Smith Culbertson, *Alexander Hamilton: An Essay* (New Haven, CT: Yale University Press, 1911), pp. 73–78.

While those who favored a weaker central government preferred a narrower view, others viewed a much wider range of government activities as fostering the public utility.[23] In many respects, these groups have continued their debate throughout the nation's history. In 1835, for instance, Alexis de Tocqueville wrote something that could easily have been written as a counterpoint to Lind's statement:

> No private rights are so unimportant that they can be surrendered with impunity to the caprices of government.... [T]he principle of public utility is called in, the doctrine of political necessity is conjured up, and men accustom themselves to sacrifice private interest without scruple, and to trample upon the rights of individuals in order more speedily to accomplish any public purpose.[24]

By the late 19th century, the term was sometimes applied to the railroad and telecommunications industries, and was commonly used to describe both privately and publicly owned firms that provided water, electricity, or gas services. Although there are no objective criteria for what qualifies as a public utility, some economists tend to justify public utility regulation, as well as public ownership, on the grounds that a particular industry is a natural monopoly.[25] A natural monopoly describes a situation in which only one firm finds it profitable to serve a market due to some sort of natural barrier to competition, commonly a relatively large capital investment.[26]

A firm in such an industry could be viewed as a natural monopoly because, for example, it would only be profitable to undertake the necessary investment with an extremely large customer base. It is not at all obvious, though, that any of the firms now considered public utilities were natural monopolies until governments granted them exclusive operating privileges. Thus, the justification for a natural monopoly can be circular because the guarantee of a large customer base can, in fact, justify large capital investments. Regardless of the economic theory, history shows that many private companies and government officials used the public utility concept to create arrangements detrimental to potential competitors.

Modern-Day Public Utilities Did Not Start as Monopolies. By the late 19th century, publicly owned and privately owned firms that provided water were commonly referred to as public utilities. It is currently all but taken for granted that water should be publicly provided, but it is a historical fact that many private water companies existed first and were later taken over by municipal governments.[27] Perhaps more important, evidence suggests that government regulation and taxation reduced these private firms' capital investment, thus providing a rationale for additional public takeovers.[28]

23. For a discussion of the public utility of opening roads and navigable waterways, see "Letter from Robert Morris to Alexander Martin," July 20, 1782, *Documenting the American South: Colonial and State Records of North Carolina*, Vol. 16, pp. 357–379, http://docsouth.unc.edu/csr/index.html/document/csr16-0157 (accessed March 9, 2015). James McHenry, signer of the Constitution and Secretary of War, argued that distributing Bibles to the public was important for the public utility. Principles of the Founding Fathers, "Public Utility," October 10, 2009, http://spiritualheritage.blogspot.com/2009/10/public-utility.html (accessed March 9, 2015).
24. Alexis de Tocqueville, *Democracy in America*, Part II, Book 4, No. 56, 1835.
25. Separately, some policymakers associate public utilities with the provision of *public goods*, but in practice this case is extremely weak because very few goods and services actually fit the criteria for public goods. If, for instance, a private firm can prevent nonpaying customers from benefiting from its products, the item for sale does not qualify as a public good. Providing electricity, for example, clearly does not meet the public good criteria. See Tyler Cowen, "Public Goods," in David R. Henderson, ed., *The Concise Encyclopedia of Economics* (Indianapolis, IN: Liberty Fund, 2008), p. 431.
26. Economists have formally defined a natural monopoly as an industry where there are economies of scale—that is, returns increase as the business expands—over a relevant range of output. The relevant range of output, of course, is not an objective figure, and many firms enjoy economies of scale even though they are not monopolies. In more recent times, the typical definition of a natural monopoly has undergone change and criticism. See Manuela Mosca, "On the Origins of the Concept of Natural Monopoly: Economies of Scale and Competition," *The European Journal of the History of Economic Thought*, Vol. 15, No. 2 (2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=975461 (accessed January 26, 2015).
27. For instance, in 1905 there were 113 municipally owned water companies in large U.S. cities, and 32 were previously privately owned. See Werner Troesken, "Municipalizing American Waterworks, 1897–1915," *The Journal of Law, Economics & Organization*, Vol. 19, No. 2 (2003), p. 375.
28. Ibid. Similar findings exist in the natural gas industry, where rate regulation (and the threat thereof) prevented firms from making large capital investments. See Werner Troesken, "The Sources of Public Ownership: Historical Evidence from the Gas Industry," *The Journal of Law, Economics & Organization*, Vol. 13, No. 1 (1997).

History also shows that multiple firms entered the electricity market and ultimately sought government protections that created monopolies. For example, Thomas Edison's protégé, Samuel Insull, actively lobbied for monopoly status of electricity providers while he simultaneously purchased and consolidated smaller companies. Insull argued that "monopoly and regulation were infinitely more practical than the American ideals of competition and free enterprise." [29] While the monopoly guarantee was certainly beneficial for Insull, it is difficult to argue that a natural monopoly existed in the first place, given that other private companies had already entered the market.

Similar evidence exists for other industries, such as railroads, telecommunications, and even for public transportation services that tend to be government-provided. For instance, New York City once had three competing subway lines, as well as dozens of competing bus and streetcar lines, thus casting doubt on the natural monopoly argument.[30] In the rail industry, evidence shows that "the driving force for railroad regulation came less from an outraged public seeking lower railroad rates than from shippers and merchants who wanted to stabilize their businesses."[31] In the early 1900s, more than 200 telephone companies provided service in the state of Michigan alone. But AT&T president Theodore Vail employed a strategy of acquiring local phone companies while promoting the industry as a natural monopoly; with the help of state and local officials, AT&T eventually controlled more than 80 percent of all phone lines in the U.S.[32]

Overall, evidence suggests that regulation—in general and with respect to public utilities—tends to eliminate competition and results in higher consumer prices and inefficiencies relative to competitive markets.[33] Furthermore, extensive regulation breeds regulatory capture and cronyism because it provides a means for incumbent firms to work with regulators on an ongoing basis. Regarding the financial industry, the notion that specific firms should be treated as utilities is difficult to justify with economic theory and, therefore, relatively unconventional.

The Financial Industry and FMUs. Private clearinghouses have existed in the U.S. since at least the 1830s, and there are virtually no historical references to these firms as utilities.[34] PCS firms such as those that clear derivatives contracts have also operated in the U.S. since the 1800s, but few—if any—modern derivatives textbooks refer to these firms as public utilities.[35] One of the earliest examples of policymakers comparing PCS firms' operations to those of a public utility dates to the 1970s and serves as a prime case *against* applying the concept to these companies.[36] (See text box.)

29. Forrest McDonald, "Samuel Insull and the Movement for State Utility Regulatory Commissions," *The Business History Review*, Vol. 32, No. 3 (1958), pp. 241–254. Even some public utility regulators argued against providing electricity firms with public utility status. For instance, in 1910, Delos F. Wilcox, PhD (Chief of the Bureau of Franchises of the Public Service Commission of the First District of New York), noted that "the manufacture and distribution of electricity is inherently the least monopolistic of public service utilities." Delos F. Wilcox, *Municipal Franchises: A Description of the Terms and Conditions upon Which Private Corporations Enjoy Special Privileges in the Streets of American Cities* (Rochester, NY: The Gervaise Press, 1910), p. 139.
30. Edward L. Glaeser, "Public Ownership in the American City," National Bureau of Economic Research *Working Paper* No. 8613, December 2001.
31. Mansel Grifiths Blackford, "Businessmen and the Regulation of Railroads and Public Utilities in California During the Progressive Era," *The Business History Review*, Vol. 44, No. 3 (1970), pp. 307–319, http://www.jstor.org/stable/3112616 (accessed February 24, 2015).
32. In what came to be known as the Kingsbury Commitment, AT&T agreed to simultaneously acquire new local phone systems, sell its stock in Western Union, allow competitors to connect to its network, and sell off some of its own phone lines. Interestingly enough, Alexander Graham Bell's original financial backers pinned their hopes to Graham's technology challenging Western Union's telegraph monopoly. See Diane Katz, "A Telecommunications Policy Primer: 20 Comprehensive Answers to 20 Basic Questions," Mackinac Center for Public Policy, 2004, https://www.mackinac.org/archives/2004/s2004-04.pdf (accessed March 10, 2015).
33. George Stigler, "Monopoly," in David R. Henderson, ed., *The Concise Encyclopedia of Economics* (Indianapolis, IN: Liberty Fund, 2008), pp. 363–366.
34. The regulated firms which provided electricity and water were undoubtedly referred to as public utilities long before the Fed was created in 1913, but official documents during this era did not refer to clearinghouses as utilities. See, for instance, J. G. Cannon, "Clearing-House Methods and Practices," included in Publications of National Monetary Commission, Volume VI, Clearing Houses and Credit Instruments, 1911, https://fraser.stlouisfed.org/docs/historical/nmc/nmc_491_1910.pdf (accessed February 9, 2015).
35. See, for instance, John Hull, *Options, Futures, and Other Derivatives*, 3rd ed. (Upper Saddle River, NJ: Prentice Hall, 1997).
36. Neal Wolkoff and Jason Werner, "The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition," *Review of Banking & Financial Law*, Vol. 30 (2010), pp. 313–381.

Public Utilities and PCS Firms

One of the earliest examples of U.S. policymakers comparing PCS firms' operations to those of a public utility dates to the 1970s.[1] A large spike in trading volume in the 1960s spurred Congress, the SEC, as well as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), to push for a national clearing system. There was clearly no monopoly in the industry, but the dominant firms—the NYSE and the AMEX—worked with Congress to help create this national system.[2]

Ultimately, Congress passed the Securities Act Amendments of 1975, legislation that marked a major shift in the way the SEC regulated the securities industry. These amendments gave the SEC, for the first time in its history, the power to dictate the economic structure of securities markets rather than to simply promote fair and honest markets through prosecution. The legislation required, among other things, clearing agencies to register with the SEC. This process, similar to the requirements for exchanges, submitted clearing firms to extensive SEC regulation. Smaller regional exchanges, as well as one SEC chairman, opposed this effort on the grounds that it would remove competition from the clearing market.

This factor was not the overriding concern, however, as even the SEC acknowledged the amendments were likely to be anticompetitive.[3] The whole point, ostensibly, was to establish a national market. However, one former SEC commissioner (appointed by President Jimmy Carter) involved in the process noted that the "law was an attempted political compromise of deep economic divisions within the financial community, about the extent to which brokers, dealers, banks, and other financial institutions should be permitted to freely compete with one another."[4] Regardless of which groups benefited the most, there is no doubt that the 1975 amendments greatly influenced the structure of the financial industry.

As part of this restructuring, the NYSE, the Amex, and the National Association of Securities Dealers merged their respective clearing firms into one entity named the National Securities Clearing Corporation (NSCC). When the new firm registered with the SEC, the Bradford National Clearing Corporation filed suit claiming (among other things) that the "anticompetitive impact of NSCC's operation outweighs the beneficial effects thereof."[5] Eventually, a U.S. appeals court sided with the NSCC, and its decision includes the seeds of the FMU concept. The appeals court noted that

> for purposes of comparing NYSE and AMEX transactions, NSCC is essentially a public utility that is afforded a monopoly but must offer its services to all qualified customers (its own participants or other clearing agencies) at cost.[6]

Thus, the court applied the public utility concept to one narrow aspect of the NSCC's operations based on the finding that certain customers would have no choice but to use some NSCC services. In hindsight, the decision was premature because future technological changes soon radically altered this monopolistic aspect of the NSCC. Regardless, the court did not refer to the NSCC itself as a public utility, even though it acknowledged the company effectively had a clearing monopoly in New York. Finally, it does not appear that this utility concept became widespread in the U.S. and, until just before the passage of Dodd–Frank, it appears that very few officials referred to PCS firms as utilities.

1. Neal Wolkoff and Jason Werner, "The History of Regulation of Clearing in the Securities and Futures Markets, and Its Impact on Competition," *Review of Banking & Financial Law*, Vol. 30 (2010), pp. 313–381.
2. As of 1975, the NYSE and AMEX (combined) cleared more than 70 percent of all shares traded in the U.S. See ibid., p. 314.
3. The SEC also sought to increase competitive forces by abolishing rules that tied regional clearinghouses to their respective exchanges. See ibid., p. 336.
4. Roberta Karmel, *Regulation by Prosecution: The Securities & Exchange Commission Vs. Corporate America* (New York: Simon and Schuster, 1982), p. 114.
5. Open Jurist, *Bradford National Clearing Corporation v. Securities and Exchange*, 590 F. 2d 1085, http://openjurist.org/590/f2d/1085/bradford-national-clearing-corporation-v-securities-and-exchange-commission- (accessed January 26, 2015).
6. Ibid.

Prior to Dodd–Frank, one of the few U.S. policymakers to refer to PCS firms as utilities was Timothy Geithner, New York Fed president at the time. In 2004, Geithner suggested that countries should adopt the provisions of the international Hague Securities Convention, and in doing so uttered a rare pre-Dodd–Frank reference to a *clearing utility*:[37]

> [I]t is worth reflecting on whether it makes sense to build on these efforts [to improve the clearing and settlement infrastructure] by developing and utilizing central counterparty clearing arrangements in the more standardized part of the OTC derivative market. To be sure, poorly designed central counterparties can increase risk, and they necessarily concentrate operational risk.
>
> … But it makes sense to think about whether use of a centralized clearing utility [such as a CCP] could provide significant advantages over the present bilateral arrangements by increasing transparency, enabling multilateral netting, and providing centralized risk controls, collateral management, and margin requirements. To the extent these advantages can be realized, a centralized utility can reduce the risk of damaging contagion from a failure of a financial institution affecting overall market liquidity.[38]

Geithner's comments also provide one of the first examples of U.S. policymakers suggesting that regulators should consider mandatory centralized clearing for derivatives. Geithner, of course, became U.S. Treasury Secretary in 2009, and was instrumental in shaping Dodd–Frank, the legislation that mandated (some) centralized clearing for derivatives and that also created the legal concept of the FMU.[39] This new concept effectively equates certain financial service companies with public utilities that serve some vague special purpose, even though the economic case for doing so is incredibly weak.

It is, for example, very difficult to argue that these PCS firms are natural monopolies. While it is true that some PCS firms have a dominant position, multiple PCS firms operate in various segments of financial markets.[40] Furthermore, barriers to entry are relatively small in the financial industry compared to firms classically referred to as utilities, and financial innovation has been the historical norm. In fact, new digital technologies appear poised to radically alter retail-payments systems and, possibly, the remainder of the PCS industry. It is easy to predict, though, that some PCS firms will use the FMU framework to protect their dominant positions and keep competitors at bay.

Experience shows that public utilities have accepted extensive regulations—even of the rates they charge consumers—in return for exclusive operating privileges. As a matter of fact, this public utility arrangement has effectively created the only lasting class of monopolies that exists in the U.S. Title VIII of Dodd–Frank is likely to broadly extend this anti-competitive arrangement to financial firms. Because *all* financial transactions have to be completed in some manner, policymakers can use the FMU concept to confer public-utility-like status throughout the financial sector. To some extent, this broadening of the FMU concept is already taking place.

37. The Hague Securities Convention is a proposed international treaty designed to resolve "the private international law issues relating to securities held with an intermediary on a global level" (that is, choice of law issues). As of this writing, the U.S. has signed but not ratified the convention, which has been ratified by only two countries and has not entered into force. See Hague Conference on Private International Law, "Convention of 5 July 2006 on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary," http://www.hcch.net/index_en.php?act=conventions.text&cid=72 (accessed March 9, 2015). See also Richard Potok, "The Hague Securities Convention–Closer and Closer to Reality," *Journal of Banking and Finance Law and Practice*, Vol. 15 (2004), http://www.cmvm.pt/CMVM/Publicacoes/Cadernos/Documents/C19potok.pdf (accessed February 9, 2015).

38. Timothy F. Geithner, "Challenges Facing the Global Payments System," remarks at the SIBOS 2004 Atlanta Conference, October 14, 2004, http://www.newyorkfed.org/newsevents/speeches/2004/gei041014.html (accessed January 23, 2015).

39. Title VII of Dodd–Frank newly mandated the use of CCPs for derivatives that, previously, were not cleared. Removal of those requirements would (among other things) likely lower the risks of future bailouts. Arguably, Title VIII would be unnecessary without Title VII. See Hester Peirce, "Title VII: Derivatives," in *Dodd–Frank: What It Does and Why It's Flawed*, ed. by Hester Peirce and James Broughel (Arlington, VA: George Mason University Mercatus Center, 2012), pp. 77–90, http://mercatus.org/sites/default/files/publication/dodd-frank-FINAL.pdf (accessed March 9, 2015).

40. It is also clear that these services do not fit the criteria for public goods because PCS firms can easily prevent nonpaying customers from using their services.

For example, a Federal Reserve official testified before the Senate that an FMU could benefit the tri-party repo market, a short-term loan market dominated by the Federal Reserve's primary dealers.[41] Additionally, 2014 legislation proposed to shut down GSE mortgage giants Fannie Mae and Freddie Mac and to create a "National Mortgage Market Utility" to "standardize" the process of issuing mortgage-backed securities previously undertaken by Fannie and Freddie. Viewed in combination with other policies, such as imposing a *duty to serve* on financial institutions and attempting to regulate the prices that small nonbank lenders can charge, it appears that some lawmakers want all financial firms to be treated as public utilities.[42]

Oddly enough, this policy coincides with a general shift toward fostering more competition and less regulation in firms classically viewed as public utilities. This change essentially marks widespread dissatisfaction with the regulatory regimes in the electric, gas, and water service industries.[43] To stabilize and strengthen financial markets, Congress should foster more competition, not less. In particular, Congress should:

- **Repeal Title VIII of Dodd–Frank.** The 2010 Dodd–Frank Act's answer to the financial crisis was to institute more federal regulation and oversight, despite the fact that this approach has repeatedly failed. Worse, many of the act's components did virtually nothing to address the root causes of the financial crisis and simply expanded the federal safety net for financial firms (a contributing factor to the crisis in the first place). This approach has only further socialized the cost of financial risk-taking and, therefore, has increased the likelihood of future financial crises and bailouts. Title VIII, which enshrines the concept of an FMU into the U.S. code, is no exception to this rule. Short of a full repeal of Dodd–Frank, the preferred solution, Congress should eliminate Title VIII of the law.

Conclusion

One major problem with the 2010 Dodd–Frank Act is that it broadens the concept of what constitutes a public utility. In particular, Title VIII extends this concept to the financial industry by identifying certain firms as FMUs. This change marks a dangerous shift in the relationship between government and private markets because it implies that private financial firms cannot—or should not—competitively provide financial services. Title VIII creates a new regulatory regime based on the FMU concept and also on specific PCS activities. Title VIII also provides that specially designated PCS firms will now have access to deposit and payment services at District Federal Reserve Banks.

Additionally, the Fed can now provide discount window borrowing to designated PCS firms in "unusual or exigent circumstances." Title VIII all but ensures the Federal Reserve will be viewed as part of even the nonbank financial sector's PCS system because it effectively identifies PCS firms that regulators view as too big to fail. Overall, Title VIII implies that the financial industry cannot function unless it is structured in the same manner as it is now. For all of these reasons, Title VIII will ultimately restrict competition in financial markets, lead to higher consumer prices, concentrate financial risk, and justify taxpayer bailouts in the name of the public interest. The changes in Title VIII—similar to many other Dodd–Frank changes—will fail to make financial markets any safer.

*—**Norbert J. Michel, PhD,** is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*

41. "SBC Examines the Tri-Party Repo Market; Remaining Challenges," Securities Industry and Financial Markets Association, August 2, 2012, http://www.sifma.org/members/hearings.aspx?id=8589939817 (accessed February 9, 2015).
42. The Housing and Economic Recovery Act of 2008 explicitly acknowledged a "duty to serve" role for the GSEs in the U.S. mortgage market. This supposed duty mandates that, instead of focusing on earning profits for their owners, firms have a duty to serve a higher public purpose—funding housing projects for low-income families, for instance. See John Ligon and Norbert Michel, "Focus on Eliminating Housing GSEs, Not Giving Them a Duty to Serve," The Daily Signal, March 7, 2014, http://dailysignal.com/2014/03/07/focus-eliminating-housing-gses-giving-duty-serve/, and Michel and Ligon, "GSE Reform: Affordable Housing Goals and the 'Duty' to Provide Mortgage Financing," Heritage Foundation *Issue Brief* No. 4083, November 12, 2013, http://www.heritage.org/research/reports/2013/11/affordable-housing-goals-and-the-duty-to-provide-mortgage-financing (accessed February 26, 2015).
43. Werner Troesken, "Regime Change and Corruption: A History of Public Utility Regulation," in Edward Glaeser and Claudia Goldin, eds., *Corruption and Reform: Lessons from America's Economic History* (Chicago: University of Chicago Press, 2006).