

**Testimony on**  
**Implementing Derivatives Reform: Reducing Systemic Risk and Improving Market**  
**Oversight**  
**by**  
**Chairman Mary L. Schapiro**  
*U.S. Securities and Exchange Commission*  
**before the**  
**Committee on Banking, Housing, and Urban Affairs**  
**United States Senate**  
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Chairman Johnson, Ranking Member Shelby, and members of the Committee:

I appreciate the opportunity to testify regarding the Securities and Exchange Commission's ongoing implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

As you know, Title VII creates an entirely new regulatory regime for over-the-counter ("OTC") derivatives. To that end, it directs the Commission and the Commodity Futures Trading Commission ("CFTC") to write a number of rules necessary to implement the statutory regime. Since the Dodd-Frank Act was enacted in July 2010, the Commission has proposed most of the rules required by Title VII. We are continuing to work diligently to implement all provisions of Title VII, and to coordinate implementation with the CFTC and our fellow regulators overseas.

My testimony today will provide an overview of these efforts to implement Title VII, emphasizing the Commission's activities since I last testified before this Committee on Dodd-Frank Act implementation in December.

## **Background**

### *Title VII of the Dodd-Frank Act*

Title VII of the Dodd-Frank Act mandates the oversight of the OTC derivatives marketplace and requires that the Commission and the CFTC write rules that address, among other things, mandatory clearing, the operation of security-based swap and swap execution facilities and data repositories, capital and margin requirements and business conduct standards for security-based swap and swap dealers and major participants, and regulatory access to – and public transparency for – information regarding security-based swap and swap transactions.

Under the Dodd-Frank Act, regulatory authority over swaps is divided between the Commission and the CFTC. The law assigns the Commission the authority to regulate "security-based swaps." The CFTC, on the other hand, has primary regulatory authority over "swaps," which represent the overwhelming majority of the overall market for over-the-counter derivatives subject to Title VII.

With respect to the Commission's efforts, this series of rulemakings is designed to improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other

things, to reduce counterparty risk. It also is designed to enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. By promoting transparency, efficiency, and stability, this framework is intended to foster a more nimble and competitive market.

#### *Ongoing Regulatory Coordination with the CFTC and Other Regulators*

In implementing Title VII, our staff is in regular contact with the staffs of the CFTC, Federal Reserve Board, and other financial regulators. In particular, Commission staff has consulted and coordinated extensively with CFTC staff in the development of the joint definitional rules arising under Title VII, including joint rules further defining key terms related to the products covered by Title VII, which we expect to finalize in the near term, and other joint rules further defining certain categories of market participants, which we adopted last month. Although the timing and sequencing of the CFTC's and Commission's proposal and adoption of rules may vary, they are the subject of extensive interagency discussions. As we continue with the implementation of the rules contemplated by Title VII, the objective of consistent and comparable requirements will continue to guide our efforts.

The Dodd-Frank Act also specifically requires that the Commission, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives. Accordingly, the Commission is actively working on a bilateral and multilateral basis with our fellow regulators abroad to address the regulation of OTC derivatives.

Through these discussions and our participation in various international task forces and working groups, we have gathered extensive information about foreign regulatory reform efforts, identified potential gaps, overlaps and conflicts between U.S. and foreign regulatory regimes, and encouraged foreign regulators to develop rules and standards complementary to our own under the Dodd-Frank Act. Such efforts include frequent communications and meetings with the European Union and other major foreign regulatory jurisdictions in Asia and North America. Representatives from the Commission also participate in the Financial Stability Board's Working Group on OTC Derivatives Regulation, of which a Commission representative serves as one of the co-chairs on behalf of the International Organization of Securities Commissions ("IOSCO"), and a Commission representative serves as one of the four co-chairs of the IOSCO Task Force on OTC Derivatives Regulation. In addition, representatives from the Commission, the CFTC, and a number of international regulators have met twice, most recently this month, to address cross-border issues related to the implementation of new legislation and rules to govern the OTC derivatives markets in their respective jurisdictions.

As we continue with the adoption of the Title VII rules, we remain committed to consulting with other regulators at home and abroad in an effort to foster the development of common frameworks and to help ensure a level playing field for market participants.

## *Next Steps for Implementation of Title VII*

In the near term, the Commission expects to complete the last of the core elements of our proposal phase, in particular, rules related to the financial responsibility of security-based swap dealers and major security-based swap participants. We also expect to complete our joint rulemaking on the product definitions with the CFTC in the very near term. Final product definitions will help inform derivatives market participants what products would be subject to the new swap and security-based swap requirements, which we view as a crucial step in establishing the Title VII regulatory regime. Importantly, the adoption of final product definitions will not trigger compliance with any rules the Commission is adopting under Title VII, or related statutory requirements. Instead, the compliance dates applicable to specific rules adopted by the Commission under Title VII, and related statutory requirements, will be set forth in those final rules.

The Commission also is continuing to develop a policy statement regarding how the substantive requirements under Title VII within its jurisdiction will be put into effect. This policy statement would be designed to establish an appropriate and workable sequence and timeline for the implementation of these rules. As a purely practical matter, certain of these rules will need to go into effect before others can be implemented, and market participants will need a reasonable, but not excessive, period of time in which to comply with the new rules applicable to security-based swaps. This statement should give market participants a degree of clarity as to how the Commission, in general, is thinking of ordering the compliance dates of the various sets of rules under Title VII. We intend to publish this policy statement for public comment in the very near term.

Additionally, because the OTC derivatives market has grown to become a truly global market in the last three decades, we are continuing to evaluate carefully the international implications of Title VII. The development of our cross-border approach is being informed by our discussions with the CFTC and our fellow regulators in other jurisdictions.

Rather than deal with the international implications of Title VII piecemeal, we intend to address the relevant issues holistically in a single proposal. The publication of such a proposal is intended in part to give investors, market participants, foreign regulators, and other interested parties an opportunity to consider as an integrated whole our proposed approach to the registration and regulation of foreign entities engaged in cross-border transactions involving U.S. parties. The Commission therefore anticipates that this release will be published prior to the finalization of the rules discussed therein so that the comments received can be taken into account in drafting the final rules.

The application of Title VII to cross-border transactions raises a substantial number of complex issues. Among other things, it requires consideration and appreciation of foreign regulatory frameworks and of competition concerns. This is not an easy task. However, I believe that the publication of a fully developed, comprehensive SEC proposal to address these issues, and the opportunity for all interested parties to comment on this proposal, will significantly advance the level of understanding, and greatly facilitate public dialogue, on these issues.

## **Title VII Implementation to Date**

### *Adoption of Entity Definitions Rulemaking*

Since I last testified before this Committee on Dodd-Frank Act implementation, the Commission has adopted final rules and interpretations jointly with the CFTC that further define the terms “swap dealer”, “security-based swap dealer”, “major swap participant”, “major security-based swap participant”, and “eligible contract participant”. In developing these definitions, the Commission was informed by existing information regarding the single-name credit default swaps market, which will constitute the vast majority of security-based swaps. The finalization of the entity definitions rulemaking is a foundational step toward the complete implementation of Title VII.

The entity definitions rulemaking defines the term “security-based swap dealer” and adopts interpretations providing guidance as to how the dealer-trader distinction applies to activities involving security-based swaps. This guidance describes what constitutes dealing activity and distinguishing dealing from non-dealing activities such as hedging.

The rulemaking also implements the Dodd-Frank Act’s statutory *de minimis* exception to the security-based swap dealer definition in a way that is tailored to reflect the different types of security-based swaps. To do so, the rulemaking exempts those entities or individuals who engage in dealing activity in security-based swaps below a certain notional dollar amount over a one-year period. The rule includes a phase-in of the exemption over time in a way that promotes the orderly implementation of Title VII.

In establishing who is a security-based swap dealer, Title VII gave us the task of identifying those entities that engage in dealing activity in security-based swaps. Title VII does not require most market participants that engage in security-based swaps – such as mutual funds and pension funds – to be regulated as dealers. In addition, Title VII calls for only those dealers acting above a de minimis level to be regulated as dealers. We followed the statutory language to bring dealers acting above a de minimis level under the Commission’s direct oversight, and in so doing we have ensured that the vast majority of notional dealing activity in this market will be subjected to the SEC’s Title VII dealer regulatory regime.

Additionally, the rulemaking implements the Dodd-Frank Act’s “major security-based swap participant” definition through the use of three objective tests.

The analysis of single-name credit default swap data conducted by the Commission’s Division of Risk, Strategy, and Financial Innovation was especially informative in the development of this rule. This analysis provided critically important information regarding potential dealing activity in the credit default swap market, which helped the Commission shape the final rules and evaluate the economic consequences of these rules. Nonetheless, the Commission has directed the staff to report to the Commission on whether changes are warranted to the rules based on an analysis of data after relevant provisions of Title VII are implemented. This report stems, in part, from the fact that the entity definition rules were developed based on our understanding of the existing market and currently available data. The report – together with the associated public comment – is intended to help the Commission thoroughly evaluate the practical implications

and effects of the entity definition rules following the regulation of dealers and major participants pursuant to Title VII, using data reflective of the newly regulated market.

Although the entity definition rules technically will be effective in the near term, security-based swap dealers and major security-based swap participants will not be required to register with the Commission until the dates provided in the Commission's final rules for the registration of security-based swap dealers and major security-based swap participants, which are to be adopted at a later point in time.

#### *Additional Actions*

The Commission staff continues to work diligently to develop recommendations for the Commission to adopt final rules in each of the twelve areas required by Title VII where rules have been proposed:

- Joint rules with the CFTC regarding further definitions of the terms “swap,” “security-based swap,” and “security-based swap agreement;” the regulation of mixed swaps; and security-based swap agreement recordkeeping;
- Rules prohibiting fraud and manipulation in connection with security-based swaps;
- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported;
- Rules regarding the obligations of security-based swap data repositories that would require them to register with the Commission and specify the extensive confidentiality and other requirements with which they must comply;
- Rules relating to mandatory clearing of security-based swaps that would establish a process for clearing agencies to provide information to the Commission about security-based swaps that the clearing agencies plan to accept for clearing;
- Rules regarding the exception to the mandatory clearing requirement for hedging by end users that would specify the steps that end users must follow, as required under the Dodd Frank Act, to notify the Commission of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;
- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the parties who enter into them;
- Rules defining and regulating security-based swap execution facilities, which specify their registration requirements, and establish the duties and implement the core principles

for security-based swap execution facilities specified in the Dodd-Frank Act;

- Rules regarding certain standards that clearing agencies would be required to maintain with respect to, among other things, their risk management and operations;
- Rules regarding business conduct that would establish certain minimum standards of conduct for security-based swap dealers and major security-based swap participants, including in connection with their dealings with “special entities,” which include municipalities, pension plans, endowments and similar entities;
- Rules regarding the registration process for security-based swap dealers and major security-based swap participants; and
- Rules intended to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

To facilitate clearing of security-based swaps, the Commission adopted final rules providing exemptions for security-based swaps transactions involving certain clearing agencies satisfying certain conditions. We also readopted certain of our beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.

Moreover, the Commission took a number of steps to provide legal certainty and avoid unnecessary market disruption that might otherwise have arisen as a result of final rules not having been enacted by the July 16, 2011, effective date of Title VII. Specifically, we have:

- Provided guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date and provided temporary relief from several of these provisions;
- Provided guidance regarding — and where appropriate, interim exemptions from — the various pre-Dodd-Frank provisions that would otherwise have applied to security-based swaps on July 16; and
- Taken other actions to address the effective date, including extending certain existing temporary rules and relief to continue to facilitate the clearing of certain credit default swaps by clearing agencies functioning as central counterparties.

## **Conclusion**

The Dodd-Frank Act provides the Commission with important tools to better meet the challenges of today’s financial marketplace and fulfill our mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As we continue with implementation of Title VII, we look forward to continuing to work closely with Congress, our fellow regulators both home and abroad, and members of the public. Thank you for the opportunity to share our progress on the implementation of Title VII. I will be happy to answer any questions.