

Testimony on “Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act” by the U.S. Securities and Exchange Commission

by

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Chairman Johnson, Ranking Member Shelby, and members of the Committee:

Thank you for inviting me to testify today on behalf of the Securities and Exchange Commission regarding its implementation of Titles VII and VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act” or “Act”), which primarily relate to the regulation of over-the-counter (“OTC”) derivatives and the supervision of systemically important payment, clearing, and settlement systems. These titles require the SEC, among other regulators, to conduct a substantial number of rulemakings and studies. Although this task is challenging, particularly when viewed in the context of the SEC’s other Dodd-Frank Act rulemaking responsibilities, we are committed to fulfilling the objectives of the Act in a responsible and diligent manner, while seeking the broad public input and consultation needed to get these important rules right. My testimony today will briefly describe our progress and plans for implementing Titles VII and VIII of the Dodd-Frank Act, with a particular focus on the regulation of the OTC derivatives marketplace

Background

OTC Derivative Marketplace

As has been frequently noted, the growth of the OTC derivatives marketplace has been dramatic over the past three decades. From its beginnings in the early 1980s, when

the first swap agreements were negotiated, the notional value of these markets has grown to almost \$600 trillion globally.¹ However, OTC derivatives were largely excluded from the financial regulatory framework by the Commodity Futures Modernization Act of 2000. As a securities and capital markets regulator, the SEC has been particularly concerned about OTC derivatives products that are related to, or based on, securities or securities issuers, and as such are connected with the markets the SEC is charged with overseeing.

Dodd-Frank Act

The Dodd-Frank Act mandates oversight of the OTC derivatives marketplace. Title VII of the Act requires that the SEC and 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 dealers and major participants, and regulatory access to and public transparency for information regarding security-based swap and swap transactions. This series of rulemakings should improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other things, to reduce counterparty risk. It should also enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. In addition, these rulemakings should establish a regulatory framework that allows OTC derivatives markets to continue to develop in a more transparent, efficient, accessible, and competitive manner.

¹ See Bank of International Settlements, Positions in Global Over-the-Counter (OTC) Derivatives Markets at End-June 2010, Monetary and Economic Department (Nov. 2010), http://www.bis.org/publ/otc_hy1011.pdf.

Title VIII of the Act provides for increased oversight of financial market utilities designated as systemically important and financial institutions that engage in payment, clearing, and settlement activities designated as systemically important by the Financial Stability Oversight Council. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability.

Implementation Generally

The implementation of these titles is a substantial undertaking and raises a number of challenges. Accordingly, we have been engaging in an open and transparent implementation process, seeking input on the various rulemakings from interested parties even before issuing formal rule proposals. We will continue to seek input on each proposal with the goal of producing effective and workable regulation of derivatives activities and oversight of financial market utilities designated as systemically important and financial institutions that engage in payment, clearing, and settlement activities designated as systemically important.

Public Consultation

We have enhanced our public consultative process by expanding the opportunity for public comment beyond what is required by law. For instance, we have made available to the public a series of e-mail boxes to which interested parties can send preliminary comments before rules are proposed and the official comment periods begin. These e-mail boxes are on the SEC website, organized by topic. We also specifically solicited comment, along with the CFTC, on the definitions contained in Title VII of the Act.

In addition, our staff has sought the views of affected stakeholders. This approach has resulted in meetings with a broad cross-section of interested parties. To further this public outreach effort, the SEC staff has held joint public roundtables and hearings with the CFTC staff on select key topics. Through these processes, we have received a wide variety of views and information that is useful to us in proposing and, ultimately, adopting rules that are appropriate for these markets.

Coordination with the CFTC and Other Regulators

In implementing Title VII, our staff is meeting regularly, both formally and informally, with the staffs of the CFTC, Federal Reserve Board, and other financial regulators. In particular, SEC staff has consulted and coordinated extensively with CFTC staff in the development of the proposed rules. Although the timing and sequencing of the CFTC's and SEC's proposed rules may vary, they are the subject of extensive interagency discussions. The SEC's rules will apply to security-based swaps and the CFTC's rules will apply to swaps, but our objective is to establish consistent and comparable requirements, to the extent possible, for swaps and security-based swaps. Due in part to differences in products, participants, and markets, some of our rule proposals contain different approaches to various issues. Nonetheless, as we move toward adoption, the objective of consistent and comparable requirements will continue to guide our efforts.

In addition, as required by the Act, we are working with the CFTC to adopt joint rules further defining key terms relating to the products covered by Title VII and certain categories of market intermediaries and participants. Joint rulemaking regarding key definitions will promote regulatory consistency and comparability, and thus help to

prevent regulatory gaps that could foster regulatory arbitrage and overlaps that could confuse, or impose unnecessary added costs upon, market participants.

Finally, we recognize that other jurisdictions are also developing regulatory frameworks that will address many of the areas covered by Title VII. The manner and extent to which we and foreign regulators regulate derivatives will affect both U.S. and foreign entities and markets. Consequently, as we progress with the implementation of Title VII, we will continue to consult with regulatory counterparts abroad in an effort to promote robust and consistent standards and avoid conflicting requirements, where possible. The SEC and CFTC are, in fact, directed by the legislation to consult and coordinate with foreign regulators on the establishment of consistent international standards governing swaps, security-based swaps, swap entities, and security-based swap entities. We believe that bilateral discussions with foreign regulators, as well as our engagement in the IOSCO Task Force on OTC Derivatives Regulation, which the SEC co-chairs, and our participation in other international forums will help us achieve this goal.

In short, we remain committed to working closely, cooperatively, and regularly with our fellow regulators to facilitate our implementation of the regulatory structure established by the Dodd-Frank Act.

Rulemaking

Actions Already Taken

The SEC has taken significant steps in implementing the rulemaking required by Titles VII and VIII of the Act. To date, the SEC has proposed a number of rulemakings required by these titles.

In October 2010, we proposed rules to mitigate conflicts of interest involving security-based swaps. These proposed rules seek to address conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

In November 2010, we proposed anti-fraud and anti-manipulation rules for security-based swaps that would subject market conduct in connection with the offer, purchase, or sale of any security-based swap to the same general anti-fraud provisions that apply to all securities and reach misconduct in connection with ongoing payments and deliveries under a security-based swap. We also proposed rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps. Those rules lay out who must report security-based swap transactions, what information must be reported, and where and when it must be reported. In addition, we have proposed rules regarding the obligations of security-based swap data repositories, which would require security-based swap data repositories to register with the SEC and specify other requirements with which security-based swap data repositories must comply.

In December 2010, we proposed rules relating to mandatory clearing of security-based swaps. These rules would set out the way in which clearing agencies would provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing. We also proposed rules relating to the exception to the mandatory clearing requirement for end users. These rules would specify the steps that end users must follow, as required under the Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions

exempt from the mandatory clearing requirement. In addition, we proposed joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and major security-based swap participants. These rules lay out objective criteria for these definitions and are a first step in helping the SEC appropriately address the market impacts and potential risks posed by these entities.

Thus far in 2011, we have proposed rules regarding the confirmation of security-based swap transactions, which would govern the way in which certain security-based swap transactions are acknowledged and verified by the parties who enter into them. We also proposed rules regarding registration and regulation of security-based swap execution facilities, which would define security-based swap execution facilities, specify their registration requirements, and establish their duties and core principles. And most recently, we proposed rules to establish minimum standards concerning the operation, governance, and risk management of clearing agencies. At the same time, we reopened the comment period for our October proposal regarding conflicts of interest at security-based swap clearing agencies, security-based swap execution facilities, and exchanges that trade security-based swaps.

In addition, we adopted interim final rules in October 2010 regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act. These interim final rules require certain security-based swap dealers and other parties to preserve and report to the SEC or a registered security-based swap data repository certain information pertaining to any security-based swap entered into prior to the July 21, 2010 passage of the Dodd-Frank Act and whose terms had not expired as of that date.

Our staff also is working closely with the Federal Reserve Board and the CFTC to develop, as required by Title VIII of the Act, a new framework to supervise systemically important financial market utilities, including clearing agencies registered with the SEC, that are designated by the Financial Stability Oversight Council as systemically important. For example, SEC staff has been actively coordinating with the other agencies to develop rules regarding submission of notices by designated financial market utilities with respect to rules, procedures, or operations that could materially affect the risks presented by such designated financial market utilities. The SEC proposed these rules in December. In addition, in March, the Financial Stability Oversight Council, of which the SEC is a member, issued a notice of proposed rulemaking regarding the criteria and analytical framework for designating financial market utilities under Title VIII and the processes and procedures that would be used to make such designations.

Our staff also has been actively coordinating with the other agencies on the new authority granted to the SEC and CFTC to develop standards for designated financial market utilities. Moreover, the SEC and CFTC staffs have begun working with staff from the Federal Reserve Board to jointly develop risk management supervision programs for designated financial market utilities pursuant to Title VIII. The SEC, CFTC, and Federal Reserve Board also are working together closely to prepare a joint report to Congress required under Title VIII that will make recommendations for improving consistency in the oversight of designated clearing entities, promoting robust risk management, and monitoring the effects of such risk management on the stability of the financial system.

Upcoming Actions

In the coming months, we expect to propose rules regarding registration procedures, business conduct standards, and capital, margin, segregation, and recordkeeping requirements for security-based swap dealers and major security-based swap participants. We also expect to propose joint rules with the CFTC governing the definitions of “swap” and “security-based swap,” as well as the regulation of “mixed swaps.”

The SEC has been carefully reviewing all the comments received regarding the rules that already have been proposed and we are in the process of considering those comments. We also are continuing discussions with various market participants about their concerns and ideas regarding the proposed rules. This information is invaluable as we move toward consideration of final rules designed to further the purposes of the Dodd-Frank Act and the SEC’s mission to protect investors, maintain fair, orderly, and efficient markets, promote the prompt and accurate clearance and settlement of securities transactions, and facilitate capital formation and provide effective regulation of the security-based swap markets without imposing unjustified costs or having unforeseen adverse consequences. We will, of course, be engaged in the same process for our upcoming proposed rulemakings, and I would like to take this opportunity to encourage market participants and the public to continue submitting comments on these upcoming proposed rulemakings.

Anticipated Completion of Rulemaking

We are working to complete the rulemaking proposal and adoption process under Titles VII and VIII and are mindful of Congress’ deadlines for implementation.

Nonetheless, this is a very challenging task. The OTC derivatives markets are large and interconnected. The issues are complex and do not lend themselves to easy solutions.

We are progressing at a deliberate pace, taking the time necessary to thoughtfully consider the issues raised by the various rulemakings before proposing specific rules. We are taking a similar approach as we move toward consideration of final rules. As we do so, we are also devoting careful thought to sequencing the implementation of final rules in such a way that market participants will have sufficient time to develop the infrastructure necessary to comply. We understand that getting the rules right and implementing them in the right order is important, and this will continue to guide our efforts in coming months

Impact of Rulemaking on Existing Markets

There are unique challenges involved in imposing a comprehensive regulatory regime on existing markets, particularly ones that until now have been almost completely unregulated. For example, in proposing margin rules, we will be mindful both of the importance of security-based swaps as hedging tools for commercial end users and also of the need to set prudent risk rules for dealers in these instruments. We also need to carefully consider how our rules might impact pre-existing contracts. For example, in developing rules that concern the capital and margin requirements for security-based swap dealers, we will need to consider dealers' pre-existing security-based swaps. The application of new rules to existing security-based swaps could be very disruptive and impose burdens on dealers or their counterparties that they did not bargain for or anticipate. We discussed this issue, along with the end-user margin issue, with various

stakeholders at a joint SEC-CFTC roundtable in December, and are taking the input we received at the roundtable and from other sources into account in writing proposed rules.

Conclusion

The Dodd-Frank Act provides the SEC 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, promote the prompt and accurate clearance and settlement of securities transactions, and facilitate capital formation. As we proceed with implementation, we look forward to continuing to work closely with Congress, our fellow regulators, and members of the financial and investing public. Thank you for inviting me to share with you our progress on and plans for implementation. I look forward to answering your questions.