Testimony on "Mitigating Systemic Risk in the Financial Markets through Wall Street Reforms"

By

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

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission regarding steps taken by the SEC to reduce systemic risk in our capital markets. In particular, you requested that I discuss the Commission's responsibilities with respect to those aspects of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or the "Act") designed to mitigate systemic risk.

The Commission, of course, recognizes the importance of addressing systemic risk and promoting financial stability. The Dodd-Frank Act gave the SEC significant new responsibilities for, among other things, over-the-counter derivatives, hedge fund and other private fund advisers, municipal advisors, and clearing agencies. The SEC has proposed or adopted rules for over 80 percent of the more than 90 Dodd-Frank Act provisions that require SEC rulemaking, and completing this rulemaking – and the rulemaking called for under the Jumpstart Our Business Startups Act ("JOBS Act") – remains a top and immediate priority. It is critical that we execute our responsibilities under both the Dodd-Frank Act and JOBS Act in as timely and smart a way as possible.

Among the Dodd-Frank Act's goals was to decrease the likelihood that an entity's failure will cause a cascading failure across the financial system as a whole. Many of the core provisions of the Act that seek to reduce systemic risks are within the sole jurisdiction of the federal banking regulators, but other provisions are within the SEC's jurisdiction, either solely or as shared with other regulators. For example, the Act:

- Established a regulatory regime for over-the-counter derivatives transactions, including security-based swaps;

- Enhanced oversight and standards for systemically important financial market utilities, including designated clearing agencies supervised by the Commission;

- Required advisers to many private funds to report data, on a confidential basis, for use in monitoring systemic risk and also supporting the SEC's mission;

- Prohibited banks and their affiliates generally from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund;

- Altered the regulation of credit rating agencies;

- Prohibited entities that create and distribute asset-backed securities from engaging in certain transactions;

- Established a new orderly liquidation authority for systemically important broker-dealers and other financial entities; and

- Created the Financial Stability Oversight Council ("FSOC") to provide a formal structure for coordination among the heads of various financial regulators to monitor systemic risk and to promote financial stability across our nation's financial system.

Beyond the actions taken in connection with the Dodd-Frank Act, the SEC has tried to diminish systemic risk in the securities markets by, among other things, providing additional safeguards for money market mutual funds.

Below is an overview of the steps the SEC has undertaken to try to mitigate systemic risk in our securities markets, with an emphasis on those actions mandated by the Dodd-Frank Act. [1]

Over-the Counter Derivatives

Among the key provisions of the Dodd-Frank Act are those that establish a new oversight regime for the over-the counter ("OTC") derivatives marketplace. Title VII of the Dodd-Frank Act ("Title VII") requires the Commission to regulate "security-based swaps" and to write rules that address, among other things: mandatory clearing; trade reporting and trade execution; the operation of clearing agencies, trade data repositories, and trade execution facilities; capital and margin requirements and business conduct standards for dealers and major market participants; and public transparency for transactional information. Such rules are intended to achieve a number of goals, including:

- Facilitating the centralized clearing of swaps, with the intent of reducing counterparty and systemic risk;

- Increasing market transparency for regulators and market participants;

- Increasing security-based swap transaction disclosure; and

- Addressing potential conflict of interest issues relating to security-based swaps.

[1] A list of the rulemaking provisions in the Dodd-Frank Act applicable to the SEC is attached as Appendix A

To date, the Commission has: proposed substantially all of the core rules required by Title VII; adopted a number of final rules and interpretations; provided a "roadmap" to implement Title VII and to inform market participants of the sequence in which the new requirements will become effective and how the proposed rules would apply in a cross border context; and taken other actions to provide legal certainty to market participants during the implementation process. In advancing its regulatory initiatives, the Commission also takes into account the potential disruption and cost to the market. The Commission's more recent Title VII initiatives are discussed below in more detail.

Proposal of Rules Regarding the Application of Title VII in the Cross-Border Context

Given the global nature of the derivatives market, the Commission has been working with its counterparts abroad and the Commodity Futures Trading Commission ("CFTC") to coordinate an approach to the regulation of derivatives. In May, the Commission proposed rules and interpretive guidance regarding the application of Title VII to cross-border security-based swap transactions.[2] The proposal includes rules and interpretive guidance that, among other things, would inform parties to a security-based swap transaction about which regulatory requirements apply when their transaction occurs in part within and in part outside the U.S. In addition, the proposal would provide interpretive guidance regarding when a trading platform or clearing agency is required to register with the Commission.

The proposal generally would subject security-based swap transactions to the requirements of Title VII if they are entered into with a U.S. person or otherwise conducted within the United States. In addition, foreign affiliates whose security-based swap transactions are guaranteed by U.S. persons would be subject to certain requirements under Title VII, based on the risk such guaranteed transactions might pose to the U.S. financial system.

Under the proposal, a party may have the ability to comply with Commission requirements by complying instead with some or all of the requirements of a foreign regulatory regime, provided that those requirements have been determined by the Commission to achieve comparable regulatory outcomes. The Commission's proposal refers to this approach as "substituted compliance." Under substituted compliance, a foreign market participant would be permitted to comply with the requirements imposed by its own home country, so long as those requirements achieve regulatory outcomes comparable with the regulatory outcomes of the relevant provisions of Title VII. If the home country does not have any requirements that achieve comparable regulatory outcomes, substituted compliance would not be permitted and the foreign entity would be required to comply with the applicable U.S. requirements. The 60-day reopening of the comment period for certain Title VII rulemaking releases and the policy statement ended July 22, 2013, and the comment period for our proposal on cross-border security-based swap transactions ends August 21, 2013. We are actively reviewing public input on the proposals, as well as the final guidance approved by the CFTC on July 12, 2013.

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[2] *See* Release No. 34-69490, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (May 1, 2013), http://sec.gov/rules/proposed/2012/34-68071.pdf.

The Commission has been, and continues to be, strongly supportive of coordination of regulatory reforms to meet the G-20 Leaders' commitments to central clearing, trading, and reporting of OTC derivatives. The Commission has been actively engaged in ongoing discussions with foreign regulators regarding the direction of international derivatives regulation and the Commission's efforts to implement the requirements of Title VII, including participation in the Financial Stability Board and the International Organization of Securities Commissions ("IOSCO"), and engaging in regulatory dialogues with other countries about our respective regulatory reform efforts.

Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants

In July 2012, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII, such as the meaning of "swap" and "security-based swap".[3] This effort followed the joint adoption of entity definitions by the Commission and the CFTC in April 2012, which further defined the key terms "swap dealer" and "security-based swap dealer," provided guidance as to what constitutes dealing activity, and implemented the Dodd-Frank Act's "major security-based swap participant" definition.[4]

In October 2012, the Commission proposed rules that would, among other things, prescribe how much capital security-based swap dealers would need to maintain, when and how these dealers would need to collect margin collateral to protect against counterparty losses, and how these dealers would need to segregate and protect customer funds and securities.[5] The proposal also would establish capital and margin collateral requirements for major security-based swap participants and raise capital requirements for certain large broker-dealers that use internal models in computing capital. The proposal would further require those large broker-dealers and security-based swap dealers to compute capital utilizing internal models, perform a liquidity stress test at least monthly, and maintain liquidity reserves sufficient to address potential funding needs during a stress event.

Taken together, the goal of these rules is to help ensure that market participants remain highly liquid and well capitalized so that they can meet their obligations to customers and

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[3] *See* Release No. 33-9338, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (July 18, 2012), http://www.sec.gov/rules/final/2012/33-9338.pdf.

[4] *See* Release No. 34-66868, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant* (April 27, 2012), http://www.sec.gov/rules/final/2012/34-66868.pdf.

[5] *See* Release No. 34-68071, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers* (Oct. 18, 2012), http://www.sec.gov/rules/proposed/2012/34-68071.pdf

counterparties without creating unnecessary burdens that impede liquidity and efficient capital formation. In addition, in the event of a failure, enhanced capital, margin, and customer segregation rules should help ensure that customers and counterparties will be protected, thus limiting systemic effects in the capital markets and the broader economy.

Requirements for Security-Based Swap Clearing Activity

Title VII of the Dodd-Frank Act requires that an entity acting as a clearing agency with respect to security-based swaps register with the Commission and that the Commission adopt rules with respect to clearing agencies that clear security-based swaps. As described below, in October 2012, the Commission adopted a rule that establishes operational and risk management standards for clearing agencies, including clearing agencies that clear security-based swaps. In June 2012, the Commission adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies. These rules include provisions detailing how clearing agencies will provide information to the Commission about the security-based swaps the clearing agencies plan to accept for clearing, which will then be used by the Commission to aid in determining whether those security-based swaps are required to be cleared.

Financial Market Utilities

Title VIII of the Dodd-Frank Act ("Title VIII") aims to mitigate systemic risk in the financial system and promote financial stability by providing for increased regulation of financial market utilities[6] ("FMUs") and financial institutions engaging in payment, clearing, and settlement activities that are designated as systemically important.

Enhanced Standards for Systemically Important Financial Market Utilities

Under Title VIII, FSOC is authorized to designate an FMU as systemically important if the failure, or a disruption to the functioning, of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets, thereby threatening the stability of the U.S. financial system. FSOC established an interagency FMU designations committee to develop a framework for the designation of systemically important FMUs. In July 2012, FSOC designated eight FMUs as systemically important under Title VIII ("DFMUs"), and the Commission acts as primary supervisory agency for four of these: the Depository Trust Company, Fixed Income Clearing Corporation, National Securities Clearing Corporation, and The Options Clearing Corporation.[7]

[6] Section 803(6) of the Dodd-Frank Act defines a financial market utility 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."

[7] Two other clearing agencies registered with the Commission are designated systemically important for which the CFTC is the primary supervisory agency: Chicago Mercantile Exchange, Inc. and ICE Clear Credit LLC. The Federal Reserve Board acts as primary supervisory agency for two payment systems that were designated as systemically important FMUs: CLS Bank International and the Clearing House International Payments System.

Title VIII provides a framework for an enhanced supervisory regime for DFMUs, including oversight in consultation with the Federal Reserve Board ("Federal Reserve") and FSOC. It permits the Commission to prescribe regulations for risk management and operations, and also directs the Commission to take into consideration relevant international standards and existing prudential requirements for the DFMUs it supervises.[8] The Commission is also required to examine such DFMUs annually.

Title VIII also establishes a process for a DFMU to submit to the Commission, with a copy to the Federal Reserve, advance notices identifying changes to its rules, procedures, or operations that could materially affect the nature or level of risk presented by the FMU.[9] In June 2012, the Commission adopted rules that establish procedures for how it will address these advance notices,[10] and it has since considered a significant number of such notices.[11]

Adoption of Clearing Agency Standards

Clearing agencies play a critical role in financial markets by ensuring that transactions settle on time and on agreed-upon terms. To enhance the integrity of clearing agency operations and governance, the Commission adopted rules in October 2012 requiring all registered clearing agencies – including, as noted above, clearing agencies that clear security-based swaps – to maintain certain standards with respect to risk management and operations.[12] The rules contain specific requirements for clearing agencies that perform central counterparty services, including, for example, written policies and procedures addressing measuring credit exposures, use margin requirements, maintaining financial resources sufficient to withstand defaults, and fair and reasonable membership opportunities for persons who are not dealers or security-based swap dealers. The requirements are designed to strengthen the Commission's oversight of securities clearing agencies and promote consistency in the regulation of clearing organizations generally,

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[8] *See* § 805(a)(2) of the Dodd-Frank Act. Commission staff also worked jointly with the staffs of the CFTC and the Federal Reserve to submit a required report to Congress in July 2011 discussing recommendations regarding risk management supervision of clearing entities that are DFMUs. Risk Management Supervision of Designated Clearing Entities, Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act (July 2011), http://www.sec.gov/news/studies/2011/813study.pdf. The report discussed several recommendations, including finalizing rulemakings to establish enhanced risk management for such clearing entities, formalizing the process for ongoing consultations and information sharing regarding such clearing entities and systemic risk, and enhancing clearing entity examinations.

[9] *See* § 806(e)(4) of the Dodd-Frank Act.

[10] *See* Release No. 34-67286, *Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations* (June 28, 2012), http://www.sec.gov/rules/final/2012/34-67286.pdf.

[11] Advance notices are published on the Commission website at http://www.sec.gov/rules/sro.shtml.

[12] *See* Release No. 34-68080, *Clearing Agency Standards* (October 22, 2012), http://www.sec.gov/rules/final/2012/34-68080.pdf.

thereby helping to ensure that clearing agency regulation reduces systemic risk in the financial markets.

Form PF: Systemic Risk Reporting by Advisers to Private Funds

Title IV of the Dodd-Frank Act directed the Commission to establish reporting requirements for investment advisers to private funds as necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk by the FSOC.[13] The Dodd-Frank Act specifies that such reporting must include certain information about private funds, including but not limited to the amount of assets under management, use of leverage, counterparty credit risk exposure, and trading practices for each private fund managed by the adviser.[14] The Commission implemented this provision of the Dodd-Frank Act when it adopted Form PF in October 2011, a systemic risk reporting form for advisers to private funds.[15] As required by the Dodd-Frank Act, Form PF was designed in consultation with FSOC. To date, approximately 2,300 investment advisers managing over $7 trillion in private fund assets have filed approximately 4,000 reports on Form PF concerning approximately 6,700 hedge funds, 66 liquidity funds and 5,900 private equity funds.

The requirement to file Form PF applies to investment advisers registered with the Commission that advise one or more private funds and have at least $150 million in private fund assets under management at the end of the adviser's most recently completed fiscal year. The filing requirements of Form PF vary depending on the size of the adviser. Both the amount of information required to be reported and the frequency with which Form PF must be filed depend on the amount of the adviser's assets under management and the types of funds it advises.[16] Most advisers are required to file Form PF once a year, and report basic information regarding the private funds they advise, such as the types of private funds that an adviser advises, and information relating to such funds' size, leverage, types of investors, liquidity and performance. Advisers managing hedge funds must also report information about fund strategy, counterparty credit risk, and the use of trading and clearing mechanisms.

To comply with enhanced confidentiality provisions established under the Dodd-Frank Act with respect to Form PF, Commission staff has been developing a secure filing environment

[13] Section 404 of the Dodd-Frank Act (codified at Section 204(b) of the Investment Advisers Act of 1940, as amended).

[14] Section 404 of the Dodd-Frank Act.

[15] *See* Release No. IA-3308, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (Oct. 31, 2011), http://www.sec.gov/rules/final/2011/ia-3308.pdf.

[16] Large private fund advisers must provide more detailed information than smaller private fund advisers. The content and frequency of this more detailed reporting is different depending on the type of private fund the large adviser manages. For example, advisers with $1.5 billion or more in hedge fund assets under management must report on risk metrics, financing information and fund exposure for each hedge fund managed that has a net asset value of at least $500 million.

for Form PF to protect the information when and after it is filed, including controls and systems to handle the data across the agency and to deliver the data electronically to the Office of Financial Research ("OFR") within the Department of the Treasury. As of May 1, 2013, the Commission received a complete set of initial Form PF filings from those investment advisers required to file. Commission staff has started to use the data in carrying out the Commission's regulatory mission, including examinations, investigations, and investor protection efforts.

The Volcker Rule

Section 619 of the Dodd-Frank Act (known as the "Volcker Rule") generally prohibits and restricts banks, bank affiliates, and certain nonbank financial companies from engaging in proprietary trading, or sponsoring, investing, or having certain interests or relationships with a hedge fund or private equity fund. The statute provides exceptions to these prohibitions for certain customer-service oriented activities, such as market making, underwriting, and, subject to certain limitations, organizing and offering hedge funds and private equity funds as part of bona fide trust, fiduciary, or investment advisory services provided to a bank's customers.

In October 2011, the federal banking agencies and SEC jointly proposed rules to implement the Volcker Rule.[17] In January 2012, the CFTC issued a substantially similar proposal. To date, we have received nearly 19,000 comment letters in response to the proposal. SEC staff has carefully reviewed these comments and continues to engage in regular and active consultation with the staffs at our fellow federal financial regulators to develop recommendations for implementing the Volcker Rule in ways that advance the goals of Section 619while also limiting the potential for unintended market impacts.

Credit Rating Agencies

The Dodd-Frank Act required the Commission to undertake a number of rulemakings related to credit rating agencies registered as nationally recognized statistical rating organizations, or "NRSROs." The Commission has proposed a series of rules intended to strengthen the integrity of credit ratings by, among other things, improving the transparency of ratings methodologies and performance.[18]

Additionally, the Dodd-Frank Act required each federal agency, to the extent applicable, to review its regulations that require use of credit ratings as an assessment of the credit-worthiness of a security, remove these references, and replace them with appropriate standards of credit-worthiness. The Commission has proposed and, in some cases, adopted amendments to a

[17] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf.

[18] Release No. 34-64514, *Proposed Rules for Nationally Recognized Statistical Rating Organizations* (May 18, 2011), http://www.sec.gov/rules/proposed/2011/34-64514.pdf.

number of its rules to remove references to credit ratings. [19] The Commission plans to take further action in the near term to complete implementation of these mandates.

The Dodd-Frank Act also required the Commission to study the credit rating process for structured products and the conflicts of interest associated with the issuer-pay and subscriber-pay rating agency models, and to examine the feasibility of establishing an assigned ratings system or alternative means for compensating NRSROs. In December 2012, the Commission submitted a required report to Congress containing the findings of the study and recommendations for regulatory or statutory changes that should be made to implement the findings of the study.[20] In May 2013, the Commission held a roundtable dedicated to these topics.

Prohibition against Conflicts of Interest in Certain Securitizations

In September 2011, the Commission proposed a rule to implement Section 621 of the Dodd-Frank Act, which prohibits entities that create and distribute asset-backed securities from engaging in transactions that involve or result in material conflicts of interest with respect to the investors in such asset-backed securities.[21] The proposed rule would prohibit underwriters, placement agents, initial purchasers, and sponsors of an asset-backed security, among others, from engaging in any transaction that would involve or result in any material conflicts of interest with respect to any investor in the relevant asset-backed security.

The Commission received a number of comment letters discussing a range of complex issues, including the ability of portfolio managers to hedge the credit risk that a bank holds on its balance sheet through synthetic securitizations. Commission staff is carefully considering each of the issues and concerns raised in the comment letters.

Orderly Liquidation Authority

Title II of the Dodd-Frank Act created a new process, modeled on the receivership process used for failed banks, pursuant to which the Federal Deposit Insurance Corporation

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[19] *See* Release No. IC-No. 30268, *Purchase of Certain Debt Securities by Business Development Companies Relying on an Investment Company Act Exemption* (Nov. 19, 2012), http://www.sec.gov/rules/final/2012/ic-30268.pdf; Release No. 34-67448, *Commission Guidance Regarding Definitions of Mortgage Related Security and Small Business Related Security* (Jul. 17, 2012), http://www.sec.gov/rules/interp/2012/34-67448.pdf; Release No. 34-9245, *Security Ratings* (Jul. 27, 2011), http://www.sec.gov/rules/final/2011/33-9245fr.pdf; Release No. 34-9244, *Re-proposal of Shelf Eligibility Conditions for Asset-Backed Securities and Other Additional Requests for Comment* (Jul. 26, 2011), http://www.sec.gov/rules/proposed/2011/33-9244fr.pdf; Release No. 34-64352, *Removal of Certain References to Credit Ratings under the Securities Exchange Act of 1934* (Apr. 27, 2011), http://www.sec.gov/rules/proposed/2011/34-64352.pdf; Release No. IC-9193, *References to Credit Ratings in Certain Investment Company Act Rules and Forms* (Mar. 3, 2011), http://www.sec.gov/rules/proposed/2011/33-9193fr.pdf.

[20] *See Report to Congress on Assigned Credit Ratings* (December 2012), http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf.

[21] *See* Release No. 34-65355, *Prohibition against Conflicts of Interest in Certain Securitizations* (September 19, 2011), http://www.sec.gov/rules/proposed/2011/34-65355.pdf.

("FDIC") may serve as receiver for certain large financial companies, including broker-dealers, whose failure poses a significant risk to financial stability in the United States. Under Title II, the Commission and the FDIC are required to develop joint rules governing the orderly liquidation of broker-dealers, and the Commission staff is working to prepare a recommendation for the Commission's consideration. The rules should provide greater certainty and transparency regarding the process the FDIC would follow during the orderly liquidation of a systemically important broker-dealer.

Other Commission Actions Addressing Potential Systemic Risks

Beyond actions taken in connection with the implementation of the Dodd-Frank Act, the Commission has taken additional steps to further reduced systemic risk in our securities markets.

Enhancing Operational Integrity

Nearly all trading in the equity and options markets today depends on the reliable performance of highly automated systems, as reliance on technology has enabled the markets to achieve extraordinary levels of speed and efficiency. When technology systems do not work as intended, however, the failures can harm not only the operator of the system, but also a wide range of other market participants.

In November 2010, the Commission adopted a new Market Access Rule to require broker-dealers with market access to put in place risk management controls and supervisory procedures on a pre-trade basis. Among other things, the rule requires any broker using or providing access to trading on the securities markets to implement pre-trade controls reasonably designed to manage the financial, regulatory, and other risks of such access.

In March of this year, the Commission proposed Regulation Systems Compliance and Integrity ("Regulation SCI"),[22] which would require exchanges, certain alternative trading systems, clearing agencies, and plan processors to maintain policies and procedures reasonably designed to meet certain technology standards, and take appropriate corrective action if problems do occur. The comment period for proposed Regulation SCI closed on July 8, and Commission staff is currently in the process of reviewing the comment letters.

Addressing Significant Market Volatility

The Commission also recently approved a National Market System ("NMS") Plan to implement a "limit up-limit down" mechanism to create "speed bumps" to limit abrupt market movements in individual securities,[23] and amendments to the market-wide circuit breakers to

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[22] *See* Release No. 34-69077, *Regulation Systems Compliance and Integrity* (March 8, 2013), http://www.sec.gov/rules/proposed/2013/34-69077.pdf.

[23] *See* Release No. 67091, *Order Approving, on a Pilot Basis, the National Market System Plan to Address Extraordinary Market Volatility by BATS Exchange, Inc., BATS Y-Exchange, Inc., Chicago Board Options Exchange, Incorporated, Chicago Stock Exchange, Inc., EDGA Exchange, Inc., EDGX Exchange, Inc., Financial Industry Regulatory Authority, Inc., NASDAQ OMX BX, Inc., NASDAQ OMX PHLX LLC, The Nasdaq Stock Market*

provide for brief, coordinated, cross-market trading halts during a sharp decline in the securities market.[24] The market-wide circuit breakers and phase I of the NMS Plan relating to the limit up-limit down mechanism were implemented on April 8, 2013.[25]

Money Market Funds

While there are many possible explanations for the redemptions from money market funds during the 2007-2008 financial crisis, regardless of the cause or causes, money market funds' experience in the 2007-2008 financial crisis demonstrates the harm that can result from rapid heavy redemptions in money market funds. Since that time, the Commission and its staff have reexamined the Commission's regulation of money market funds. This effort began with the Commission's 2010 reforms to money market fund regulation, followed by a 2011 Commission roundtable on money market funds and systemic risk, a new and detailed study in 2012 by SEC economists, and most recently a June 2013 proposal requesting public comment on additional reforms to the Commission's regulation of money market funds.[26] The staff also has used data collected from money market funds on Form N-MFP to monitor trends and risks in this area, which was particularly useful during the Eurozone sovereign debt crisis.

The Commission's recent proposal requests comment on a variety of reforms designed to reduce money market funds' susceptibility to heavy redemptions, to mitigate potential contagion effects from heavy redemptions, and to increase the transparency of their risks, while preserving

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LLC, National Stock Exchange, Inc., New York Stock Exchange LLC, NYSE MKT LLC, and NYSE Arca, Inc. (May 31, 2012), http://www.sec.gov/rules/sro/nms/2012/34-67091.pdf; Release No. 34-68953, *Notice of Filing and Immediate Effectiveness of the Second Amendment to the Limit Up-Limit Down Plan* (February 20, 2013), http://www.sec.gov/rules/sro/nms/2013/34-68953.pdf; Release No. 34-69287, *Order Approving the Third Amendment to the Limit Up-Limit Down Plan* (April 3, 2013), http://www.sec.gov/rules/sro/nms/2013/34-69287.pdf.

[24] *See* Release No. 34–67090, *Notice of Filing of Amendments No. 1 and Order Granting Accelerated Approval of Proposed Rule Changes as Modified by Amendments No. 1, Relating to Trading Halts Due to Extraordinary Market Volatility* (May 31, 2012), http://www.sec.gov/rules/sro/bats/2012/34-67090.pdf. The operative date of the revised circuit breakers was delayed from February 4, 2013 to April 8, 2013. *See*, *e.g.*, Release No. 34–68784, *Notice of Filing and Immediate Effectiveness of Proposed Rule Change Delaying the Operative Date of A Rule Change to NYSE Rule 80B, Which Provides for Methodology for Determining When to Halt Trading in All Stocks Due to Extraordinary Market Volatility, From the Date of February 4, 2013, Until April 8, 2013* (January 31, 2013), http://www.sec.gov/rules/sro/nyse/2013/34-68784.pdf.

[25] Phase I applies the limit up-limit-down mechanism to stocks in the S&P 500, the Russell 1000, and to select exchange-traded products. Phase II, currently scheduled for implementation in November 2013, will apply to all remaining exchange-traded equity securities, and will be implemented six months following the implementation of Phase I.

[26] *See* Release No. IC-30551, *Money Market Fund Reform; Amendments to Form PF* (Jun. 5, 2013), http://www.sec.gov/rules/proposed/2013/33-9408.pdf; *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher, a report by staff of the Division of Risk, Strategy, and Financial Innovation* (Nov. 30, 2012), http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf; *U.S. Securities and Exchange Commission, Roundtable on Money Market Funds and Systemic Risk*, unofficial transcript (May 10, 2011), http://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm; Release No. IC-29132, *Money Market Fund Reform* (Feb. 23, 2010), http://www.sec.gov/rules/final/2010/ic-29132.pdf.

the benefits of this product to both retail and institutional investors to the extent possible. There are two principal reform proposals – which could be adopted separately or in combination. The first – would require that all prime institutional money market funds operate with a floating net asset value. The second would require that all non-government money market funds impose a 2% liquidity fee if the fund's level of weekly liquid assets fell below 15% of its total assets, unless the fund's board determined that it was not in the best interest of the fund. The second reform alternative also would permit the fund's board of directors to temporarily suspend redemptions in the fund for up to 30 days if it crossed that liquidity threshold. With respect to both alternatives, the proposed reforms also would tighten diversification requirements, enhance disclosure requirements, improve data reporting on both registered and unregistered money market funds, and strengthen fund stress testing. We look forward to receiving public input on the proposal and whether it strikes the right balance between addressing systemic risk concerns while also maintaining money market funds as a viable investment product. The 90-day comment period ends in mid-September.

Financial Stability Oversight Council

Title I of the Dodd-Frank Act provides that the Chairman of the Commission shall serve as a voting member of FSOC.[27] Pursuant to the Dodd-Frank Act, the purposes of the Council are:

- Identifying risks to the financial stability of the United States that could arise from the material financial distress or failure – or ongoing activities – of large, interconnected bank holding companies or nonbank financial holding companies, or that could arise outside the financial services marketplace;

- Promoting market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure; and

- Responding to emerging threats to the stability of the United States financial system.[28]

In addition, FSOC provides a formal structure for coordination among the various financial regulators. As Chairman of the SEC, I participate in the activities of the Council, including consideration of designation of certain nonbank financial companies as systemically important financial institutions ("SIFIs") subject to heightened prudential supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve Board").[29]

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[27] Dodd-Frank Act § 111(b)(1).

[28] Dodd-Frank Act § 112(a)(1)(E).

[29] *See* Dodd-Frank Act §§ 112(a)(2)(H) and 113. *See also Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability* (Jul. 9, 2013), http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx.

Conclusion

The Commission recognizes the importance of limiting systemic risk in our financial markets and is committed to taking appropriate steps to address systemic threats to our financial system in a balanced manner that preserves the strengths of the system and protects investors. Thank you for inviting me to testify today. I would be happy to answer any questions you may have.