

Testimony on Title VII Implementation

by Robert Cook

Director, Division of Trading & Markets, U.S. Securities and Exchange Commission

**Before the Capital Markets and Government Sponsored Enterprises Subcommittee of the
Committee on Financial Services
U.S. House of Representatives**

December 12, 2012

Chairman Garrett, Ranking Member Waters, and members of the Subcommittee:

I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission regarding the 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 substantially all of the rules required by Title VII, and in some cases has adopted final rules. We are continuing to work diligently to implement all provisions of Title VII, and to coordinate our efforts with the CFTC and other regulators here and overseas.

My testimony today will provide an overview of these efforts to implement Title VII, emphasizing the Commission's activities since Chairman Schapiro last testified before this Subcommittee in April, as well as the Commission's efforts to address the application of the security-based swap provisions of Title VII in the cross-border context.

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 to 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 has primary regulatory authority over “swaps,” which represent the overwhelming majority of the overall market for OTC derivatives subject to Title VII.

With respect to the Commission’s efforts, the Title VII rulemakings are designed to improve transparency and reduce counterparty and systemic risks by, among other things, facilitating the centralized clearing of security-based swaps. They also are 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 security-based swap market and enhance regulatory oversight and monitoring of this market by facilitating improved access to comprehensive data on security-based swap transactions.

Ongoing Regulatory Coordination with the CFTC and Other Regulators

In implementing Title VII, the staff of the Commission is in regular contact with the staffs of the CFTC, Federal Reserve Board, and other federal regulators. In particular, Commission staff has consulted and coordinated extensively with CFTC staff in the development of the joint definitional rules required under Title VII.

Commission staff also engages in extensive interagency discussions concerning rules to implement Title VII that are not required to be adopted jointly. Although the timing and sequencing of the CFTC’s and Commission’s proposal and adoption of these rules have varied, the objective of consistent and comparable requirements continues to guide the Commission’s 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 the Americas. 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”). A Commission representative also serves as one of the four co-chairs of the IOSCO Task Force on OTC Derivatives Regulation. In addition, senior representatives from the Commission, the CFTC, and a number of foreign regulators have met numerous times, most recently in late

November, to discuss 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 consistent with the requirements of the Act.

Title VII Implementation to Date

Since Chairman Schapiro last testified before this Subcommittee in April, the Commission has continued its efforts to adopt final rules under Title VII. In addition, the Commission proposed substantially all of the core rules required by Title VII.

Adoption of Key Definitional Rules

In July, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII. This effort follows the Commission's work on the entity definitions rules, which the Commission adopted jointly with the CFTC in April. The completion of these joint rulemakings is a foundational step toward the complete implementation of Title VII. However, this step did not trigger compliance with other rules the Commission is adopting under Title VII. Instead, the compliance dates applicable to each final rule will be set forth in the adopting release for the applicable rule. In this way, the Commission is better able to provide for an orderly implementation of the various Title VII rules.

The first joint rulemaking addresses certain product definitions and further defines the terms "swap," "security-based swap," and "security-based swap agreement," and adopts rules regarding the regulation of "mixed swaps" and the books and records requirements for security-based swap agreements. The product definitions rulemaking includes three general categories of rules and interpretations:

- First, it sets out rules and interpretations that will assist market participants in determining whether particular agreements, contracts, and transactions are subject to Title VII.
- Second, it sets out rules and interpretations that will assist market participants in determining whether a particular Title VII instrument is a swap subject to CFTC regulation, a security-based swap subject to Commission regulation, or a mixed swap subject to regulation by both the CFTC and the Commission.
- Third, it sets out rules and interpretations that provide a regulatory framework for mixed swaps, require market participants to maintain the same books and records for security-based swap agreements as they would under the CFTC's books and records requirements for swaps, and establishes a process that will allow market participants to request a determination from the Commission and CFTC of whether a product is a swap, a security-based swap, or both (i.e., a mixed swap). In addition, the rules establish a

process by which persons may request modified regulatory treatment for mixed swaps by joint order of the Commission and CFTC.

The second joint rulemaking addresses certain entity definitions, further 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 distinguishes 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 designed to promote the orderly implementation of Title VII.

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

As with other Commission rulemaking efforts, the Commission’s Division of Risk, Strategy, and Financial Innovation (“RSFI”) was extensively involved in the Commission’s development of both of these rule sets. In particular, RSFI’s analysis of single-name credit default swap data was especially informative in the development of the entity definition rules. 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 their potential economic consequences.

Adoption of Rules related to Clearing Infrastructure

In addition to the key definitional rules, the Commission has adopted rules under Title VII relating to clearing infrastructure. In October, the Commission adopted a rule that establishes standards for how registered clearing agencies, including clearing agencies that clear security-based swaps, should manage their risks and run their operations. The rule is designed to help ensure that clearing agencies will be able to fulfill their responsibilities in the multi-trillion dollar derivatives market as well as in more traditional securities markets. In particular, the rule requires registered clearing agencies that provide central counterparty services to maintain certain standards with respect to risk management and operations. Among other things, the rule sets standards with respect to measurement and management of credit exposures, margin requirements, financial resources, and margin model validation. The rule also establishes certain recordkeeping and financial disclosure requirements for all registered clearing agencies, as well as several new operational standards for these entities.

In June, the Commission adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies. These rules detail 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. The adopted rules also include rules requiring clearing agencies that are designated as “systemically important” under Title VIII of the Dodd-Frank Act to submit advance notice of changes to their rules, procedures, or operations if the changes could materially affect the nature or level of risk at those clearing agencies.

Proposal of Capital, Margin, and Segregation Requirements

In October, the Commission proposed capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants. With the completion of this proposal, the Commission has now proposed substantially all of the rules required by Title VII of the Dodd-Frank Act. The Commission proposed to:

- set minimum capital requirements for nonbank security-based swap dealers and nonbank major security-based swap participants;
- establish margin requirements for nonbank security-based swap dealers and nonbank major security-based swap participants with respect to non-cleared security-based swaps; and
- establish segregation requirements for security-based swap dealers and notification requirements with respect to segregation for security-based swap dealers and major security-based swap participants.

In addition, the rulemaking proposed certain risk management requirements for security-based swap dealers.

Issuance of Implementation Policy Statement

In addition to its work to propose and adopt Title VII rules, the Commission issued a policy statement in June describing and requesting public comment on the order in which it expects to require compliance by market participants with the final Title VII rules. The Commission’s approach aims to avoid the disruption and cost that could result if compliance with all of the rules were required simultaneously or haphazardly. More generally, the policy statement is part of our overall commitment to making sure that market participants know what the “rules of the road” are before requiring compliance with those rules.

The implementation policy statement is divided into five broad categories of final rules to be adopted by the Commission and explains how the compliance dates of these rules would be sequenced in relative terms by describing the dependencies that exist within and among the categories. The statement emphasizes that those subject to the new regulatory requirements arising from these rules will be given adequate, but not excessive, time to come into compliance with them.

In addition, the statement discusses the timing of the expiration of temporary relief the Commission previously granted security-based swap market participants from certain provisions

of the federal securities laws. The expiration of much of this relief is tied to the effective or compliance dates of certain rules to be adopted pursuant to Title VII.

Market participants have provided comments on the sequencing set out in the policy statement, and we are taking those into account as we work toward completing the Title VII adoption process.

Next Steps for Implementation of Title VII

Application of Title VII in the Cross-Border Context

In the near term, we intend to propose rules and interpretive guidance to address the international implications of the security-based swap provisions of Title VII. With very limited exceptions, the Commission has not addressed the application of the security-based swap provisions of Title VII in the cross-border context in its proposed or final rules. Rather than addressing these issues in a piecemeal fashion through each of the various substantive rulemakings implementing Title VII, the Commission stated in its implementation policy statement that it was instead planning to address them holistically in a single proposing release. We believe this approach will provide investors, market participants, foreign regulators, and other interested parties with an opportunity to consider, as an integrated whole, the Commission's proposed approach to the application of the security-based swap provisions of Title VII in the cross-border context.

The cross-border release will involve notice-and-comment rulemaking, not only interpretive guidance. As a rulemaking proposal, the release will consider investor protection and incorporate an economic analysis that considers the effects of the proposal on efficiency, competition, and capital formation. Although the rulemaking approach takes more time, we believe there are a number of benefits that will make this approach worth the effort—including, among others, a full articulation of the rationales for, and consideration of any reasonable alternative to, particular approaches.

As indicated previously by Chairman Schapiro, we expect the scope of the effort to be broad. The proposal will address the application of Title VII in the cross-border context with respect to each of the major registration categories covered by Title VII for security-based swaps: security-based swap dealers; major security-based swap participants; security-based swap clearing agencies; security-based swap data repositories; and security-based swap execution facilities. It also will address the application of Title VII in connection with reporting and dissemination, clearing, and trade execution, as well as the sharing of information with regulators and related preservation of confidentiality with respect to data collected and maintained by security-based swap data repositories.

We are very conscious of the challenges associated with developing a new regulatory regime for a pre-existing market. In the traditional securities space, the Commission has a long history of addressing cross-border issues, going back over 40 years. However, unlike in the traditional securities markets, where the Commission has had the opportunity to consider cross-border issues incrementally, the Dodd-Frank Act requires us to develop a completely new regulatory regime all at once for a pre-existing market, as well as determine how to apply the regime to

cross-border transactions. These challenges are particularly heightened in the context of the security-based swap market as a result of its already global nature.

In light of these considerations, the development of our cross-border proposal is necessarily being informed by our discussions with our fellow regulators in other jurisdictions, as well as the CFTC, as described above. We also are paying close attention to comments on the CFTC's proposed cross-border guidance.

Additional Steps

In addition to proposing rules and interpretive guidance designed to address the international implications of Title VII, the Commission expects to propose rules relating to books and records and reporting requirements for security-based swap dealers and major security-based swap participants. The Commission also is working to address petitions with the SEC and the CFTC seeking exemptive relief to permit portfolio margining of cleared customer credit default swap positions that use both swaps and security-based swaps. In addition, the Commission expects to consider the application of mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act.

Finally, the Commission staff continues to work diligently to develop recommendations for the Commission to adopt final rules in each of the remaining areas required by Title VII where rules have been proposed, but have not yet been adopted.

Conclusion

The Dodd-Frank Act provides the Commission with important tools to better meet the challenges of today's financial marketplace and fulfill its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. As the Commission and its staff continue with the 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 and current thinking on the implementation of Title VII. I will be happy to answer any questions.