Testimony on "Financial Regulatory Reform: The International Context"

by

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Chairman Bachus, Ranking Member Frank, and members of the Committee:

Thank you for the opportunity to testify today on behalf of the Securities and Exchange Commission ("SEC") regarding the international implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").

The Dodd-Frank Act establishes a host of new reforms that will have implications for U.S. companies that compete internationally and the U.S. investors who own those companies. My testimony today will outline some of these implications, as well as the SEC's attempts to facilitate coordination and limit regulatory arbitrage, both domestically and internationally. In particular, I will discuss the international implications of the Dodd-Frank Act for regulation of over-the-counter ("OTC") derivatives and foreign investor adviser registration. I also will provide a brief update on the status of international accounting convergence.

OTC Derivatives

The OTC derivatives marketplace has grown dramatically over the past three decades to become enormous and truly international. Since the early 1980s, when the first swap agreements were negotiated, the global notional value of this marketplace has grown to just over $600 trillion.[1] However, OTC derivatives were largely excluded from the financial regulatory framework by the Commodity Futures Modernization Act of 2000.

Title VII of the Dodd-Frank Act would bring this market under the regulatory umbrella and requires that the SEC and Commodity Futures Trading Commission ("CFTC") write rules relating to security-based swaps and swaps that address, among other things, mandatory clearing, the operation of 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 transaction information.

This series of rulemakings is designed to improve transparency and facilitate the centralized clearing of swaps and security-based swaps, helping, among other things, to improve oversight and reduce counterparty risk. It also will increase disclosure regarding swap and security-based swap transactions and help to mitigate conflicts of interest involving swaps and security-based

[1] *See* Bank of International Settlements, OTC Derivatives Market Activity in the Second Half of 2010, Monetary and Economic Department (May 2011), available at http://www.bis.org/publ/otc_hy1105.pdf.

swaps. By promoting transparency, efficiency and stability, this framework should help foster a more nimble and competitive market.

Because the OTC derivative marketplace already exists as a functioning, global market with limited oversight or regulation, international coordination is very important to seek to limit creating opportunities for cross-border regulatory arbitrage and competitive disadvantages, and to address unnecessarily duplicative and conflicting regulation, as well as, for achieving the goals of reform: reducing the systemic risks, increasing the transparency and improving the integrity of the OTC derivatives marketplace, while being mindful of the potential effects on efficiency and liquidity.

Pittsburgh G20 Communiqué

While the U.S. has been a leader in this important area, significant international consensus exists around core components of OTC derivatives reform. For example, in September 2009, the G20 Leaders agreed that:

- "[a]ll standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest,"
- "OTC derivatives contracts should be reported to trade repositories," and
- "[n]on-centrally cleared contracts should be subject to higher capital requirements."

The G20 deadline contemplates that every G20 country will have completed the legislation, rulemaking and implementation of these reforms by the 2012 deadline. While progress is being made internationally, other jurisdictions lag behind our efforts here. Apart from the United States, only Japan has enacted OTC derivatives reform legislation since the September 2009 G20 Communiqué, and its legislation only covers clearing and reporting, not mandatory trading. In the European Union, legislation is currently being considered that would establish criteria for the mandatory clearing of eligible OTC derivatives contracts, rules on risk mitigation for OTC derivatives contracts that are not centrally cleared, reporting obligations to, and registration requirements for, trade repositories, and organizational requirements for central counterparties. The proposed legislation is expected to be enacted before year-end 2011, with draft implementing regulations to be proposed to the European Commission by the market regulator by the end of June 2012, at the earliest. With regard to mandatory trading and post-trade reporting, the European Commission published a consultative paper in December 2010 on the issue of moving OTC derivatives trading to exchanges and electronic platforms and establishing post-trade requirements. A legislative proposal in this area has yet to be released.

Although U.S. action on OTC derivatives gives us an opportunity to shape the OTC derivatives regulatory landscape, we also face challenges in negotiating with other regulators, as they have limited scope to commit to regulatory coordination before their own legislative and regulatory frameworks have been established.

Ongoing Regulatory Coordination

Domestically, the SEC is working closely with the CFTC, the Federal Reserve Board, and other federal prudential regulators, as required by the Dodd-Frank Act, to develop a coordinated approach to implementing the statutory provisions of Title VII to the extent practicable, while recognizing relevant differences in products, entities, and markets. Working closely domestically also helps our efforts internationally.

Similarly, the Dodd-Frank Act specifically requires the SEC, the CFTC, and the prudential regulators to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives in order to promote consistent global regulation.

Accordingly, the SEC has been extremely active in bilateral and multilateral discussions with regulators at home and abroad. We have been engaged with international securities and market regulators and other bodies, both through informal conversations and more formally through participation in various international task forces and working groups, to discuss issues surrounding the regulation of OTC derivatives, thereby encouraging coordination and limiting opportunities for regulatory arbitrage.

SEC staff has encouraged international securities regulators that are contemplating OTC derivatives market reforms to use the Dodd-Frank Act and its regulations as a model for developing robust and complementary regulatory regimes. The SEC is continuing to actively coordinate with our counterparts in other jurisdictions to foster the development of common frameworks and, in that way, avoid the potential for market participants to engage in regulatory arbitrage. Such efforts include our active involvement in:

- Financial Stability Board Working Group on OTC Derivatives Regulation ("FSB Working Group"): In April 2010, at the initiative of the FSB, a working group led by representatives from the Committee on Payment and Settlement Systems ("CPSS"), the International Organization of Securities Commissions ("IOSCO"), and the European Commission was formed to make recommendations on the implementation of the G20 Leaders' September 2009 commitments. The SEC serves as one of the co-chairs of the FSB Working Group on IOSCO's behalf. The FSB Working Group is comprised of international standard setters and authorities responsible for translating the G20 Leaders' commitments into standards and implementing regulation.

- IOSCO Task Force on OTC Derivatives Regulation ("IOSCO Task Force"): The IOSCO Task Force was formed in October 2010 by the Technical Committee of IOSCO in order to coordinate international securities and futures regulators' efforts to work together in the development of supervisory and oversight structures related to the OTC derivatives markets. The SEC is one of the four co-chairs of the IOSCO Task Force. The IOSCO Task Force seeks to: (1) develop consistent international standards related to OTC derivatives regulation in the areas of clearing, trading, trade data collection and reporting, and the oversight of certain market participants; (2) coordinate other international initiatives relating to OTC derivatives regulation, including addressing certain recommendations made by the FSB Working Group; and (3) serve as a centralized group

within IOSCO through which IOSCO members can consult and coordinate generally on issues relating to OTC derivatives regulation.

- CPSS/IOSCO: The CPSS/IOSCO fora (which cover various topics, including principles for financial market infrastructures (e.g., clearinghouses), are joint endeavors through which CPSS, as an organization for central bankers, and IOSCO, as an international policy forum for securities regulators, work together to address issues of concern to both prudential and market regulatory authorities.

Regulatory Divergence and Competitiveness

The SEC also is charged with protecting U.S. investors and reducing systemic risk in the security-based swaps markets, and in doing so we consider the potential impact on the global competitiveness of U.S. companies. U.S. markets have been global leaders in part because of a legal framework that promotes firms and markets that are a benchmark for strength, resilience and transparency.

To this end, we have been carefully considering the potential consequences of certain provisions of Title VII and our proposed rulemaking for domestic and foreign market participants – in particular the impact on the ability of U.S. market participants to compete effectively with foreign market participants that may not be subject to the Dodd-Frank Act. Our goal is to establish a framework that meets the requirements and objectives established by the Congress, while fostering, to the maximum extent possible, a fair and level playing field for all market participants.

One area where these issues arise acutely is in the differing margin standards for U.S. and foreign market participants, where U.S. regulators seek strong standards to maximize safety and soundness, but U.S. firms are concerned that these rules could place their overseas operations at a competitive disadvantage to foreign-owned firms that meet different standards. To address these and other issues, U.S. regulators are working closely with foreign regulators to establish similar standards that will reduce risk more broadly and address competitiveness concerns.

Process

Rather than addressing the international implications of Title VII of the Dodd-Frank Act piecemeal, we are considering addressing the relevant international issues holistically in a single proposal. Such a release would give investors, market participants, foreign regulators, and other interested parties an opportunity to consider our proposed approach to the registration and regulation of foreign entities engaged in cross-border transactions involving the U.S. as an integrated whole. This approach should generate thoughtful and constructive comments for us to consider regarding the application of Title VII to cross-border transactions.

In the meantime, in considering international jurisdictional and harmonization issues in our implementation framework, we continue to welcome input from interested parties, and we look forward to continued discussions about the most effective means of providing necessary regulation without being unduly burdensome to market participants or their competitiveness in the global markets.

Implementation Challenges Generally

Part of balancing regulatory concerns with competitiveness concerns also involves establishing an implementation process for derivatives regulation that permits market participants sufficient time to establish systems and procedures in order to comply with new regulatory requirements without imposing undue implementation burdens and yet does not unnecessarily delay bringing this market under the regulatory umbrella. This is particularly a challenge when imposing a comprehensive regulatory regime on existing markets, particularly ones that until now have been largely unregulated.

We recognize that there are costs and benefits associated with compliance, and we have been keeping these costs and benefits in mind as we have moved forward in proposing rules implementing Title VII. We have requested extensive comment on the costs and benefits associated with the SEC's proposed rulemakings, and have been engaged in many discussions with market participants, as well as domestic and foreign regulators, regarding such costs and benefits.

To this end, we have been working with our fellow regulators and with market participants to craft rules and establish expeditious implementation timeframes that are reasonable for the various rulemakings, and are reviewing what steps market participants will need to take in order to comply with our proposed rules. These discussions are vital to establishing an implementation timeline that is workable. We also recognize the importance of obtaining input on an implementation timeline for Title VII.

After proposing all of the key rules under Title VII, we intend to consider seeking public comment on a detailed implementation plan that will permit a roll-out of the new securities-based swap requirements in an efficient manner, while minimizing unnecessary disruption and costs to the markets. Let me assure you that the implementation plan is not a mechanism for delay. Instead is should help facilitate the important and necessary reform of the OTC derivatives market.

Steps to Address Effective Date of Title VII

We also have announced that we intend to take a series of actions in the coming weeks to clarify the requirements that will apply to security-based swap transactions as of July 16 – the one-year effective date of Title VII of the Dodd-Frank Act – and provide appropriate temporary relief. Specifically, we intend to:

- provide guidance regarding which provisions in Title VII governing security-based swaps become operable as of the effective date and provide temporary relief from several of these provisions;

- provide guidance regarding – and where appropriate, temporary relief from – the various pre-Dodd-Frank provisions that would otherwise apply to security-based swaps on July 16;

- take 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.

We also have proposed rules that would exempt transactions by clearing agencies in security-based swaps that they issue from all provisions of the Securities Act, other than the Section 17(a) anti-fraud provisions, as well as exempt these security-based swaps from Exchange Act registration requirements and from the provisions of the Trust Indenture Act, provided certain conditions are met.

Volcker Rule

Section 619 of the Dodd-Frank Act, often known as the Volcker Rule, may also have international implications. Under the Volcker Rule, banks and bank holding companies and their affiliates as well as the U.S. operations of foreign banks and foreign bank holding companies and their affiliates, including their affiliated broker-dealers (collectively defined as "banking entities" in the Dodd-Frank Act), are generally prohibited from engaging in proprietary trading or sponsoring or investing in a hedge fund or private equity fund. The Volcker Rule includes certain exceptions for activities such as market-making-related activities, risk-mitigating hedging, underwriting, and trading on behalf of customers. Otherwise-permitted activities are impermissible if they involve material conflicts of interest, high-risk assets or trading strategies, or threats to the safety and soundness of the banking entity or U.S. financial stability.

In January, as required by the Dodd-Frank Act, the Financial Stability Oversight Council ("FSOC") issued a study on the Volcker Rule pursuant to requirements under the Dodd-Frank Act. The study was published on January 18, 2011. The FSOC study recommended a supervisory framework for implementing the prohibition on proprietary trading consisting of a programmatic compliance regime (e.g., policies and procedures, internal controls, recordkeeping and reporting, etc.), metrics, supervisory review and oversight, and enforcement procedures for violations. For the restrictions on proprietary trading, the study recognizes the close relationship between impermissible proprietary trading and other permitted activities (for example, whether the position was taken in anticipation of customer demand or for speculative purposes). The recommended supervisory framework seeks to leverage industry compliance efforts involving data review and metrics analysis with examination and testing by the SEC and other financial regulatory agencies to enforce compliance.

Where a banking entity is permitted to invest in a hedge fund or private equity fund to facilitate customer-related business under the Volcker Rule, the study provided that agencies should consider requirements for banking entities to disclose the nature and amount of any such investment. The FSOC study also sets forth various methods that agencies may use to define "customers" for purposes of the "organize/offer" exception, factors to consider in determining the scope of funds that will be included in the definition of "hedge fund" and "private equity fund," and considerations regarding the calculation of a de minimis investment, among other things.

The SEC is required to consider the FSOC's study and coordinate and consult with the federal banking agencies and the CFTC in implementing the Volcker Rule with respect to any entity for

which the SEC is the primary financial regulatory agency. The SEC is the primary regulator for registered broker-dealers, registered investment advisers, registered security-based swap dealers, and major security-based swap participants that are affiliates of insured depository institutions.

We are still considering rulemaking regarding the Volcker Rule, and we have been in extensive discussions with other regulators about how to address the various issues raised by the Volcker Rule. We will be seeking extensive comment on the issues of global competitiveness to the extent we can address them in any proposed rulemaking regarding the Volcker Rule.

Global Accounting Standards

Accounting and financial reporting standards are essential to efficient allocation of capital by investors everywhere in the world. Although the Dodd-Frank Act does not specifically address the issue, the SEC is continuing its work on this long standing and important issue. Our primary consideration is the best interests of U.S. investors.

The SEC has long promoted a single set of high-quality globally accepted accounting standards. This position advances the dual goals of improving financial reporting within the United States and reducing country-by-country disparity in financial reporting. As evidenced by the recent economic crisis, the activities and interests of investors, companies, and markets are increasingly global.

In pursuit of this goal, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") have been prioritizing projects most in need of improved global standards, including revenue recognition, leases, financial instruments, and insurance. Their efforts have been marked by rigorous outreach and field-testing. These tasks are important elements of due process and critical to the quality of any globally-accepted accounting standards.

As the Boards move into the phase of final deliberations on some of the highest priority projects, we are encouraging them not only to consider the results of the outreach and field-testing, but to evaluate carefully the feedback and extensive comments received on the proposals as well.

Last year, the SEC published a statement providing an update regarding our consideration of whether and how to incorporate IFRS into the financial reporting system for U.S. issuers, including the SEC's continued support for the convergence of U.S. Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS"). We will continue to consider the ongoing work of the FASB and the IASB to develop and improve financial accounting standards, including its implications with respect to the SEC's ongoing consideration of the potential incorporation of IFRS for U.S. issuers.

In response to the broad public feedback the Commission received on earlier efforts in this area, the SEC determined that a comprehensive analysis was necessary to lay out transparently the work that must be done to support consideration of incorporating IFRS, including the scope, timeframe, and methodology for any such transition. We asked our Office of the Chief Accountant, with consultation from other SEC Divisions and Offices, to carry out the work plan.

Specifically, the principal areas of the work plan include:

- the sufficiency of IFRS' development and application for the U.S. domestic reporting system;
- the independence of IFRS standard-setting process for the benefit of investors;
- investor understanding and education regarding IFRS;
- examination of the U.S. regulatory environment that would be affected by a change in accounting standards;
- the impact on issuers, both large and small; and
- human capital readiness.

The first two areas consider characteristics of IFRS and its standard setting that would be the most relevant to a future determination by the Commission regarding whether to incorporate IFRS into the financial reporting system for U.S. issuers. The remaining four areas relate to transitional considerations that will enable the staff to better evaluate the scope of, timing of, and approach to changes that would be necessary to effectively incorporate IFRS into the financial reporting system for U.S. issuers, should the commission determine in the future to do so.

The staff is executing the work plan in an open and deliberative manner. Last October, the staff published a progress report that discussed each section of the work plan and provided an update of the staff's outreach, research and preliminary observations. Last month, the staff published a paper to provide additional detail and request comment on one potential method of incorporation.

In various forums, the Commission and its staff previously have described and sought public comments on several other possible approaches for progressing toward a single set of high-quality, globally accepted accounting standards. Those approaches include: full adoption of IFRS on a specified date, without any endorsement mechanism; full adoption of IFRS following staged transition over several years, similar to the approach described in the Commission's Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers; and an option for U.S. issuers to apply IFRS, as described in the Commission's Concept Release and the Proposed Roadmap. In addition, in response to the requests for comment on these alternative approaches, some commenters have suggested that the U.S. retain U.S. GAAP with continued convergence efforts, with or without a specific mechanism in place to promote alignment with IFRS. A public roundtable is scheduled for early next month to focus on topics such as investor understanding of IFRS, the impact on smaller public companies, and the regulatory implications of incorporating IFRS.

In addition to acknowledging the clear benefits of a single set of high quality, global accounting standards, we also acknowledge the magnitude of the task that will be involved, and the transition time and costs that would be necessary to incorporate IFRS for U.S. issuers. Accordingly, we are carefully considering the potential incorporation of IFRS for U.S. issuers.

In addition, the SEC has affirmed its belief that, looking forward, the FASB will continue to play a substantive role in achieving the promise of high-quality global accounting standards, and that role will remain critical.

Other Issues

Indemnification Requirement

The Dodd-Frank Act includes a provision requiring domestic and foreign authorities, in certain circumstances, to provide written agreements to indemnify SEC and CFTC-registered trade repositories (i.e., swap and security-based swap data repositories), as well as the SEC and CFTC, for certain litigation expenses as a condition of obtaining data directly from the trade repository regarding swaps and security-based swaps. In addition, the trade repository must notify the SEC or CFTC upon receipt of an information request from a domestic or foreign authority.

Concerns have been raised about the potential effect of the indemnification and notice provisions on the ability of foreign regulators to obtain access to data regarding transactions, positions and market participants active in the derivatives markets. Regulators also must have the ability to verify that trade repositories are complying with their statutory and regulatory obligations. We understand that in response to the indemnification requirement, European regulators are considering including in their final legislation a reciprocal provision that would prohibit a non-EU trade repository from operating in the EU unless the repository's home country regulator has agreed to indemnify the repository and EU authorities for any litigation expenses related to the information provided by the repository to the home country regulator. Like most regulators, the SEC is not in a position to enter into an open-ended indemnification agreement.

Given our need for access to data held in trade repositories registered with a foreign authority and in response to European concerns about their regulators' access to data held in SEC and CFTC-registered trade repositories, Chairman Gensler and I recently provided EU Commissioner Michel Barnier of the European Commission a letter that analyzes the scope of the Dodd-Frank Act's indemnification provision. The European Commission is expected to finalize its data access provisions later this year.

Foreign Investment Adviser Registration and Reporting.

Title IV of the Dodd-Frank Act repeals an exemption from registration for private investment advisers, which means that many hedge fund and private equity fund advisers will be required to register with the Commission. However, the Act also adds certain exemptions from registration for foreign private advisers, venture capital fund advisers and private fund advisers with less than $150 million in assets under management in the United States.

Next week, the Commission will consider final rules that, among other things, would do the following: (1) clarify the meaning of certain terms included in the foreign private adviser exemption; (2) define "venture capital fund"; (3) implement the exemption for private fund advisers with less than $150 million in assets under management; (4) establish tailored reporting requirements for advisers relying on the venture capital and private fund adviser exemptions; and (5) extend the deadline for previously exempt advisers to come into compliance to the first

quarter of 2012. In implementing the new registration requirements and exemptions for foreign advisers provided under the Act, the Commission has sought to protect U.S. investors and the functioning of U.S. markets while minimizing potential conflicts with foreign regulation. These rules are intended to provide certainty to foreign advisers who are eager to determine their registration and compliance requirements under U.S. law.

Staff members also continue to work on analyzing and addressing comments in response to the joint proposal of the Commission and the CFTC for private fund reporting.[2] In developing this proposal, the staffs of the Commissions drew heavily on the experience and input of foreign regulators which had conducted or were developing reporting standards for hedge funds. Commission staff are continuing to coordinate with the European Securities and Markets Authority (ESMA), the U.K. Financial Services Authority (FSA) and the International Organization of Securities Commissions (IOSCO) to seek comparability of data and the consistency of reporting requirements. Staff also continue to consult with staff of the other FSOC member agencies.

Conclusion

In conclusion, the Dodd-Frank Act requires the SEC, among other regulators, to conduct a substantial number of rulemakings and studies that, directly or indirectly, may have international implications for U.S. companies and investors seeking to access foreign financial markets. 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 am happy to respond to your questions.

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[2] *See* Release No. IA-3145, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF* (January 26, 2011), available at http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.