

Testimony on Title VII Implementation

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Chairman Stabenow, Ranking Member Roberts, and members of the Committee:

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

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

Background

Title VII of the Dodd-Frank Act

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

Under the Dodd-Frank Act, regulatory authority over swaps is divided between the Commission and the CFTC. The law assigns the Commission the authority to regulate "security-based swaps." The CFTC, on the other hand, has primary regulatory authority over "swaps," which represent the overwhelming majority of the overall market for over-the-counter derivatives subject to Title VII. As described more fully below, I am pleased to report that we recently adopted final rules that further define and interpret these and other key terms of the Act and that open the path to further implementation by both agencies.

With respect to the Commission's efforts, the Title VII rulemakings are designed to improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other things, to reduce counterparty risk. 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 financial regulators. In particular, Commission staff has consulted and coordinated extensively with CFTC staff in the development of the joint definitional rules arising under Title VII, including joint rules further defining key terms related to the products covered by Title VII, which we adopted earlier this month, and the joint rules further defining certain categories of market participants, which we adopted in April.

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 may vary, the objective of consistent and comparable requirements continues to guide our efforts.

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

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

As we continue with the adoption of the Title VII rules, we remain committed to consulting with other regulators at home and abroad in an effort to foster the development of common

frameworks and to help ensure a level playing field for market participants consistent with the requirements of the Act.

Title VII Implementation to Date

Adoption of Key Definitional Rules

Since Chairman Schapiro last testified before this Committee, the Commission has adopted final rules and interpretations jointly with the CFTC regarding key definitions under Title VII. Earlier this month, the Commission completed the product definitions rulemaking, and in April the Commission completed the entity definitions rulemaking. The completion of these joint rulemakings is a foundational step toward the complete implementation of Title VII. However, this step will 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.

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

The entity 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.

The Commission's Division of Risk, Strategy, and Financial Innovation was involved in the Commission's development of both of these rule sets. In particular, the Division'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. To further ensure that the entity definition rules are appropriately calibrated, the Commission has directed the staff to report to the Commission on whether changes may be warranted to the rules based on a further analysis of data after relevant provisions of Title VII are implemented. This report stems, in part, from the fact that the entity definition rules were developed based on our understanding of the existing market and currently available data. The report — together with the associated public comment — is intended to help the Commission thoroughly evaluate the practical implications and effects of the entity definition rules following the regulation of dealers and major participants pursuant to Title VII, using data reflective of the newly regulated market. More broadly, the Commission seeks to inform its rulemaking and implementation efforts through data analysis.

Issuance of Implementation Policy Statement

In June, the Commission issued a policy statement describing and requesting public comment on the order in which it expects to require compliance by market participants with the final rules to be adopted by the Commission pursuant to Title VII. 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.

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.

Adoption of Clearing Procedures Rules

Also 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.

Next Steps for Implementation of Title VII

In the near term, the Commission expects to complete the last of the core elements of our proposal phase – in particular, rules related to the financial responsibility of security-based swap dealers and major security-based swap participants. Additionally, we intend to propose rules and interpretive guidance to address the international implications of Title VII in the near term, reflecting the fact that the OTC derivatives market has grown to become a truly global market in the last three decades. The development of our cross-border approach is being informed by our discussions with the CFTC and our fellow regulators in other jurisdictions. The publication of a single proposal addressing the international implications of Title VII is intended in part to give investors, market participants, foreign regulators, and other interested parties an opportunity to consider as an integrated whole our proposed approach to the registration and regulation of foreign entities engaged in cross-border transactions involving U.S. parties. The Commission therefore anticipates that this release will be published prior to the finalization of the rules discussed therein so that the comments received can be taken into account in drafting the final rules.

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

Such a proposal will also give interested parties an opportunity to compare the Commission’s approach to addressing the cross-border application of Title VII to the security-based swap market to the CFTC’s recent proposed interpretive guidance regarding the cross-border application of Title VII to the swap market. In its proposal, the CFTC proposed approaches to a number of very difficult issues, such as the appropriate definition of U.S. person and the treatment of guarantees in the cross-border context. We are continuing to consider the CFTC’s proposed approaches to these issues in addition to alternative approaches for the security-based swap market.

For instance, we understand the concerns the CFTC has raised regarding the ability of market participants to enter into swap transactions offshore but bring the risk of those transactions

directly back into the United States. The CFTC has proposed one approach to this issue by requiring foreign swap dealers receiving U.S. guarantees to register even if they are engaged exclusively in non-U.S. business. In addition to considering this approach, Commission staff is evaluating alternative ways of addressing any risks posed to the U.S. financial system by such overseas transactions.

Similarly, the CFTC has proposed to interpret the term “U.S. person” broadly to include certain foreign entities whose swap activities or transactions have a direct and significant connection with activities in, or effect on, U.S. commerce. For example, the CFTC would include in the definition of “U.S. person” foreign entities in which U.S. persons have a majority ownership interest, as well as foreign entities in which U.S. persons are responsible for their liabilities. In addition to considering this approach, Commission staff is evaluating alternative ways to address potential risk to the U.S. financial system from business conducted outside the United States.

I expect that the Commission’s proposal will address these and other issues. In particular, I expect that it will address the cross-border application of Title VII with respect to each of the major registration categories covered by Title VII relating to market intermediaries and infrastructures for security-based swaps, and transaction-related requirements under Title VII in connection with reporting, clearing, and trade execution for security-based swaps.

Additional Actions

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

- Rules prohibiting fraud and manipulation in connection with security-based swaps;
- Rules regarding trade reporting, data elements, and real-time public dissemination of trade information for security-based swaps that would lay out who must report security-based swaps, what information must be reported, and where and when it must be reported;
- Rules regarding the obligations of security-based swap data repositories that would require them to register with the Commission and specify the extensive confidentiality and other requirements with which they must comply;
- Rules regarding the exception to the mandatory clearing requirement for hedging by end users that would specify the steps that end users must follow, as required under the Dodd-Frank Act, to notify the Commission of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;
- Rules regarding the confirmation of security-based swap transactions that would govern the way in which certain of these transactions are acknowledged and verified by the

parties who enter into them;

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

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.