Testimony on "Monitoring Systemic Risk and Promoting Financial Stability"
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U.S. Securities and Exchange Commission

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Chairman Johnson, Ranking Member Shelby, Members of the Committee:

Thank you for the opportunity to testify[1] regarding the Securities and Exchange Commission's efforts to monitor systemic risk and promote financial stability, two functions that are critical in fulfilling our mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Over the past few years, all financial regulators have been faced with key issues of systemic risk and financial stability. At the SEC, our activities have included a broad-based appraisal of both the strengths and weaknesses of our current equity market structure, and our capacity to monitor trading across all trading venues and to enforce the securities laws and regulations and self-regulatory organization (SRO) rules.

With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Congress provided the SEC with important tools to better meet the challenges of today's financial marketplace. These provisions included a mandate for oversight of the over-the-counter derivatives marketplace, private fund adviser registration and reporting, and rulemakings related to nationally recognized statistical rating organizations ("NRSROs"). Additionally, Title I of the Dodd-Frank Act created the Financial Stability Oversight Council

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission, a member of FSOC, and do not necessarily represent the views of the full Commission.

(“FSOC”), and with it, a formal structure for coordination amongst the various financial regulators to monitor systemic risk and to promote financial stability across our nation’s financial system. Each of these developments has enhanced the Commission’s ability to protect America’s investors and oversee financial markets.

Strengthening Market Structure

Market structure encompasses all aspects of the organization of a market, including the number and types of venues that trade a financial product and the rules by which they operate. Although these issues can be complex and the rules technical, a fair, orderly and efficient market structure is the backbone of the equity markets and has significant implications for our financial system more broadly. The Commission has undertaken a broad-based appraisal of both the strengths and weaknesses of our current equity market structure. This review includes an evaluation of recent market structure performance and an assessment of whether rules have kept pace with recent significant changes in trading technology and practices. The goal of this evaluation is to effectively address any market structure weaknesses while preserving its strengths.

In addition, last year, the SEC published a concept release on equity market structure in (the “Concept Release”). The Concept Release described the current market structure and then broadly requested comment from the public on three categories of issues: (1) the quality of performance of the current market structure, (2) high frequency trading, and (3) undisplayed liquidity in all its forms.

To date, the Commission has received more than 200 comments in response to the Concept Release. A number of commenters identified benefits of the current market structure, in particular noting that it has fostered competition among trading venues and liquidity providers that has lowered spreads and brokerage commissions. These investors cautioned against regulatory changes that might lead to unintended consequences. Other commenters, however, raised concerns about the quality of price discovery and questioned whether the current market structure continues to offer a level playing field to investors in which all can participate meaningfully and fairly. These commenters suggested a variety of possible initiatives.

The Commission continues to evaluate these issues in a responsible, timely, and comprehensive fashion, with particular focus on obtaining the appropriate data and analysis to support our decisions to proceed with or to table any particular initiative.

Responses to May 6 Trading Disruption

Just over one year ago, the U.S. equity markets experienced one of the most significant price declines and reversals since 1929. In September, the staffs of the SEC and the Commodity Futures Trading Commission (CFTC) published their second joint report on their inquiry into the day's events. Producing the report required an extraordinary amount of staff resources. On the securities side in particular, much of the time and effort was devoted to collecting and then painstakingly sifting through the data necessary to reconstruct trading. These efforts highlighted the pressing need for enhanced data functionalities in the securities markets.

The joint report lays out the multiple factors that in our view significantly contributed to the liquidity failure and disruptive trading on that day, outlining the complex interplay of multiple factors across the securities and futures markets. This interplay is significant because it demonstrates the need for a multi-faceted regulatory response that addresses the full scope of the risks in a comprehensive and responsible way.

It is vital that the rules that govern market structure and market participant behavior support equity markets that warrant the full confidence of investors and listed companies. The Commission recently has adopted a number of important initiatives to further this goal:

- Less than two weeks after May 6, the Commission posted for comment proposed exchange rules that would halt trading for certain individual stocks if their price moved 10 percent in a five minute period. Barely more than six weeks after the event, exchanges began putting in place a pilot uniform circuit breaker program for S&P 500 stocks. In September, the program was extended to stocks in the Russell 1000 Index and specified exchange-traded products. The aim of this program is to halt trading under disorderly market conditions, which in turn should help restore investor confidence by ensuring that markets operate only when they can effectively carry out their critical price-discovery functions.

- In September, the Commission approved pilot exchange rules designed to bring order and transparency to the process of breaking "clearly erroneous" trades. On May 6, nearly 20,000 trades were invalidated for stocks that traded 60 percent or more away from their price at 2:40 PM. That 60 percent benchmark, however, was set after the fact. We now have consistent rules in place governing clearly erroneous trades that will apply to a future disruption.

- In November, the Commission approved exchange rules to enhance the quotation standards for market makers. In particular, the new rules eliminate "stub quotes" – a bid to buy or an offer to sell a stock at a price so far away from the prevailing market that it is not intended to be executed, such as a bid to buy at a penny or an offer to sell at $100,000. Executions against stub quotes represented a significant proportion of the trades that were executed at extreme prices on May 6 and were subsequently broken.

- Also in November, the Commission took an important step to promote market stability by adopting a new market access rule. Broker-dealers that access the markets themselves or offer market access to customers will be required to put in place appropriate pre-trade risk management controls and supervisory procedures. The rule effectively prohibits broker-dealers from providing customers with "unfiltered" access to an exchange or alternative trading system. By helping ensure that broker-dealers appropriately control the risks of market access, the rule should prevent broker-dealers or their customers from engaging in practices that threaten the financial condition of other market participants and clearing organizations, as well as the integrity of trading on the securities markets.

- In addition, the Commission recently proposed exchange and FINRA rules that provide for a limit up/limit down procedure that would directly prohibit trades outside specified parameters, while allowing trading to continue within those parameters. This procedure should prevent many anomalous trades from ever occurring, as well as limiting the disruptive effect of those that do occur.

In addition to these rules, the Commission has proposed large trader reporting requirements and a consolidated audit trail system to improve our ability to regulate the equity markets. These proposals would tremendously enhance regulators' ability to identify significant market participants, collect information on their activity, and analyze their trading behavior. Both of these initiatives seek to address significant shortcomings in the agency's present ability to collect and monitor data in an efficient and scalable manner and to address discrete market structure problems.

Today, there is not a standardized, automated system to collect data across the various trading venues, products and market participants. Some, but not all, markets have their own individual and often incomplete audit trails. As a result, regulators tracking suspicious activity or reconstructing an unusual event must obtain and merge a sometimes immense volume of disparate data from a number of different markets. And even then, the data does not always reveal who traded which security, and when. To obtain individual trader information the Commission must make a series of manual requests that can take days or even weeks to fulfill. In brief, the Commission's tools for collecting data and surveilling our markets do not incorporate the technology currently used by those we regulate. Further, they do not provide the Commission with adequate information to conduct timely reconstructions of market events.

If implemented, the consolidated audit trail would, for the first time, allow SROs and the Commission to track trade data across multiple markets, products and participants simultaneously. It would allow us to rapidly reconstruct trading activity and to more quickly analyze both suspicious trading and unusual market events. It is important to recognize, however, that implementation of the consolidated audit trail is a significant undertaking, and thus will need to be implemented in phases over time. In addition, in order to obtain the maximum benefit from this new infrastructure, the Commission's own technology and human resources will need to be expanded beyond their current levels.

Finally, a principal lesson of the financial crisis is that, because today's financial markets and their participants are dynamic, fast-moving, and innovative, the regulators who oversee them must continuously improve their knowledge and skills to regulate effectively. In response to the ever-changing nature of our financial system, the SEC's Office of Compliance, Investigations and Examinations and our Division of Enforcement have adopted new approaches to promote fair, orderly and efficient operation of the markets.

New Tools Provided by the Dodd-Frank Act

The Dodd-Frank Act includes over 100 rulemaking provisions applicable to the SEC. Several of those provisions will play an important role in enhancing the Commission's ability to mitigate systemic risk and promote financial stability.

<u>Over-The-Counter Derivatives</u>. The Dodd-Frank Act mandates oversight of the OTC derivatives marketplace. Title VII of the Act provides that the Commission will regulate

security-based swaps and the CFTC will regulate other swaps. To implement the security based swap provisions, the SEC is writing rules that address, among other things, mandatory clearing, the operation of security-based swap execution facilities and data repositories, capital and margin requirements and business conduct standards for security-based swap dealers and major security-based swap participants, and regulatory access to and public transparency for information regarding security-based swap transactions. This series of rulemakings should improve transparency and facilitate the centralized clearing of security-based swaps, helping, among other things, to reduce counterparty risk. It should also enhance investor protection by increasing disclosure regarding security-based swap transactions and helping to mitigate conflicts of interest involving security-based swaps. In addition, these rulemakings should establish a regulatory framework that allows OTC derivatives markets to continue to develop in a more transparent, efficient, accessible, and competitive manner.

Private Fund Adviser Registration and Reporting. Under Title IV of the Dodd-Frank Act, hedge fund advisers and private equity fund advisers will be required to register with the Commission, which is expected to occur in the first quarter of 2012. Under the Act, venture capital fund advisers and private fund advisers with less than $150 million in assets under management in the United States will be exempt from the new registration requirements. In addition, family offices will not be subject to registration. To implement these provisions, the Commission has proposed:

- Amendments to Form ADV, the investment adviser registration form, to facilitate the registration of advisers to hedge funds and other private funds and to gather information about these private funds, including identification of the private funds' auditors, custodians and other "gatekeepers;"[2]

- To implement the Act's mandate to exempt from registration advisers to private funds with less than $150 million in assets under management in the United States; [3]
- A definition of "venture capital fund" to distinguish these funds from other types of private funds;[4] and
- A rule to exempt "family offices" and a definition of "family office" that focuses on firms that provide investment advice to family members (as defined by the rule), certain key employees, charities and trusts established by family members and entities wholly owned and controlled by family members.[5]

In addition, following consultation with staff of the member agencies of the Financial Stability Oversight Council (FSOC), the Commission and CFTC jointly proposed rules to implement the Act's mandate to require advisers to hedge funds and other private funds to report information for use by the FSOC in monitoring for systemic risk to the U.S. financial system.[6] The proposal, which builds on coordinated work on hedge fund reporting conducted with

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[2] *See* Release No. IA-3110, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/ia-3110.pdf.

[3] *See id.*

[4] *See* Release No. IA-3111, *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management and Foreign Private Advisers* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/ia-3111.pdf.

[5] *See* Release No. IA-3098, *Family Offices* (October 12, 2010); http://www.sec.gov/rules/proposed/2010/ia-3098.pdf.

[6] *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), http://www.sec.gov/rules/proposed/2011/ia-3145.pdf.

international regulators, would institute a "tiered" approach to gathering the systemic risk data, which would remain confidential. Thus, the largest private fund advisers – those with $1 billion or more in hedge fund, private equity fund, or "liquidity fund" assets – would provide more comprehensive and more frequent systemic risk information than other private fund advisers.

Financial Stability Oversight Council

FSOC was created by Title I of the Dodd-Frank Act and has 10 voting members: the senior officials at each of the nine federal financial regulators[7] and an independent member with insurance expertise appointed by the President. FSOC's composition also includes five nonvoting advisory members: three from various state financial regulators[8] as well as the Directors of the new Federal Insurance Office and Office of Financial Research ("OFR").[9]

Under the Dodd-Frank Act, Congress has given FSOC the following primary responsibilities:

- 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;

[7] The senior officials are the Secretary of the Treasury (Chairperson); Chairman of the Board of Governors of the Federal Reserve; Comptroller of the Currency; Director of the Consumer Financial Protection Bureau; Chairman of the Securities and Exchange Commission; Chairperson of the Federal Deposit Insurance Corporation; Chairperson of the Commodity Futures Trading Commission; Director of the Federal Housing Finance Agency; and Chairman of the National Credit Union Administration. *See* Dodd-Frank Act § 111(b)(1).

[8] The state financial regulators include a state insurance commissioner designated by the state insurance commissioners; a state banking supervisor designated by the state banking regulators; and a state securities commissioner designated by the state securities commissioners. *See* Dodd-Frank Act § 111(b)(2).

[9] *See* Dodd-Frank Act § 111(b)(2).

- 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 (*i.e.*, addressing the moral hazard problem of "too big to fail"); and
- identifying and responding to emerging threats to the stability of the United States financial system.[10]

In fulfilling its responsibilities, FSOC is charged with identifying and designating certain nonbank financial companies as systemically important financial institutions ("SIFIs") for heightened prudential supervision by the Board of Governors of the Federal Reserve System ("Federal Reserve Board").[11] In addition, FSOC may make recommendations to the Federal Reserve Board concerning the establishment and refinement of heightened prudential standards for firms designated under the SIFI process and large, interconnected bank holding companies already supervised by the Federal Reserve Board.[12] Such recommendations may address, among other things, risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures and overall risk management.[13] In addition, FSOC must identify and designate financial market utilities ("FMUs") and payment, clearing, and settlement activities that are, or are likely to become, systemically important.[14]

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[10] *See* Dodd-Frank Act § 112(a)(1).

[11] *See* Dodd-Frank Act §§ 112(a)(2)(H) and 113.

[12] *See* Dodd-Frank Act § 112(a)(2)(I).

[13] *See id.*

[14] *See* Dodd-Frank Act §§ 112(a)(2)(J) and 804(a).

The recent financial crisis demonstrated the potential for risks to quickly spread across the financial sector and undermine general confidence in the financial system. To address issues of "siloed" information and the potential for regulatory arbitrage, another key responsibility of FSOC is to monitor the financial markets and regulatory framework to identify gaps, weaknesses and risks and make recommendations to address those issues to its member agencies and to Congress.[15] In addition, by combining the information resources of its member agencies and working with the OFR, FSOC is responsible for facilitating the collection and sharing of information about risks across the financial system.[16]

FSOC Activities Update

Since passage of the Dodd-Frank Act, FSOC has taken steps to create an organizational structure, coordinate interagency efforts, and build the foundation for meeting its statutory responsibilities. In the weeks leading up to the inaugural October 1, 2010 meeting of the principals of the FSOC agencies, staff from the Treasury Department coordinated interagency staff work to establish by-laws and develop a transparency policy. During that period, FSOC also formed several interagency committees to address specific statutory requirements.

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[15] *See* Dodd-Frank Act § 112(a)(2)(C)-(G).

[16] *See* Dodd-Frank Act § 112(a)(2)(A)-(B).

Designation of Systemically Important Financial Institutions

To begin defining and implementing the process to identify and designate SIFIs for heightened supervision by the Federal Reserve Board, FSOC established a SIFI designations committee and several staff subcommittees to tackle specific tasks.

On October 6, 2010, FSOC issued an advanced notice of proposed rulemaking soliciting public comment on the specific criteria and analytical framework for the SIFI designation process, with a focus on how to apply the statutory considerations for such designations. FSOC received over 50 comment letters from trade associations, financial firms, individuals, and others. These comment letters included views on the designation process itself, as well as suggestions on the specific criteria and metrics to be used and the frameworks for their application.

On January 26, 2011, FSOC issued a notice of proposed rulemaking regarding the SIFI designation process. The proposed rule describes the criteria that will inform – and the processes and procedures established under the Dodd-Frank Act for – designations by FSOC. Such criteria would be rooted in the eleven statutory considerations set forth in the Dodd-Frank Act for such designations, and would include, among other considerations, a firm's size, leverage, liquidity risk, maturity mismatch, and interconnectedness with other financial firms. The proposed rule also implements certain other provisions of the designation process, including: (1) the anti-evasion authority of FSOC; (2) procedures for notice of, and the opportunity for a hearing on, a proposed determination; and (3) procedures regarding consultation, coordination, and judicial review in connection with a determination. We plan to provide additional guidance regarding the Council's approach to designations and will seek public comment on it.

Designation of Systemically Important Financial Market Utilities

Financial Market Untilities (FMUs) are essential to the proper functioning of the nation's financial markets.[17] These utilities form critical links among marketplaces and intermediaries that can strengthen the financial system by reducing counterparty credit risk among market participants, creating significant efficiencies in trading activities, and promoting transparency in financial markets. However, FMUs by their nature create and concentrate new risks that could affect the stability of the broader financial system. To address these risks, Title VIII of the Dodd-Frank Act provides important new enhancements to the regulation and supervision of FMUs designated as systemically important by FSOC ("DFMUs") and of payment, clearance and settlement activities. This enhanced authority in Title VIII should provide consistency, promote robust risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system.[18] Importantly, the enhanced authority in Title VIII is designed to be in addition to the authority and requirements of the Securities Exchange Act and Commodity Exchange Act that may apply to FMUs and financial institutions that conduct designated activities.[19]

[17] 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."

[18] *See* Dodd-Frank Act § 802.

[19] *See* Dodd-Frank Act § 805.

FSOC established an interagency DFMU committee to develop a framework for the designation of systemically important FMUs, in which staff from the SEC has actively participated. On December 21, 2010, FSOC published an advanced notice of proposed rulemaking seeking public comment on the designation process for FMUs. In response, FSOC received twelve comment letters from industry groups, advocacy and public interest groups, individual FMUs and financial institutions. Among other things, commenters generally encouraged the development of metrics and an analytical framework to further define the statutory considerations for designation contained in Title VIII, and also emphasized the need for FSOC to apply consistent standards for all FMUs under consideration for designation that incorporate both qualitative and quantitative factors.

On March 28, 2011, FSOC published a notice of proposed rulemaking to provide further information on the process it proposed to follow when reviewing the systemic importance of FMUs. FSOC is considering using a two-stage process for evaluating FMUs prior to a vote on a proposed designation by the Council. The first stage would consist of a largely data-driven process to identify a preliminary set of FMUs whose failure or disruption could potentially threaten the stability of the U.S. financial system. In the second stage, FMUs so identified would be subject to a more in-depth review, with a greater focus on qualitative factors and FMU- and market-specific considerations. Under the proposal, the Council expects to use the statutory considerations as a base for assessing the systemic importance of FMUs.[20] Application of this

[20] Section 804(a)(2) of the Dodd Frank Act provides that these considerations are: (1) the aggregate monetary value of transactions processed by the FMU or carried out through the PCS activity; (2) the aggregate exposure of the FMU or a financial institution engaged in PCS activities to its counterparties; (3) the relationship, interdependencies, or other interactions of the FMU or PCS activity with other FMUs or PCS activities; (4) the effect that the failure of or a disruption to the FMU or PCS activity would have on critical markets, financial institutions, or the broader financial system; and (5) any other factors that FSOC deems appropriate.

framework, however, would be adapted for the risks presented by a particular type of FMU and business model.

Systemic Risk Assessment

In addition to initiating work on the identification of SIFIs and DFMUs, FSOC has established a Systemic Risk Committee that seeks to identify, highlight and review possible risks that could develop across the financial system. The Dodd-Frank Act also requires FSOC to report annually to Congress regarding these risks,[21] and we expect the work of this committee will inform that report.

Other Activities

In addition to seeking to identify possible risks in the financial system, FSOC was required under Section 619(b) of the Dodd Frank Act to study and make recommendations on implementing the Act's restrictions on proprietary trading, commonly referred to as the "Volcker rule," to achieve certain goals enumerated in the statute, including:

- to promote and enhance the safety and soundness of banking entities;
- protect taxpayers and consumers; and
- enhance financial stability by minimizing the risk that insured depository institutions and their affiliates will engage in unsafe and unsound activities.

On January 18, 2011, FSOC released its study and recommendations on implementation of the Volcker rule. The study recommends the creation of rules and a supervisory framework

[21] *See* Dodd-Frank Act § 112(a)(2)(N).

that effectively prohibit proprietary trading activities throughout "banking entities" – as defined by the Dodd-Frank Act – and appropriately distinguish prohibited proprietary trading from statutorily described permitted activities. The recommended supervisory framework consists of a programmatic compliance regime, metrics, supervisory review and oversight, and enforcement procedures for violations for the respective regulatory agencies conducting supervisory review and oversight. In addition, the study identified potential challenges in delineating prohibited proprietary trading activities from permitted activities, including potential difficulties in determining whether a position was taken in anticipation of near term customer demand or for non-permissible prop trading purposes.

The study also recognizes that effective oversight by the agencies will require specialized skills and be resource intensive. For example, the study notes agencies will need additional resources to develop appropriate data points, build infrastructure to obtain and review information, and hire and train additional staff with quantitative and market expertise to identify and investigate outliers and questionable trading activity.

Money Market Fund Roundtable

Earlier this week, the SEC hosted a Money Market Fund Roundtable, which included representatives of each of the voting members of FSOC. The roundtable featured an in-depth discussion of various policy options to address the risk that a run on money market funds could have on the broader financial markets. Participants at the roundtable included money market fund sponsors, investors, academics, industry observers and representatives from entities that issue the commercial paper in which many money market funds invest. The roundtable enabled

SEC Commissioners, FSOC principals and their representatives to discuss first-hand – and in a public forum – a significant issue related to the ongoing monitoring of systemic risk. I look forward to continued work on coordination with FSOC with respect to money market funds.

Next Steps

While FSOC has made substantial progress in taking up its new responsibilities, its efforts are ongoing, and much remains to be done. Some of the most challenging issues regarding the potential designation of systemically important financial institutions and FMUs lie ahead, and public input both generally on this process – and specifically with respect to the notices of proposed rulemaking – will be critically important. In addition, as Dodd-Frank implementation proceeds, the coordination of the FSOC agencies will continue to be a vital consideration.

Conclusion

In sum, the Commission recognizes the importance of monitoring systemic risk and promoting financial stability, and has responded to the challenges presented by recent market developments. As the Commission moves forward, we will look comprehensively at the issues, and take appropriate steps, both within the Commission and with our regulatory partners in the FSOC, to address any threats to our nation's financial system in a balanced manner that preserves the strengths of the system and protects investors. As we move ahead, we look forward to working closely with Congress to continue addressing these critical issues. Thank you for inviting me to testify today. I would be happy to answer any questions you may have.