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ENHANCED OVERSIGHT AFTER THE FINANCIAL CRISIS: THE WALL STREET REFORM ACT AT ONE YEAR

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE IMPACT OF THE FINANCIAL CRISIS ON AMERICAN CONSUMERS, INVESTORS AND THE OVERALL ECONOMY, HOW THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT HAS IMPROVED THE FINANCIAL REGULATORY FRAMEWORK, AND HOW THE WALL STREET REFORM ACT WILL HELP PREVENT ANOTHER CRISIS

JULY 21, 2011

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COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

C O N T E N T S

THURSDAY, JULY 21, 2011

WITNESSES

Additional Material Supplied for the Record

ENHANCED OVERSIGHT AFTER THE FINANCIAL CRISIS: THE WALL STREET REFORM ACT AT ONE YEAR

THURSDAY, JULY 21, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m. in room SD–538 Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I would like to call this hearing to order. Today marks the first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Wall Street Reform Act was a direct response to the worst financial crisis since the Great Depression. It created a sound regulatory foundation to protect consumers and investors and to help prevent or mitigate future crises. I am pleased to have one of the architects of this historic legislation, Representative Barney Frank, here with us today.

I also welcome our panel of distinguished regulators to discuss the steps they have taken to implement the provisions of this important law to enhance their agencies' oversight of the financial services industry.

But Congress must also do its part. As Chairman of this Committee, I am committed to holding rigorous oversight of the implementation process and restoring Americans' trust in a credible financial system.

While it appears that many on Wall Street, and even some here in Washington, have already forgotten the real costs of inadequate financial regulations, I have not. And neither have the millions of Americans who lost their jobs, their homes, their savings, and who are still waiting for the recovery.

Unfortunately, these reforms have been under constant attack since this bill was signed into law. Opponents of Wall Street reform continually repeat misleading claims that the new law was hastily conceived, will be overly burdensome, and will harm our economy.

But the American public disagrees. In fact, a poll released this week by Lake Research Partners found that Americans broadly and strongly support Wall Street reform. They support the legislation's goals of holding Wall Street accountable, making the financial system more transparent, and enhancing oversight of Wall Street firms that have shown they could put the entire economy at risk. Even after hearing arguments supporting and opposing this legislation, Democrats, Republicans, and Independents support the Wall Street reform law.

But we cannot take that support for granted. Since the bill's passage, this Committee has taken its oversight responsibilities seriously, ensuring that the regulators are on the right track to implement the law's provisions. Passing the Wall Street Reform Act was a monumental achievement, and while the regulators have completed many rulemakings, there is much work left to be done. This will take time, but we owe it to the American people to get it right.

I thank our witnesses again for being here today, and I look forward to the testimony.

Ranking Member Shelby, your opening statement.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Yesterday, in a Wall Street Journal op-ed piece by Secretary Geithner, he claimed that financial reform was "designed to lay a stronger foundation for innovation, economic growth, and job creation." However, for millions of Americans, the 1-year anniversary of Dodd-Frank provides little comfort as they continue to deal with the harsh economic reality marked by little to no innovation, anemic, economic growth, and virtually no job creation.

The unemployment rate remains stubbornly above 9 percent, with more than 14 million Americans still out of work. Secretary Geithner also wrote that the Obama administration "expected backing from both sides of the aisle" when the debate over the financial reform began, implying that there was not any. The truth is that there was as great deal of agreement on a number of issues until the White House decided that the only issue that mattered was the creation of a massive new consumer bureaucracy. In fact, Chairman Dodd and I had agreed to create early on a consolidated banking regulator where the authorities of the Federal Reserve, OCC, OTS, and FDIC would be joined in a single entity. It even had a name: the Financial Institutions Regulatory Authority.

There was strong agreement at that time that the current regulators had failed and radical reform was needed. Also agreed was to elevate consumer protection to equal status with prudential regulation. I proposed at that time giving the Consumer Protection Division equal access to Congress and to provide it with dedicated funding. We even agreed to permit nonbanks to be supervised and subject to enforcement.

By any measure, the Republicans were willing to meet our Democratic colleagues and the Administration more than halfway on a number of issues, including consumer protection. Any hope for a bipartisan agreement evaporated when the word came down from the Administration that it was going to be their way or the highway.

A similar dynamic was at work in the Agriculture Committee where Senators Chambliss and Lincoln had agreed on a bipartisan derivatives title until the former Senator from Arkansas was told that there was not going to be any compromise.

Secretary Geithner also wrote, and I will quote:

Senior Republican negotiators on the Senate Banking Committee were unable or unwilling to define a core set of reforms they could support.

Mr. Chairman, the first thing the Republican Members of this Committee did was to draft a set of core principles to guide our consideration of regulatory reform. I have a copy of that in my hand. I would like for it to be made part of the record here.

These principles that I reference would address all of the major issues, including systemic risk regulation, prudential regulation, consumer protection, and derivatives regulation.

Also, Republicans filed hundreds of amendments based on this core set of reform principles, and prior to the bill's markup, we were informed, however, that not a single amendment would receive any Democratic support. Once again, it was their way or the highway.

Secretary Geithner also wrote in his op-ed piece, and I will quote: "We have already turned a profit on the TARP investments made in banks." However, as I have said in the past, claims of TARP's profitability are premature at best. Many financial institutions have yet to fully repay their TARP funds, and the taxpayer will still likely take losses on TARP's housing and auto bailout programs. Moreover, TARP used taxpayer dollars for very risky investments.

A proper evaluation of the returns on any investment must appropriately adjust for risk. I believe such an evaluation would show that taxpayers were not adequately compensated for the large risk the Administration took with their money. In addition, what matters most is TARP's negative long-term impact on the overall economy, which will dwarf any so-called profit. On that basis, TARP's record has not been good for American families.

Since TARP was enacted, the unemployment rate has reached and stayed at record levels. Lending remains stagnant and millions of Americans continue to face foreclosure. Secretary Geithner took credit for the banking regulators having forced the largest financial institutions to increase their capital basis "as the most important step toward diminishing the risk of future crises."

For years, I have been arguing—and other Republicans here have, too—that capital standards have been inadequate. While some bank regulators, such as former FDIC Chairman Sheila Bair, actively sought to increase bank capital standards, others remained on the sideline right here.

One of the regulators who did nothing to improve bank capital standards before the last crisis was the President of the Federal Bank of New York. The New York Fed's supervisory responsibilities include the largest financial institutions that received the largest TARP bailouts during the crisis. Who was the New York Fed President who failed to oversee our largest banks and then presided over the TARP bailouts? None other than our current Treasury Secretary.

Secretary Geithner further wrote that the regulators have outlined major elements of reforms to bring oversight, transparency, and greater stability to the $600 trillion derivatives market.

Republicans offered a derivatives substitute amendment that accomplished all of these goals while preserving Main Street's ability to hedge their business risk. Main Street businesses had nothing to do with the financial crisis. Nevertheless, Dodd-Frank will impose huge costs on them at a time when they can least afford it. The Secretary failed to mention that fact.

Secretary Geithner also said that the Obama administration has started the process of "winding down Fannie Mae and Freddie Mac." Can you believe it? However, Fannie and Freddie's market share is actually increasing. They now account for 75 percent of all mortgage-backed securities that were issued. In fact, with other Government programs included, the Federal Government now controls 97 percent of the market. Meanwhile, housing finance reform has not even begun in the Congress.

Secretary Geithner claims that success will "depend on making sure that we can write sensible rules that promote the health of the broader economy instead of the interests of individual firms. However, politically connected unions and other special interest groups were among the bigger winners under Dodd-Frank. The Act contains an assortment of new corporate governance and executive compensation requirements that harm shareholders by empowering special interests in the board room and encouraging short-term thinking by managers.

Fifty years ago, President Dwight D. Eisenhower famously admonished us all "to guard against the acquisition of unwarranted influence by the defense industry and the Pentagon." I am afraid, however, Mr. Chairman, that his words have gone unheeded in this context in that the only thing Dodd-Frank has truly accomplished is the creation of a financial regulatory analog to the military-industrial complex.

Dodd-Frank has created a cottage industry for Wall Street lawyers and special interest lobbyists. It has turned the financial regulatory landscape into a nightmare.

Secretary Geithner also claims that Republicans are blocking nominations "so that they can ultimately kill reform." However, Senate Republicans have been clear that the structure of the Bureau of Consumer Financial Protection needs to be properly reformed before we consider any nominee to lead it.

We have urged President Obama to adopt three specific reforms:

First, establish a board of directors to oversee the Bureau. Diversifying the leadership of this untested and very powerful fledgling bureaucracy would ensure the consideration of multiple viewpoints in the Bureau's decisionmaking process.

Second, subject the Bureau to the appropriations process to ensure that the Bureau has an effective oversight and does not engage in wasteful or inappropriate spending.

Third, establish a safety and soundness check for the prudential regulators. After all, one of the best consumer protections is a safe and a sound bank.

Finally, I believe that the most disturbing claim made by the Secretary is that Republicans formed "the forces of opposition to reform." This statement reflects the unfortunate view that anyone who does not support their idea of reform must be against any reform. That is nonsense.

As I have explained and reiterated many times, there were numerous areas where Republicans and Democrats could have easily reached an agreement. Unfortunately, the Administration decided early on that there would be no compromise. The result was the bill that this hearing purports to celebrate.

I do not believe, Mr. Chairman, that the American people are in the mood to celebrate yet.

Thank you.

Chairman JOHNSON. Representative Frank, I welcome you to the Senate Banking Committee today. As one of the architects of the Wall Street reform bill, I want to thank you again for all your hard work in ushering this legislation through Congress. I know that you have to get back to manage a bill on the House floor, so please begin.

STATEMENT OF BARNEY FRANK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. FRANK. Thank you, Mr. Chairman, and I am glad to be here in this spirit of bipartisanship, and I say that because I was struck by the very bipartisan tone of the Ranking Member's statement. For example, he was extremely critical of the Bush administration. I might not have anticipated that. But I say that because, as Members will remember, it was in the fall of 2008 that we were summoned by Secretary Paulson and then-Chairman Bernanke, two Bush appointees, and asked to do the TARP. And, in fact, it was a bipartisan response to that.

The gentleman from Alabama was very critical of the TARP. I think he is unfair to the Bush administration in that regard, but I do appreciate the bipartisan nature of his criticism.

I would note he said Secretary Geithner said they made a profit on the loan to the banks, and he rebutted that with reference to the automobiles and the foreclosures. Well, that does not rebut the statement. He very carefully said it was from the banks. It is true we have not yet recovered the money from the automobiles. What we have instead is a thriving American automobile industry, GM and Chrysler, which I think would not have happened if we had not intervened. And I would note that Ford, which was not seeking any of the funds, actively supported that for fear that if both General Motors and Chrysler had gone bankrupt and were not assisted, the supply chain would have disappeared.

So at a time when we all talk about enhancing manufacturing in America, that was, I think, the single biggest thing that we did.

Second, I would have to say, though, that the gentleman from Alabama's description of the legislative process does not cover what went on in the House. As for the Senate, I know there was some discussion between him and the Senator from Tennessee, and I was not privy to them. But it certainly was not a case where the Administration told us to go forward.

On the Consumer Bureau, I was one of the ones who said no. The solution that he talked about—namely, elevating the status bureaucratically of a consumer protection function within an entity that is primarily a bank regulator—would not work. There is a qualitative difference between having an independent consumer regulatory and having it as one of the things bank regulators do, because the history was clear that bank regulators did not do it.

In fact, interestingly, the largest single chunk of authority to protect consumers that existed before this law was passed was at the

Federal Reserve, and when we questioned the Federal Reserve, they had had very little to do with things.

I would note again, by the way—I was struck when the Senator from Alabama talked about it—that he appeared to think that Mr. Geithner was more important in the Bush administration than any of the Presidential appointees. Yes, he was President of the Federal Reserve. He served under Ben Bernanke, who was the appointee of President Bush to be Chairman of the Council of Economic Advisers and then of the Federal Reserve, and he worked with Secretary Paulson. So once again, I think if there is criticism, it goes to all of them.

But to return to the Consumer Bureau, I do think it is important that it be independent, that it not be a second thought from the bank regulators, whether it was just one bank regulator or individual bank regulators. And I believe that makes a great deal of sense to give the consumer—the gentleman says let us give them equal status. The only way you do that is to make them an equal entity, not subject to others.

As to the bill itself, it had a common theme. One of the criticisms we heard was that the bill was too big. Well, I am sorry that we apparently exceeded the attention span of some Members of Congress, but I guess they could wait for the movie. Maybe it will be coming forward. But the fact is that we are dealing with an interconnected system, and to have dealt piecemeal with an interconnected system would not have been a good idea. And there was a central theme there. The theme was this: that by sources of liquidity outside the banking system and by increased information technology, people in the financial industry had figured out a way to engage in lending while appearing to escape the burden of risk; and they appeared to be able to avoid risk themselves.

Of course, this did not go away. It accumulated elsewhere in the system, and it exploded on all of us. So what we have done is to basically make people be responsible for their risk. And I would say here one very important issue that has come up—and I differ with some of my friends on the liberal side here—is the question of risk retention. I would urge people to look at Michael Lewis' book "The Big Short." When people make loans and have no responsibility for whether or not they are repaid, they will not be as prudent. And that is a market incentive. The alternative that I have been told—and this is ironic—by some of my friends in the banking industry is, oh, no, the regulators will be able to tell you what is a good loan and what is not. No, we are on the market side here. I do not want to depend on the regulators to be able to look at all these loans. Yes, we have banned the worst kind of loans, but there are still going to be loans that could be made, properly or not. And the choice is: Do you rely solely on the discretion of the regulators to supervise all those loans? Or do you build a market incentive in with risk retention? And I am told, well, then, we will not have the loans made.

Well, if that is the case, I have a question, because securitization—I went back. There was testimony by Lew Ranieri before this very Committee in which he talked about securitization taking off. That was in 1986. So I do have this question: If securitization without risk retention—which is not going to rival taxation without representation as a slogan for the ages. But securitization without risk retention, if that is necessary for there to be a housing market, what were people living in before 1986? Were there no loans made before 1986?

This notion that people have got to be able to avoid risk is a great mistake, and I am for an exception for those loans that are very solid. But I think the notion that risk retention is somehow an impediment is a great mistake.

The insurance industry, of course—and that is where we borrowed the concept—follows it. You cannot get reinsurance without some risk retention. And I think that some of my friends are falling into that trap once again.

As to derivatives, the law does not mandate any requirement that affects people who are the users of the commodity in question. It gives full discretion to the regulators to make differences and to, in fact, focus on the kind of transactions that AIG engaged in with other financial institutions, not with end users.

And I would add to this—and there may be a debate on this. One of these things I want to address here—and then if you want me to answer questions, I can do that. But one of the things we have done is to empower the CFTC—and if it gets the funding, then it would be able to do this—to deal with speculation. Now, there is a legitimate economic argument about whether or not speculation does, in fact, affect prices, and I think it is probably the case that 30 years ago it may not have done so so much. What has happened, however, in the interim is there is a greatly increased amount of liquidity and very great sophistication in information technology. As somebody pointed out, if you look at the charts, individual commodities used to move in different directions. It tends to be more of a uniform—they used to move in the same direction. Now it is more individualized.

There is a consensus now from Goldman Sachs, from Wilbur Ross, an investor, from people in the home heating oil business, from gasoline distributors, and from the facts that speculation does add something to the price of oil. One of the big issues here is this: Will the Commodity Futures Trading Commission be allowed to exercise the powers we have given it to put limits on people who are not end users so that we are not trying to—what we are saying, if you are somebody who never goes near a barrel of oil, in fact, you are probably somebody who does not go near oil at all because you have got somebody else to pump your gas for you, your chauffeur, maybe. If you are in that category, we want to limit the amount you can buy because we see that—we are told billions of dollars will be lost if they cannot trade in the financial area. Well, where do those billions of dollars come from? They did not come from the sky. They get added to the price.

So those are two areas, whether or not we can deal with speculation and what we do about risk retention, where I intend to keep pressing.

The further point I would make is this, and it has to do with the funding. I have talked to some business people, one of the leading business people of Boston in my office just last week. I understand people who think we have too much regulation, but I think the analog here is to the pharmaceutical industry where the major pharmaceutical companies might not like some of what the FDA has, but they have worked to provide the FDA with enough money to carry it out. You might think that less regulation would be better, but clearly the worst of all worlds is to have regulations on the books and have regulatory authorities that are not able to deal with them appropriately. They cannot hire the right people and have the right information technology.

So this nickel-and-diming the SEC and the CFTC I think does grave harm, and it is, of course, a Catch-22 to complain that they are not moving appropriately with the rules but then deny them the funding to do it. And I have to say this: For people who are prepared to have America stay in Iraq for a couple more years—and I was encouraged when my colleague from Alabama talked about the military-industrial complex. Let us work on cutting them down, too, to help. But when people tell me they want to stay in Iraq over the Bush administration decision to get out, and, of course, the billions and billions, but we cannot find $150 million for the CFTC, I am not impressed. And let us be clear with the SEC that that is an area where there is no taxpayer money.

Finally, I do want to talk about Fannie Mae and Freddie Mac. I have to say here—let me be a little partisan. I am impressed with the on-again, off-again nature of this with my colleagues in the House. I do not here address the Senate. My Republican colleagues in the House talk very tough about Fannie Mae and Freddie Mac when they are in the minority. But when they are in the majority, something happens. They are affected by a strange kind of paralysis that comes with responsibility. I say that because last year, when we dealt with this bill in conference, the Republicans in the House offered the Hensarling bill, a total abolition of Fannie Mae and Freddie Mac, with no particular attention to its succession, as an amendment. We said no, we said it was not germane.

We are now almost 7 months into this session with the Republicans in the majority. Mr. Hensarling is a member of the majority. He is a subcommittee chairman. They have not offered it. In fact, we had a discussion about some smaller bills to deal with this, which the Wall Street Journal said was a poor way to do it, and here is what Mr. Bachus said: "I speak for all members of all the subcommittee chairs. We would like a comprehensive bill." This is on Fannie Mae and Freddie Mac. "Now, can we get a comprehensive bill? I do not know. I do not think so."

So the Republicans in power in the House are much less certain. The gentleman from Alabama said where are we. Well, I do not know. Ask your colleague from Alabama on the next plane ride home.

And I will say this. Somewhat embarrassed by this failure of memory once he became the majority. The gentleman from Alabama blamed the Obama administration, and this is really extraordinary, and I will close with this. Of all the issues in all the world—I feel like Humphrey Bogart in "Casablanca." Of all the issues in all the world, when it comes to Fannie Mae and Freddie Mac, the Republicans in the House cannot proceed without Obama. Why haven't we seen one? Because Obama will not let them do it. I suppose a more recent entertainment analogy is, for those who remember, Flip Wilson, which the Republicans in the House are Geraldine, and Obama is the devil who will not let them do it.

The Chairman said, inaccurately—I am sure he misunderstood—that he was asked by the Obama administration to wait. I have checked with the Secretary of the Treasury. I have checked with HUD. I have checked with the Administration. He misunderstood them. No one in the Obama administration has asked him to wait, and the notion that they cannot proceed on Fannie and Freddie, that they have said "May I?" to the Obama administration and they have not gotten permission—I have a rule that I try to follow myself. I would advise this to my Republican colleagues here. No matter how tight the corner you are in because of problems, try to avoid saying something that no one will believe. It is not going to help you. The notion that they are not acting on Fannie and Freddie—oh, the gentleman from New Jersey, Mr. Garrett, said that it is not a simple problem, that is why they cannot act.

So here is the deal. The Republicans in the House, here is why we are not acting on Fannie and Freddie. They have the Hensarling bill, which is opposed by everybody who deals with the housing market, who want to get the private market back in—the realtors, the mortgage bankers, the Financial Services Roundtable, the American Bankers Association, the home builders. That collection of radicals all disagree with the Hensarling plan, all think you will have to have a more comprehensive approach for what happens afterwards. But the Republicans have this problem in the House. Their ideology and reality are having a heck of a fight, and it is a draw right now. Ideologically, they are committed to the Hensarling bill, but everybody who cares about housing says, "Do not do that."

So Mr. Bachus then says, "OK, I cannot do anything until the Obama administration lets me." That is not plausible, and I agree with the gentleman—I would say this, by the way. The only time since 1992 that the Congress has acted on Fannie Mae and Freddie Mac was in 2007 and 2008 when I was the Chairman and Mr. Dodd was the Chairman, and we got together a bill at the request of Secretary Paulson, which President Bush signed, which gave Secretary Paulson the authority to put Fannie and Freddie into conservatorship, which he did. And while there were serious problems before and we have to deal with this, in the current situation I agree with Mr. Shelby. They have too much of the market. But at least it is not the kind of cost on us that it was before. Fannie and Freddie today are behaving in a much more responsible fashion because we gave them the power to do that, and I think that was bipartisan at the time in 2008, and Secretary Paulson acted on it.

Mr. Chairman, I appreciate this opportunity.

Chairman JOHNSON. Thank you again, Representative Frank, for coming over here today. I know you need to get back to the House. Senator Shelby has a couple——

Mr. FRANK. I do feel at home here. I counted nine of my former colleagues up here, so I did not feel entirely isolated. Oh, 10.

Chairman JOHNSON. Senator Shelby has a couple very quick——

Senator SHELBY. A few observations. I know Congressman Frank and I have sparred over the years on different issues, agreed on some. Some. I do agree with Congressman Frank that there is a heck of a lot of difference between managing risk and speculation. And I think we all agree on that. That speculation will cause people to get in trouble. Managing risk will help people, and we have got to recognize the difference.

Mr. FRANK. Agreed.

Senator SHELBY. As far as Fannie Mae and Freddie Mac, the Congressman knows when we were in control here—I was the Chairman of this Committee—we pushed hard—hard—for a reform of Fannie and Freddie. We got it out of the Committee. We pushed it hard. We will continue to do that. I do not know what is going on in the House. As he knows, it has been 25 years since I was there. But I can tell you, we hope, working with Chairman Johnson, that sooner or later—the sooner the better—that we can do something comprehensive, something substantive dealing with Fannie and Freddie because they continue to hemorrhage.

Mr. FRANK. I welcome that.

Senator SHELBY. Yet we all recognize they are the only game in town right now as far as——

Mr. FRANK. Could I say, Senator? I agree with—first of all, two things. As you remember—and I remember that in 2005 and 2006 doing a bill. But as I remember, your major opponent at that point was my Republican Chairman, Mr. Oxley. He had a very different bill, and there was a dispute. Mr. Oxley——

Senator SHELBY. I think he had a weaker bill.

Mr. FRANK. Right. In fact, Mr. Oxley——

Senator SHELBY. You must have helped him with it.

Mr. FRANK. No, I——

[Laughter.]

Mr. FRANK. The notion that—actually, Mr. DeLay was calling the shots then. You know, I wanted to deal with this. People have said, well, I was blocking it. I was in the minority. Tom DeLay was a major factor in the House, and if Tom DeLay was really susceptible to my suggestions, we would not have gone to war in Iraq, and he would not have gone on the dance show.

[Laughter.]

Mr. FRANK. I have to say that he was not someone who listened to me. But I hope we can move ahead on Fannie Mae and Freddie Mac, but I will say that was when the Republicans were in power and there was an intercameral dispute. But we did work together in 2008. We had cooperation. And the only thing I would say to amend your statement is I think we stopped the hemorrhaging. There is still a problem. It is still too much of the market. But if you look at the people that President Bush put in power and since, they will tell you that the problem that we are facing is losses incurred before it went into conservatorship. Since then, it has been running in a much more conservative and responsible fashion, but we still need to fix it.

Chairman JOHNSON. I will now call up our second panel of witnesses today.

[Laughter.]

Mr. FRANK. Thank you.

Chairman JOHNSON. I want to welcome our witnesses back to the Banking Committee and I will keep the introductions brief. Second panel, please come forward.

[Pause.]

Chairman JOHNSON. I will keep the introductions brief.

The Honorable Neal S. Wolin is Deputy Secretary of the U.S. Department of the Treasury.

The Honorable Ben S. Bernanke is currently serving his second term as Chairman of the Board of Governors of the Federal Reserve System.

The Honorable Mary Schapiro is Chairman of the U.S. Securities and Exchange Commission.

The Honorable Gary Gensler is the Chairman of the Commodities Futures Trading Commission.

The Honorable Marty Gruenberg is the new Acting Chair of the Federal Deposit Insurance Corporation. As a former Senate Banking Committee server, I also welcome you back to a very familiar Senate committee room.

Mr. John Walsh is Acting Comptroller of the Currency of the Office of the Comptroller of the Currency.

I thank all of you again for being here today. I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Secretary Wolin, you may begin your testimony.

STATEMENT OF NEAL S. WOLIN, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. WOLIN. Chairman Johnson, Ranking Member Shelby, Members of the Committee, I appreciate the opportunity to appear before the Committee. One year ago today, the President signed into law a comprehensive set of reforms to the financial system, reforms which are essential to making our economy stronger and more resilient.

Those reforms were enacted in the wake of the most devastating financial crisis since the Great Depression.

In the depths of the crisis, the economy lost an average of 800,000 jobs per month. American families saw $5 trillion of household wealth erased in the last 3 months of 2008. Credit was frozen. Financial markets were barely functioning.

The Administration and its predecessors put in place a comprehensive strategy to repair the financial system. As a result of that strategy, the U.S. financial system today is stronger, more stable, and better able to fuel growth and create jobs.

But in order to protect our economy and create the conditions for long-term prosperity, we needed to put in place comprehensive reform of the financial system.

That is why we proposed, Congress passed, and the President signed into law a sweeping set of reforms.

The Dodd-Frank Wall Street Reform and Consumer Protection Act made important and fundamental changes to the structure of the U.S. financial system to strengthen safeguards for consumers and investors and to provide better tools for limiting risk in the major financial institutions and the financial markets. The core elements of the law were designed to build a stronger, more resilient financial system, less vulnerable to crisis, more efficient in allocating financial resources, and less susceptible to fraud and abuse.

These reforms were responsive to the many weaknesses that together nearly brought our financial system to collapse. They include: tougher constraints on excessive risk taking and leverage across the financial system, stronger consumer protection, comprehensive oversight of derivatives, and a new orderly liquidation authority to wind down a failing financial firm in a manner that protects taxpayers and the broader economy.

The statute created three new institutions that fall within Treasury's implementation responsibility: The Financial Stability Oversight Council, to identify, monitor, and respond to threats across the financial system; the Office of Financial Research, to enhance the quality and analysis of financial data available to policymakers and the public; and the Consumer Financial Protection Bureau, to help consumers make informed financial decisions and to protect them from abuses in the marketplace.

We are far along in standing up these institutions and they have each begun to play their critical roles.

As we move forward, we must continue to move quickly but carefully, taking the time we need to get things right. We must make sure our efforts are coordinated. We must make sure to take care to regulate firms in a manner appropriate to the risk they pose to the financial system. We must be sure to work to improve the efficiency and effectiveness of financial regulation as we write a new set of rules. We must work with our international partners to create a level playing field with a set of high global standards. And we must make sure regulators have the funding they need to do their jobs.

A year ago, in the wake of a catastrophic financial crisis, Dodd-Frank was enacted to reform our financial system. These reforms were an obligation, not a choice. Without them, we could not build the financial system we need, a financial system with the stability and the resilience necessary to support our economy and to protect it in times of stress.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Secretary Wolin.

Chairman BERNANKE.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you, Mr. Chairman, Ranking Member, for this opportunity to testify on the first anniversary of the Dodd-Frank Act.

On this anniversary, it is worth reminding ourselves of why Congress passed the sweeping financial reforms a year ago. The financial crisis of 2008–2009 was unprecedented in its scope and severity. Some of the world's largest financial firms collapsed or nearly did so, sending shock waves through the highly interconnected global financial system. Critical financial markets came under enormous stress. Asset prices fell sharply and flows of credit to American families and businesses were disrupted. The crisis, in turn, wreaked havoc on the U.S. and global economies, causing sharp declines in production and trade and putting millions out of work.

Extraordinary actions by authorities around the world helped stabilize the situation, but nearly 3 years later, the recovery from the crisis in the United States and in many other countries remains far from complete.

In response to the crisis, we have seen a comprehensive rethinking and reform of financial regulation, both in the U.S. and around the world. Among the core objectives of both the Dodd-Frank Act and the global regulatory reform effort are, first, enhancing regulators' ability to monitor and address threats to financial stability. Second, strengthening both the prudential oversight and resolvability of Systemically Important Financial Institutions, known as SIFIs. And third, improving the capacity of financial markets and infrastructures to absorb shocks.

First, to help regulators better anticipate and prepare for threats to financial stability, legislatures in both the United States and other developed economies have instructed central banks and regulatory agencies to adopt what has been called a macroprudential approach to supervision and regulation. That is an approach that supplements traditional supervision and regulation of individual firms or markets with explicit consideration of threats to the stability of the financial system as a whole.

As you know, the Dodd-Frank Act created a council of regulators, the so-called FSOC, to coordinate efforts to identify and mitigate threats to U.S. financial stability across a range of institutions and markets. The Council's monitoring efforts are well underway, and this new organization has contributed to what has been a very positive atmosphere of consultation and coordination among its member agencies.

The Council is also moving forward with its rulemaking responsibilities, including rules under which it will be able to designate systemically important nonbank financial institutions and financial market utilities for additional supervisory oversight, including by the Federal Reserve.

For its part, the Fed has also made organizational changes to promote a macroprudential approach to regulation. Among these changes is the establishment of high-level multi-disciplinary working groups to oversee the supervision of large complex banking firms and financial market utilities, with a strong focus on the development side of implication for financial stability. We have also created an Office of Financial Stability Policy and Research to help coordinate our efforts to identify and analyze potential risk to the broader financial system and to serve as liaison with the Council.

The second major objective of financial reform is to mitigate the threats to financial stability posed by the too-big-to-fail problem. Here, the Dodd-Frank Act takes a two-pronged approach. The first prong empowers the Fed to reduce the SIFIs' probability of failure through tougher prudential regulations and supervision, including enhanced risk-based capital and leverage requirements, liquidity requirements, single counterparty credit limits, stress testing, an early remediation regime, and activities restrictions. The Federal Reserve and other agencies face the ongoing challenge of aligning domestic regulations with international agreements, including the

Basel III requirements for globally active banks. These efforts are going well. In particular, the Federal Reserve expects to issue proposed rules on the oversight of SIFIs later this summer, and working with other banking agencies, we are on schedule to implement Basel III.

Ending too-big-to-fail also requires allowing a SIFI to fail if it cannot meet its obligations and to do so without inflicting serious damage on the broader financial system. Thus, the second prong of the Dodd-Frank Act's effort to end too-big-to-fail empowers the Fed and the FDIC to reduce the effect on the system in the events of a SIFI's failure through tools such as the new orderly liquidation authority and improved resolution planning by firms and supervisors. In particular, the Federal Reserve is working with the FDIC to require SIFIs to better prepare for their own resolution by adopting so-called living wills. A joint final rule on living wills is expected later this summer.

Reducing the likelihood of a severe financial crisis also requires strengthening the resilience of our financial markets and infrastructure, a third major objective of the Dodd-Frank Act. Toward that end, provisions of the Act improve the transparency and stability of the over-the-counter derivatives markets and strengthen the oversight of financial market utilities and other critical parts of our financial infrastructure. We and our colleagues at the SEC, the CFTC, and other agencies are moving this work forward in consultation with appropriate foreign regulators and international bodies. The U.S. agencies are also working together to address structural weaknesses in areas not specifically addressed by the Dodd-Frank Act, such as the tri-party repo market and the money market mutual fund industry.

To be sure, any sweeping reform comes with costs and uncertainties. In implementing the statute, the Federal Reserve is committed to the promulgation of rules that are economically sensible, appropriately weigh costs and benefits, protect smaller community institutions, and most important, promote the sound extension of credit in the service of economic growth and development.

A full transition to the new system will require much more work by both the public and private sectors, and no doubt, we will learn lessons along the way. However, as we work together to implement financial reform, we must not lose sight of the reason that we began this process, which is ensuring that events like those of 2008 and 2009 are not repeated. Our long-term economic health requires that we do everything possible to achieve that goal. Thank you.

Chairman JOHNSON. Thank you, Chairman Bernanke.

Chairman SCHAPIRO.

STATEMENT OF MARY L. SCHAPIRO, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. SCHAPIRO. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to testify on the occasion of the 1-year anniversary of the Dodd-Frank Act. Following the biggest financial crisis since the Great Depression, Congress passed legislation that is already reshaping the U.S. regulatory landscape, reducing systemic risk, and helping to restore confidence in the financial system.

At the SEC, we were given broad new investor protection and market integrity responsibilities, and in the past year, we have made significant progress in our efforts to meet them. Already, we have proposed or adopted rules for about three-fourths, or about 70, of the mandatory rulemaking provisions we were assigned. In addition, we have finalized 10 studies and reports that the Act required us to complete.

In my prior testimony before this Committee, I outlined our efforts to establish a process to help us not only get the rules done, but get them done right. Among our efforts, we created internal cross-disciplinary working groups to coordinate the rulemaking process and facilitate our action. We increased transparency and aggressively sought input from the public. We forged and strengthened collaborative relationships with other Federal and State regulators and our international counterparts. We engaged in a substantial outreach effort, participated in scores of interagency and working group meetings, conducted public roundtables, met with hundreds of interested groups and individuals, including investors, academics, and industry participants, and received, reviewed, and considered thousands of public comments.

All of these efforts, in addition to Congressional input and robust Commission debate, are helping us write rules that effectively protect investors and the financial system without imposing undue burdens on market participants. While some feel we are moving too quickly and others feel we are not moving rapidly enough, I believe we are proceeding at a pace that ensures that we will get the rules right.

My written statement illustrates the breadth and complexity of the rulemaking activities that have engaged the SEC for the past year—activities that range from hedge fund registration to the obligations of investment advisors and broker-dealers, to implementation of the new whistleblower program. Other priorities include completing the specialized disclosure rules called for in the Act, continuing to establish a new oversight regime for the over-the-counter derivatives market, strengthening oversight of credit rating agencies, increasing oversight of systemically important financial market utilities, putting in place new oversight for municipal advisors, implementing the Act's corporate governance and executive compensation requirements, engaging our foreign counterparts in detailed discussions aimed at limiting the potential for regulatory arbitrage, and making effective use of the Act's enhanced enforcement powers to address wrongdoing.

While the SEC has made tremendous progress over the past year, the provisions of the Dodd-Frank Act vastly expand the SEC's responsibilities and will require significant additional resources to fully implement the law. To date, the SEC has proceeded with the first stages of implementation without additional funding, taking staff from other responsibilities and working without sufficient investments in areas such as information technology. While it is, of course, incumbent upon us to use our existing resources efficiently, the new responsibilities assigned to us are so significant that they cannot be achieved solely by wringing efficiencies out of the existing budget. Attempting to do so will hamper our ability to meet both new and existing responsibilities.

If the SEC does not receive additional resources, circumstances that contributed to the financial crisis will not be adequately addressed as the SEC will not be able to build out the technology and hire the expertise needed to oversee and police these new areas of responsibility.

I would note that the Dodd-Frank Act requires the SEC to collect transaction fees to offset the annual appropriation of the agency. So regardless of the amount appropriated to the SEC, because it will be fully offset by fees that we collect, it will have no impact on the nation's budget deficit.

Though the SEC's efforts to implement the Dodd-Frank Act have been extensive, we know our work continues. Thank you for inviting me to share with you our progress to date and our plans going forward. I look forward to answering your questions.

Chairman JOHNSON. Thank you, Chairman Schapiro.

Chairman GENSLER.

STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of this Committee. I thank you for inviting me here to testify today and I am pleased to testify on behalf of the Commodities Futures Trading Commission.

On this anniversary, it is important to remember why the law's derivatives reforms were so necessary. When AIG and Lehman Brothers failed, we all paid the price. All of your constituents paid the price. And what is more, the effects of the crisis continue to be very real, with significant uncertainty in the economy and millions of Americans still out of work.

And though the crisis had many causes, it is clear that the derivatives or swaps marketplace played a central role. Swaps added leverage to the financial system, with more risk being backed by less capital. They contributed, particularly through the product called credit default swaps, to a bubble in the housing market and I believe helped accelerate problems as we went into that crisis.

And they also contributed to a system where large financial institutions, once just thought too-big-to-fail, were all of the sudden—this new phrase—too interconnected to be allowed to fail. So swaps, which are still to this day so important in helping manage and lower risk for thousands of end users in this economy, also in that moment of crisis concentrated and heightened risk in the financial system and thus to the public.

So what did Dodd-Frank do to address this? First, the Dodd-Frank Act broadened the scope of the oversights of the CFTC and SEC for the first time to cover swaps and securities-based swaps.

Second, the Act promotes market transparency, something that has worked in the securities and futures markets since the 1930s, and that is through real-time reporting of transactions and bringing those transactions that can to a centralized place called swap execution facilities. Economists for decades have found that transparency reduces cost to users of the markets.

Third, the Act lowered risk to the public and the overall economy by directly regulating the dealers and moving that which we can to central clearing.

Fourth, the Act provides important new enforcement authorities and reporting requirements so that regulators themselves, the CFTC and SEC, can better police the markets for fraud, manipulation, and other abuses. In fact, this month, the Commission finalized a rule on anti-manipulation which is very similar to what the SEC has had for decades, and we think it will help.

And fifth, I note that the Ranking Member Shelby and Ranking Member Frank had a discussion about speculation. Congress actually mandated that the CFTC set aggregate position limits for physical commodities, expanding the scope to certain swaps and linked contracts.

So the CFTC is working along with other regulators, particularly the SEC, deliberately, efficiently, and transparently to write rules to implement these and other provisions of the Act. This spring, we substantially completed the proposal phase of rulemaking, and then we provided the public an extra 30 days to look at the whole mosaic at once. And now the staff and Commissioners have turned toward final rules, approving eight so far. We anticipate taking up in August rules with regard to swap data repositories, in September, clearing, position limits, and others, October, and we will be moving forward continuing to finalize rules.

But as we finalize rules, we are reaching out broadly to market participants, with over 21,000 comments to date, including roundtables and public comment periods to consider how best to implement this, talking to international regulators. And we are also looking very closely at phased implementation, which helps lower costs and risk.

Before I close, I would like to just make note that the CFTC is taking on a significant expanded scope and mission, a market that is seven times the size of what we currently oversee. The Commission must be adequately resourced to effectively police this market and protect the public. Without sufficient funds, there will be fewer cops on the beat, but also, we will not really even have enough staff to answer the basic questions for market participants and the public on the new rules.

In conclusion, we are working thoughtfully at the Commission to get these rules right based on significant public input, but it is more important to get it right than work against the clock and that is not what we are doing. We are going to get this right and move forward. But until the CFTC completes its rule-writing process and implements and enforces the new rules, the public remains unprotected.

I thank you. I look forward to your questions.

Chairman JOHNSON. Thank you, Chairman Gensler.

Acting Chairman Gruenberg.

STATEMENT OF MARTIN J. GRUENBERG, ACTING CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GRUENBERG. Thank you, Mr. Chairman. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the 1-year anniversary of the passage of the Dodd-Frank Act.

Chairman Johnson, if I may, thank you for your kind words at the outset. It does occur to me that it used to be more comfortable for me to sit behind you all on the dais than where I am right now, but I am privileged to have the opportunity.

The Dodd-Frank Act provided the FDIC with important new authorities in the areas of deposit insurance and systemic resolution that we believe will significantly enhance financial stability and on which we have made significant progress toward implementation.

First, the Act grants the FDIC new authorities to manage the Deposit Insurance Fund in a way that will make it more resilient in a future crisis. The FDIC has already implemented provisions in the Act that make permanent the increase in the deposit insurance coverage limit to $250,000 and provide insurance on the entire balance of non-interest-bearing transaction accounts through the end of 2012.

We have also implemented the changes in the assessment base mandated by the Act, which generally shifts the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for funding. The change in the assessment base from deposits to assets will result in an aggregate decrease of 30 percent in deposit insurance assessments for insured institutions with assets under $10 billion.

In addition, the Act provided the FDIC with new flexibility in setting the target size of the Deposit Insurance Fund. We have used the new authority to adopt a long-term fund management plan that should maintain a positive insurance fund balance even during a banking crisis while preserving steady and predictable assessment rates through economic and credit cycles. This will enable us to avoid imposing procyclical deposit insurance assessments on financial institutions during an economic downturn.

The Dodd-Frank Act also provides for a new systemic resolution framework to be used in those rare instances when we must act to mitigate the systemic risk posed by the resolution of a financial company in bankruptcy. The framework includes an orderly liquidation authority and a requirement for resolution plans that will give regulators much better tools with which to manage the failure of large complex financial institutions.

If the FDIC is appointed as receiver for a covered financial company under the orderly liquidation authority, we are required to carry out an orderly liquidation in a manner that ensures that creditors and shareholders appropriately bear losses while maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard.

Critical to the exercise of this authority is a clear and transparent process. The FDIC Board approved a final rule implementing the orderly liquidation authority on July 6. This final rule provides a framework to resolve systemically significant financial institutions using many of the same powers we have long used to manage failed bank receiverships.

The FDIC and the Federal Reserve Board, as Chairman Bernanke mentioned, are also working jointly to issue regulations implementing new resolution plan requirements. The comment period on the Notice of Proposed Rulemaking ended on June 10 and we hope to issue a final rule in the near future.

In order to carry out these responsibilities for the resolution of Systemically Important Financial Institutions, the FDIC has established a new Office of Complex Financial Institutions which will have three key functions: To monitor the condition of systemically important financial companies from the standpoint of resolvability; to oversee jointly with the Federal Reserve the development of resolution plans by these companies; and to engage with the supervisors of the foreign operations of these companies in regard to resolution planning.

Finally, the Dodd-Frank Act contains provisions that will complement the ongoing Basel III reforms that will make capital requirements more uniformly strong across the banking system. Section 171 of the Dodd-Frank Act states that capital requirements for the largest banks and bank holding companies must not be less than the capital requirements that are generally applicable to insured institutions. The FDIC, the Federal Reserve, and the Comptroller of the Currency recently finalized a rule implementing this provision.

We have made significant progress in the past year but still have considerable work ahead of us. Throughout this process, we have sought input from the industry and the public and we continue to report back to Congress on our progress. We have sought to make the process as transparent as possible. We believe that successful implementation of these provisions will lead to a financial system that is more stable and less susceptible to crises and better prepared to withstand crises if and when they develop.

Thank you, and I look forward to answering your questions.

Chairman JOHNSON. Thank you, Acting Chairman Gruenberg.

Acting Comptroller Walsh.

STATEMENT OF JOHN WALSH, ACTING COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. WALSH. Thank you, Chairman Johnson, Ranking Member Shelby, Members of the Committee. I appreciate the opportunity to be here today to discuss the progress that the OCC and other regulatory agencies have made in implementing the Dodd-Frank Act in the year since the law was passed.

Although we have weathered the worst financial crisis since the Great Depression, it will be years before we put all of its effects behind us. Dodd-Frank took important steps to strengthen the financial system and guard against future crises, and I think all of us are determined to implement those safeguards as quickly and effectively as possible.

As I have said in previous testimony, the OCC is involved in 85 individual projects stemming from Dodd-Frank, including a number of interagency rulemakings that will have a very significant impact on the financial system. Our biggest single task has been to integrate the staff and functions of the Office of Thrift Supervision into the OCC, but we have also devoted considerable effort to the transfer of supervisory responsibilities to the new Consumer Financial Protection Bureau, and we have participated in the early work of the Financial Stability Oversight Council, which has the potential to serve as an important defense against market disruption.

Regarding OTS integration, I am pleased to report that on Monday 674 employees of the Office of Thrift Supervision reported for duty at the OCC in offices around the country. We have worked very hard over the past year to ensure a smooth transition, and we have now succeeded in moving to a single regulator for national banks and Federal thrifts. We will need every bit of the talent and experience of former OTS staff to help fulfill our combined supervisory mission, and the men and women joining us from OTS have been fully integrated into policy and field units where their talents can best be utilized.

We also recognize the importance of communication to the industry so that thrift executives know what to expect from the combined agency, and among our efforts we held 17 outreach meetings around the country and had more than 1,000 thrift executives join us for those meetings.

As part of the transition, we have engaged in several rulemakings affecting the thrift industry. Today we posted an interim final rule that republishes as OCC rules those OTS regulations that the OCC has authority to administer and enforce going forward. We are continuing to review regulations—those as well as our own—to see where improvements may be in order.

We also published a final rule today that addresses a number of areas important for continuity of supervision after July 21st, including assessments of Federal savings associations. That rulemaking, published in today's Federal Register, also addressed the areas where Dodd-Frank made changes in the standard upon which the OCC's rules on preemption and visitorial powers were based.

The rulemaking scales back our current rules in a number of areas. The amendments eliminate the obstruct, impair, or condition preemption standard from our regulations. They eliminate preemption for operating subsidiaries of both national banks and federally chartered thrifts, limit Federal savings associations to the same standard of conflict preemption that applies to national banks, and expressly recognize the enhanced visitorial authorities of State Attorneys General that are provided under Dodd-Frank. We also implement new procedures for future preemption decisions, including consultation with the CFPB.

Over the past year, we have provided considerable support for the stand-up of the CFPB and worked to ensure cooperation between the OCC and the new Consumer Bureau in our complementary supervisory roles. In addition to participating in numerous informational briefings with CFPB staff, we have assisted in developing the agency's procurement and personnel management processes. To ensure the agency has the information it needs about the banks it will be supervising, we executed a memorandum of understanding that allowed us to share reports of examination, supervisory letters, information on enforcement matters, and other important confidential information.

We have also agreed to provide transitional support for other CFPB functions, including consumer complaints. The OCC will continue to operate our Customer Assistance Group to handle consumer complaints about the large banks now under CFPB supervision while the Bureau builds its own capacity in this area.

As we discussed in our last appearance before the Committee, we have participated in the interagency effort to create an effective Financial Stability Oversight Council as a forum for participants to share views, perspectives and expertise in a confidential setting on emerging risks across the system. The Council will be an important venue for averting and addressing future market disruptions.

And, finally, Dodd-Frank also calls for a number of rulemakings, and we have proposed interagency rules to address credit risk retention, incentive compensation, and margin and capital requirements for covered swap entities, among others.

Clearly, we have a great deal of work ahead in implementing the many important provisions of Dodd-Frank, but I am confident that we will get it done in a way that strengthens the financial system and protects it against the kinds of risks that led to the last crisis.

Thank you, and I am happy to answer your questions.

Chairman JOHNSON. Thank you for your testimony.

We will now begin the questioning of our witnesses. Will the clerk please put 5 minutes on the clock for each Member for their questions?

Secretary Wolin, I think it is important to keep in mind the damage inflicted by the crisis and what the Wall Street Reform Act will do to prevent or mitigate another crisis. Could you highlight in your opinion the greatest costs of the crisis and the most important benefits of the new regulatory framework?

Mr. WOLIN. Thank you, Mr. Chairman, for that question. The costs which I tried to enumerate in my testimony were really extraordinary. The financial system came to the brink of utter failure—credit markets froze up. In the end our economy was enormously affected in a way that hurt all Americans with respect to the availability of credit, with respect to the destruction of an enormous amount of wealth, lost jobs, lost homes, and so forth. And a key reason for all of that, of course, is that the framework we had for our financial system was manifestly inadequate. It had gaps and weaknesses that needed to be addressed. We had no alternative really but to do that, and the Dodd-Frank statute does exactly that. It makes sure that our financial system rests on a more stable, more resilient foundation, requiring firms, especially those that are more risky and present more risk to the system, to hold bigger capital, to have greater liquidity standards and leverage constraints. It brought the derivatives markets and the swap markets out of the darkness. That was clearly an important factor that created or led to the crisis. And it strengthens enormously consumer protection because we know that consumers did not have information and were not put in a position to make fundamental choices about the kinds of credit they undertook, and that led, of course, to enormous amounts of credit being extended in ways that neither they nor the overall system could bear.

In all of these ways, and many others, I think, the Dodd-Frank Act makes important strikes to put ourselves on a foundation that allows our financial system to contribute what it can to the economy and its growth, which is, after all the critical need we have as a country.

Chairman JOHNSON. I have a question directed at Chairman Bernanke, Acting Chairman Gruenberg, and Acting Comptroller Walsh. We are all concerned about the unnecessary regulatory burden for financial institutions that did not cause the crisis. Can each of you describe what your agencies are doing to ensure that we have an appropriate set of rules that work, but also that are not duplicative, contradictory, and overly burdensome to small businesses and small financial institutions? Chairman Bernanke?

Mr. BERNANKE. Yes, thank you. We agree that small banks are critical to our financial system. They have the ability to make loans in a local community that large banks often do not have, including loans to small businesses. And so it is very important to minimize the burden on those banks.

First of all, the law itself, is very focused on the largest firms and on the most complex activities, so the direct implications of the law for smaller banks is less.

That being said, it is important for us as regulators to make clear to smaller banks that they are exempt and to make sure that they are effectively exempt. We are trying in our rules to provide more guidance to small banks about what applies to them and what does not apply to them. I think small banks will benefit to some extent from the fact that tougher rules on the biggest banks and on nonbank institutions will create a more level playing field. It will be of assistance to them.

Finally, I would mention that the Fed has made a very strong effort to reach out to smaller institutions. For example, our Supervision Committee has a subcommittee which is focused on making sure that the rules that we pass do not have excessive burden on small banks, and we have created a Community Bank Council that meets three times a year with the Federal Reserve Board to give us maximum feedback.

So we are taking a lot of steps to try to achieve that objective. I agree with you it is a very important one.

Chairman JOHNSON. Acting Chairman Gruenberg?

Mr. GRUENBERG. Thank you, Chairman Johnson. This is a matter of significant priority for the FDIC because we are the leading Federal supervisor of the majority of community banks in the United States, so it is a matter we take very seriously.

One of the challenges that the community banks have told us about is with the number of regulations required by the Dodd-Frank Act. There is an issue for them simply sorting through which ones actually have relevance and applicability to them.

To try to respond to that, on every financial institution letter—and we issue a letter for each regulation—we provide a box on the front that specifically summarizes the applicability of that regulation to institutions with assets under $1 billion. So they have a quick shorthand place to go to identify the relevance of the regulation to them.

In addition, we have an ongoing statement of policy at the FDIC on the development and review of FDIC regulations and a policy which requires regular periodic reviews by us of our regulations and their impact, and that is something we are undertaking specifically in regard to the implementation of the Dodd-Frank Act.

And, finally, I would mention we also have a Community Bank Advisory Committee that has been extremely helpful to us, and one of the recommendations they made was to conduct a review of the questionnaires and surveys that we require our regulated institutions to fill out. In response to that review, we have created a new place on the FDIC Web site consolidating all of those questionnaires and surveys, so it is in a single place institutions can go to, and they will now be able to fill out those questionnaires and surveys online, which they were not able to do before. So this is a matter of ongoing attention for us.

Chairman JOHNSON. Acting Comptroller Walsh, could you elaborate a bit?

Mr. WALSH. Well, I would certainly join my colleagues in expressing the same concerns, and, in fact, the approach that we are taking, about 2,000 of our 2,100 institutions are community banks. We have substantial outreach to them. We have an Internet-based BankNet system that enables them to come and look at updates on regulation and to remain apprised of things that are happening.

Certainly, they share the concern that there are a lot of rules, and they are not quite sure what affects them and what does not. And it is true that most of those rules are aimed at larger institutions and more complex activities. But we continue to work with them to understand those things that will affect them and the many that will not.

Chairman JOHNSON. Thank you.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Bernanke, it seems to me that after most crises, we are told that if regulator only had more resources, they could have prevented whatever crisis it was. As a result, the standard response by Congress is to grow the bureaucracies. Dodd-Frank fits this pattern, it seems to me. Because of Dodd-Frank, regulators have seen their powers grow over the American economy and their budgets also grow. Dodd-Frank also will add over 4,000 new Government jobs, many of them very well paying jobs. Employees, for example, at the SEC and other agencies can earn up to $230,000 a year. Meanwhile, as we all know, private sector job growth has been flat.

Mr. Chairman, do we now have enough Government bureaucrats to protect the financial system?

Mr. BERNANKE. Senator, let me go back to the premise of your question.

Senator SHELBY. OK.

Mr. BERNANKE. Which is I really do think that—and I believe there is widespread agreement—the regulatory structure before the crisis was inadequate. There were obviously large gaps in our coverage. There was nobody responsible for looking at the system as a whole. There were significant weaknesses in the structure of our financial system, including the shadow banking system and so on.

I congratulate you on some of your attention early on to Fannie and Freddie, to capital standards, and so on. These were things that were inadequate.

This is not just a pointless response. There are clearly a lot of things that need fixing and that we can improve, and I believe that, broadly speaking, the Dodd-Frank Act covers the main bases, with the main exception of housing finance, which was discussed earlier.

You need more people to carry out more regulations, write more regulations, and to do just in general a better job of overseeing private sector activity.

That being said, what we want is quality more than quantity. We want it done well. We want to make sure that there is clarity in terms of the rules, that financial institutions understand what the rules of the game are, and so that we achieve these results at the least cost to the financial system.

Let me just say that the Fed does do regular cost/benefit analyses of all our rules, and it is always our intention to try to meet the goals of the statute in the least cost way that we can.

Senator SHELBY. Didn't the Inspector General of the Fed recently call that into question, the cost/benefit methodology that the Fed was using that they claim was antiquated?

Mr. BERNANKE. I do not believe that is correct.

Senator SHELBY. OK.

Mr. BERNANKE. There have been several studies, one by a group of the IGs, I believe, and another by the GAO which is more related to some of the programs we did during the crisis. I am sure you will correct me if I am wrong, but my understanding is that the Fed IG took a positive view of the Fed's consistent application of cost/benefit principles to the rules we write.

Senator SHELBY. It is my understanding that the Inspector General of the Federal Reserve recently revealed that the Fed's internal written policy for rulemaking procedures is more than 30 years out of date and, therefore, does not adequately reflect current statutory requirements to perform cost/benefit analysis. If that is not right, maybe we can both review this. But if that is right, then the Fed needs to step up to the plate there, does it not? Assuming that is right.

Mr. BERNANKE. Well, Senator, again, if that is right, that is a statement about written policies.

Senator SHELBY. OK.

Mr. BERNANKE. In actual practice we are very attentive to the costs and benefits.

Senator SHELBY. OK. Chairman Gensler, I have asked you twice in written questions for the record for my colleagues here in the whole Committee how the CFTC would exercise its authority under Title VIII with respect to financial institutions engaged in activities designated under that title. In both instances you responded with a discussion of the regulation of financial market utilities, which does not answer the question.

Let me ask you again: What are the CFTC's plans with respect to financial institutions other than financial market utilities? In other words, I will ask it this way: What are the CFTC's plans with respect to financial institutions engaged in activities that are designated by the Council to be systemically important?

Mr. GENSLER. I thank you for clarifying. I do not think I really fully understood the question in written form.

Senator SHELBY. OK.

Mr. GENSLER. So I understand it now.

Title VIII, I think, addressed itself to financial market utilities, and I think that through the Council there will be some that are designated. We currently oversee I think 16 clearinghouses, and I assume some of them will be included. I do not know whether the Council will designate any activities, so that is why I did not envision them. Right now I would suspect we will focus on one, two, or three clearinghouses and then no other institutions will probably come under Title VIII.

Senator SHELBY. Speaking of clearinghouses, the FSOC recently approved rules that laid the groundwork, as I understand it, to determine which clearinghouses will be deemed systemically important. Will the CFTC provide clarity on whether or not it will allow clearinghouses more time before they must decide whether to accept or reject swap trades?

Mr. GENSLER. Well, I think that for most it is up to the clearinghouse and their risk committee. Clearinghouses will have a mandate, but it is important that they——

Senator SHELBY. Let them do it?

Mr. GENSLER. Well, they—and Dodd-Frank I think addressed it. They are the first line. They get to decide. A mandate then only happens if we then also seek public comment.

Senator SHELBY. Do you think that the ability of systemically important clearinghouses to access the Fed's discount window makes it more or less likely that clearinghouses will accept riskier products? Or will you try to make sure that they do not?

Mr. GENSLER. Well, I think it is our responsibility, each of us, to make sure taxpayers do not stand behind any financial institution, not clearinghouses——

Senator SHELBY. Like we have stood behind it before?

Mr. GENSLER. I agree with you, sir. I think the perverse outcome of the crisis is that some might think we are do more of that, and I think it is important that we do everything in our rulewriting to ensure that the public not stand behind the clearinghouses or other financial institutions.

Senator SHELBY. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

On Tuesday, the Chamber of Commerce released a report that criticized Federal agencies for not keeping up with markets and technology, and they noted:

> A modern, well-regulated market is one in which the regulators also use current technologies and techniques to keep pace with market developments.

Chairman Schapiro and Chairman Gensler, the House Appropriations Committee is proposing significant cuts which I presume would diametrically oppose this request that you keep up with markets through technology. What is your perception?

Ms. SCHAPIRO. Thank you, Senator. Under the House appropriation, we would probably cut about $10 million out of our information technology budget, and the end result of that would be postponed critical investment in market surveillance technology. I have talked with this Committee many times about the Flash Crash of May of last year, the implications that had for investors and for public companies seeking reliable capital markets in which to raise money, and the fact that it took the two agencies many months to be able to actually diagnose what happened because of a lack of technology capability.

It would also mean a delay in the modernization of the EDGAR System, which is absolutely critical to public companies who file their disclosures via EDGAR, to our staff's capability to analyze public company disclosure, and also to much of the information that we will be gathering as a result of Dodd-Frank, which filed via the EDGAR System; and then, of course, our ability to bring in data, again, for our oversight of hedge funds, over-the-counter derivatives, and in another area, the consolidated audit trail and large trader reporting systems as the SEC is moving forward apart from Dodd-Frank. All require that we have the capacity to invest in technology, and we have not had that, and under the House bill we would not have that.

Senator REED. Chairman Gensler.

Mr. GENSLER. Briefly, technology is very important so we can be an efficient cop on the beat and efficiently provide the public the protections they want. We spent this year about $37 million on technology, which is less than most of the largest financial institutions spend in 1 week. And the industry is spending $20 to $25 billion a year. It is less than they spend in a day. In 1 year that is what we do.

We think it would be helpful to about double that, and we have only asked for about 30 percent more people. So technology is a way to be efficient on the people side and, of course, to oversee markets, which are about seven times the size.

It is very important for this setting of aggregate position limits as well so that we can aggregate the data and bring it in and use the computers to do that which computers are good at. And the House appropriation bill cut us 15 percent. We obviously could not do any of that with the cut of 15 percent.

Senator REED. In effect, this is almost sort of setting you up for not falling behind these markets we are trying to create, but eventually failing to be able to even have any transparency or any insight to the markets.

Mr. GENSLER. I think that is right. We will complete the rulewriting process. It will be thoughtful. It will take longer than Congress had laid out. But we will finish that rulewriting process. But I fear that then we will not have the people to answer the questions, to have the transparency, to aggregate the market and put it out on our Web site. Public market transparency needs the technology and the resources.

Senator REED. Chairman Schapiro?

Ms. SCHAPIRO. Senator, can I add to that? I think we have said repeatedly we will not be able to operationalize the Dodd-Frank rules. We, too, will get them done. Hopefully they will be reasonable and appropriate rules.

But the other area where we will fall behind is that we receive about 2,000 requests a year in the form of self-regulatory organization rule filings, requests for exemptions, and no-action letters. Our capacity to keep up with that kind of volume on a declining budget will be severely impacted. And those are things industry really wants from us. They need that guidance and that exemptive relief from time to time. And so I think everybody has a stake in these agencies being in a position to do their jobs.

Senator REED. It seems from your comments that the possibility exists of having the worse of two worlds: regulations on the books which will require you under Dodd-Frank, but ineffective resources to respond to legitimate questions of business, to interpret the regulations, to respond promptly to their requests. I would think the business community would be worse off in this situation because, again, the liabilities are here on the books, but if they cannot get any traction or response from the agencies.

Ms. SCHAPIRO. I think that is right, and to follow up on what Chairman Bernanke said, it is in the interest of the industry to have expert people within the regulatory agencies who can, in fact, efficiently and effectively do examinations, provide guidance, provide information and assistance, as well as to enforce the law, which we are also charged with doing. And I think the public has to understand what the limitations are of a regulatory regime that has no compliance or enforcement behind it.

Senator REED. Just one final point. I think the only real beneficiaries are not the rank-and-file business men and women, but those who deliberately will try to avoid following the law in the hopes they will not get discovered because of the lack of resources. But then the unscrupulous—and I think the vast majority of businesses will be laboring to do what they can, but getting no help or guidance from the regulators.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thank you, Mr Chairman, and thanks to the witnesses for being back once again. I have two questions. The first I think I would like to direct to Ms. Schapiro.

As you know better than anyone, last year the SEC developed a whole new set of rules and regulations regarding money market funds—tightened standards for credit quality, enhanced liquidity, shortened portfolio maturities, a number of very meaningful measures to basically diminish the risks and I think significantly reduce the risk that any kind of a run would be likely to occur or that there would be systemic risk from these funds.

Nevertheless, we do hear a discussion from time to time that there is also an interest in moving to a floating NAV, and what concerns me about a floating net asset value is the complexity of administering this, keeping up with the paperwork, and even tax implications that could become very complex and onerous to what is a very large and important part of our financial system.

So I guess my question is: Is imposing the net asset value rule still under consideration? Or is that off the table?

Ms. SCHAPIRO. The FSOC has taken a lot of interest, appropriately so, in the money market fund issues, and as you point out, we did do a complete overhaul of money market fund credit quality and liquidity standards a year ago. I think they have been fairly universally appraised as being very positive, very helpful to build the resiliency of money market funds. We also require reporting of shadow NAV so that investors can become accustomed to the idea that, in fact, the value does fluctuate for a money market fund.

At FSOC we have discussed the issue several times. We held a public roundtable at the SEC with all FSOC members in attendance and members of the industry and academia to talk about how to prevent runs on money market funds and what are the options available to us. And I would say that we are actively discussing floating NAV as one of the ideas that has been floated and was raised in the President's Working Group's (now FSOC's), study on Money Market Funds, as well as capital buffers. The industry came forward with the idea of a liquidity exchange bank.

So there are a number of areas where we are having discussions. I would say nothing has been decided, but we continue to seek public input and our fellow regulators' input on what we can do to ensure that we do not have a situation as we did when the Primary Reserve Fund broke the buck and effectively caused a run on money market funds, in large part because of the stable NAV. So on the issue we are continuing to explore.

Senator TOOMEY. I hope we will keep in mind what seems to me an absence of empirical evidence that suggests that a floating NAV would solve a problem here and the fact that very substantial measures have already been taken.

I have a separate question that I would like to address to Mr. Gensler and perhaps Mr. Bernanke, as well. This has to do with the proposed margin rules for swaps under Title VII. My understanding is that these rules would require the subsidiaries of American banks operating overseas and doing business with non-American counterparts, that these subsidiaries would nevertheless be required to hold margin on behalf of their counterparts. It is also my understanding that the Europeans and Asians have not imposed a comparable requirement, and therefore, I am concerned that that would put our firms at a competitive disadvantage with respect to transactions that do not occur on U.S. soil, do not have an American counterpart. So are you concerned that we are in the process, we are heading toward putting ourselves at a competitive disadvantage in this area?

Mr. GENSLER. I thank you for the question. I think not just in the margin area, but even more broadly, we have been working actively with international regulators because capital and risk knows no geographic border. It will move somewhere else. On margin, more specifically, we are reaching out and trying with Treasury, the Federal Reserve, and SEC to have an international approach to margin and regimes.

On the specific, on the bank rules, I will defer to Chairman Bernanke because we are only setting margin for the nonbanks.

Senator TOOMEY. Mr. Chairman?

Mr. BERNANKE. Senator, you are absolutely correct that if those margin rules for foreign operations are maintained and Europeans and other foreign jurisdictions do not match it, that that would be a significant competitive disadvantage.

I think the best solution, which we are pursuing with some assiduity, is that we get some kind of global agreement on margin rules for swaps and other instruments. And again, we are working on that. If that does not happen, we will need to think again about how to meet Dodd-Frank's requirements for improved prudential safety, which is what margins are intended to achieve, without disadvantaging our banks in their foreign operations.

So our first choice is to equalize the playing field. If that does not work, we will look at many of the suggestions we received in the comment process to think about how to address that issue.

Senator TOOMEY. I would just like to suggest, it just seems to me that if we do have global uniformity, then that obviates the need for extraterritoriality in our regulations in the first place. And second, with respect to margin requirements of end users, as we all know, that can be very disruptive for the ability of the end user to hedge risks and, therefore, very problematic, and essentially, at the end of the day, it is a credit decision that presumably the banking entities are qualified to make, so——

Mr. GENSLER. Could I just, Senator Toomey, at least in what we have proposed at the CFTC, the nonbank swap dealers would not be required to collect or receive margin from the nonfinancial end users, the commercial companies.

Senator TOOMEY. OK. Great. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you to all the panel.

You know, news reports came out this week from the Associated Press and Reuters that allege that despite the regulators' assurances to us that the banks' illegal robo-signing was being fixed, the practice is still widespread, that it is still going on for both foreclosed homes and also for homes that are not in foreclosure, which basically amounts to forging documents and in some cases wrongfully foreclosing on people, which is why I and 10 of my colleagues, including several Members of this Committee, and a dozen House members, as well, have written to the OCC, the Federal Reserve, and the FDIC urging you that you make the foreclosure reviews and other foreclosure-related documents fully transparent and that you release the results of those reviews on a bank-by-bank basis so the public can evaluate the performance of each bank.

There is a tremendous interest in the public seeing these problems properly resolved, so I want to ask those three agencies—the Fed, the FDIC, and the OCC will you release the results of the foreclosure reviews on a bank-by-bank basis? Will you release the mortgage servicers' action plans that respond to problems in the consent orders? And what about the engagement letters for the supposedly, quote-unquote, "independent" consultants who are hired by the banks themselves to perform the foreclosure reviews of the banks?

Mr. BERNANKE. Well, Senator, we are as concerned about these issues as you are. As you know, we have issued cease and desist orders. We have told the banks that they have to engage independent consultants and we have been making sure that they are independent. They will be providing both supplementary diagnosis over and above the work we have done as well as action plans for the banks. And we will be both reviewing those action plans and the conformity of the banks to those plans.

Our current plan is to provide a report that we will share with you that will explain what the findings were and what the proposals were and what the reactions were and the performance by the banks——

Senator MENENDEZ. But you are not—but, Mr. Chairman, I hate to interrupt you, but I only have less than 5 minutes. You are not going to—I have a specific question. Are you going to release those three entities that I have asked you?

Mr. BERNANKE. May I consult further with my legal and supervisory teams and get back to you on that?

Senator MENENDEZ. Surely. How about the other two agencies?

Mr. WALSH. Senator, we will certainly be, as Chairman Bernanke indicates, releasing more information and the——

Senator MENENDEZ. I have a very—I hate to interrupt you——

Mr. WALSH. Right.

Senator MENENDEZ.——but I have a very specific question and I do not want to be played with. Are you going to release the mortgage servicers' action plans that respond to the consent orders? Are you going to release the foreclosure reviews on a bank-by-bank basis? And are you going to release the engagement letters for the supposedly independent consultants? It is either yes or no.

Mr. WALSH. We will have to evaluate the individual documents——

Senator MENENDEZ. OK.

Mr. WALSH.——and see if there is anything that would be of a confidential supervisory nature, but certainly we will be releasing some information.

Mr. GRUENBERG. Senator, the FDIC is actually not the regulator of any of the servicers, so it is not something within our authority to make that decision.

Senator MENENDEZ. Well, let me just say, I hope you understand—I have the privilege of chairing the Housing Subcommittee here and I hope you understand it is incredibly difficult to create public trust that the companies hired by the banks to perform the foreclosure reviews, and those companies were the same companies who are already doing business with those banks and may get future business. I hope you have a little understanding that the public trust as regulators, when you are assuring us that the problem of the banks illegally forging documents to foreclose on homes more easily has been fixed when news reports allege that the problem has not been fixed and is still widespread.

I am going to share with you the Congressional Research Service analysis that I asked for to see if you had the legal wherewithal to do this, because I figured I would get that as an answer, and their answer is, to synthesize it, is that our request, the regulators have the discretion to release the results on a bank-by-bank basis if they feel it is in the public interest and point out they can surely come to some middle ground when they release a report with high-level bank-by-bank results, like a HAMP report, while still redacting loan level information that would be confidential to banks.

You know, rarely around here do we get 10 members of the Senate to focus on a specific request for information, a dozen members or so of the House of Representatives. I think we need a little transparency in this process. If Dodd-Frank is about anything, at the end of the day, it is about taking and creating transparency and a new era of transparency and openness, and I am going to be like a dog on a bone on this. So I hope we get some good answers here, because otherwise, I am going to use every means possible, along with my colleagues, to get to the bottom of this.

It is not acceptable—it is not acceptable—to violate the law. It is not acceptable to do robo-signings. There is a clear reason why the law dictates a procedure before you take over someone's most cherished, probably their biggest asset in their life, and that is not being pursued correctly. And the agencies that are responsible for that give us assurances that it is, and yet public reports constantly suggest that it is not. So I am looking forward to your responses.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Kirk.

Senator KIRK. Thank you, Mr. Chairman, and once again, congratulations on your 97-to-2 win yesterday on the military VA bill.

Chairman JOHNSON. It was teamwork.

Senator KIRK. That is right.

I want to focus on systemic risk, a central concept behind the legislation, because I am worried that while much of the crisis that the American people suffered from was triggered by Fannie Mae and Freddie Mac, in my view, because it was loaded with politically connected lawyers and lobbyists, the Congress did not reform it. The institutions pretty much with the same cast of rogues is still running it, even though it was triggered, and you guys were not allowed to touch them.

I am worried that, so often, the Government is slow, dead, uninnovative, as opposed to the private sector. And also, you guys are politically controlled by us, by the White House, and not allowed to look at new risks.

One of the risks that I am worried about is the Government Accounting Standards Board recently proposed that Government entities be required to fully disclose unfunded liabilities that they face, particularly with regard to promised pension obligations. In 2009, the Pew Center for the States published a trillion-dollar gap report outlining 21 States that had pension obligations funded at less than the 80 percent actuarial sound requirement that GASBI recommended. Now, this would be totally unacceptable for the public corporations that you are allowed to torture, and I am wondering, because systemic risk is now out there, for Mary, under Dodd-Frank and the Municipal Investment Act advisors that you have, would the SEC now be recommending that municipal debt issuers conform to the GASBI requirement?

Ms. SCHAPIRO. Senator, I would want to make sure I am on strong legal ground here, but let me just say that we have brought some enforcement cases, as you know——

Senator KIRK. To New Jersey and Illinois, where you basically alleged that they were lying to their investors about their——

Ms. SCHAPIRO. New Jersey so far.

Senator KIRK. Right.

Ms. SCHAPIRO. There are a number of others that are still under investigation with respect to the adequacy of their disclosure while they were doing bond issuances. So we have approached it that way. We do not have the authority, although we are preparing a report for Congress to discuss a number of these issues, to mandate particular disclosure requirements for municipal issuers.

And you may know that we have been holding a series of roundtables around the country to gather thoughts of municipalities, Government finance officers, investors, and others to talk about how we might strengthen the municipal disclosure system, among other things. We are actually having a hearing in Birmingham, Alabama, next week, the home of Jefferson County, as we continue to work on these issues. I think GASB took a very important step with respect to their proposal for disclosure of unfunded pension liabilities, but, of course, not everybody is required, as you point out, to utilize GASB GAAP.

Senator KIRK. Right. Thank you. I would just hope you would use your systemic risk authority, because I think that is your big "get out of jail free" card, to look at threats to the U.S. financial system, and I am worried that States are so powerful and so politically connected, you will hold back.

Ms. SCHAPIRO. We will not hold back, but——

Senator KIRK. I am worried.

Second, another central concept behind Dodd-Frank would be too-big-to-fail, and yet what we have seen from 2008 to 2010 is in 2008, the top 10 banks held 48 percent of all domestic banking assets, and in 2010, while the number of banks fell by 3 percent, the top 10 banks' share had grown to 53 percent. That is Bank of America, JPMorgan Chase, CitiBank, Wells Fargo, U.S. Bank, PNC, FIA Card Service, Bank of New York Mellon, HSBC Bank USA, and TD Bank. So they are now even bigger and less capable of failing than they were before Dodd-Frank. Chairman Bernanke, what can we do about that?

Mr. BERNANKE. Senator, you make an obviously important observation. Some of the increase in concentration in the last few years was a byproduct of the events of the crisis. Several medium-sized firms disappeared, some others were acquired, *et cetera.* So it is not necessarily a trend that we are seeing here.

There are a number of aspects of Dodd-Frank which help address too-big-to-fail. Directly, there is the Volcker concentration rule, for example. There is the authority of the Fed not to approve a merger if there are financial stability concerns.

But I think the main issues here are that we are going to have much tighter oversight and prudential regulations over so-called SIFIs, and one thing we have noticed is that banks and other institutions do not want to be SIFIs. They consider it to be this additional burden, an oversight to constrain them. And if it was truly a mark of too-big-to-fail, they might prefer to be designated as SIFIs.

The other thing which I think is absolutely crucial, and it is still a work in progress, in order to get rid of too-big-to-fail, we have to have "fail." We have to have a way for the biggest firms actually to fail. And you have heard some discussion this morning about the Fed's and FDIC's work on the orderly liquidation authority, living wills, *et cetera.* I think it will be a sign of success when we see large firms actually getting themselves smaller to try to get out of some of the oversight, and if we see the costs of funding increasing because the backstop of the Government is not there. We are not there yet, but I do note that some of the rating agencies have been talking about downgrading large banks based on the possible absence of Government support in a crisis.

So we are not there yet. I think we absolutely must get there, and there are many aspects of Dodd-Frank which, if carried to their fruition will help us get rid of too-big-to-fail.

Senator KIRK. Mr. Chairman, thank you.

Chairman JOHNSON. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman. I want to add my welcome to the panel of regulators for our country.

Chairman Schapiro, good to see you again. The Dodd-Frank Act creates the Office of Investor Advocate and it reestablishes the Investor Advisory Committee. I urge you to continue working to get this office and committee up and running. My question to you is what will be done to ensure that the past efforts of the first Investor Advisory Committee will inform and support the work of the Investor Advocate and the reestablished Advisory Committee.

Ms. SCHAPIRO. Thank you, Senator. We are working now to create the new Investor Advisory Committee, having disbanded the prior one so that the new committee could meet the statutory standards. I expect there will be some overlap in committee members, so that will give us a certain amount of continuity. Of course, the new committee will be fully briefed on all the activities of the prior committee. The staff support for the new committee will be largely the same as the staff support was for the prior committee. So I think that we should not have any—we should not miss a beat in terms of transitioning to our new Advisory Committee.

What we will not have yet is the new Investor Advocate Office in place. We have sought reprogramming from our appropriators for that. We received the Senate's authorization for reprogramming just within the last week, so we are now waiting for the House. Once they have authorized it, we can go ahead and establish formally the Office of the Investor Advocate and appoint a person to that position.

But I want to assure you that in the interim, all of the activities that would be engaged in by the Investor Advocate are being carried out by other staff throughout the SEC. We think of ourselves all as investor advocates, so that work is ongoing.

Senator AKAKA. Thank you very much.

Mr. Wolin, one important aspect of consumer protection that is sometimes overlooked is financial empowerment. Through Title XII of the Dodd-Frank Act, we ensured that the viable alternatives to high-cost products and services are developed while protections and oversight are strengthened. Would you please update us on the Treasury's initiatives to improve access to mainstream financial institutions and services.

Mr. WOLIN. Senator Akaka, thank you for that question and for your leadership on these critical issues. From our perspective, the financial access provisions of Dodd-Frank are critical and these are issues that we are spending a lot of time working on. We are busy continuing to develop the infrastructure for our efforts to support community-based efforts at financial access.

We have been working hard at putting together a program called Bank On USA, which allows us to work with communities to develop programs that will enable access in the communities tailored to the particular circumstances in each of those places. Our efforts on this will, of course, require some resources which we have requested and we hope we receive because we think we have, on the basis of Title XII and of work that we have been doing in response, an awful lot of exciting things that we can be doing.

I think, Senator, in addition, you will see in short order from us a further public expression of how we intend to organize and structure our Office of Financial Education and Financial Access, an important office within the Office of the Assistant Secretary for Financial Institutions that will be focused on the Bank On program, but also other efforts in the context of Title XII to continue our work on these critical issues.

Senator AKAKA. Mr. Gruenberg, I have a related question for you, but first, I would like to congratulate you on your nomination. The FDIC has been a leader in working to improve financial access among the unbanked and under-banked. Please explain whether or not you believe that financial inclusion is a component of consumer protection, and what more can be done by the FDIC in this area.

Mr. GRUENBERG. Thank you, Senator. The issue of financial inclusion has been a significant priority for the FDIC, both under former Chairman Bair and myself. We established a number of years ago an advisory committee on financial inclusion made up of community leaders, financial institutions, academics, to focus on this issue.

As a starting point, if I may mention, the FDIC partnered with the Census Bureau on the first national survey ever undertaken by the Census on who is unbanked and under-banked in the United States, just to get a handle on the dimensions of the issue, and the findings of the survey were quite revealing. It found that about 7 percent of U.S. households have no relationship with an insured financial institution and nearly another 18 percent may have an account but utilize high-cost nonbank providers of financial services, such as payday lenders and check cashers. Taken together, the survey found that about a quarter of U.S. households can be defined as unbanked or under-banked.

So it is a substantial issue and it is a critical component both of consumer protection and of economic opportunity. Having an account at an insured institution is really, in many ways, a starting point for economic citizenship, to be able to develop a credit record, build savings, and really become a participant in our economy, and it has been a major priority for us. We have undertaken a number of initiatives in this area, including organizing a series of local partnerships around the country of financial institutions, community organizations, local government leaders to develop local strategies for expanding access to insured financial institutions. We have also developed model transaction and savings accounts to encourage financial institutions to provide low-cost services that are particularly suited to the needs of the unbanked.

This has been a matter of ongoing attention to us and will certainly be a priority going forward.

Senator AKAKA. Thank you very much. Thank you, Mr. Chairman.

Chairman JOHNSON. Thanks again to my colleagues and our panelists for being here today. This hearing and the investor and consumer protection hearings we have held over the past 2 weeks highlight the need for an enhanced regulatory framework after the financial crisis. As I have said before, there is still work ahead of us, but we are making progress and it is important that we all get this right.

The hearing record will be open for 7 days for Members to submit additional materials and questions for the record.

This hearing is adjourned.

[Whereupon, at 12 noon, the Committee was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

EMBARGOED UNTIL DELIVERY

DEPUTY SECRETARY OF THE TREASURY NEAL S. WOLIN
WRITTEN TESTIMONY BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

"Enhanced Oversight after the Financial Crisis: The Wall Street Reform Act at One Year."

July 21, 2011

Chairman Johnson, Ranking Member Shelby, and members of the Committee, I appreciate the opportunity to appear today and discuss the important work that has been done to rebuild and strengthen our financial system over the past year. As this hearing commemorates, one year ago today the President signed into law a comprehensive set of reforms to the financial system, reforms which are essential to making our economy stronger and more resilient.

Those reforms were enacted in the wake of the most devastating financial crisis since the Great Depression.

In the depths of the crisis, the economy lost an average of 800,000 jobs per month. American families saw $5 trillion of household wealth erased in the last three months of 2008. Credit was frozen. Financial markets were barely functioning.

The Administration and its predecessors put in place a comprehensive strategy to repair the financial system. As a result of that strategy, the U.S. financial system today is stronger, more stable, and better able to fuel growth and create jobs.

Many of the weakest parts of the system—the firms that took the most risk—no longer exist or have been significantly restructured. Of the 15 largest financial institutions in the United States before the crisis, only nine remain as independent entities.

Those that survived did so because they were able to raise capital from private investors. The 19 firms that were put through the stress tests have together increased common equity by more than $300 billion since 2008.

The average level of common equity to risk weighted assets across these institutions is now 10 percent, much higher than before the crisis. And the average level of total leverage in these institutions has fallen substantially – from $16 of assets for every dollar of common equity to $11.

These firms are now funded more conservatively, so that they are much less vulnerable to a loss of liquidity during a future downturn. Debt maturing in one year or less at these institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

Assets in the "shadow banking system" are roughly half the level seen in 2007. Funding through tri-party repurchase agreements has fallen 40 percent from its peak in 2007, and asset-backed commercial paper outstanding—which was often used to fund leveraged off-balance sheet vehicles—is a third of where it was in 2007.

Finally, the vast majority of large financial companies that received government support have repaid it—at a positive return to taxpayers. Just two years ago, hundreds of billions in losses were projected on investments in banks. But to date, these investments have returned a total of $10 billion dollars.

These accomplishments were crucial to ending the crisis and providing a basis for growth. But in order to protect our economy and create the conditions for long-term prosperity, we needed to complement this set of changes with comprehensive reform of the financial system. Without reform, any progress our economy made would lack a stable foundation.

As the crisis made clear, prior to the enactment of Dodd-Frank the financial system we had lacked such a foundation, and was weak and susceptible to crisis. The prior system had all too many gaps. Too often it allowed firms to choose their regulators. The prior system did not provide adequate buffers against shock and stress. It did not provide adequate consumer protection. It favored short-term gains for individual firms over the stability and growth of the economy as a whole. And when the system began to fall apart, taxpayers were forced to save it.

We had no choice but to build a better system.

That's why we proposed, Congress passed, and the President signed into law a sweeping set of reforms.

Core Elements of the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act made important and fundamental changes to the structure of the U.S. financial system to strengthen safeguards for consumers and investors and to provide better tools for limiting risk in the major financial institutions and the financial markets. The core elements of the law were designed to build a stronger, more resilient financial system, less vulnerable to crisis, more efficient in allocating financial resources, and less susceptible to fraud and abuse.

These reforms were responsive to the many weaknesses that together nearly brought our financial system to collapse. They include:

- **Tougher constraints on excessive risk-taking and leverage across the financial system.** To lower the risk of failure of large financial institutions and reduce the damage to the broader economy of such failures, Dodd-Frank provided authority for regulators to impose more conservative limits on risk that could threaten the stability of the financial system.

- **Stronger consumer protection**. Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) to concentrate authority and accountability for consumer protection in a single federal agency, with the ability to enforce protections on banks as well as other types of firms involved in the business of consumer finance.

- **Comprehensive oversight of derivatives.** Dodd-Frank created a new regulatory framework for the over-the-counter derivatives market to increase oversight, transparency, and stability in this previously unregulated area.

- **Transparency and market integrity.** Dodd-Frank included a number of measures that increase disclosure and transparency of financial markets, including new reporting rules for hedge funds, trade repositories to collect information on derivatives markets and improved disclosures on asset-backed securities.

- **Orderly liquidation authority.** Dodd Frank created a new orderly liquidation authority to break up and wind down a failing financial firm in a manner that protects taxpayers and the economy.

- **Accountability for stability and oversight across the financial system.** Dodd-Frank established the Financial Stability Oversight Council (FSOC) to coordinate across agencies in monitoring risks and emerging threats to U.S. financial stability, and the Office of Financial Research (OFR) to improve data quality and facilitate access to and analysis of data for the Council and its member agencies.

Financial Stability Oversight Council

The Dodd-Frank Act created the Financial Stability Oversight Council to, among other things, coordinate across agencies, foster joint accountability for the stability of the financial system, identify and monitor risks to U.S. financial stability, respond to emerging threats in the system and promote market discipline. The Dodd-Frank Act also provides the Council with a leading role in several important regulatory decisions, including determining which nonbank financial companies will be subject to consolidated supervision by the Federal Reserve and enhanced prudential standards, and which financial market utilities will be subject to new risk management standards.

The Council has made significant progress in the year since Dodd-Frank was signed into law. Since enactment, the Council has: (1) built its basic organizational framework; (2) laid the groundwork for the designation of nonbank financial companies and financial market utilities; (3) initiated monitoring for potential risks to U.S. financial stability; (4) carried out the explicit statutory requirements of the Council, including the completion of several studies, progress towards rulemakings, and expected near-term release of its annual report; and (5) served as a forum for discussion and coordination among the agencies implementing Dodd-Frank.

Identification of and monitoring threats to financial stability is a cornerstone of the Council's mandate. FSOC principals and their deputies have been actively engaged in the identification and monitoring of current domestic and global risks, such as the European sovereign debt crisis.

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At the FSOC's meeting earlier this week, members discussed their first annual report, which details this monitoring process. As required by statute, the report will: outline the activities of the Council, including any designations or recommendations made with respect to activities that could threaten financial stability; detail significant financial market and regulatory developments, including insurance and accounting regulations and standards; and, describe potential emerging threats to the financial stability of the United States. The report will also include, as required by statute, recommendations to enhance the integrity, efficiency, competitiveness, and stability of the United States financial markets; promote market discipline; and maintain investor confidence. I expect that the report will be released in coming days.

At the meeting, the FSOC also approved a final rule regarding the procedures for designation of financial market utilities (FMU). An FMU designated by the FSOC as systemically important would be subject to the heightened prudential and supervisory provisions of Title VIII of Dodd-Frank. This final rule follows the Council's issuance of an Advanced Notice of Proposed Rulemaking (ANPR) in November of 2010 and a Notice of Proposed Rulemaking (NPR) in March 2011. The Council solicited and reviewed public comment to inform the rule, and provided a transparent process by which interested parties could engage in the rulemaking process.

In addition, the FSOC released its statutorily required study evaluating the potential effect of imposition of haircuts on fully secured creditors of a financial company under the new Title II orderly liquidation authority (OLA). The report concludes that the combination of the OLA and the new prudential supervision of the largest, most interconnected firms under Title I, can be used to address the goals of market discipline and taxpayer protection effectively without the need for secured creditor haircuts.

The FSOC is also actively engaged in of the establishment of effective criteria and procedures for nonbank designations. The Council issued an ANPR in October 2010 and an NPR in January 2010. The FSOC received significant input from interested parties in this rulemaking process in an effort to develop a consistent approach that incorporates both quantitative and qualitative criteria. The Council plans to provide additional guidance regarding the criteria for designations. The guidance will include specific metrics that will help provide clarity on the FSOC's evaluation of firms for potential designation, and will outline both the quantitative and qualitative elements of the analytical framework to be used. The designation process will employ the judgment of the council's members based on a comprehensive understanding of a firm's risks. I anticipate that this proposed guidance will be issued for public comment in the near future.

Office of Financial Research

Dodd-Frank established the Office of Financial Research to improve the quality of financial data available to policymakers and the public, and to facilitate more robust and sophisticated analysis of the financial system.

The search for an OFR Director is ongoing and a high priority for the Administration. The Administration is evaluating candidates based on a combination of strong analytical ability, knowledge about financial markets, management experience, and communication skills. In the interim, Richard Berner, who has been hired as a Counselor to the Treasury Secretary, is leading our efforts to stand-up the office.

The OFR is making progress in the establishment of its research team and network, which will include academics from across the country and in a variety of disciplines. Leading academics and quantitative finance experts are lending their experience and knowledge to help establish the OFR's research operation, including its structure, agenda, and fellowship programs. They also are working on and guiding specific research projects, including those that will support the FSOC's monitoring of risks to the financial system.

We project that by the end of September, the OFR will have about 60 full-time employees. Treasury is committed to providing this implementation team with needed support and guidance, and I, along with other senior Treasury officials, meet with the team weekly to make sure priorities are identified, progress is measured and that the stand-up of the OFR is well-executed.

As the OFR continues to recruit additional highly-qualified individuals to lead and support its work, currently staff are already working with regulators and industry to standardize financial reporting. The OFR's first step in this direction has been to promote the establishment of a legal entity identifier (LEI) system. This public-private initiative, which was launched in November 2010, will create a global standard for the identification of parties to financial transactions. Such a standard will improve the abilities of regulators and firms to manage counterparty risk, assure the integrity of business practices, and lower processing costs for financial transactions.

Over the past few months, the OFR has made great strides in gaining private sector support and global consensus around its LEI initiative. This month, a global coalition of market participants and their members published recommendations for how to best adopt the LEI. U.S. regulators are also working with their international counterparts to develop a consistent approach for the adoption of the LEI. And just earlier this week, the Financial Stability Board released a public statement affirming its support for efforts by financial regulators and industry to establish an LEI, and agreeing to arrange a workshop this fall to discuss the issues that will need to be addressed and on how best to coordinate next steps forward.

In addition to these efforts, OFR staff is supporting the work of the FSOC. This includes providing data and analysis to help develop the analytical framework for FSOC's evaluation of nonbank financial companies for designation and its annual report. The OFR is also working with FSOC member agencies to fulfill data-related requirements from Dodd-Frank. Additionally, the OFR is working with regulators to catalogue the data they already collect to ensure the OFR relies on existing data whenever possible. The OFR will help government get the most out of existing data by facilitating sharing among agencies.

Consumer Financial Protection Bureau

While the FSOC and OFR are designed to help monitor and address risk in the broader financial system, the Consumer Financial Protection Bureau was created to address a specific gap in our regulatory structure—the need for a single agency dedicated to consumer protection.

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Before the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act, consumer financial protection had not been the primary focus of any federal agency, and no agency had effective tools to set the rules for and oversee the whole market. The consumer agency was created to increase government accountability and efficiency by consolidating consumer financial protection authorities that had existed across seven different federal agencies into one. The CFPB will work to make sure that consumers have the information they need to understand the terms of their agreements with financial companies. It will also work to make regulations and guidance as clear and streamlined as possible in order to ease the burden on providers of consumer financial products and services.

In addition to attracting extremely qualified staff from industry, the private sector, and academia, the Bureau has developed an organizational design that will provide the infrastructure needed to meet its responsibilities in the months and years ahead. Key divisions within this structure include:

- consumer engagement and education – to provide, through a variety of initiatives and methods, information to consumers that will allow them to make the decisions that are best for them;
- supervision, fair lending and enforcement – to ensure compliance with federal consumer financial laws by supervising market participants and bringing enforcement actions when appropriate;
- research, markets, and regulations – to understand consumer financial markets and consumer behavior and to evaluate whether there is a need for regulation and the costs and benefits of potential or existing regulations; and
- external affairs – to ensure that the CFPB maintains robust dialogue with various stakeholders that have an interest in its work in order to promote understanding, transparency, and accountability.

The CFPB has received favorable recognition of its stand-up efforts. Notably, the Inspectors General of the Federal Reserve Board and the Department of the Treasury recently issued a strongly positive joint review of the CFPB's stand-up efforts. The report noted that the CFPB identified and documented implementation activities critical to its functions and necessary to address Dodd-Frank requirements. The report found that the CFPB developed and implemented appropriate plans for the transfer occurring today, and that the CFPB communicated this planning and implementation to stakeholders and other consumer regulatory agencies.

Today, the Bureau takes over federal consumer financial supervision of our nation's 111 largest depository institutions and their affiliates. The CFPB supervision program is charged with finding, mitigating, and remedying risks to consumers. Importantly, the CFPB's examination process will strive for transparency, efficiency, and fairness. The Bureau will communicate with institutions throughout its examination cycle, meet with management to discuss findings and conclusions prior to finalizing an exam report, and share aggregate exam findings, including industry guidance, in quarterly public reports

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In May, the CFPB launched the Know Before You Owe project, an effort to combine two federally required mortgage disclosures into a single, simpler form that makes the costs and risks of the loan clear and allows consumers to comparison shop for the best offer. The CFPB began testing two alternate prototype forms that are designed to be given to consumers who have just applied for a mortgage loan. This testing—which will continue in the coming months and involve one-on-one interviews with consumers, lenders, and brokers—will precede and inform the CFPB's formal rulemaking process. The CFPB also has posted the prototypes on its website with an interactive tool to gather public input about the designs.

Under the leadership of Holly Petraeus, a longtime advocate for military families, the CFPB has worked hard to get an early start on helping servicemembers navigate the unique circumstances that affect their finances. Under Holly's leadership, the CFPB has entered into an agreement with the Judge Advocate Generals of all the armed services regarding the protection of servicemembers from financial abuse.

The CFPB has begun second stage testing of a consumer response center. Initially, the consumer response center will assist those with credit card complaints. Over the course of the next year, the Bureau will add more products to the consumer response system. As the CFPB builds its infrastructure, the Bureau will work in coordination with the prudential regulators to address other complaints.

The CFPB released two reports this week, which address issues central to consumer protection, meeting the congressional deadlines set by the Wall Street Reform and Consumer Protection Act. The first study examines the variations between the credit scores sold to creditors and those sold to consumers by certain consumer reporting agencies. The second report focuses on how a consumer's remittance history could be used to enhance her credit score, the impediments to using a consumer's remittance history in this way, and recommendations on ways to maximize transparency and disclosure to consumers of exchange rates used for remittance transfers.

This week, President Obama has nominated Richard Cordray to be the first Director of the CFPB. Mr. Cordray is currently the Chief of Enforcement at the CFPB. Previously, he served as Attorney General of Ohio and earned a reputation as one of America's strongest advocates for the interests of consumers. Prior to his tenure as Ohio's Attorney General, Mr. Cordray developed significant experience in finance and the law while serving as Treasurer and Solicitor General of Ohio, and serving in both the Clinton and Bush Justice Departments. Richard Cordray is an outstanding public servant whose career has centered on fighting for middle class families, and we hope that the Senate will move expeditiously to confirm him.

Challenges Ahead

We face a number of challenges as we move forward to complete reform of our financial system.

- We must continue to move forward, quickly but carefully, to implement the law. Continued progress is crucial to giving financial institutions and markets the clarity they need to do business effectively and help our economy grow. At the same time, we will continue to prioritize quality over speed, and we will take the time we need to get it right.

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- We must make sure our efforts are coordinated. Without coordination, we risk the formation of gaps like those that contributed to the crisis. Coordination will help prevent regulatory arbitrage, and it will also help provide market participants with clarity and consistency. The better job we do of making sure regulations fit together when areas of finance overlap, the easier it will be for everyone to understand them. The Secretary of the Treasury, as Chair of the Financial Stability Oversight Council, believes that coordination among regulators is a top priority.

- We must take care to recognize important distinctions in our financial system. A key objective of reform is to regulate institutions in a manner appropriate to the risks that they pose to the system. A small bank, for example, cannot and should not have to comply with the same set of rules as a large financial firm, and as we implement reform, we will continue to avoid a one-size-fits-all approach.

- We must continue to improve the quality of regulation as we implement Dodd-Frank. In January, President Obama issued an Executive Order directing executive agencies to streamline and simplify regulations, seeking to ensure cost-effective, evidence-based regulations that are compatible with economic growth, job creation, and competitiveness. And this month, the President issued a second Executive Order encouraging each independent regulatory agency to develop a plan under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified, streamlined, expanded, or repealed so as to make the agency's regulatory program more effective or less burdensome in achieving the regulatory objectives. The implementation of comprehensive reform provides financial regulators with a tremendous opportunity. We should therefore work to remove rules that overlap or conflict, ones that are outmoded in today's financial system, and ones that do not make sense in the context of the new law.

- We must continue to work closely with our international partners to create a level playing field and avoid a race to the bottom. Strong international cooperation, with the U.S. playing a leadership role will be central to the success of global reform. In particular, we will continue to promote international consistency in areas such as OTC derivatives, and financial institutions' liquidity, leverage, and capital. We need a high set of global standards, so that risk cannot simply shift to other markets.

- We must make sure that regulators have the funding they need to do their jobs. Cutting funding for regulators, especially at a time when they are charged with putting in place an historic and essential set of reforms, will undermine their ability to protect the financial system and our broader economy. Funding for the regulators is an absolutely necessary insurance policy on our financial health, because the costliest system of all is one that is prone to collapse. We cannot afford not to provide regulators with the resources they need.

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Conclusion

A year ago, in the wake of a catastrophic financial crisis, Congress passed and the President enacted a law to reform our financial system. These reforms were an obligation, not a choice. Without them, we could not build the financial system we need—a financial system with the stability and the resilience necessary to support our economy and protect it in times of stress. Our country needs a financial system that is stronger and more robust, and also promotes innovation, fosters growth, and creates jobs—a system that channels capital effectively to businesses and to consumers.

We do not have to choose between stability and growth. Rather, they are both key ingredients to a healthy economy, and our careful, balanced approach to implementation recognizes the importance of both. But if we are to succeed in creating a system with both strength and dynamism, we must continue to move forward. We must complete our implementation of the Dodd-Frank Act.

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Statement by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 21, 2011

Chairman Johnson, Ranking Member Shelby, and other members of the Committee, thank you for the opportunity to testify on the first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[1]

On this anniversary, it is worth reminding ourselves of why the Congress passed sweeping financial reforms a year ago. The financial crisis of 2008-09 was unprecedented in its scope and severity. Some of the world's largest financial firms collapsed or nearly did so, sending shock waves through the highly interconnected global financial system. Critical financial markets came under enormous stress. Asset prices fell sharply and flows of credit to American families and businesses were disrupted. The crisis, in turn, wreaked havoc on the U.S. and global economies, causing sharp declines in production and trade and putting millions out of work. Extraordinary actions by authorities around the world helped stabilize the situation, but, nearly three years later, the recovery from the crisis in the United States and in many other countries remains far from complete.

In response to the crisis, we have seen a comprehensive re-thinking and reform of financial regulation, both in the United States and around the world. Among the core objectives of both the Dodd-Frank Act and the global regulatory reform effort are: enhancing regulators' ability to monitor and address threats to financial stability, strengthening both the prudential oversight and resolvability of systemically important financial institutions (SIFIs), and improving the capacity of financial markets and infrastructures to absorb shocks. I will briefly discuss each of these objectives.

First, to help regulators better anticipate and prepare for threats to financial stability, legislatures in both the United States and other developed economies have instructed central

[1] An appendix to this testimony provides details on the Federal Reserve's progress in meeting its responsibilities under the Dodd-Frank Act.

banks and regulatory agencies to adopt what has been called a *macroprudential* approach to supervision and regulation--that is, an approach that supplements traditional supervision and regulation of individual firms or markets with explicit consideration of threats to the stability of the financial system as a whole. Under a macroprudential approach, regulators are enjoined not only to look for emerging financial risks but also to try to identify structural weaknesses or gaps in the regulatory system, thereby helping the regulatory framework keep pace with financial innovation and other market developments.

As you know, the Dodd-Frank Act created a council of regulators, the Financial Stability Oversight Council, to coordinate efforts to identify and mitigate threats to U.S. financial stability across a range of institutions and markets. The Council's monitoring efforts are well under way, and this new organization has contributed to what has been a very positive atmosphere of consultation and coordination among its member agencies. The Council is also moving forward with its rulemaking responsibilities, including rules under which it will be able to designate systemically important nonbank financial institutions and financial market utilities for additional supervisory oversight, including by the Federal Reserve. For its part, the Federal Reserve has also made organizational changes to promote a macroprudential approach to regulation. Among these changes is the establishment of high-level, multidisciplinary working groups to oversee the supervision of large, complex banking firms and financial market utilities, with a strong focus on developments that have implications for financial stability. We have also created an Office of Financial Stability Policy and Research to help coordinate our efforts to identify and analyze potential risks to the broader financial system and to serve as liaison with the Council.

A second major objective of financial reform is to mitigate the threats to financial stability posed by the too-big-to-fail problem. Here the Dodd-Frank Act takes a two-pronged approach. The first prong empowers the Federal Reserve to reduce a SIFI's probability of failure through tougher prudential regulation and supervision, including enhanced risk-based capital and leverage requirements, liquidity requirements, single-counterparty credit limits, stress testing, an early remediation regime, and activities restrictions. The Federal Reserve and other agencies face the ongoing challenge of aligning domestic regulations with international agreements, including the Basel III requirements for globally active banks. These efforts are going well; in particular, the Federal Reserve expects to issue proposed rules on the oversight of SIFIs later this summer and, working with other banking agencies, is on schedule to implement Basel III.

Ending too-big-to-fail also requires allowing a SIFI to fail if it cannot meet its obligations--and to do so without inflicting serious damage on the broader financial system. Thus, the second prong of the Dodd-Frank Act's effort to end too-big-to-fail empowers the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) to reduce the effect on the system in the event of a SIFI's failure through tools such as the new orderly liquidation authority and improved resolution planning by firms and supervisors. In particular, the Federal Reserve is working with the FDIC to require SIFIs to better prepare for their own resolution by adopting so-called living wills. A joint final rule on living wills is expected later this summer.

Reducing the likelihood of a severe financial crisis also requires strengthening the resilience of our financial markets and infrastructure--a third major objective of the Dodd-Frank Act. Toward that end, provisions of the act improve the transparency and stability of the over-the-counter derivatives markets and strengthen the oversight of financial market utilities and other critical parts of our financial infrastructure. We and our colleagues at the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other agencies are moving this work forward, in consultation as appropriate with foreign regulators and international bodies. The U.S. agencies are also working together to address structural weaknesses in areas not specifically addressed by the Dodd-Frank Act, such as the triparty repo market and the money market mutual fund industry.

To be sure, any sweeping reform comes with costs and uncertainties. In implementing the statute, the Federal Reserve is committed to the promulgation of rules that are economically sensible, appropriately weigh costs and benefits, protect smaller community institutions, and, most important, promote the sound extension of credit in the service of economic growth and development. A full transition to the new system will require much more work by both the public and private sectors, and no doubt we will learn lessons along the way. However, as we work together to implement financial reform, we must not lose sight of the reason that we began this process: ensuring that events like those of 2008 and 2009 are not repeated. Our long-term economic health requires that we do everything possible to achieve that goal.

Thank you. I would be pleased to take your questions.

Appendix A to statement by
Ben S. Bernanke, Chairman Board of Governors of the Federal Reserve System,
Before the Committee on Banking, Housing, and Urban Affairs U.S. Senate
Washington, D.C., July 21, 2011

As of July 20, 2011

Key Implementation Initiatives of the Board of Governors of the Federal Reserve System Under the Dodd-Frank Wall Street Reform and Consumer Protection Act

The following highlights key initiatives undertaken by the Board of Governors of the Federal Reserve System (Board) in connection with the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). By the one-year anniversary of the Act, the Board expects to have issued or considered nearly twenty-seven rules, three public notices, and nine reports or studies under the Act.

Table 1. Summary of the Board's Rulemaking Efforts Under the Dodd-Frank Act[1]

Seq.	*Description*	*Due*	*Status*
Rulemaking Under Title I			
1.	**Proposed Rule to Establish Certain Definitions Under Title I [R-1405].** On February 8, 2011, the Board issued a proposed rule to define when a nonbank company is "predominantly engaged" in financial activities; and the terms "significant nonbank financial company" and "significant bank holding company." (Section 102)	No Deadline	Comment period closed. Final rule under development.
2.	**Proposed Rule on Resolution Plans (living wills) [R-1414].** On April 12, 2011, the Board and the FDIC issued a joint proposed rule that would require large, systemically significant bank holding companies and nonbank financial companies to submit annual resolution plans and quarterly credit exposure reports. (Section 165)	1/1/2012	Comment period closed. Final rule under development.
3.	**Final Rule to Establish Minimum Risk-Based Capital Requirements (Collins Amendment) [R-1402].** On June 14, 2011, the Board issued a joint final rule, along with the FDIC and the OCC, to establish a floor for the risk-based capital requirements applicable to the largest, internationally active banking organizations. (Section 171)	No Deadline	Completed.

[1] The implementation initiatives highlighted below do not include the Board's rulemaking responsibilities as part of the new Financial Stability Oversight Council, or rulemaking initiatives where the Board serves in a consultative role.

Rulemaking Under Title III			
4.	**Notice of Intent to Require Reporting Forms For Savings and Loan Holding Companies.** On February 3, 2011, the Board provided public notice of its intention to require savings and loan holding companies (SLHCs) to submit the same reports as bank holding companies, beginning with the March 31, 2012 reporting period. (Title III, generally)	No Deadline	Comment period closed.
5.	**Notice Related to Supervision of SLHCs [OP-1416].** On April 15, 2011, the Board issued a public notice that outlines how it intends to apply certain parts of its current consolidated supervisory program for bank holding companies to SLHCs after assuming supervisory responsibility for SLHCs. (Title III, generally)	No Deadline	Comment period closed. Final rule under development.
6.	**Notice of OTS Regulations To Be Continued.** On July 13, 2011, the Board approved public notice of all OTS regulations that it anticipates continuing to enforce. (Section 316)	7/21/11	Completed.
7.	**Interim Final Rule to Amend OTS Regulations.** The Board will soon consider an interim final rule setting forth regulations for SLHCs. The interim final rule has three components: (1) a new Regulation LL, setting forth regulations generally governing SLHCs; (2) a new Regulation MM, setting forth regulations governing SLHCs in mutual form (MHCs); and (3) several technical amendments to current Board regulations necessary to accommodate the transfer of supervisory authority for SLHCs from the OTS to the Board. (Section 312)	No Deadline	Board consideration expected soon.
Rulemaking Under Title VI			
8.	**Final Rule to Allow Interest on Demand Deposits [R-1413].** On July 14, 2011, the Board issued a final rule repealing Regulation Q and allowing payment of interest on demand deposits at institutions that are member banks of the Federal Reserve System. (Section 627)	No Deadline	Completed.

9.	**Proposed Rule on Registration of Securities Holding Companies.** The Board will soon consider a proposed rule that outlines the requirements that a nonbank company that owns at least one registered broker or dealer, and that is required by a foreign regulator or provision of foreign law to be subject to comprehensive consolidated supervision ("securities holding company"), must satisfy in order to register with the Board and subject themselves to supervision by the Board. (Section 618)	No Deadline	Board consideration expected soon.
10.	**Final Rule to Implement the Volcker Rule Conformance Period [R-1397].** On February 9, 2011, the Board issued a final rule to implement the provisions of the Act that give banking firms a period of time to conform their activities and investments to the prohibitions and restrictions of the Volcker Rule. (Section 619(c)(6))	1/21/11	Completed.
Rulemaking Under Title VII			
11.	**Proposed Rule on Margin and Capital Requirements for Swaps [R-1415].** On April 12, 2011, the Board issued a joint proposed rule with the FCA, FDIC, FHFA and OCC to establish margin and capital requirements for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants. The Agencies previously extended the comment period to July 11, 2011, to allow interested persons more time to analyze the issues and prepare their comments. (Sections 731 and 764)	No Deadline	Comment period closed. Final rule under development.
12.	**Proposed Rule on Retail Foreign Exchange Futures and Options.** The Board will soon consider a proposed rule that would permit entities under the Board's jurisdiction to engage in retail foreign exchange futures and options. (Section 742)	No Deadline	Board decision expected soon.
Rulemaking Under Title VIII			
13.	**Proposed Rule on Financial Market Utilities (FMU) Risk Management Standards and Procedures [R-1412].** On March 30, 2011, the Board issued a proposed rule related to the supervision of FMUs designated as systemically important by the Financial Stability Oversight Council. (Sections 801and 806)	No Deadline	Comment period closed. Final rule under development.

Rulemaking Under Title IX			
14.	**Advanced Notice of Proposed Rulemaking on Alternatives to the Use of Credit Ratings in Capital Rules (Regulations H and Y) [R-1391].** On August 10, 2010, the Board issued an advanced notice of proposed rulemaking regarding the alternatives to the use of credit ratings in the risk-based capital rules for banking organizations. (Section 939A)	No Deadline	Proposed rule under development.
15.	**Proposed Rule on Credit Risk Retention [R-1411].** On March 29, 2011, the Board issued a joint proposed rule with five other federal agencies, to implement the credit risk retention requirements applicable in connection with the issuance of asset-backed securities. The agencies have announced the extension of the comment period for the proposed rule to August 1, 2011. This will allow interested persons more time to analyze the issues and prepare their comments. (Section 941)	4/17/11	Comment period extended.
16.	**Proposed Rule on Incentive Compensation [R-1410].** On March 30, 2011, the Board issued a joint proposed rule with the OCC, FDIC, OTS, NCUA, SEC and FHFA to prohibit incentive-based compensation arrangements that encourage inappropriate risk-taking by covered financial companies, and to require the disclosure and reporting of certain incentive-based compensation information by covered financial companies. (Section 956)	4/21/11	Comment period closed. Final rule under development.
Rulemaking Under Title X			
17.	**Proposed Rule on Data Requirements for Motor Vehicle Dealers [R-1426].** On June 20, 2011, the Board issued a proposed rule under Regulation B to clarify that motor vehicle dealers temporarily are not required to comply with certain data collection requirements in Act until the Board issues final regulations to implement the statutory requirements. (Section 1071)	No Deadline	Comment period open.
18.	**Proposed Rules on Remittance Transfers Disclosures (Regulation E) [R-1419].** On May 12, 2011, the Board issued a proposed rule to require that remittance transfer providers make certain disclosures to senders of remittance transfers, including information about fees and the exchange rate, as applicable, and the amount of currency to be received by the recipient. The proposed rule also would provide error resolution and cancellation rights for senders of remittance transfers. (Section 1073)	1/21/12	Comment period closed (rule will transfer to the CFPB).

19.	**Debit Interchange—Final Rules Establishing Interchange Standards and Limitations on Payment Card Restrictions [R-1404].** On June 29, 2011, the Board issued a final rule to establish standards for debit card interchange fees, regulations governing network fees, and prohibitions against network exclusivity arrangements and routing restrictions. The statutory deadline for issuing interchange and network fee rules was April 21, 2011. The final rules to implement the exclusivity and routing restrictions of the Act were not due until July 21, 2011, but have been combined with the rules on interchange fees. (Section 1075)	4/21/11 and 7/21/11	Completed.
20.	**Debit Interchange—Interim Final Rule Regarding Fraud Prevention Adjustment [R-1404].** On June 29, 2011, the Board issued an interim final rule that allows for an upward adjustment of no more than 1 cent to an issuer's debit card interchange fee if the issuer develops and implements policies and procedures reasonably designed to achieve the rule's fraud-prevention standards. (Section 1075)	4/21/11	Completed.
Rulemaking Under Title XI			
21.	**Final Rule to Expand Coverage Under the Truth in Lending Act (Regulation Z) [R-1399].** On March 25, 2011, the Board issued a final rule to require creditors to disclose key terms of consumer loans and prohibit creditors from engaging in certain practices with respect to those loans. (Section 1100(E))	No Deadline	Completed.
22.	**Final Rule to Expand Coverage Under the Consumer Leasing Act (Regulation M) [R-1400].** On March 25, 2011, the Board issued a final rule requiring lessors to provide consumers with disclosures regarding the cost and other terms of personal property leases. (Section 1100(E))	No Deadline	Completed.
23.	**Final Rule to Increase Exemption Threshold Under the Consumer Leasing Act (Regulation M) [R-1423].** On June 13, 2011, the Board issued a final rule under Regulation M (Consumer Leasing) to increase the dollar threshold for exempt consumer lease transactions. These annual adjustments are required by statute. (Section 1100(E))	No Deadline	Completed.

24.	**Final Rule to Increase Exemption Threshold Under the Truth in Lending Act (Regulation Z) [R-1424].** On June 13, 2011, the Board issued a final rule to increase the dollar threshold for exempt consumer credit transactions. These annual adjustments are required by statute. (Section 1100(E))	No Deadline	Completed.
25.	**Final Rule Revising Risk-Based Pricing Notices Under the Fair Credit Reporting Act (FCRA) (Regulation V) [R-1407].** On July 6, 2011, the Board and the FTC issued a joint final rule to revise the content requirements for risk-based pricing notices and to add related model forms to reflect the new credit score disclosure requirements. (Section 1100F)	No Deadline	Completed.
26.	**Final Rule Implementing Combined FCRA Notices Under the Equal Credit Opportunity Act (Regulation B) [R-1408].** On July 6, 2011, the Board issued a final rule amending Regulation B to include the disclosure of credit scores and related information if a credit score is used in taking adverse action. The revised model notices reflect the new content requirements in section 615(a) of the FCRA, as amended by section 1100F of the Act. (Section 1100F)	No Deadline	Completed.
Rulemaking Under Title XIV			
27.	**Proposed Rule on Escrow Account Requirements Under the Truth in Lending Act (Regulation Z) [R-1406].** On February 23, 2011, the Board issued a proposed rule to expand the minimum period for mandatory escrow accounts for first-lien, higher-priced mortgage loans from one to five years, and longer under certain circumstances; provide an exemption from the escrow requirement for certain creditors that operate in rural or underserved counties; and implement new disclosure requirements contained in the Act. (Sections 1411, 1412 and 1414)	1/21/13	Comment period closed (rule will transfer to the CFPB)
28.	**Proposed Rule Regarding Ability to Repay Under the Truth In Lending (Regulation Z) [R-1417].** On April 19, 2011, the Board issued a proposed rule under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards. The proposal would also implement the Act's limits on prepayment penalties. The Board is soliciting comment on the proposed rule until July 22, 2011. (Sections 1411, 1412 and 1414)	1/21/13	Comment period open (rule will transfer to the CFPB)

29.	**Final Rule on Escrow Requirements Under the Truth in Lending Act (Regulation Z) [R-1392].** On February 23, 2011, the Board issued a final rule to increase the annual percentage rate threshold used to determine whether a mortgage lender is required to establish an escrow account for property taxes and insurance for first-lien "jumbo" residential mortgage loans, effective April 1, 2011. (Section 1461)	1/21/13	Completed.
30.	**Interim Final Rule on Appraisal Independence (Regulation Z) [R-1394].** On October 18, 2010, the Board issued an interim final rule that is intended to ensure that real estate appraisers are free to use their independent professional judgment in assigning home values without influence or pressure from those with interests in the transactions. (Section 1472)	10/19/10	Completed.

Table 2. Reports and Studies Under the Dodd-Frank Act

Seq.	*Description*	*Due*	*Status*
1.	**Study of the Impact of Credit Risk in Securitization Markets.** On October 19, 2010, the Board issued a report on the potential impact of credit risk retention requirements on securitization markets. (Section 941)	10/19/10	Completed.
2.	**Report on OTS Transition Plan.** On January 25, 2011, the Board, OTS, OCC, and FDIC issued a joint report to Congress and the Inspectors General of the participating agencies on the agencies' plans to implement the transfer of OTS authorities. (Section 327)	1/20/11	Completed.
3.	**Report on Debit Card Transactions.** On June 29, 2011, the Board issued a report disclosing certain aggregate or summary information concerning interchange transaction and payment card network fees charged or received in connection with electronic debit transactions. (Section 1075)	7/21/11	Completed.
4.	**Study of the Resolution of Financial Companies under the Bankruptcy Code.** The Board has approved and will issue soon a study the Board has conducted, in consultation with the Administrative Office of the U.S. Courts, related to the resolution of financial companies under the Bankruptcy Code. (Section 216)	7/21/11	Completed.

5.	**Study of International Coordination Relating to the Resolution of Systemic Financial Companies.** The Board has approved and will issue soon a study the Board has conducted, in consultation with the Administrative Office of the U.S. Courts, regarding international coordination relating to the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign law. (Section 217)	7/21/11	Completed.
6.	**Report on Remittance Transfers: Automated Clearing House Expansion (ACH).** On July 19, 2011, the Board approved a report to Congress on the status of ACH expansion for remittance transfers to foreign countries. (Section 1073)	7/21/11	Completed.
7.	**Report on Designated Clearing Entities.** The Board, CFTC and SEC have approved and soon will issue a joint report to Congress containing recommendations for promoting robust risk management standards and consistency in the supervisory programs of the CFTC and SEC for designated clearing entities. (Section 813)	7/21/11	Completed.
8.	**Report on the Use of Credit Ratings in the Board's Rules.** The Board will issue soon a report to Congress discussing the review the Board has conducted on the use of credit ratings in its regulations and sometime thereafter report to Congress. (Section 939A)	7/21/11	Expected Soon.
9.	**Report on Government Prepaid Cards.** The Board soon will issue a report to Congress on the use of prepaid cards by government authorities, and the interchange transaction and cardholder fees charged with respect to such prepaid cards. (Section 1075)	7/21/11	Expected Soon.

Table 3. Other Implementation Initiatives Under the Dodd-Frank Act

Seq.	*Description*	*Due*	*Status*
1.	**Assistance to the Financial Stability Oversight Council (FSOC).** The Board has been providing significant support to the FSOC. The Board continues to assist the FSOC in designing its systemic risk monitoring and evaluation process and in developing its analytical framework and procedures for identifying systemically important nonbank firms and FMUs. The Board also has contributed significantly to the FSOC's recent studies and reports. (Title I, generally)	Various deadlines	Ongoing.
2.	**OTS Transition Initiatives.** The Board has made substantial progress in its plans relating to the transfer of the supervisory authority of the OTS for SLHCs to the Board. (Title III, generally)	Transfer date is 7//21/11	Ongoing.
3.	**Establishment of the Consumer Financial Protection Bureau (CFPB).** The Board has established a transition team, headed by Governor Duke, to work closely with staff at the CFPB and at the Treasury Department to facilitate the transition. The Board has provided technical assistance as well as staff to the CFPB to assist it in setting up its functions. The Board has finalized an initial funding agreement and provided initial funding to the CFPB. Moreover, the Board has made substantial progress toward a framework for transferring Federal Reserve staff to the CFPB and integrating CFPB employees into the relevant Federal Reserve benefit programs. (Title X, generally)	Transfer date is 7/21/11	Ongoing.
4.	**Federal Reserve Governance, Transparency and Audit Initiatives.** On December 1, 2010, the Board provided detailed information on its public website about more than 21,000 individual credit and other transactions conducted during the financial crisis. The Board also has provided on its public website certain audit and related financial information, including audit reports, financial statements and reports to Congress on the Board's facilities under Section 13(3) of the Federal Reserve Act. (Sections 1109 and 1103)	12/1/10 for certain disclosures	Ongoing.
5.	**Office of Minority and Women Inclusion.** The Board and the Federal Reserve Banks each have established a formal Office of Minority and Women Inclusion to consolidate and build on existing equal opportunity and contracting resources. (Section 342)	1/21/11	Offices established. Initiative ongoing.

Testimony on
"Enhanced Oversight After the Financial Crisis: The Wall Street Reform Act at One Year"
by
Chairman Mary L. Schapiro
U.S. Securities and Exchange Commission

Before the United States Senate Committee on Banking, Housing and Urban Affairs

July 21, 2011

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

Thank you for inviting me to testify on the occasion of the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act").[1]

This landmark legislation set out to reshape the U.S. regulatory landscape, reduce systemic risk and help restore confidence in the financial system. Among other things, the Act brings hedge fund and other private fund advisers under the regulatory umbrella of the Investment Advisers Act, creates a new whistleblower program, establishes an entirely new regime for the over-the-counter ("OTC") derivatives market, enhances the SEC's authority over nationally recognized statistical rating organizations ("NRSROs") and clearing agencies, and heightens regulation of asset-backed securities ("ABS").

To help fulfill its objective, the Act directs the SEC to write a large number of rules necessary to implement the Act and, over the past year, the SEC has accomplished much. Of the more than 90 mandatory rulemaking provisions, the SEC already has proposed or adopted rules for more than two-thirds of them -- not including rules stemming from the dozens of other provisions that give the SEC discretionary rulemaking authority. Additionally, the SEC has finalized ten of the more than twenty studies and reports that it is required to complete under the Act. While the Commission has voted unanimously on the vast majority of these rules and studies, specific rules, proposals and studies have generated robust debate among Commissioners. Even in the instances where the votes were not unanimous, the diverse views and input from Commissioners has benefited and strengthened the work product as we try to develop the best possible rules.

While we have had much success, we are continuing to work diligently to implement all provisions of the Act for which we have responsibility – even as we continue to perform our longstanding core responsibilities. Indeed, we are well on our way to completing the rulemakings and studies assigned to us under the Act.

In my prior testimony before this Committee on Dodd-Frank Act implementation, I outlined our efforts to modernize our internal processes to enable us to better accomplish both our preexisting responsibilities and those added by the Act. Among others, these efforts include the creation of new cross-disciplinary working groups; our focus on increasing transparency, consultation and

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

public input; and the forging and strengthening of collaborative relationships with other federal regulators and our international counterparts. To date, we have participated in scores of interagency and working group meetings, conducted five public roundtables, met with hundreds of interested groups and individuals including investors, academics and industry participants, and received, reviewed and considered thousands of public comments.

While some feel we are moving too quickly and others feel we are not moving rapidly enough, I believe we are proceeding at a pace that ensures we get the rules right. And, provided the SEC receives the appropriate funding and uses its resources effectively and efficiently, we will be able to successfully implement those rules and help further protect investors, as the law intended.

The progress we have made so far is the result of the exceptional work of my fellow Commissioners and our staff, whose extraordinary efforts have enabled us to accomplish so much in a relatively short time. While the Dodd-Frank Act added significantly to their workload, they have been implementing the Act in a thoughtful, thorough, and professional manner.

My testimony today will provide an overview of these activities, emphasizing the Commission's efforts since the Committee's Dodd-Frank Act implementation hearing in February.

Hedge Fund and Other Private Fund Adviser Registration and Reporting

The Commission already has completed a suite of rulemaking under the many Dodd-Frank Act amendments to the Investment Advisers Act of 1940 ("Advisers Act"). Those rules require registration and reporting by investment advisers to hedge funds and other private funds.

Several of those rules, adopted by the Commission on June 22, 2011, become effective today, including rules that:

- require the registration of, and reporting by, advisers to hedge funds and other private funds and other advisers previously exempt from SEC registration;
- require reporting by investment advisers relying on certain new exemptions from SEC registration; and
- reallocate regulatory responsibility to the state securities authorities for advisers that have between \$25M and \$100M in assets under management.[2]

The three new Advisers Act exemptions from registration include: (i) advisers solely to venture capital funds; (ii) advisers solely to private funds with less than \$150 million in assets under management in the U.S.; and (iii) certain foreign advisers without a place of business in the U.S. and with only a de minimis amount of U.S. business.[3] The Commission also approved a rule

[2] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act* (June 22, 2011), http://www.sec.gov/rules/final/2011/IA-3221.pdf.

[3] *See* Release No. IA-3222 *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers* (June 22, 2011), http://www.sec.gov/rules/final/2011/IA-3222.pdf.

defining "family offices" – a group that historically has not been required to register as advisers – that excludes private advisers to a single family from the definition of investment adviser.[4] The Commission also defined "venture capital fund" as required by the Act.

As a result of these rules, both regulators and the public will have access to identifying data and an operational overview of private fund advisers and the hedge funds and other funds they manage.

In addition, on January 26, 2011, in a joint release with the CFTC, the Commission proposed a new rule that would require hedge fund advisers and other private fund advisers to report systemic risk information on a new form – Form PF.[5] This new form requires the non-public reporting of information about private funds managed by advisers for the purpose of the assessment of systemic risk by the Financial Stability Oversight Council ("FSOC"), as provided in Title IV of the Dodd-Frank Act.

Also, this month, the Commission issued an order that raises, to adjust for inflation, the dollar amount thresholds in Rule 205-3 under the Advisers Act, that determine whether an investment adviser can charge its clients performance-based compensation.[6] The Commission also has proposed related amendments to the rule that would specify the method for calculating future inflation adjustments of these dollar amount thresholds, and exclude the value of a client's primary residence from the calculation of net worth.[7]

Staff Studies Regarding Investment Advisers and Broker-Dealers

In January, the Commission submitted to Congress two staff studies in the investment management area as required under the Dodd-Frank Act.

The first study, mandated by Section 914, analyzed the need for enhanced examination and enforcement resources for investment advisers that are registered with the Commission.[8] It found that the Commission likely will not have sufficient capacity in the near or long term to

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[4] *See* Release No. IA-3220, *Family Offices* (June 22, 2011), http://www.sec.gov/rules/final/ia-3220.pdf.

[5] *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.

[6] *See* Release No. IA-3236 (July 12, 2011).

[7] *See* Release. No. IA-3198, *Investment Adviser Performance Compensation*, (May 10, 2011), http://www.sec.gov/rules/proposed/2011/ia-3198.pdf.

[8] *See Study on Enhancing Investor Adviser Examinations* (January 2011), http://www.sec.gov/news/studies/2011/914studyfinal.pdf; *see also* Commissioner Elisse B. Walter, Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2010), http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.

conduct effective examinations of registered investment advisers with adequate frequency. Therefore, the study stated that the Commission's examination program requires a source of funding that is adequate to permit the Commission to meet new examination challenges and sufficiently stable to prevent adviser examination resources from continuously being outstripped by growth in the number of registered investment advisers.

The study highlighted the following three options to strengthen the Commission's investment adviser examination program: (1) imposing user fees on Commission-registered investment advisers to fund their examinations; (2) authorizing one or more self-regulatory organizations that assess fees on their members to examine, subject to Commission oversight, all Commission-registered investment advisers; or (3) authorizing FINRA to examine a subset of advisers – i.e., dually registered investment advisers and broker-dealers – for compliance with the Advisers Act.

The second staff study, as required by Section 913 of the Dodd-Frank Act, addressed the obligations of investment advisers and broker-dealers.[9] This study reviewed the broker-dealer and investment adviser industries, the regulatory landscape surrounding each, issues raised by stakeholders who commented during the preparation of the report, and other considerations.

The study made two primary recommendations: that the Commission (1) exercise its discretionary rulemaking authority to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they are providing personalized investment advice about securities to retail investors; and (2) consider harmonization of broker-dealer and investment adviser regulation when broker-dealers and investment advisers provide the same or substantially similar services to retail investors and when such harmonization adds meaningfully to investor protection.

Under Section 913, the uniform fiduciary standard to which broker-dealers and investment advisers would be subject would be "no less stringent" than the standard that applies to investment advisers today.

As the study notes, the distinction between an investment adviser and a broker-dealer is often lost on investors and it remains difficult to justify why there should be different rules and standards of conduct for the two roles – especially when the same or substantially similar services are being provided. Investment professionals' first duty must be to their clients, and we look forward to implementing the study's recommendations.

Whistleblower Program

Section 922 of the Dodd-Frank Act established a whistleblower program that requires the SEC to pay an award to eligible whistleblowers who voluntarily provide the agency with original

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[9] *See Study on Investment Advisers and Broker-Dealers* (January 2011), http://www.sec.gov/news/studies/2011/913studyfinal.pdf; *see also* Statement by SEC Commissioners Kathleen L. Casey and Troy A. Paredes Regarding Study on Investment Advisers and Broker-Dealers (January 21, 2011), http://www.sec.gov/news/speech/2011/spch012211klctap.htm.

information about a violation of the federal securities laws that leads to the successful enforcement of an SEC action.

In May, the Commission adopted final rules to implement the new program.[10] The rules outline the process by which individuals can apply for awards, describe the Commission's procedures for making decisions on claims, generally explain the scope of the whistleblower program to the public and define certain critical terms.

There were many complex policy considerations associated with the promulgation of these rules. These included, for example, whether the program should reward culpable whistleblowers who participated in the alleged misconduct, and whether the rules should require employees to first report possible violations through their employer's internal compliance procedures before coming to the SEC. The Commission's proposed rules provoked strongly held and diverse views on these and a number of other significant topics. The proposal underwent a robust comment process, which included hundreds of comment letters from various interested constituencies including whistleblower advocacy groups, public companies, corporate compliance personnel, professional associations, and individual investors.

Perhaps the most vigorously-debated issue was the effect of the whistleblower program on internal corporate compliance processes. Many advocated that the Commission require whistleblowers to report violations through their employers' internal compliance systems before or at the same time they report to the SEC in order to qualify for an award. After careful consideration, the Commission concluded that an absolute requirement that whistleblowers report internally to qualify for an award would be detrimental to the SEC's enforcement program.

Requiring whistleblowers to first reveal incriminating information to the very persons they may be suggesting acted unlawfully would significantly decrease the likelihood of whistleblowers coming forward. That is why the rules leave the decision as to whether or not to report internally in the hands of the person best equipped to make that decision – the whistleblower, considering the circumstances of his or her individual situation. But, recognizing the significant value that effective corporate compliance programs deliver in identifying, remediating, and deterring wrongdoers, the rules include a number of provisions designed to incentivize whistleblowers to utilize their companies' internal compliance and reporting systems, when appropriate, by increasing the likelihood and potential recovery for an award in instances where a whistleblower chooses to report internally first.

The whistleblower rules reflect a thoughtful and thorough weighing of the comments that were received and a careful balancing of these and many other important policy considerations. Although it is too early to assess the impact of our new whistleblower program, the agency is already seeing the effects of the whistleblower provisions in the quality of tips we are getting. While the SEC has a history of receiving high volumes of tips and complaints, the quality of the tips has improved since the enactment of Section 922, and this trend is expected to continue.

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[10] *See* Release No. 34-64545, *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934* (May 25, 2011), http://www.sec.gov/rules/final/2011/34-64545.pdf.

Section 924 of the Dodd-Frank Act also required the SEC to establish an office to administer the whistleblower program. The new Office of the Whistleblower is now staffed and busy reviewing whistleblower complaints. Due to budgetary constraints, the office has been staffed by detailing current Commission staff from their normal responsibilities until we can hire permanent staff.

Additional Investor Protection Provisions

Nationwide Service of Process: The SEC is seeing the benefits of the many other enforcement-related investor protection provisions contained in the Dodd-Frank Act. For example, Section 929E allowed for nationwide service of process so that the SEC can compel a witness to appear at trial anywhere in the United States. Already, this authority has enabled our trial team to subpoena and present witnesses' live testimony, and ultimately prevail, in the recent *SEC v. Delphi* trial.

Live testimony can be invaluable in litigating securities law violations, which often turn on the credibility of those testifying. Our trial teams have also used the new provision to subpoena documents, which enables them to more efficiently present documentary evidence.

Collateral Bars: With respect to new sanctions available to the Commission, the Dodd-Frank Act provides the SEC with the authority to bar or suspend persons -- who have engaged in misconduct in one industry that the Commission regulates -- from other industries that the Commission regulates. Since the enactment of Section 925, the Commission has used this "collateral bar" authority to impose broad prophylactic relief to provide more effective protection to investors.

In one example, the Commission last month imposed cross-industry sanctions against a Swiss trader employed by a registered broker-dealer and investment adviser for engaging in insider trading that netted him illegal profits of almost $1.2 million.[11] Prior to the enactment of Dodd-Frank, the Commission would have been able to bar the respondent from the broker-dealer industry, but it would not have been able to similarly protect investors in any of the other industries we regulate. Using the new authority, the Commission was able to extend the protection to other vulnerable investors by barring the respondent from associating with any broker, dealer, investment adviser, municipal securities dealer, transfer agent, municipal advisor, or nationally recognized statistical ratings organization.

In another example, just last week, the Commission sanctioned an unregistered broker for his role in an offering fraud and Ponzi scheme that raised at least $2.5 million from approximately 75 investors.[12] Under Section 925, the Commission was able to bar this person from associating with any transfer agent, broker, dealer, investment adviser, municipal securities dealer, municipal advisor, or nationally recognized statistical rating organization.

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[11] *See In the Matter of Giuseppe Tullio Abatemarco, Release No. 34-64600 (June 3, 2011) (http://www.sec.gov/litigation/admin/2011/34-64600.pdf).*

[12] *See In the Matter of Gregory D. Wood, Release No. 34-64873 (July 13, 2011) (http://www.sec.gov/litigation/admin/2011/34-64873.pdf).*

Penalties in Cease and Desist Proceedings: The Commission also has used the authority granted in Dodd-Frank Section 929P(a) to impose penalties in administrative cease and desist actions against non-regulated individuals and entities. Although the Commission could impose penalties against regulated persons administratively prior to Dodd-Frank, it could obtain penalties against non-regulated persons only in enforcement actions filed in district court. The Act now permits the Commission to obtain penalties against non-regulated violators of the federal securities laws in either forum.

In one recent example of our exercise of this authority, the Commission imposed a $200,000 administrative penalty against Hudson Highland Group, Inc. for its failures to maintain appropriate internal controls and books and records relating to its sales tax liabilities that resulted in a $3.9 million tax liability for the corporation.[13] Prior to the Dodd-Frank Act, the Commission would not have been able to impose a penalty against Hudson in a cease-and-desist proceeding; that sanction would only have been available in a district court action. Accordingly, to obtain full relief, the Commission would have had to either file the entire action in district court or, alternatively, file two separate actions – one administrative and one civil. With the new authority granted in Section 929P(a), the Commission no longer has to file multiple actions or abandon what may be the more appropriate forum in order to obtain an appropriate penalty.

Greater Access to Foreign Papers: The Dodd-Frank Act's amendments to Sarbanes-Oxley Section 106 require foreign accounting firms that perform work for a domestic registered public accounting firm to designate an agent for service of process to allow both the SEC and the PCAOB to serve requests for documents and enforcement pleadings that may arise out of a violation of Section 106. This provision, which has aided our enforcement efforts, resolves a significant impediment to ensuring that the SEC will have the ability to serve requests for documents expeditiously.

OTC Derivatives

Among the key provisions of the Dodd-Frank Act are those that will establish a new oversight regime for the OTC derivatives marketplace. Title VII of the Act requires the SEC to work with other regulators – the Commodity Futures Trading Commission ("CFTC") in particular – to write rules that:

- Address, among other things, mandatory clearing, the operation of trade execution facilities and data repositories, business conduct standards for certain market intermediaries, capital and margin requirements, and public transparency for transactional information;
- Improve transparency and facilitate the centralized clearing of swaps, helping, among other things, to reduce counterparty risk and systemic risk that results from exposures by market participants to uncleared swaps;
- Enhance investor protection by increasing security-based swap transaction disclosure and helping to mitigate security-based swap conflicts of interest; and

[13] *See In the Matter of Hudson Highland Group, Inc., Release No. 34-63688 (Jan. 10, 2011) (http://www.sec.gov/litigation/admin/2011/34-63688.pdf).*

- Allow the OTC derivatives market to continue to develop in a more transparent, efficient, and competitive manner.

Title VII Implementation to Date

To date, the SEC has proposed rules in twelve areas required by Title VII:

- Rules prohibiting fraud and manipulation in connection with security-based swaps;[14]
- 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;[15]
- Rules regarding the obligations of security-based swap data repositories that would require them to register with the SEC and specify the extensive confidentiality and other requirements with which they must comply;[16]
- Rules relating to mandatory clearing of security-based swaps that would establish a process for clearing agencies to provide information to the SEC about security-based swaps that the clearing agencies plan to accept for clearing;[17]
- 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 Act, to notify the SEC of how they generally meet their financial obligations when engaging in security-based swap transactions exempt from the mandatory clearing requirement;[18]
- 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 Act;[19]
- Joint rules with the CFTC regarding the definitions of swap and security-based swap dealers, and major swap and security-based swap participants;[20]

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[14] *See* Release No. 34-63236, *Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps* (November 3, 2010), http://www.sec.gov/rules/proposed/2010/34-63236.pdf.

[15] *See* Release No. 34-63346, *Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63346.pdf.

[16] *See* Release No. 34-63347, *Security-Based Swap Data Repository Registration, Duties, and Core Principles* (November 19, 2010), http://www.sec.gov/rules/proposed/2010/34-63347.pdf.

[17] *See* Release No. 63557, *Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63557.pdf.

[18] *See* Release No. 34-63556, *End-User Exception of Mandatory Clearing of Security-Based Swaps* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63556.pdf.

[19] *See* Release No. 34-63825, *Registration and Regulation of Security-Based Swap Execution Facilities* (February 2, 2011), http://www.sec.gov/rules/proposed/2011/34-63825.pdf.

- 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;[21]
- Rules regarding certain standards that clearing agencies would be required to maintain with respect to, among other things, their risk management and operations;[22]
- Joint rules with the CFTC regarding further definitions of the terms "swap", "security-based swap," and "security-based swap agreement"; the regulation of mixed swaps; and security-based swap agreement recordkeeping;[23]
- Rules regarding business conduct that would establish certain minimum standards of conduct for security-based swap dealers and major security-based swap participants, including in connection with their dealings with "special entities", which include municipalities, pension plans, endowments and similar entities;[24] 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.[25]

The Commission also adopted an interim final rule regarding the reporting of outstanding security-based swaps entered into prior to the date of enactment of the Dodd-Frank Act.[26] This interim final rule notifies certain security-based swap dealers and other parties of the need to preserve and report to the SEC or a registered security-based swap data repository certain information pertaining to any security-based swap entered into prior to the July 21, 2010 passage of the Dodd-Frank Act and whose terms had not expired as of that date.

In addition, in order to facilitate clearing of security-based swaps, the Commission proposed rules providing exemptions under the Securities Act, the Exchange Act, and the Trust Indenture

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[20] *See* Release No. 34-63452, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap participant" and "Eligible Contract Participant"* (December 7, 2010), http://www.sec.gov/rules/proposed/2010/34-63452.pdf.

[21] *See* Release No. 34-63727, *Trade Acknowledgment and Verification on Security-Based Swap Transactions* (January 14, 2011), http://www.sec.gov/rules/proposed/2011/34-63727.pdf.

[22] *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 2, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

[23] *See* Release No. 33-9204, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (April 27, 2011), http://www.sec.gov/rules/proposed/2011/33-9204.pdf.

[24] *See* Release No. 34-64766, *Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants* (June 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64766.pdf.

[25] *See* Release No. 34-63107, *Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC* (October 14, 2010), http://www.sec.gov/rules/proposed/2010/34-63107.pdf.

[26] *See* Release No. 34-63094, *Reporting of Security-Based Swap Transaction Data* (October 13, 2010), http://www.sec.gov/rules/interim/2011/34-63094.pdf.

Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions.[27] We also readopted certain of our beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.[28]

Next Steps for Implementation of Title VII

While the Commission has made significant progress to date, much remains to be done to fully implement Title VII. First, there is a need to complete the core elements of our proposal phase, focusing in particular on rules related to the registration and financial responsibility of security-based swap dealers and major security-based swap participants.

In addition, because the OTC derivatives market has grown to become a truly global market in the last three decades, we must continue to evaluate carefully the international implications of Title VII. Rather than deal with these implications piecemeal, we intend to address the relevant international issues holistically in a single proposal. The publication of such a proposal would 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.

More broadly, the SEC has been working with our fellow regulators and with market participants to consider implementation timeframes that are reasonable for the various rulemakings, and we are reviewing what steps market participants will need to take in order to comply with our proposed rules. These discussions are vital to establishing a coordinated implementation timeline that is workable.

After proposing all of the key rules under Title VII, we intend to seek public comment on a detailed implementation plan that will permit a roll-out of the new securities-based swap requirements in logical, progressive, and efficient manner, while minimizing unnecessary disruption and costs to the markets. Implementing the new rules through a coherent and sequenced plan should help avoid undue delay in the creation of a more sound foundation for the regulatory oversight of the OTC derivatives market.

Steps to Address the Effective Date of Title VII

As the Commission continues to move forward with the implementation of Title VII, it has taken a number of steps to provide legal certainty and avoid unnecessary market disruption that might otherwise have arisen as a result of final rules not having been enacted by the July 16 effective date of Title VII. Specifically, we:

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[27] *See* Release No. 33-9222, *Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies* (June 9, 2011), http://www.sec.gov/rules/proposed/2011/33-9222.pdf.

[28] *See* Release No. 34-64628, *Beneficial Ownership Reporting Requirements and Security-Based Swaps* (June 8, 2011), http://www.sec.gov/rules/final/2011/34-64628.pdf.

- Provided guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date and provided temporary relief from several of these provisions;[29]
- Provided guidance regarding – and where appropriate, interim exemptions from – the various pre-Dodd-Frank provisions that would otherwise have applied to security-based swaps on July 16;[30] and
- Took 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.[31]

Clearing Agencies

Title VIII of the Dodd-Frank Act provides for increased regulation of financial market utilities and financial institutions that engage in payment, clearing and settlement activities that are designated as systemically important. Clearing agencies play a critical role in the financial markets by ensuring that transactions settle on time and on agreed-upon terms. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability.

To help ensure the integrity of clearing agency operations and governance, the Commission proposed certain enhanced requirements for clearing agencies.[32] Specifically, the proposed rules would require clearing agencies to maintain certain standards with respect to risk management and operations, have adequate safeguards and procedures to protect the confidentiality of trading information, have procedures that identify and address conflicts of interest, require minimum governance standards for boards of directors, designate a chief compliance officer, and disseminate pricing and valuation information if the clearing agency performs central counterparty services for security-based swaps. Many of the proposed requirements would apply to all clearing agencies, while others would focus more specifically on clearing agencies that clear security-based swaps.

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[29] *See* Release No. 34-64678, *Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps* (June 15, 2011), http://www.sec.gov/rules/exorders/2011/34-64678.pdf.

[30] *See* Release No. 34-64795, Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment (July 1, 2011), http://sec.gov/rules/exorders/2011/34-64795.pdf; and Release No. 33-9231, Exemptions for Security-Based Swaps (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9231.pdf.

[31] *See* Release No. 34-64796, Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions from Clearing Agency Registration Requirements under Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps (July 1, 2011), http://sec.gov/rules/exorders/2011/34-64796.pdf; and Release No. 33-9232 Extension of Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps (July 1, 2011) http://www.sec.gov/rules/interim/2011/33-9232.pdf.

[32] *See* Release No. 34-64017, *Clearing Agency Standards for Operation and Governance* (March 3, 2011), http://www.sec.gov/rules/proposed/2011/34-64017.pdf.

The proposal was the result of close work between the Commission staff and staffs of the CFTC and the Federal Reserve Board ("Board"). The proposed requirements are consistent with – and build on – current international standards, and they are designed to further strengthen the Commission's oversight of securities clearing agencies, promote consistency in the regulation of clearing organizations generally, and thereby help to ensure that clearing agency regulation reduces systemic risk in the financial markets.

In addition, as directed by Title VIII, the SEC staff worked jointly with the staffs of the CFTC and the Board over the past year to develop a report to Congress reflecting recommendations regarding risk management supervision of clearing entities designated as systemically important by the FSOC – each called a "designated clearing entity" or "DCE". The staffs of the agencies met regularly and engaged in constructive dialogue to develop a framework for improving consistency in the DCE oversight programs of the SEC and CFTC, promoting robust risk management by DCEs, promoting robust risk management oversight by DCE regulators, and improving regulators' ability to monitor the potential effects of DCE risk management on the stability of the financial system of the United States. The joint report recommended finalizing rulemakings to establish enhanced risk management for DCEs, formalizing the process for consultations and information sharing regarding DCEs, enhancing DCE examinations, and developing ongoing consultative mechanisms to promote understanding of systemic risk. The report should establish a strong framework for ongoing consultation and cooperation in clearing agency oversight among the Commission, the CFTC, and the Board, which in turn should help to mitigate systemic risk and promote financial stability.

Credit Rating Agencies

Under the Dodd-Frank Act, the Commission is required to undertake approximately a dozen rulemakings related to NRSROs. The Commission adopted the first of these required rulemakings in January, and in May, the Commission published for public comment a series of proposed rules that would largely implement this requirement.[33] The proposed rules are intended to strengthen the integrity of credit ratings, including by improving their transparency. Under the Commission's proposals, NRSROs would, among other things, be required to:

- Report on their internal controls;
- Better protect against any conflicts of interest;
- Establish professional standards for their credit analysts;
- Publicly provide – along with the publication of any credit rating – disclosure about the credit rating and the methodology used to determine it; and
- Provide enhanced public disclosures about the performance of their credit ratings.

The proposals also would require disclosure concerning third-party due diligence reports for asset-backed securities.

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

The Act also requires the SEC to conduct three studies relating to credit rating agencies. In December, the Commission requested public comment on the feasibility and desirability of standardizing credit rating terminology.[34] The Act also requires (1) a two-year study on alternative compensation models for rating structured finance products and (2) a three-year study on NRSRO independence.

With respect to alternative compensation models, the Act directs the Commission to study the credit rating process for structured finance products and the conflicts associated with the "issuer-pay" and the "subscriber-pay" models. The Act further requires the Commission to study the feasibility of establishing a system in which a public or private utility or a self-regulatory organization would assign NRSROs to determine the credit ratings for structured finance products. Accordingly, in May the Commission published a request for public comment on the feasibility of such a system, asking interested parties to provide comments, proposals, data and analysis by September.[35]

In addition, the Act requires every federal agency to review its regulations that require use of credit ratings as an assessment of the credit-worthiness of a security and undertake rulemakings to remove these references and replace them with other standards of credit worthiness that the agency determines are appropriate.

- In February 2011, the Commission proposed rule amendments that would remove credit ratings as conditions for companies seeking to use short-form registration when registering securities for public sale. Under the proposed rules, the new test for eligibility to use Form S-3 or Form F-3 short-form registration would be tied to the amount of debt and other non-convertible securities a particular company has sold in registered primary offerings within the previous three years.[36] In addition, prior to adoption of the Act, in April 2010 the Commission proposed new requirements to replace the current credit rating references in shelf eligibility criteria for asset-backed security issuers with new shelf eligibility criteria.[37]

- In March 2011, the Commission proposed to remove credit ratings from rules relating to what securities a money market fund can purchase.[38] This proposal includes amendments to Rule 2a-7, which governs the operation of money market funds and

[34] *See* Release No. 34-63573, *Credit Rating Standardization Study* (December 17, 2010), http://sec.gov/rules/other/2010/34-63573.pdf.

[35] *See* Release No. 34-64456, *Solicitation of Comment to Assist in Study on Assigned Credit Ratings* (May 10, 2011), http://www.sec.gov/rules/other/2011/34-64456.pdf.

[36] *See* Release No. 33-9186, *Security Ratings* (February 9, 2011), http://www.sec.gov/rules/proposed/2011/33-9186.pdf.

[37] *See* Release No. 33-9117, *Asset-Backed Securities* (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf.

[38] See Release Nos. 33-9193; IC-29592, *References to Credit Ratings in Certain Investment Company Act Rules and Forms* (March 3, 2011), http://www.sec.gov/rules/proposed/2011/33-9193.pdf.

requires these funds to invest only in highly liquid, short-term investments of the highest quality. These proposed amendments would replace the current requirement that rated portfolio securities have received a first or second tier rating. They are designed to offer protections comparable to those provided by NRSRO ratings and to retain a degree of risk limitation similar to the current rule.

- In April 2011, the Commission proposed to remove references to credit ratings in rules concerning broker-dealer financial responsibility, distributions of securities, and confirmations of transactions.[39]

In September 2010, as required by Section 939B of the Act, the Commission adopted a rule amendment to remove communications with credit rating agencies from the list of excepted communications in Regulation FD.[40]

In addition, the Dodd-Frank Act requires the SEC to conduct staff examinations of each NRSRO at least annually and issue an annual report summarizing the exam findings. Our staff is in the process of completing the first cycle of these exams, but at our current funding level achieving that statutory mandate has required drawing away critical resources from other parts of our examination and NRSRO programs.

Volcker Rule

In January, the FSOC approved and released to the public a study formalizing its findings and recommendations for implementing Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule.[41] Informed by these recommendations, the Commission staff is working closely with staffs from the federal banking agencies and the CFTC in drafting proposed rules to implement Section 619. The agency staffs are consulting and coordinating efforts in order to assure that the proposed regulations are comparable and provide for consistent application and implementation across regulated entities subject to the Volcker Rule, to the extent possible. We anticipate that the proposal will solicit comments on a variety of issues, including the costs and benefits of the proposed rule and its potential impact on competitiveness.

Municipal Advisors

Section 975 of the Dodd-Frank Act requires the registration of municipal advisors with the Commission. This new registration requirement became effective on October 1, 2010, making it

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[39] *See* Release No. 34-64352, *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934* (April 27, 2011), http://www.sec.gov/rules/proposed/2011/34-64352.pdf.

[40] *See* Release No. 33-9146, *Removal from Regulation FD of the Exemption for Credit Rating Agencies* (September 29, 2010), http://www.sec.gov/rules/final/2010/33-9146.pdf.

[41] The FSOC Volcker Rule study and recommendations can be found at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. *See also*, http://sec.gov/spotlight/dodd-frank/volckerrule.htm.

unlawful for any municipal advisor to provide advice to a municipality unless registered with the Commission. Last September, the Commission adopted an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement.[42] In December, the Commission proposed a permanent rule creating a new process by which municipal advisors must register with the SEC.[43] We have received approximately 1,000 comment letters on the proposal, including many expressing concerns regarding the treatment of appointed officials and traditional banking products and services. We will give all of these comments careful consideration before adopting a final rule.

Broker-Dealer Audits and Custody Arrangements

In June, the Commission proposed amendments to its broker-dealer financial reporting rule in order to strengthen the audits of broker-dealers as well as its oversight of the way broker-dealers handle their customers' securities and cash.[44] The proposed amendments also would facilitate the ability of the Public Company Accounting Oversight Board to implement its new oversight authority over independent public accountants of broker-dealers that was provided in Section 982 of the Dodd-Frank Act.

Asset-Backed Securities

During the past year, the Commission has been active in implementing Subtitle D of Title IX of the Dodd-Frank Act, entitled "Improvements to the Asset-Backed Securitization Process." Most recently, on March 30, 2011, the Commission joined its fellow regulators in issuing for public comment proposed risk retention rules to implement Section 941 of the Act.[45] Section 941, which is codified as new Section 15G of the Securities Exchange Act of 1934, generally requires the Commission, the Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in the case of the securitization of any "residential mortgage asset," the Federal Housing Finance Agency and Department of Housing and Urban Development, to jointly prescribe regulations that require a securitizer to retain not less than five percent of the credit risk of any asset that the securitizer – through the issuance of an asset-backed security – transfers, sells, or conveys to a third party. Section 15G also provides that the jointly prescribed regulations must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain.[46]

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[42] *See* Release No. 34-62824, *Temporary Registration of Municipal Advisors* (September 1, 2010), http://www.sec.gov/rules/interim/2010/34-62824.pdf.

[43] *See* Release No. 34-63576, *Registration of Municipal Advisors* (December 20, 2010), http://sec.gov/rules/proposed/2010/34-63576.pdf.

[44] *See* Release No. 34-64676, *Broker-Dealer Reports* (June 15, 2011), http://www.sec.gov/proposed/2011/34-64676.pdf.

[45] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/34-64148.pdf.

[46] *See* § 78o-11(c)(1)(A).

Under the proposed rules, a sponsor generally would be permitted to choose from a menu of four risk retention options to satisfy its minimum five percent risk retention requirement. These options were designed to provide sponsors with flexibility while also ensuring that they actually retain credit risk to align incentives. The proposed rules also include three transaction-specific options related to securitizations involving revolving asset master trusts, asset-backed commercial paper conduits, and commercial mortgage-backed securities. Also, as required by Section 941, the proposal provides a complete exemption from the risk retention requirements for ABS collateralized solely by "qualified residential mortgages" (or QRMs) and establishes the terms and conditions under which a residential mortgage would qualify as a QRM. We have received a number of comments regarding the QRM exemption, which we will carefully consider as we move forward with the interagency rulemaking process. Although the original comment period was scheduled to close on June 10, 2011, in light of requests from various sources for an extension to allow sufficient time for data gathering and impact analyses related to the provisions of the proposed rule, we extended the comment period to August 1, 2011.

In January 2011, the Commission proposed rules in connection with Section 942(a) of the Dodd-Frank Act, which eliminated the automatic suspension of the duty to file reports under Section 15(d) of the Exchange Act for ABS issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The proposed rules would permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by non-affiliates of the depositor.[47]

The Commission also adopted rules in January 2011 implementing Section 943, on the use of representations and warranties in the market for ABS,[48] and Section 945, which requires an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS and disclose the nature of such review.[49]

We also are working on rules prohibiting material conflicts of interest in certain securitizations[50] and rules requiring the disclosure of asset-level information regarding the assets backing each tranche or class of security.[51]

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[47] *See* Release No. 34-63652, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934* (January 6, 2011), http://www.sec.gov/rules/proposed/2011/34-63652.pdf.

[48] *See* Release No. 33-9175, *Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9175.pdf.

[49] *See* Release No. 33-9176, *Issuer Review of Assets in Offerings of Asset-Backed Securities* (January 20, 2011), http://www.sec.gov/rules/final/2011/33-9176.pdf.

[50] *See* Section 27B of the Securities Act, as added by Section 621 of the Dodd-Frank Act.

[51] *See* Section 942(b) of the Dodd-Frank Act. In April 2010, the Commission proposed, among other things, to require that, with some exceptions, prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information about each of the assets in the pool. *See* Release No. 33-9117, *Asset-*

Corporate Governance and Executive Compensation

The Dodd-Frank Act includes an array of corporate governance and executive compensation provisions that require Commission rulemaking. Among others, such rulemakings include:

- **Say on Pay.** The Commission adopted rules in January that require, in accordance with Section 951 of the Act, public companies subject to the federal proxy rules to provide a shareholder advisory "say-on-pay" vote on executive compensation, a separate shareholder advisory vote on the frequency of the say-on-pay vote, and disclosure about, and a shareholder advisory vote to approve, compensation related to merger or similar transactions, known as "golden parachute" arrangements.[52] The Commission also proposed rules to implement the Section 951 requirement that institutional investment managers report their votes on these matters at least annually.[53]

- **Compensation Committee and Adviser Requirements.** Section 952 requires the Commission to, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not comply with new compensation committee and compensation adviser requirements. In March 2011, the Commission issued a proposal to implement Section 952 that would require the exchanges to establish listing standards that require each member of a listed issuer's compensation committee to be a member of the board of directors and to be "independent."[54]

  The proposed rules also would direct the exchanges to prohibit the listing of any equity security of any issuer that is not in compliance with certain requirements relating to compensation committees and compensation advisers. The proposal also would amend the Commission's existing compensation consultant disclosure rules to require disclosure about whether the issuer's compensation committee retained or obtained the advice of a compensation consultant; whether the work of the compensation consultant has raised any conflicts of interest; and, if so, the nature of any such conflict and how it is being addressed. The comment period for the proposal ended on May 19, 2011, and the staff is currently developing recommendations for final rules.

- **Incentive-Based Compensation Arrangements.** Section 956 of the Dodd-Frank Act requires the Commission along with six other financial regulators to jointly adopt

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Backed Securities (April 7, 2010), http://www.sec.gov/rules/proposed/2010/33-9117.pdf. The April 2010 proposals, if adopted, would implement the requirements for registered offerings of Section 942(b).

[52] *See* Release No. 33-9178, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation* (January 25, 2011), http://www.sec.gov/rules/final/2011/33-9178.pdf.

[53] *See* Release No. 34-63123, *Reporting of Proxy Votes on Executive Compensation and Other Matters* (October 18, 2010), http://www.sec.gov/rules/proposed/2010/34-63123.pdf.

[54] *See* Release No. 33-9199, *Listing Standards for Compensation Committees* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/33-9199.pdf.

regulations or guidelines governing the incentive-based compensation arrangements of certain financial institutions, including broker-dealers and investment advisers with $1 billion or more of assets. Working with the other regulators, in March the Commission published for public comment a proposed rule that would address such arrangements. The Commission has received voluminous comment letters on the proposed rule, and the Commission staff, together with staff from the other regulators, is carefully considering the issues and concerns raised in those comments before adopting any final rules.

- **Prohibition on Broker Voting of Uninstructed Shares.** Section 957 of the Act requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares on the election of directors (other than uncontested elections of directors of registered investment companies), executive compensation matters, or any other significant matter, as determined by the Commission by rule. To date, the Commission has approved changes to the rules with regard to director elections and executive compensation matters for most of the national securities exchanges,[55] and we anticipate that corresponding changes to the rules of the remaining national securities exchanges will be considered by the Commission in the near future.

The Commission also is required by the Act to adopt several additional rules related to corporate governance and executive compensation, including rules mandating new listing standards relating to specified "clawback" policies,[56] and new disclosure requirements about executive compensation and company performance,[57] executive pay ratios,[58] and employee and director hedging.[59] These provisions of the Act do not contain rulemaking deadlines, but the staff is working on developing recommendations for the Commission concerning the implementation of these provisions of the Act.

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[55] *See* Release No. 34-62874 (September 9, 2010), http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf (New York Stock Exchange); Release No. 34-62992 (September 24, 2010), http://www.sec.gov/rules/sro/nasdaq/2010/34-62992.pdf (NASDAQ Stock Market LLC); Release No. 34-63139 (October 20, 2010), http://www.sec.gov/rules/sro/ise/2010/34-63139.pdf (International Securities Exchange); Release No. 34-63917 (February 16, 2011), http://www.sec.gov/rules/sro/cboe/2011/34-63917.pdf (Chicago Board Options Exchange); Release No. 34-63918 (February 16, 2011), http://www.sec.gov/rules/sro/c2/2011/34-63918.pdf (C2 Options Exchange, Incorporated); Release No. 34-64023 (March 3, 2011), http://www.sec.gov/rules/sro/bx/2011/34-64023.pdf (NASDAQ OMX BX, Inc.); Release No. 34-64121 (March 24, 2011), http://www.sec.gov/rules/sro/chx/2011/34-64121.pdf (Chicago Stock Exchange); Release No. 34-64122 (March 24, 2011), http://www.sec.gov/rules/sro/phlx/2011/34-64122.pdf (NASDAQ OMX PHLX LLC); Release No. 34-64186 (April 5, 2011), http://www.sec.gov/rules/sro/edgx/2011/34-64186.pdf (EDGX Exchange); Release No. 34-64187 (April 5, 2011), http://www.sec.gov/rules/sro/edga/2011/34-64187.pdf (EDGA Exchange).

[56] *See* Section 954 of the Dodd-Frank Act.

[57] *See* Section 953(a) of the Dodd-Frank Act.

[58] *See* Section 953(b) of the Dodd-Frank Act.

[59] *See* Section 955 of the Dodd-Frank Act.

Specialized Disclosure Provisions

Title XV of the Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. government entities. The Commission published rule proposals for the three specialized disclosure requirements in December 2010, and the comment period ended on March 2, 2011.[60] The staff is developing recommendations for the Commission's consideration. The Commission expects to consider adoption of final rules implementing these specialized disclosure provisions in the late summer or early fall of this year.

Exempt Offerings

Under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D. The Commission proposed rules to implement the requirements of Section 926 on May 25, 2011.[61] Under the proposal, the disqualifying events include certain criminal convictions, court injunctions and restraining orders; certain final orders of state securities, insurance, banking, savings association or credit union regulators, federal banking agencies or the National Credit Union Administration; certain types of Commission disciplinary orders; suspension or expulsion from membership in, or from association with a member of, a securities self-regulatory organization; and certain other securities-law related sanctions. The comment period for this rule proposal ended on July 14, 2011.

In addition, the Commission proposed rule amendments in January that would implement Section 413(a) of the Act, which requires the Commission to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the $1 million threshold required for "accredited investor" status.[62] The comment period on this proposal ended on March 11, 2011 and the staff is preparing final rule recommendations for the Commission. This section was effective on the date of enactment of the Dodd-Frank Act; the implementing rules are designed to clarify the requirements and codify them in the Commission's rules.

Financial Stability Oversight Council

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[60] *See* Release No. 34-63547, *Conflict Minerals* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63547.pdf; Release No. 33-9164, *Mine Safety Disclosure* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/33-9164.pdf, Release No. 34-63549, *Disclosure of Payments by Resource Extraction Issuers* (December 15, 2010), http://www.sec.gov/rules/proposed/2010/34-63549.pdf.

[61] *See* Release No. 33-9211, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings* (May 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9211.pdf.

[62] *See* Release No. 33-9177, *Net Worth Standard for Accredited Investors* (January 25, 2011), http://www.sec.gov/rules/proposed/2011/33-9177.pdf.

In addition to the rulemaking activity described above, Title I of the Dodd-Frank Act created the FSOC, and with it, a formal structure for coordination among the various financial regulators to monitor systemic risk and to promote financial stability across our nation's financial system. FSOC has 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;
- 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.[63]

As Chairman of the SEC, I am a voting member of FSOC. Senior SEC staff and I have actively participated in the FSOC and found its focus on identifying and addressing risks to the financial system to be important and helpful to the SEC as a capital markets regulator. The FSOC also has fostered a healthy and positive sense of collaboration among the financial regulators, facilitating cooperation and coordination for the benefit of investors and our overall financial system. Since passage of the Dodd-Frank Act, the FSOC has taken steps to create an organizational structure, coordinate interagency efforts, and build the foundation for meeting its statutory responsibilities.

To begin defining and implementing the process to identify and designate systemically important financial institutions ("SIFIs") for heightened supervision by the Board, 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, as well as a notice of proposed rulemaking. FSOC is preparing additional guidance regarding the Council's approach to designations and will seek public comment on it.

Financial Market Utilities ("FMUs") are essential to the proper functioning of the nation's financial markets.[64] 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

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

[64] 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."

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.[65] 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.[66]

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, and also published an advanced notice of proposed rulemaking seeking public comment on the designation process for FMUs.

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. The FSOC finalized this rule earlier this week.[67]

New Commission Offices

In addition to the Whistleblower Office mentioned earlier, the Dodd-Frank Act requires the Commission to create four new offices within the Commission, specifically, the Office of Credit Ratings, Office of the Investor Advocate, Office of Minority and Women Inclusion, and Office of Municipal Securities. As each of these offices is statutorily required to report directly to the Chairman, the creation of these offices is subject to approval by the Commission's Appropriations subcommittees to reprogram funds for this purpose.[68]

While reprogramming approval is a necessary step in moving forward to create these new offices, the provision of additional funding to staff them at adequate levels also would be necessary for the SEC to fully execute the new responsibilities. In the meantime, the initial functions of the offices are being performed on a limited basis by other divisions and offices.

Cost-Benefit Analyses

We are keenly aware that our rules have both costs and benefits, and that the steps we take to protect the investing public impact both financial markets and industry participants who must comply with our rules. This is truer than ever given the scope, significance and complexity of the Dodd-Frank Act. Our Division of Risk, Strategy, and Financial Innovation, which has been expanded in both stature and size, directly assists our rule writers in analyzing the economic impact of those rules.

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[65] *See* Dodd-Frank Act § 802.

[66] *See* Dodd-Frank Act § 805.

[67] http://www.treasury.gov/initiatives/Documents/Finalruledisclaimer7-18-2011.pdf.

[68] The Senate Committee on Appropriations' Subcommittee on Financial Services and General Government Appropriations provided reprogramming approval to the Commission on July 14, 2011.

When engaging in rulemaking, we analyze the direct and indirect costs and benefits of the Commission's proposed decisions against alternative approaches, including, the effects on competition, efficiency and capital formation. We invite the public to comment on our analysis and provide any information and data that may better inform our decision making. In adopting releases, the Commission responds to the information provided and revises its analysis as appropriate. This approach helps ensure a regulatory framework that strikes the right balance between the costs and the benefits of regulation.[69]

Funding for Implementation of the Dodd-Frank Act

The provisions of the Dodd-Frank Act expand the SEC's responsibilities and will require significant additional resources to fully implement the law. To date, the SEC has proceeded with the first stages of implementation without the necessary additional funding. As described above, implementation up to this point has largely involved performing studies, analysis, and the writing of rules. These tasks have taken staff time from other responsibilities, and have been done almost entirely with existing staff and without sufficient investments in areas such as information technology.

It is incumbent upon us to use our existing resources efficiently and effectively as we strive to fulfill statutory mandates, protect investors and achieve our mission. That said, the new responsibilities assigned to the agency under the Dodd-Frank Act are so significant that they cannot be achieved solely by wringing efficiencies out of the existing budget without also severely hampering our ability to meet our existing responsibilities.

The budget justification the SEC submitted in February in connection with the President's FY 2012 budget request estimates that, over time, full implementation of the Dodd-Frank Act will require a total of approximately 770 new staff, of which many will need to be expert in derivatives, hedge funds, data analytics, credit ratings, or other new or expanded responsibility areas.[70] The SEC also will need to invest in technology to facilitate the registration of additional entities and capture and analyze data on these new markets.

The Dodd-Frank Act requires the SEC to collect transaction fees to offset the annual appropriation to the SEC. Accordingly, regardless of the amount appropriated to the SEC, the appropriation will be fully offset by the fees that we collect and will have no impact on the nation's budget deficits.

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[69] After reviewing cost benefit analyses included in six of our Dodd-Frank Act rulemaking releases, the SEC's Inspector General issued a report last month. While the Office of Inspector General ("OIG") is continuing to review the Commission's cost benefit analyses, this report concluded that "a systematic cost-benefit analysis was conducted for each of the six rules reviewed. Overall, [the OIG] found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful review of the economic analysis of the six proposed released that [the OIG] scrutinized in [its] review." *See* U.S. SEC Office of the Inspector General, *Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Rulemakings* (June 13, 2011) http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf at 43. We look forward to continuing to work with the OIG as it conducts a further review.

[70] *See* the SEC's FY2012 Congressional Budget Justification http://www.sec.gov/about/secfy12congbudgjust.pdf.

If the SEC does not receive additional resources, many of the issues highlighted by the financial crisis and which the Dodd-Frank Act seeks to fix will not be adequately addressed, as the SEC will not be able to build out the technology and hire industry expertise and other staff desperately needed to oversee and police these new areas of responsibility. Examples of likely impacts include:

- The implementation of rules for the OTC derivatives markets will be delayed, depriving financial firms and market participants of the legal certainty they need to make routine investment decisions, upgrade systems and technology infrastructure, and improve risk management opportunities for manufacturers, pension funds, municipalities, and others. Even after the rules are eventually finalized, market participants will face further delays and uncertainty due to the lack of adequate Commission staff to process and review on a timely basis requests for registrations or other required approvals. Further, the Commission will be unable to conduct adequate oversight and examinations of registered swap market participants, or to use newly-available data to surveil the security-based swap markets for excessive risks or other threats to our markets and investors.

- Oversight of vital clearing functions and expected new securities-based swap data repositories will be wholly inadequate. The average transaction volume cleared and settled by clearing agencies is approximately $1.8 trillion a day. For the current actively-registered nine clearing agencies, the SEC has approximately ten examiners devoted to them, with limited on-site presence in only three of those. This situation will worsen as more clearing agencies register with the SEC as a result of Dodd-Frank.

- The SEC will continue to have only a skeletal crew to handle analysis of complex legal and regulatory issues that will increase significantly as more than 750 advisers to hedge funds and private equity funds begin to register with the Commission. Even after shifting staff from other important program areas, the SEC's Division of Investment Management will be able to dedicate only a handful of staff to this area.

The Dodd-Frank Act also established a $50 million SEC Reserve Fund to allow the SEC to respond to unexpected market events (such as the May 6th market plunge), invest in multi-year IT projects, and manage authorized programs during continuing resolutions. If this fund is eliminated or the SEC is not permitted to access the fund, it would have significant consequences for important IT projects, such as building out the infrastructure to take in, manage and analyze the significant amounts of critical new data we will soon receive from previously unregulated markets, including a segment of the $600 trillion OTC derivatives market and hedge fund and other private fund advisers. Without the appropriate IT infrastructure, our ability to establish effective monitoring regimes will be significantly hindered.

Section 967 Organizational Assessment

While additional resources are needed to implement the Dodd-Frank Act, it is also critical that we use existing resources effectively and efficiently. In order to implement our new responsibilities and to effectively supervise the changing financial markets, the SEC is carefully examining its operations and processes to maximize efficiency and effectiveness. Section 967 of the Dodd-Frank Act directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC internal operations. This organizational assessment was recently performed by the Boston Consulting Group, Inc. ("BCG") [71] and is providing valuable guidance and structure for our efforts. Among other issues, the organizational assessment raises significant issues regarding SEC resources and questions whether the statutory design of the four new offices creates management complexity, duplication and a need for new support capacity when many of their functions already exist at the SEC. SEC staff is currently reviewing the recommendations of the study and will be moving forward with those suggested changes that could improve organizational effectiveness.

Conclusion

Though the SEC's efforts to implement the Dodd-Frank Act have been extensive, we know our work is far from over and we are committed to finishing the job. Thank you for inviting me to share with you our progress to date and our plans going forward. I look forward to answering your questions.

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[71] On March 10, 2011, BCG submitted to the SEC and to the Congress its Report, *U.S. Securities and Exchange Commission: Organizational Study and Reform*. The report is available to the public at www.sec.gov/news/studies/2011/967study.pdf.

TESTIMONY OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

WASHINGTON, DC

July 21, 2011

Good morning Chairman Johnson, Ranking Member Shelby and members of the Committee. I thank you for inviting me to today's hearing on the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC). I also thank my fellow Commissioners and CFTC staff for their hard work and commitment on implementing the legislation.

Financial Crisis

One year ago, the President signed the Dodd-Frank Act into law. And on this anniversary, it is important to remember why the law's derivatives reforms are necessary.

The 2008 financial crisis occurred because the financial system failed the American public. The financial regulatory system failed as well. When AIG and Lehman Brothers faltered, we all paid the price. The effects of the crisis remain, and there continues to be significant uncertainty in the economy.

Though the crisis had many causes, it is clear that the derivatives or swaps market played a central role. Swaps added leverage to the financial system with more risk being backed by less capital. They contributed, particularly through credit default swaps, to the bubble in the housing market and helped to accelerate the financial crisis. They contributed to a system where large financial institutions were thought to be not only too big to fail, but too interconnected to fail. Swaps – developed to help manage and lower risk for end-users – also concentrated and heightened risk in the financial system and to the public.

FSOC

To help protect the American public, the Dodd-Frank Act included the establishment of the Financial Stability Oversight Council. This Council is an opportunity for regulators – now and in the future – to ensure that the financial system works better for all Americans. Adding to our challenge is the perverse outcome of the financial crisis, which may be that many people in the markets have come to believe that a handful of large financial firms will – if in trouble – have the backing of the taxpayers. We must do our utmost to ensure that when those challenges arise, the taxpayers are not forced to stand behind those institutions and that these institutions are free to fail.

Derivatives Markets

Each part of our nation's economy relies on a well-functioning derivatives marketplace. The derivatives market – including both the historically regulated futures market and the heretofore unregulated swaps market – is essential so that producers, merchants and end-users can manage their risks and lock in prices for the future. Derivatives help these entities focus on what they know best – innovation, investment and producing goods and selling and services – while finding others in a marketplace willing to bear the uncertain risks of changes in prices or rates.

With notional values of more than $300 trillion in the United States – that's more than $20 of swaps for every dollar of goods and services produced in the U.S. economy – derivatives markets must work for the benefit of the American public. Members of the public keep their savings with banks and pension funds that use swaps to manage interest rate risks. The public buys gasoline and groceries from companies that rely upon futures and swaps to hedge swings in commodity prices.

That's why oversight must ensure that these markets function with integrity, transparency, openness and competition, free from fraud, manipulation and other abuses. Though the CFTC is not a price-setting agency, recent volatility in prices for basic commodities – agricultural and energy – are very real reminders of the need for common sense rules in all of the derivatives markets.

The Dodd-Frank Act

To address the real weaknesses in swaps market oversight exposed by the financial crisis, the CFTC is working to implement the Dodd-Frank Act's swaps oversight reforms.

Broadening the Scope

Foremost, the Dodd-Frank Act broadened the scope of oversight. The CFTC and the Securities and Exchange Commission (SEC) will, for the first time, have oversight of the swaps and security-based swaps markets.

Promoting Transparency

Importantly, the Dodd-Frank Act brings transparency to the swaps marketplace. Economists and policymakers for decades have recognized that market transparency benefits the public.

The more transparent a marketplace is, the more liquid it is, the more competitive it is and the lower the costs for hedgers, which ultimately leads to lower costs for borrowers and the public.

The Dodd-Frank Act brings transparency to the three phases of a transaction.

First, it brings pre-trade transparency by requiring standardized swaps – those that are cleared, made available for trading and not blocks – to be traded on exchanges or swap execution facilities.

Second, it brings real-time post-trade transparency to the swaps markets. This provides all market participants with important pricing information as they consider their investments and whether to lower their risk through similar transactions.

Third, it brings transparency to swaps over the lifetime of the contracts. If the contract is cleared, the clearinghouse will be required to publicly disclose the pricing of the swap. If the contract is bilateral, swap dealers will be required to share mid-market pricing with their counterparties.

The Dodd-Frank Act also includes robust recordkeeping and reporting requirements for all swaps transactions so that regulators can have a window into the risks posed to the system and can police the markets for fraud, manipulation and other abuses.

On July 7, the Commission voted for a significant final rule establishing that clearinghouses and swaps dealers must report to the CFTC information about the swaps activities of large traders in the commodity swaps markets. For decades, the American public has benefited from the Commission's gathering of large trader data in the futures market, and now will benefit from this additional information to police the commodity swaps markets.

Lowering Risk

Other key reforms of the Dodd-Frank Act will lower the risk of the swaps marketplace to the overall economy by directly regulating dealers for their swaps activities and by moving standardized swaps into central clearing.

Oversight of swap dealers, including capital and margin requirements, business conduct standards and recordkeeping and reporting requirements will reduce the risk these dealers pose to the economy.

The Dodd-Frank Act's clearing requirement directly lowers interconnectedness in the swaps markets by requiring standardized swaps between financial institutions to be brought to central clearing.

This week, the Commission voted for a final rule establishing a process for the review by the Commission of swaps for mandatory clearing. The process provides an opportunity for public input before the Commission issues a determination that a swap is subject to mandatory clearing. The Commission will start with those swaps currently being cleared and submitted to us for review by a derivatives clearing organization.

Enforcement

Effective regulation requires an effective enforcement program. The Dodd-Frank Act enhances the Commission's enforcement authorities in the futures markets and expands them to the swaps markets. The Act also provides the Commission with important new anti-fraud and anti-manipulation authority.

This month, the Commission voted for a final rule giving the CFTC authority to police against fraud and fraud-based manipulative schemes, based upon similar authority that the Securities and Exchange Commission, Federal Energy Regulatory Commission and Federal Trade Commission have for securities and certain energy commodities. Under the new rule, the Commission's anti-manipulation reach is extended to prohibit the reckless use of fraud-based manipulative schemes. It closes a significant gap as it will broaden the types of cases we can pursue and improve the chances of prevailing over wrongdoers.

Dodd-Frank expands the CFTC's arsenal of enforcement tools. We will use these tools to be a more effective cop on the beat, to promote market integrity and to protect market participants.

Position Limits

Another critical reform of the Dodd-Frank Act relates to position limits. Position limits have been in place since the Commodity Exchange Act passed in 1936 to curb or prevent excessive speculation that may burden interstate commerce.

In the Dodd-Frank Act, Congress mandated that the CFTC set aggregate position limits for certain physical commodity derivatives. The law broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade, in addition to U.S. futures and options on futures. Congress also narrowed the exemptions for position limits by modifying the definition of a bona fide hedge transaction.

When the CFTC set position limits in the past, the purpose was to ensure that the markets were made up of a broad group of market participants with a diversity of views. Market integrity is enhanced when participation is broad and the market is not overly concentrated.

Rule-Writing Process

The CFTC is working deliberatively, efficiently and transparently to write rules to implement the Dodd-Frank Act.

This spring, we substantially completed the proposal phase of rule-writing and further benefited from an extra 30 days for public comment. Now, the staff and commissioners have turned toward final rules. We held two public commission meetings this month and approved eight final rules. In the coming months, we will hold additional public meetings to continue to consider finalizing rules.

The Dodd-Frank Act set a deadline of 360 days for the CFTC and SEC to complete the bulk of our rulemakings, which was July 16, 2011.

Last week, the Commission granted temporary relief from certain provisions that would otherwise apply to swaps or swap dealers on July 16. This order provides time for the Commission to continue its progress in finalizing rules.

Phasing of Implementation

The Dodd-Frank Act gives the CFTC and SEC flexibility to set effective dates and a schedule for compliance with rules implementing Title VII of the Act. The order in which the Commission finalizes the rules does not determine the order of the rules' effective dates or applicable compliance dates. Phasing the effective dates of the Act's provisions will give market participants time to develop policies, procedures, systems and the infrastructure needed to comply with the new regulatory requirements.

In May, CFTC and SEC staff held a roundtable to hear directly from the public about the timing of implementation dates of Dodd-Frank rulemakings. Prior to the roundtable, CFTC staff released a document that set forth concepts that the Commission may consider with regard to the effective and compliance dates of final rules for swaps under the Dodd-Frank Act. We also offered a 60-day public comment file to hear specifically on this issue. The roundtable and resulting public comment letters will help inform the Commission as to what requirements can be met sooner and which ones will take a bit more time. This public input has been very helpful to staff as we move forward in considering final rules.

We are planning to request additional public comment on a critical aspect of phasing implementation – requirements related to swap transactions that affect the broad array of market participants. Market participants that are not swap dealers or major swap participants may require more time for the new regulatory requirements that apply to their transactions. There may be different characteristics amongst market participants that would suggest phasing transaction compliance by type of market participant. In particular, such phasing compliance may relate to: the clearing mandate; the trading requirement; and compliance with documentation standards, confirmation and margining of swaps.

Our international counterparts also are working to implement needed reform. We are actively consulting and coordinating with international regulators to promote robust and consistent standards and to attempt to avoid conflicting requirements in swaps oversight. Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the U.S. unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the U.S. We are developing a plan for application of 722(d) and will seek public input on that plan in the fall.

Conclusion

Only with reform can the public get the benefit of transparent, open and competitive swaps markets. Only with reform can we reduce risk in the swaps market – risk that contributed to the 2008 financial crisis. Only with reform can users of derivatives and the broader public be confident in the integrity of futures and swaps markets.

The CFTC is taking on a significantly expanded scope and mission. The Commission must be adequately resourced to effectively police the markets and protect the public.

Without sufficient funds, there will be fewer cops on the beat. The agency must be adequately resourced to assure our nation that new rules in the swaps market will be strictly enforced -- rules that promote transparency, lower risk and protect against another crisis.

Until the CFTC completes its rule-writing process and implements and enforces those new rules, the public remains unprotected.

Thank you, and I'd be happy to take questions.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

MARTIN J. GRUENBERG
ACTING CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

ENHANCED OVERSIGHT AFTER THE FINANCIAL CRISIS: WALL STREET REFORM AT ONE YEAR

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

July 21, 2011
538 Dirksen Senate Office Building

Chairman Johnson, Ranking Member Shelby and members of the Committee, thank you for the opportunity to testify today on the one year anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

In the wake of the most severe episode of financial distress and the longest economic recession since the 1930s, the Dodd-Frank Act provides regulators with important new authorities to enhance financial stability and to respond to the regulatory challenges posed by large, complex *systemically-important financial institutions* (SIFIs). For example, the Dodd-Frank Act grants the Federal Deposit Insurance Corporation (FDIC) new authorities to manage the Deposit Insurance Fund (DIF) in a way that will make it more resilient in any future crisis. The Act also provides for a new SIFI resolution framework, including an Orderly Liquidation Authority and a requirement for SIFI resolution plans, which will give regulators much better tools with which to manage the failure of large, complex institutions. Finally, the Dodd-Frank Act also contains provisions that will complement the ongoing Basel III reforms that will make capital requirements more uniformly strong across the banking system.

My testimony today will focus specifically on the implementation of these Dodd-Frank provisions to enhance the future stability of our financial system.

Promoting Stability by Strengthening the Deposit Insurance Fund

The FDIC has moved quickly to implement the Dodd-Frank Act changes in the FDIC deposit insurance program. These changes will help to ensure that coverage is sufficient to preserve public confidence in a crisis, that premiums are proportional to insurance risks, and that the fund itself is restored to long-term health and maintained at levels that will withstand future periods of financial distress. The following sections highlight important developments in the financial condition of the DIF and changes to the management of the fund, assessment system, and coverage limits.

Restoring the Deposit Insurance Fund. Since year-end 2007, the failure of 377 FDIC-insured institutions has imposed total estimated losses of $84 billion on the DIF. In the recent crisis, as in the banking crisis of two decades ago, the sharp increase in bank failures caused the fund balance (the fund's net worth) to become negative. In the recent crisis, the DIF balance turned negative in the third quarter of 2009 and hit a low of negative $20.9 billion in the following quarter.

As the DIF balance declined, the FDIC adopted a statutorily required Restoration Plan and increased assessments to handle the high volume of failures and begin replenishing the fund. The FDIC increased assessment rates at the beginning of 2009, which raised regular assessment revenue from $3 billion in 2008 to over $12 billion in 2009 and almost $14 billion in 2010. In June 2009, the FDIC imposed a special assessment that brought in an additional $5.5 billion from the banking industry. Furthermore, in December 2009, to increase the FDIC's liquidity, the FDIC required that the industry prepay almost $46 billion in assessments, representing over three years of estimated assessments.

While the FDIC had to impose these measures at a very challenging time for banks, they enabled the agency to avoid borrowing from the U.S. Treasury. The measures also reaffirmed the longstanding commitment of the banking industry to fund the deposit insurance system.

Since the FDIC imposed these measures, the DIF balance has steadily improved. It increased throughout 2010 and stood at negative $1.0 billion as of March 31 of this year. We expect to report that the DIF balance is once again positive when we release second quarter results next month. Under the Restoration Plan for the DIF, the FDIC has put in place assessment rates necessary to achieve a reserve ratio (the ratio of the fund balance to estimated insured deposits) of 1.35 percent by September 30, 2020, as the Dodd-Frank Act requires.

Expanding the Assessment Base. The FDIC has also implemented the Dodd-Frank Act requirement to redefine the base used for deposit insurance assessments as average consolidated total assets minus average tangible equity. The FDIC does not expect this change to materially affect the overall amount of assessment revenue that otherwise would have been collected. However, as Congress intended, the change in the assessment base will generally shift some of the overall assessment burden from community banks to the largest institutions, which rely less on domestic deposits for their funding than do smaller institutions. The result will be a sharing of the assessment burden that better reflects each group's share of industry assets. The FDIC estimates that aggregate premiums paid by institutions with less than $10 billion in assets will decline by approximately 30 percent, primarily due to the assessment base change.

Raising Deposit Insurance Coverage Limits. In retrospect, it appears clear that expanding the coverage of deposit accounts during the crisis helped maintain public confidence in the banking system and particularly helped community banks maintain deposits. In the aftermath of the crisis, the Dodd-Frank Act made permanent the increase in the coverage limit to $250,000. It also provided deposit insurance coverage on the entire balance of non-interest bearing transaction accounts at all insured depository institutions until December 31, 2012. This provision extends, with some modifications, an FDIC program that provided stability to banks and their business customers during the crisis. The two-year extension of full coverage for non-interest bearing transaction accounts will especially help smaller banks retain accounts commonly used for payroll and other business transaction purposes and maintain the ability to make loans within their communities.

Long-term Changes to DIF Management. The Dodd-Frank Act provided the FDIC with substantial new flexibility in setting reserve ratio targets and paying dividends. The FDIC has used its new authority to adopt a long-term fund management plan that should maintain a positive DIF balance even during a banking crisis while preserving steady and predictable assessment rates throughout economic and credit cycles. FDIC analysis of the past two banking crises has shown that the DIF reserve ratio must be 2 percent or higher in advance of a banking crisis to avoid high deposit insurance assessment rates when banking institutions are strained and least able to pay. Consequently, the FDIC recently established a 2 percent reserve ratio target (also known as the Designated Reserve Ratio, or DRR) as a critical component of its long-term fund management strategy.

Promoting Stability by Improving Our Capacity to Address SIFI Failures

A key feature of the Dodd-Frank Act is a series of new authorities that together provide the basis for a new SIFI resolution framework that will greatly enhance the ability of regulators to address the problems of large, complex financial institutions in any future crisis.

Orderly Liquidation Authority. Title II of the Dodd-Frank Act vests the FDIC with orderly liquidation authority that is similar in many respects to the authorities it already has for insured depository institutions. If the FDIC is appointed as receiver for a covered financial company, it is required to carry out an orderly liquidation of the company in a manner than ensures that creditors and shareholders appropriately bear the losses of the financial company while maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard. Under this authority, common and preferred stockholders, debt holders and other unsecured creditors will know that they will bear the losses of any institution placed into receivership, and management will know that it could be replaced. In addition, management that is substantially responsible for the failure of a covered financial company will be subject to the claw-back of compensation earned during the two previous years.

Critical to the exercise of this authority is a clear and transparent process that is efficient and fair. With this in mind, the FDIC commenced the process of proposing rules implementing the Orderly Liquidation Authority immediately upon the passage of the Dodd-Frank Act. A Proposed Rule addressing a few critical elements of the Orderly Liquidation Authority was published last October. In January 2011, following consideration of comments, an Interim Final Rule was promulgated which implemented the initial Proposed Rule with appropriate changes, while continuing to solicit additional comment and feedback. That initial rulemaking addressed the treatment of similarly situated creditors, protection for employees of covered financial companies that continue to work for the company following failure, and protection for policyholders of insurance companies under the orderly liquidation process, among other things.

A second Proposed Rule addressing the implementation authority more broadly was published with request for comment last March. This Proposed Rule addressed the important topics of the recoupment of compensation of senior executives and directors who are substantially responsible for the failure of a systemically important financial institution, as well as the priority of claims and the treatment of secured and unsecured creditors. We considered all of the comments to the Interim Final Rule and the second

Proposed Rule and consulted with our fellow members of the Financial Stability Oversight Council (FSOC). With appropriate changes to address those comments and concerns, a Final Rule was approved by the Board of Directors on July 6, 2011, covering all of the aspects of the Orderly Liquidation Authority addressed in these earlier rules. This Final Rule provides a framework to resolve any U.S. financial institution, no matter its size, using many of the same powers that the FDIC has long used to manage failed-bank receiverships.

While the adoption of the Final Rule Implementing Certain Orderly Liquidation Authority Provisions under Title II completes a large portion of the rulemaking required with respect to the exercise of Orderly Liquidation Authority under the Dodd-Frank Act, there is still more to do. As required by the Act, we are working with the Securities and Exchange Commission on a joint regulation implementing the Title II authority to resolve covered broker-dealers. The agencies are in agreement on the approach to the exercise of this authority, and have been meeting to finalize language of a Proposed Rule that we expect to be published in the Federal Register for public comment in the near future. Similarly, work is ongoing on a joint rule with all of the primary financial regulators regarding recordkeeping requirements for derivatives. The FDIC's experience in resolving failed financial institutions is helpful in addressing this issue, as we have a rule in place regarding recordkeeping of these qualified financial contracts with respect to insured depository institutions.

In addition, work is ongoing on other rulemakings required by Title II of the Act, including a rule governing eligibility of prospective purchasers of assets of failed financial institutions, and finalization of a Proposed Rule issued in consultation with the Department of the Treasury regarding certain key definitions for determining which organizations are financial institutions within the meaning of the Dodd-Frank Act. Work also is underway to provide additional guidance to the industry in response to questions and comments received on areas such as the creation, operation and termination of bridge financial companies, and the implementation of certain minimum recovery requirements established under the Act.

Resolution Plans. The Dodd-Frank Act also requires the FDIC and the Federal Reserve Board of Governors (FRB) jointly to issue final regulations within 18 months of enactment to implement new resolution planning and credit exposure reporting requirements. These rules will apply to bank holding companies with total assets of $50 billion or more and nonbank financial companies designated by the FSOC for enhanced supervision by the FRB. A Notice of Proposed Rulemaking for such a joint rule on resolution plans was published in April, and the comment period closed last month. Under the Proposed Rule, covered companies would be required to submit a resolution plan within a specified period after the final regulation becomes effective. The Proposed Rule provides that each covered company develop a plan for its rapid and orderly resolution under the Bankruptcy Code in the event of material financial distress or failure. Each resolution plan is required to contain an executive summary, a strategic analysis of the plan's components, a description of the covered company's corporate governance structure for resolution planning, information regarding the covered company's overall organization structure and related information, information regarding the covered company's management information systems, a description of interconnections and interdependencies among the covered company and its material entities, and supervisory and regulatory information.

Following submission of a plan, the FDIC and FRB will review the plan to determine if it is credible and will facilitate an orderly resolution of the covered company under the Bankruptcy Code. If a resolution plan does not meet the statutory standards, after an opportunity to remedy its deficiencies, the agencies may jointly determine to impose more stringent regulatory requirements on the covered company. Further, if, after two years following the imposition of the more stringent standards, the resolution plan still does not meet the statutory standards, the FDIC and the FRB may, in consultation with the appropriate FSOC member, direct a company to divest certain assets or operations.

In connection with this rulemaking, the agencies are working to develop a deliberative process for reviewing resolution plans to determine whether a plan is both credible and would facilitate an orderly resolution of the covered company under the Bankruptcy Code. Careful consideration is being given to the need to keep proprietary information contained in the resolution plans confidential to the extent permitted by law to ensure that financial companies provide full and accurate disclosures. These important issues will be addressed in the Final Rule the agencies expect to adopt in the near future.

SIFI Designation. The SIFI resolutions framework authorized under the Dodd-Frank Act will automatically apply to bank holding companies with assets of $50 billion or more, as well as non-bank financial companies that are deemed by the FSOC to pose a risk to financial stability. The FDIC is currently working with its FSOC counterparts to jointly develop criteria for designating SIFIs under this authority. The FSOC agencies issued an Advanced Notice of Proposed Rulemaking (ANPR) last October and a Notice of Proposed Rulemaking (NPR) on January 26, 2011 describing the processes and procedures that will inform the FSOC's designation of nonbank financial companies under the Dodd-Frank Act.

In response to the FSOC's ANPR and NPR, several commenters raised concerns about the lack of detail and clarity surrounding the designation process. The industry does need clarity about which firms will be expected to provide the FSOC with this additional information. To achieve this, the FSOC will seek to establish simple and transparent metrics, such as firm size, similar to the approach used for bank holding companies under the Dodd-Frank Act, and incorporate other relevant indicators. The goal will be to establish a clear and transparent process for SIFI designation.

The FDIC Office of Complex Financial Institutions (OCFI). An important element of the FDIC's implementation effort has been the creation of a new Office of Complex Financial Institutions (OCFI) to coordinate the execution of our new SIFI resolution authorities under the Dodd-Frank Act. OCFI is already actively working with the FRB and the other agencies of FSOC to develop the capabilities needed to resolve SIFIs, if necessary, in a manner that mitigates systemic risk without reliance on taxpayer support.

OCFI is structured into three groups: monitoring, resolution planning and international outreach. Staff in the *monitoring group* will have responsibility to evaluate risks across the financial system and at individual entities. Unlike a prudential supervisor, the monitoring group will specifically focus on the financial, operational and execution risks that could be posed in a resolution. This group is also charged with collecting information for resolution planning and exercising the FDIC's backup authority. The *resolutions group* will review the resolution plans that systemically important entities develop to orderly unwind through the U.S. bankruptcy process.

Additionally, staff in the resolution group will develop resolution plans for these entities using the FDIC's authority under Title II of the Dodd-Frank Act. Finally, as the name implies, the *international outreach and coordination group* will coordinate our efforts with those in other jurisdictions charged with similar responsibilities.

A critical component of successfully addressing a distressed SIFI is having sufficient information and clear strategic options at the time of failure to enable decision makers to reasonably foresee the outcomes of alternative scenarios. One of the FDIC's biggest challenges during the fall of 2008 was not having the information necessary to make informed decisions. Robust pre-planning – which entails understanding how and where these enterprises operate, as well as the structure of their business lines, counterparties, business risks, their role in the financial system, and their place in financial intermediation – is essential in giving regulators viable resolution options other than a bailout in the midst of a crisis. OCFI's monitoring activity of these systemic enterprises will be the principal mechanism for validating the entities' resolution plans and informing the FDIC on the development of Title II resolution plans.

OCFI's implementation of the Dodd-Frank Act SIFI resolution authorities builds on years of FDIC experience in successfully resolving failed depository institutions. While the basic framework and principles of successfull resolution apply to both small and large institutions, the resolution of large, complex and highly-interconnected institutions poses special challenges. The strategy for resolving a systemically important entity must be custom tailored to the characteristics and systemic nature of the entity, the circumstances of failure, and the overall economic environment. Business models and organizational structures change over time, as do financial and market conditions. That is why the FDIC has directed resources to approach resolution planning as an ongoing regulatory process, not as a one-time exercise.

FDIC Systemic Resolution Advisory Committee. To ensure that we have the benefit of the best thinking on complex resolution issues, the FDIC has chartered a *Systemic Resolutions Advistory Commitee* to provide advice and recommendations on a broad range of issues relevant to the failure and resolution of SIFIs. The Committee is composed of leading academics, prominent former policymakers, and experts from the financial industry itself. Although it has no decision-making role, Committee members will be asked to opine on topics related to the nature of systemic risk, the effects of the choice of resolution strategy on stakeholders and customers, international coordination of resolution activities, and how the market understands the new SIFI resolution authorities and how they would be applied in a future crisis.

Promoting Financial Stability by Strengthening Bank Capital

No banking system can maintain stability over the ups and downs of the business cycle without a strong capital base. Capital allows an institution to absorb large unexpected losses while maintaining the confidence of its counterparties and continuing to lend. In other words, strong capital minimizes the likelihood that large institutions will become troubled and need to be resolved in some way by the federal government during an economic downturn. Moreover, in situations where an institution does need to be resolved, a strong capital base provides regulators time to structure that resolution in an orderly manner without federal support and solicit bids from potential acquirers. In this sense, stronger bank capital requirements complement the Dodd-Frank Act resolution tools designed to prevent future bailouts of financial companies.

Insufficient capital, in contrast, heightens a banking system's exposure to periodic crises. The knowledge that capital cushions are thin compared to the magnitude of risks that abruptly and unexpectedly loom large can contribute to a panic atmosphere and feed a crisis. Thin capital cushions also contribute to the kind of abrupt deleveraging we saw in the recent crisis and its aftermath. Since the crisis, U.S. banks have contracted lending by over $750 billion and reduced their loan commitments by more than $2.7 trillion.

For all these reasons, the FDIC supports recent initiatives to strengthen bank capital requirements. While beyond the scope of this testimony, a recent initiative includes Basel III - an important initiative to strengthen the quality of capital and increase the level of minimum capital requirements. The FDIC also supports important provisions of the Dodd-Frank Act that that deal with bank capital. We believe that these provisions, contained in Section 171 and Section 165 of the Act, complement Basel III and will help promote a safe-and-sound banking system in the U.S.

Section 171 of the Dodd-Frank Act states among other things that the capital requirements for the largest banks and bank holding companies must not be less than the capital requirements that are generally applicable to insured banks. The FDIC, the FRB and Comptroller of the Currency (OCC) recently finalized a rule implementing this aspect of Section 171. Consistent with Section 171, the Final Rule states that the capital requirements computed under the agencies' general risk-based capital rules will be a floor for the capital requirements of large banks that use the Advanced Approaches of Basel II (banking organizations with assets exceeding $250 billion are required to use the Advanced Approaches). In different words, the capital requirement for a large bank using the Advanced Approaches may not be less in proportionate terms than the capital requirement for a community bank with the same exposures.

An important part of Section 171 is to ensure that regulatory capital for Bank Holding Companies (BHCs) is defined in a way that is at least as stringent as regulatory capital for insured banks. This expectation is consistent with the longstanding principle that BHCs should serve as a source of strength for their subsidiary banks. But during the crisis, we observed that BHCs were often less strongly capitalized on a consolidated basis than their subsidiary banks. This was largely a result of the widespread use of Trust Preferred Securities (TruPS), a form of subordinated debt, that are impermissible as Tier 1 capital for insured banks but have been permitted to meet a portion of a BHC's Tier 1 capital requirements since 1996. As debt instruments, TruPS cannot absorb losses while an organization operates as a going concern. This is an important reason why BHCs with heavier reliance on TruPS failed more often than other insured institutions during the crisis. Under Section 171, TruPS are phased-out of Tier 1 capital for BHCs with assets of at least $15 billion as of year-end 2009, with the phase-out occurring over a period of three years starting January 1, 2013. Important exceptions and grandfathering provisions exist for smaller BHCs.[1]

The FDIC considers Section 171 as an important safeguard for the capital adequacy of the U.S. banking system. Without Section 171, large U.S. banks could use their internal models to reduce their risk-based capital requirements, potentially well below the levels required for community banks, to levels that are inconsistent with safe and sound operations.

Another important capital provision is contained in Section 165 of the Dodd-Frank Act, which requires the FRB to establish heightened capital standards for BHCs

[1] Under Section 171, BHCs subject to the FRB's Small Bank Holding Company Policy Statement (generally BHCs with assets less than $500 million) are exempt from Section 171, while the existing TruPS (issued on or before May 19, 2010) of other BHCs with assets less than $15 billion may continue to be included in their Tier 1 capital.

with assets of at least $50 billion and designated nonbank financial companies. These requirements can be viewed as the U.S. counterparts to the so-called SIFI capital surcharges that the Basel Committee on Banking Supervision recently published for comment. We believe a requirement for additional loss absorbency at the largest institutions is appropriate given the potential impact of a failure of one of these institutions on the financial system and the broader economy.

Changes to the Regulatory Structure Under the Dodd-Frank Act

The Dodd-Frank Act also mandated important changes to the structure of the financial regulatory agencies, including the sunset of the Office of Thrift Supervision (OTS) and the creation of the Consumer Financial Protection Bureau (CFPB). These changes will have important implications for the FDIC's supervisory, policy and data collection functions.

Changes Related to OTS Sunset. The winding down of the OTS under the Dodd-Frank Act will result in the transfer of supervisory responsibility for 59 state-chartered savings associations to the FDIC.[2] These institutions are located in 18 states and territories, with almost half of the total charters located in Ohio.

All of the state-chartered institutions transferring to the FDIC are small, with the largest having assets of just over $2 billion and only 3 of the 59 having total assets exceeding $1 billion. Given the small number of charters transferring to the FDIC and their relative lack of problems and complexity, the FDIC will absorb all state-chartered savings associations into our existing supervisory program. We have assigned responsibility for examinations and other supervisory activities for each state-chartered

[2] There were 61 state-chartered savings associations as of the enactment date; two institutions have since merged out of existence.

savings association to the appropriate FDIC Regional Office. FDIC and OTS supervisory personnel began coordinating early in 2011 to ensure that that there will be no gaps in supervision and that the supervisory approach for these institutions will continue to be rigorous, consistent, and balanced both during and after the transition.

We also recognize the importance of communicating regularly with the industry throughout this process. Two FDIC outreach events were held in Ohio to assist institutions in understanding the transition, and institutions in other states were contacted directly to ensure that their questions about the transition were answered.

The FDIC is fully integrating OTS staff into its current organizational structure. In addition to absorbing the supervisory responsibility for state-chartered thrifts, the FDIC will transfer approximately 95 employees from the OTS, including commissioned examiners as well as other staff. The FDIC plans to open one additional local office in southern Ohio to manage the concentration of additional examination work in that location. Since the FDIC has historically recognized and accepted professional examination credentials from other federal banking agencies, including the OTS, it will treat as commissioned FDIC examiners all OTS examiners who transfer to the FDIC with OTS accreditation. The FDIC will address any individual training gaps that emerge after the transfer date through individual training and development plans. The FDIC has also worked closely with the OCC and the OTS to ensure that all transferred OTS employees are treated in full accordance with the requirements of sections 322(e) and 322(k)(2) of the Dodd-Frank Act with respect to their status, tenure, pay, and benefits.

The agencies have determined, subject to public notice and comment and OMB approval, that it would be best to phase out the separate collection of Thrift Financial Report (TFR) data and to merge that data collection process into the Call Report process used by other FDIC-insured depository institutions beginning with the March 2012 reporting period. The FDIC will assume responsibility for TFR reporting on an interim basis beginning with the second quarter 2011 TFR.

OTS staff previously responsible for collecting and analyzing TFR data will transfer to the FDIC to support the transition of thrifts to the Call Report and the ongoing reporting process for these institutions. In addition, OTS personnel who are assigned to the FDIC will continue to process all of the existing Savings and Loan Holding Company (SLHC) reports that were previously required to be filed by the OTS until the SLHCs can be transitioned to holding company reports required by the FRB.

Changes Related to the Establishment of the CFPB. While the CFPB will be responsible for writing consumer protection rules for lenders of all types and all sizes, the current primary federal regulators will retain their enforcement responsibilities for FDIC-insured banks and thrifts with assets of less than $10 billion. This means that the FDIC will continue to examine about 4,500 state-chartered, non-member banks for compliance with consumer laws and regulations.

The FDIC has held several meetings with CFPB staff to discuss transition issues, including data sharing, hiring, and consumer complaint handling, and recently supplied the CFPB with information they requested on institutions that will be transferred to its oversight, including examination reports and consumer complaint information. We are working with the CFPB on a joint Memorandum of Understanding (MOU) to provide for the transfer to the CFPB of consumer complaints involving large financial institutions.

We are working hard to close out as many open examinations and enforcement cases as possible prior to the July 21 handover. But as part of our ongoing discussions, the CFPB has asked the FDIC to continue handling certain consumer complaints after the

July 21 handover to provide for the orderly transition of complaint handling for large banks. We anticipate the possibility of ongoing work related to the transfer of consumer complaints between the FDIC and CFPB including, among other things, procedures for sharing information about complaints handled by each agency. The FDIC has also issued a solicitation of interest for experienced staff to apply for employment with the CFPB. At this point, 40 FDIC employees have accepted CFPB offers to transfer.

Conclusion

Today's testimony highlights the FDIC's progress in implementing financial reforms authorized by the Dodd-Frank Act. The Act authorized important reforms to the FDIC's deposit insurance program that will ensure that coverage is sufficient to preserve public confidence in a crisis, that premiums are proportional to insurance risks, and that the fund itself is restored to long-term health and maintained at levels that will withstand future periods of financial distress. These deposit insurance reforms are critical to both ensuring financial stability and preserving competitive balance between the largest institutions and smaller community institutions. The Act contains a number of provisions that, together, form the basis for a new SIFI resolution framework that substantially improves the ability of regulators to respond to severe financial distress on the part of a large, complex financial institution. These reforms are not a cure-all, but are designed to work in concert with the other Dodd-Frank Act reforms, including those that strengthen capital requirements and the DIF, to promote competitive balance and make financial crises less frequent and less costly in the future.

Since the Dodd-Frank Act became law one year ago, the FDIC has proceeded – on our own authority and in concert with our regulatory counterparts – to implement its provisions. We have made much progress in one year, but still have considerable work ahead of us. Throughout this process, we have sought input from the industry and the public, and we continue to report back to Congress on our progress. We believe that successful implementation of these provisions will represent a significant step forward in providing a foundation for a financial system that is more stable and less susceptible to crises in the future, and better prepared to respond to crises if and when they develop.

Thank you. I would be glad to take your questions.

For Release Upon Delivery
10:00 a.m., July 21, 2011

TESTIMONY OF

JOHN WALSH
ACTING COMPTROLLER OF THE CURRENCY

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

July 21, 2011

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Chairman Johnson, Ranking Member Shelby, and members of the Committee, today marks the one-year anniversary of the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). I appreciate the opportunity to provide the Committee with a progress report about the initiatives the Office of the Comptroller of the Currency (OCC) has undertaken to implement the Dodd-Frank Act.

The Committee's letter of invitation requests that I testify about the impact of the financial crisis on the economy, how the Dodd-Frank Act has improved the financial regulatory framework, and how the legislation will help prevent or mitigate another crisis. During the financial crisis, problems that originated primarily in the residential mortgage sector triggered disruption of the financial system more broadly, leading to severe loss of market liquidity and generating deep losses for investors, financial firms, and others. The global financial crisis was unprecedented in severity and duration, and the depth of the associated recession was the most severe we have experienced in the U.S. since the Great Depression of the 1930s. These financial and economic developments led, quite rightly, to a reconsideration of the ways financial markets and financial firms operate, and gave impetus to efforts to reform the financial system and its oversight.

In response, Congress passed the Dodd-Frank Act to address major gaps and flaws in the regulatory landscape, to tackle the systemic issues that contributed to, or that accentuated and amplified the effects of, the recent financial crisis, and to build a stronger financial system. The Act requires the Federal regulators to put in place new buffers and safeguards to protect against future financial crises and to revise and rewrite many of the rules governing the most complex areas of finance. Additionally, it consolidates authority that had been spread among multiple agencies, and it provides the Federal regulators a number of new tools that should help us avoid problems in the future. For example, the Financial Stability Oversight Council (FSOC or Council) offers a real opportunity to identify key risks across the entire financial system. Ultimately, we hope these reforms will ensure that we will not soon face another crisis of this magnitude.

Much has been written about the causes of the crisis and the efforts to reshape the regulatory landscape through the Dodd-Frank Act. In response to the Committee's invitation letter, I intend to focus my testimony today on the specific actions taken by the OCC to implement the Dodd-Frank Act. My testimony highlights the OCC's work in the following key areas:

- The integration of the staff and functions of the Office of Thrift Supervision (OTS) into the OCC;
- Our efforts to date to support the Bureau of Consumer Financial Protection (CFPB) in standing up its operations;,
- An update on the OCC's contributions to, and participation in, the FSOC;
- OCC efforts underway to implement the Dodd-Frank Act provisions that strengthen risk-based capital, leverage, and liquidity requirements; and
- Our progress in implementing certain key Dodd-Frank Act rulemakings.

I. <u>OTS/OCC Integration</u>

Today is the effective date of the transfer to the OCC of the OTS's responsibilities for supervising federal savings associations. Our goal was to make this transition as smooth as possible, and I am pleased to report our success in this regard. This past

Monday 674 OTS employees reported for duty at the OCC in locations around the country. The official personnel transfers will occur on July 31 to coincide with the beginning of the first full pay period after the official transfer date. In the meantime, these employees are detailed to the OCC under the terms of a blanket Memorandum of Understanding between the two agencies.

When I testified before this Committee in February 2011 and September of last year,[1] I described the steps the OCC was taking to prepare for our expanded supervisory responsibilities and for the integration of OTS staff that is so essential to the success of that effort. This included our close work with the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) to coordinate the transfer of OTS staff, assets, authority and responsibilities; numerous outreach efforts to educate the industry about our new supervisory responsibilities for federal savings associations; and the internal preparations for our expanded supervisory authority. We also noted the designation of a Deputy Comptroller for Thrift Supervision who reports directly to our Senior Deputy Comptroller for Midsize and Community Bank Supervision.

Since then, we have continued our efforts to prepare for an effective integration of the OTS into the OCC. I am very proud of the work done by numerous staff members of the OCC and OTS to accomplish that objective in accordance with the specific requirements of the Dodd-Frank Act. The following section discusses the general

[1] Testimony of John Walsh, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, February 17, 2011. Testimony of John Walsh, Acting Comptroller of the Currency, Before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, September 30, 2010.

framework for the integration and updates the specific actions the OCC has taken since my last testimony on this topic.

Organizational Realignment to Accommodate Expanded Supervisory Responsibilities

Our work in preparing for effective integration of OTS functions and staff focused on: ensuring that the employee protections afforded by the legislation were fully and equitably implemented; building a sustainable organizational structure to execute effective supervision and regulation of both national banks and federal savings associations on a going forward basis; fostering an environment that will maximize opportunities for staff; and promoting communication with employees and the industry throughout the transition planning process. The OCC's Community Bank Supervision staff will supervise the vast majority of the 648 thrifts for which the OCC is now responsible, while the Midsize and Large Bank Supervision programs will supervise federal savings associations with profiles that align with those units. The Special Supervision portfolio has been expanded to include certain troubled federal savings associations.

The OCC recognizes the importance of leveraging the talent and experience of former OTS staff to help us fulfill our supervisory responsibility for federal savings associations. The transferred OTS staff have been fully integrated into the various policy and field operations units where their skills and experience can best be utilized. All of our examiners will be able to participate in the supervision of both federal savings associations and national banks. Ultimately, the OCC's National Bank Examiner commission will expand to ensure that each commissioned examiner has the skill set and credentials to lead examinations of both national banks and federal savings associations. In the meantime, thrift examinations will continue to be led by accredited Federal Thrift Regulators, while examinations of national banks will be led by commissioned National Bank Examiners. We have completed a thorough evaluation of the OCC and OTS training and certification programs to identify where they coincide and where we need to address gaps. The OCC will work to fill those gaps going forward, but in the near term we are confident we have a sufficient combination of accredited and commissioned examiners to lead examinations of all the institutions we are charged with supervising.

Thrift Industry Outreach

The OCC communicated regularly with the thrift industry during the past year to share information and address concerns. The communication process began with a personal letter that I sent in September to the chief executive officer of each federal savings association. Five additional letters have been sent since that time to provide further information about the integration process. Senior OCC leaders also accepted numerous invitations to participate in industry-sponsored events that provided opportunities to speak directly with management representatives of federal savings associations. Additionally, the OCC developed a day-long program for thrift executives to provide them with information and perspective on the agency's approach to supervision and regulation. The OCC District Deputy Comptrollers and OTS Regional Directors co-hosted 17 of these sessions in locations around the country during the first quarter of 2011. Approximately 1,000 thrift industry representatives attended these sessions. The feedback from the attendees was very positive. They were reassured to learn that the OCC will examine them on the same FDICIA examination cycles as the OTS and that the OTS's historical supervisory information will be maintained and used to ensure continuity and minimize regulatory burden.

The OCC will continue to communicate regularly with thrift industry representatives outside of the supervision process to clarify our expectations, discuss emerging issues, and respond to their concerns. We participate in numerous industry-sponsored events during the year and conduct a variety of outreach activities, including Meet the Comptroller events, chief executive officer roundtables, and teleconferences on topical issues. We also plan to form advisory councils for mutually-owned federal savings associations and minority-owned institutions later this year to replace similar organizations that were sponsored by the OTS.

Review and Continuation of OTS Regulations

As a result of the Dodd-Frank Act's transfer to the OCC of the OTS's supervisory functions relating to federal savings associations, beginning today, the OCC will assume responsibility for the ongoing examination, supervision, and regulation of federal savings associations. The Act also transferred to the OCC rulemaking authority of the OTS relating to all savings associations, both state and federal. Importantly, the Dodd-Frank Act preserves the federal savings association charter going forward, and it retains the Home Owners' Loan Act, the primary statute governing the charter. The OTS's regulations relating to federal savings associations also remain in effect until modified or superseded by the OCC.

The OCC is undertaking a multi-phased review of its regulations, as well as those of the OTS, to determine what changes are needed. We expect first to revise provisions of the OCC's regulations that will be immediately helpful in effecting the transfer of supervisory jurisdiction for federal saving associations to the OCC. This would include the revision of regulations integral to the operations of the agency as well as changes to regulations needed to implement certain Dodd-Frank Act provisions that become effective today. Next, we will republish as OCC regulations the OTS regulations that the OCC will administer going forward to reduce confusion for federal savings associations and to remove duplication. Finally, over the coming months, we will continue to review OCC and OTS regulations, making substantive changes where needed and combining appropriate regulations to further reduce duplication. The following discussion details these efforts.

In addition to transferring to the OCC supervisory responsibility for federal savings associations, Title III of the Dodd-Frank Act transfers all functions of the OTS relating to state savings associations to the FDIC and all functions relating to the supervision of any savings and loan holding company to the FRB. To clarify which agency will be enforcing the OTS rules, the Dodd-Frank Act required the OCC and the FDIC to publish a notice in the Federal Register identifying those regulations of the OTS that the OCC, with respect to federal savings associations, and the FDIC, with respect to state savings associations, will enforce. The OCC published its notice on July 6, 2011.

On May 26, 2011, the OCC also issued a notice of proposed rulemaking (NPRM) revising certain OCC rules that are central to internal agency functions and operations immediately upon the transfer of supervisory jurisdiction for federal savings associations. These proposed changes include clarifying how the public can obtain information from the OCC about federal savings associations under the Freedom of Information Act

(FOIA), the release of non-public OCC information, including information about savings associations, and restrictions on the post-employment activities of senior examiners and assessments of federal savings associations.

The NPRM also contained amendments to the OCC's regulations relating to preemption and visitorial powers to implement the provisions of the Dodd-Frank Act that become effective today, that pertain to national bank and federal savings association preemption and to codify the Supreme Court's decision in the *Cuomo* case. These amendments effect the changes required by the Act, such as the elimination of preemption for both national bank and federal thrift operating subsidiaries. They do not expand federal preemption. The final rule, which appears in today's Federal Register, responds to key issues raised by commenters.

The OCC also has worked closely with OTS staff to prepare an interim final rule, effective shortly, that will republish most OTS regulations in the OCC's chapter of the Code of Federal Regulations and renumber them accordingly as OCC rules, with nomenclature and other technical amendments to reflect the OCC's supervision of federal savings associations. This action consolidates the regulations applicable to national banks and federal savings associations in the regulations of the OCC.

In the next phase of our regulatory review, the OCC will consider more comprehensive substantive amendments to former OTS regulations to reduce duplication and provide consistency with OCC rules. For example, we may propose to repeal or combine provisions in cases where OCC and former OTS rules are substantively identical or substantially overlap. In addition, we may propose to repeal or modify OCC or former OTS rules where differences in regulatory approach are not required by statute or warranted by features unique to either the national bank or federal savings association charter. In all cases we will seek public comment to assist in making these regulations workable and effective for federal savings associations.

II. Transfers of Specified Functions to the CFPB

The OCC also has been working to ensure an orderly transition of certain functions to the CFPB and to assist the CFPB where possible in standing up its operations. Although there are a handful of issues that still need to be resolved, we are striving to ensure that the OCC and CFPB will serve complementary supervisory roles.

On the administrative front, we have contributed staffing expertise by detailing six full time staff members to the CFPB to assist with operational issues. These OCC staff members provided expertise from various areas of the OCC, including the Law Department, the consumer complaints group, bank supervision, information technology, and the OCC's Office of Management. In addition, the OCC has assisted in developing the CFPB's procurement and personnel management processes by providing administration and human resources assistance and by sharing information on salary ranges, position descriptions, and benefits.

Moreover, OCC staff members have participated in numerous informational meetings with CFPB staff to advise them about OCC practices and to assist them in developing their own processes going forward. These meetings have covered a range of topics, including general supervisory matters and enforcement processes, as well as detailed information requests concerning fair lending supervision and analytics, and mortgage and credit card data metrics.

During these discussions, we also considered issues regarding staffing and transfer processes. The OCC and CFPB jointly determined that a voluntary solicitation of interest process would be used for the transfer of OCC employees that perform or support the consumer financial protection functions of the OCC that are transferred to the CFPB. The CFPB solicited interest in a potential transfer to the CFPB from OCC employees working in "transfer-process functions" (*e.g.*, compliance examination functions, enforcement and interpretation of consumer financial law, and consumer education) and made offers to several OCC "transfer-process" employees.

Additionally, we anticipate that we will be providing transitional support for other CFPB functions. One important area in this regard relates to consumer complaints. The OCC will continue to operate our Consumer Assistance Group (CAG) for complaints concerning consumer issues within the jurisdiction of the OCC. In addition, we expect to enter into a Memorandum of Understanding with the CFPB under which, while the CFPB builds its capacity to handle complaints, the OCC/CAG will do intake and processing of complaints on behalf of the CFPB. Under this approach, the CFPB will first begin to handle credit card related complaints involving large banks (those with assets of $10 billion or more) and consumers can contact the Bureau through its Web site, consumerfinance.gov with respect to those matters. It is our expectation that the consumer complaint function for large banks in additional areas will transition as the CFPB builds its capacity.

To inform the development of its supervisory priorities, the CFPB has made substantial requests for non-public supervisory information. In order to better share supervisory information, the OCC, the OTS, and the CFPB entered into a formal MOU.

This allowed the OCC to respond to CFPB information requests by providing: (1) reports of examination, supervisory letters, and other supervisory materials; (2) information on enforcement actions and referrals to other agencies, such as the Department of Justice; and (3) HMDA data analysis, including computer programs that the CFPB could use to recreate OCC analyses.

Finally, to facilitate ongoing communication and the coordination of supervisory matters with the CFPB, the OCC has established the Consumer Issues Steering Committee (CISC). The CISC is chaired by the Deputy Comptroller for Compliance Policy, and its members are representatives from various divisions within the OCC, including Community and Consumer Law, Mid-size Bank Supervision, Large Bank Supervision, and Compliance Policy. The CISC anticipates having regular meetings with CFPB supervision representatives to address examination coordination, information sharing, and consumer compliance issues, as needed.

III. Contributions to the Financial Stability Oversight Council

The OCC actively participates in the FSOC, whose mission is to identify risks to financial stability that could arise from the activities, material financial distress, or failure of large, interconnected financial companies; to recommend standards for implementation by the agencies in specified areas; to promote market discipline; and to respond to emerging threats to the stability of the U.S. financial system. As a means to accomplishing this, the FSOC brings together the views, perspectives, and expertise of Treasury and all of the Council member financial regulatory agencies.

The Council has had seven meetings since its inception with the most recent meeting on July 18. At the July 18 meeting, the Council approved a final rule establishing a framework for designating systemically important "financial market utilities" (FMUs). To process payments and settle transactions between financial institutions safely and efficiently, our financial system relies on certain established protocols and intermediaries, including FMUs that operate multilateral payment, clearing, or settlement systems among financial institutions. Notably, problems at one FMU have the potential to trigger disruptions among the financial institutions they serve. Title VIII of the Dodd-Frank Act directs the FSOC to designate systemically important FMUs for enhanced government oversight if the FSOC determines that the FMU's failure or disruption could create, or increase the risk of, significant liquidity and credit disruptions that would threaten the stability of the U.S. financial system. On July 18, 2011, following the FSOC's previous advance notice of proposed rulemaking (ANPR) and NPRM on this topic, the FSOC approved a final rule setting out the criteria, analytical framework, and process and procedures the FSOC will use in considering whether to designate an FMU as systemically important. The rule includes the statutory factors the FSOC is required to take into consideration and adds subcategories under each of the factors to provide examples of how those factors will be applied. The rule also outlines a two-stage process for evaluating and designating an FMU as systemically important. This process includes opportunities for an FMU to submit materials in support of or opposition to a proposed designation. Consistent with statutory provisions, any designation of an FMU will require approval by a two-thirds vote of sitting FSOC members and the Chairperson. The FSOC also must engage in prior consultation with the FRB and the relevant federal financial agency that has primary jurisdiction over the FMU.

The FSOC also is continuing its work under the provisions of the Dodd-Frank Act that require the designation of nonbank financial firms for enhanced supervision by the FRB. At its first meeting in October 2010, the FSOC approved publication of an ANPR requesting public comment regarding the criteria and analytical framework for designation of nonbank financial firms. Based on a review of comments received and consideration by the members of the FSOC at its January 2011 meeting, the FSOC approved an NPRM. The NPRM set forth the framework the FSOC proposed to use to determine whether a nonbank financial company could pose a threat to the financial stability of the United States. The comment period for this NPRM closed on February 25, 2011.

A number of commenters, as well as some members of this Committee,[2] thought that the NPRM lacked the specificity needed to provide meaningful guidance to potentially designated entities. There is general agreement among the FSOC agencies on the need to provide and seek comment on additional details regarding the standards for assessing systemic risk before issuing a final rule. Staffs are working on a more detailed approach with the goal of proposing revisions for comment in the near term.

Under the Dodd-Frank Act, the FSOC is required to report annually to Congress. This report is in its final approval stages with the FSOC-member agencies, and should be available very shortly. It will include a description of the activities of the FSOC,

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[2] *Oversight of Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability*, Hearing before the Senate Committee on Banking, Housing and Urban Affairs, 112 Cong., May 12, 2011 (Statements of Sens. Patrick J. Toomey, Sherrod Brown and Mark Warner).

significant market and regulatory developments, potential emerging threats to financial stability of the U.S., and recommendations to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets, promote market discipline, and maintain investor confidence.

IV. Strengthening Capital, Leverage, and Liquidity Requirements

The Committee's invitation also expressed an interest in receiving an update on the Dodd-Frank Act provisions relating to risk-based capital, leverage, and liquidity requirements. Section 165 of the Dodd-Frank Act authorizes the FRB, on its own or pursuant to recommendations from the Council, to establish heightened prudential standards for all designated non-bank financial companies and all bank holding companies with total consolidated assets of $50 billion or greater. These standards must address, among other things, risk-based capital, leverage, and liquidity requirements for those companies.

The Dodd-Frank Act provides a central role for the Council and the prudential regulators, including the OCC, with respect to the standards to be developed by the FRB. For example, under the Act the FSOC is required, as one of its enumerated purposes, to make recommendations to the FRB concerning the establishment of the heightened prudential standards, and the FRB, in prescribing the standards, must "take into account" the Council's recommendations. The FRB also is required to consult with the primary regulator for a depository institution subsidiary of a bank holding company – the OCC in the case of national banks or federal savings associations – before imposing heightened prudential standards on the company that are likely to significantly impact the depository institution subsidiary.

The OCC continues to be active in this consultative capacity both as a member of the Council and as the regulator of national banks and federal savings associations. The Council has established a Heightened Prudential Standards Committee, which the FRB and the OCC co-chair.

The Federal banking agencies also have moved quickly to implement other capital provisions contained in the Dodd-Frank Act. During the financial crisis, all U.S. banking institutions were required to calculate their regulatory risk-based capital requirements using the same generally applicable risk-based capital rules. Although no U.S. banking institutions have been approved to calculate their risk-based capital requirements using the internal modeling methodologies of the advanced approaches risk-based capital rules, there were concerns that large internationally active banking organizations theoretically could operate with lower minimum risk-based capital requirements using the advanced approaches rules than they would be required to hold under the general rules. To address this concern and prevent banking institutions' minimum required capital levels from falling in the wake of the financial crisis, the Dodd-Frank Act provided that the generally applicable risk-based capital rules shall serve as a floor for any other risk-based capital requirements.

Consistent with this requirement, the OCC, FRB, and FDIC published a final rule on June 28, 2011, that amends the advanced approaches risk-based capital regulations to institute a permanent floor. Under the final rule, each national bank subject to the advanced approaches risk-based capital rules must calculate its required minimum risk-based capital under both the general risk-based capital rules, which are applicable to all banks, and the advanced approaches rules, which are only applicable to the largest internationally active banks. Each quarter, an advanced approaches bank will have to calculate its minimum capital requirements under each set of rules, compare the results, and use the more stringent requirements to determine compliance with the minimum risk-based capital standards.

V. **Other Rulemakings**

As I noted in my February testimony, the OCC is participating in approximately 85 Dodd-Frank Act projects ranging in scope from our extensive efforts that helped to integrate the OTS's staff and supervisory responsibilities to consultation on a variety of rulemakings being undertaken by other agencies. This portion of my testimony highlights the progress we have made thus far in implementing certain key Dodd-Frank Act rules.

Incentive Compensation Rulemaking

Improperly structured compensation arrangements that provided executives and employees with incentives to take imprudent risks were among the many factors cited as contributing to the financial crisis. Consequently, the Dodd-Frank Act required the Federal banking agencies, the NCUA, the SEC, and the FHFA to prohibit incentive-based payment arrangements, or any feature of any such arrangement, at "covered financial institutions" (generally defined to include financial institutions with $1 billion or more in assets) that the agencies determine encourages inappropriate risks by providing excessive compensation or that could lead to material financial loss. Under the Dodd-Frank Act, covered financial institutions also must disclose to their appropriate Federal regulators the structure of their incentive-based compensation arrangements sufficient to determine whether the structure provides ''excessive compensation, fees, or benefits'' or ''could lead to material financial loss'' to the institution.

On April 14, 2011, the agencies issued a proposal to implement the incentive-based compensation provisions in Section 956 of the Dodd-Frank Act. The material financial loss provisions of the proposed rule establish general requirements applicable to all covered institutions and additional requirements applicable to larger covered financial institutions. The general requirements provide that an incentive-based compensation arrangement, or any feature of any such arrangement, established or maintained by any covered financial institution for one or more covered persons must balance risk and financial rewards and be compatible with effective controls and risk management and supported by strong corporate governance.

The proposed rule also includes two additional requirements for "larger financial institutions," which for the federal banking agencies, NCUA, and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. First, a larger financial institution must defer 50 percent of incentive-based compensation for its executive officers for a period of at least three years. Second, the board of directors (or committee thereof) of a larger financial institution also must identify, and approve, the incentive-based compensation arrangements for individuals (other than executive officers) who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These individuals may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.

The comment period on the proposed rule closed on May 31, 2011, and the agencies collectively received thousands of comments – approximately 9,700 comments were received by the OCC alone. The agencies are carefully considering the comments and diligently working toward jointly issuing the incentive-based compensation final rule.

Credit Risk Retention Rulemaking

Securitization markets are an important source of credit to U.S. households and businesses and state and local governments. When properly structured, securitization provides economic benefits that lower the cost of credit. However, when incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities, including informational and incentive problems among various parties involved in the process. To address these concerns, section 941 of the Dodd-Frank Act requires the OCC, together with the other Federal banking agencies, as well as HUD, FHFA, and the SEC to require sponsors of asset-backed securities to retain at least five percent of the credit risk of the assets they securitize. The purpose of this new regulatory regime is to correct adverse market incentive structures by giving securitizers direct financial disincentives against packaging loans that are underwritten poorly.

Pursuant to this requirement, the interagency group issued a joint proposal. In addition to requiring securitization sponsors to retain at least five percent of the credit risk of securitized assets, the proposal would establish a number of exemptions from the risk retention requirement, most notably, an exemption for securitizations backed entirely by "qualified residential mortgages" (QRMs).

Consistent with the statutory provision, the definition of QRM includes underwriting and product features that historical loan performance data indicate result in a low risk of default. Thus, the proposed QRM underwriting criteria are consistent with the premise that a complete exemption from risk retention should be supported by very high quality mortgage loans. That said, we note that this particular aspect of the proposal has been the subject of much comment. The OCC is interested in the feedback on this aspect of the proposal, and we note that if the agencies are persuaded that the proposed underwriting criteria are too restrictive on balance, the preamble to the proposal discussed several possible alternatives.

One alternative would be to permit the use of private mortgage insurance obtained at origination of the mortgage for loans with loan-to-value ratios higher than the 80 percent level specified in the proposed rule. Other alternatives discussed in the proposal include (i) imposing less stringent QRM underwriting criteria, but also imposing more stringent risk retention requirements on non-QRM loan asset-backed securities to provide incentives to originate QRM loans and reflect the relatively greater risk of the non-QRM loan market, and (ii) creating an additional residential mortgage loan asset class along side the QRM exemption with less stringent underwriting standards or private mortgage insurance, subject to a risk retention requirement set somewhere between zero and five percent.

The proposal was published in the Federal Register on April 29, 2011, and comments were due by June 10, 2011. However, the agencies extended the comment period until August 1, 2011, due to the complexity of the rulemaking and to allow parties more time to consider the impact of the proposal.

Margin and Capital Requirements for Covered Swap Entities

During the financial crisis, the lack of transparency in derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. To address this uncertainty, sections 731 and 764 of the Dodd-Frank Act require the OCC, together with the FRB, FDIC, FHFA, and Farm Credit Administration, to impose minimum margin requirement on non-cleared derivatives. Such requirements should reduce the ability of firms to take on excessive risks through swaps without sufficient financial resources to make good on their contracts. Also, because some financial institutions used derivatives to take on excessive risks, the margin requirements must be based on the risks posed by the non-cleared derivatives and derivatives counterparties. Firms that take significant risks through derivatives should face more stringent margin requirements with respect to non-cleared derivatives, while firms that take lower risks should face less stringent margin requirements.

Under the provisions of the Dodd-Frank Act, the OCC, together with the FRB, FDIC, FHFA, and Farm Credit Administration, published a proposal to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (swap entities) subject to agency supervision. Consistent with the Dodd-Frank Act requirement, the amount of margin that swap entities would be required to collect under the proposed rule would vary based on the relative risk of the counterparty and of the swap or security-based swap. A swap entity would not be required to collect margin from a commercial end user as long as its margin exposure is below an appropriate credit exposure limit established by the swap entity. A swap entity also would not be required to collect margin from low-risk financial end users as long as its margin exposure does not exceed a specific threshold; however, margin would be required to be collected from other financial end users and all swap entities. The proposed margin requirements would apply to new, non-cleared swaps or security-based swaps entered into after the proposed rule's effective date. The proposed rule does not create new capital requirements. Instead, it relies on existing capital standards that address non-cleared swaps and non-cleared security-based swaps to implement the requirement to establish capital requirement for regulated swap entities.

The proposal was published in the Federal Register on May 11, 2011, and comments were due on or before June 24, 2011. However, due to the complexity of the rulemaking, to allow parties more time to consider the impact of the proposed rule, and so that the comment period on the proposed rule would run concurrently with the comment period for similar margin and capital requirements proposed by the Commodity Futures Trading Commission (CFTC), the agencies extended the comment period until July 11, 2011.

Retail Foreign Exchange Transactions

To ensure that retail customers engaged in foreign currency trading fully understand the risks involved in the transactions, as well as to protect those customers from fraud, the Dodd-Frank Act amended the Commodity Exchange Act to provide that national banks (and other institutions) could engage in certain off-exchange transactions in foreign currency with retail customers only pursuant to rules adopted by a Federal regulatory agency, including the institution's appropriate Federal banking agency.

In general, a retail foreign exchange transaction is a transaction in foreign currency between a national bank and a retail customer that is: (i) a future or option on such a future; (ii) an option not traded or executed on a registered national securities exchange; or (iii) a certain leveraged or margined transaction. Last week, the OCC adopted a final rule that authorizes national banks to engage in certain off-exchange transactions in foreign currency with retail customers, subject to a number of requirements pertaining to disclosure, record keeping, capital and margin, reporting, business conduct, and documentation. The requirements are similar to a recently enacted CFTC rule governing retail foreign exchange transactions by CFTC registrants. The OCC decided to model its rule after the CFTC's rule to promote regulatory consistency.

VI. Conclusion

I appreciate the opportunity to update the Committee on the work we have done to date to implement the provisions of the Dodd-Frank Act, and, in particular, the actions we undertook over the course of the year to effect a smooth and workable integration of the OTS into the OCC. I am happy to answer your questions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM NEAL S. WOLIN

Q.1.a. A number of studies that purport to examine the tradeoff between increased bank capital and economic growth have been conducted by bankers, regulators, and academics. Some of these studies argue that increasing bank capital standards will result in substantially lower economic growth. Others argue that the tradeoffs are very small, and some argue that there is no tradeoff.

Do we face a tradeoff between increased bank capital and economic growth?

A.1.a. There is a potential tradeoff between higher bank capital requirements and economic growth. In making determinations regarding appropriate capital levels, it is critical to strike a careful balance. Treasury has advocated imposing heightened capital requirements to help ensure that the U.S. banking system is more stable and resilient. These requirements must be designed to allow institutions to absorb losses comparable to what the U.S. and other countries faced at the peak of the recent financial crisis, and still be able to operate without special Government support.

But while capital requirements must be high enough to provide strong cushions against loss, Treasury also believes that setting capital requirements too high could threaten the ability of banks to provide credit to households and businesses, or could drive the reemergence of risky shadow banking systems. Furthermore, it is important that banks be allowed to raise capital over an appropriate period so that they can continue to perform their essential function of providing credit to households and businesses.

It is also appropriate for regulators setting capital requirements to consider the prudential effects of other important reforms, including those required by the Dodd-Frank Act. Among these other reforms are the new liquidity requirements, limits on leverage, concentration limits, activity restrictions, margin rules for derivatives, the stronger financial cushions being built in central counterparties, and greater transparency requirements.

Q.1.b. Which specific studies led you to that conclusion?

A.1.b. There is a rich and varied literature on the potential tradeoff between capital requirements and economic growth, and the views set out above do not rely on any one study.

Q.1.c. Several prominent academics have argued that banks could be required to maintain equity capital ratios as high as 15 percent, or even 25 percent, of total assets (not risk-weighted assets) without adversely affecting economic growth. Do you agree with them? Please explain.

A.1.c. The Federal Reserve Board and other financial regulators have worked through the FSB and Basel Committee to put forward capital standards under Basel III that achieve a proper balance—

creating stronger cushions against loss, but not so high that they could threaten the ability of banks to provide credit to households and businesses, or could cause the re-emergence of risky shadow banking systems.

These new Basel III standards include a core solvency ratio (Tier 1 and Tier 2) of percent; a minimum requirement of 4.5 percent of common equity, and a 2.5 percent common equity capital conservation buffer. Further, countries may impose a countercyclical capital buffer ranging from 0 percent to 2.5 percent of common equity, according to national circumstances.

The Basel Committee on Banking Supervision in September also issued a final capital surcharge framework for globally important banking organizations (G–SIBs), which was endorsed by the Financial Stability Board in October and the G–20 at its Cannes meeting on November 4th. Under the designation criteria of the framework, G–SIBs are required to hold supplemental buffers of common equity in addition to the minimum Basel III requirements, ranging from 1 percent to 2.5 percent depending on the systemic risk posed by a banking organization.

We believe these new standards are appropriate and will provide stronger buffers against financial shocks. It also important that they be applied consistently across jurisdictions and we are working to ensure comparable implementation standards.

Q.2. Along with the FHFA and HUD, each of you had a hand in writing the proposed risk retention rule. Dodd-Frank exempted FHA-insured loans from these risk retention requirements. However, the proposed QRM section of the rule does not exempt loans insured by private mortgage insurance.

As private mortgage insurance and FHA are sometimes direct competitors, are any of you concerned that Dodd-Frank's risk retention requirements may shift more business toward FHA at a time when many experts believe that it should be trying to reduce its market share?

A.2. Although the Secretary of the Treasury, as Chairman of the Financial Stability Oversight Council (Council), is charged with coordinating the Dodd-Frank Section 941 risk retention rule, Treasury is not a rule writer. The joint rule writers are the FDIC, SEC, OCC, Federal Reserve Board, HUD, and FHFA.

The Notice of Proposed Rulemaking (NPR) was released in March 2011 and the comment period closed on August 1, 2011. The rule writers currently are considering the comments received.

Treasury agrees that a reduced Government role is important for the future of the housing finance system. We want to make sure that when the rule is finished, that the private market plays a critical role. In coordinating the agencies' writing of a final rule, Treasury will work to ensure that the role of the private market is carefully considered.

Q.3. Over a month ago, the Inspectors General from each of your agencies released reports that deepened my concern your agencies are not undertaking the type of economic analysis that is necessary to reveal how Dodd-Frank will affect our economy.

A.3. What specific steps have each of you taken, in response to the IG reports, to improve the amount and type of analysis that your agencies are conducting in implementing Dodd-Frank?

Treasury's Office of Inspector General (OIG) issued a report on June 13, 2011, regarding economic analysis by the Office of the Comptroller of the Currency (OCC) related to rulemakings in order to implement the Dodd-Frank Act. The Treasury OIG concluded that the OCC has processes in place to ensure that required economic analyses are performed consistently and with rigor in connection to its rulemaking authority.

The Treasury OIG recommended that the OCC: (1) develop procedures to ensure the coordination between the groups calculating administrative burden for various analyses and (2) update internal guidance to reflect the current statutory environment governing the rulemaking and related economic analysis processes, and develop related written procedures. The OCC has implemented these new enhancements to its rulemaking procedures including the related economic analysis.

The Treasury Secretary also has encouraged Financial Stability Oversight Council (Council) members to adopt the principles and guidelines set forth in the President's Executive Order 13563 of January 18, 2011, "Improving Regulation and Regulatory Review." Although the Executive Order does not apply to independent regulatory agencies, the Secretary encouraged all Council member agencies to adopt the principles and guidelines it sets forth. In addition, on July 11, 2011, the President signed Executive Order 13579, asking the independent regulatory agencies, to the extent permitted by law, to follow the cost-saving, burden-reducing principles in Executive Order 13563. These priorities and guidelines can help strike the right regulatory balance: helping to ensure regulations improve the performance of our economy and protect consumers and investors, without imposing undue costs on society.

Q.4. Secretary Wolin, in a recent speech by your colleague Assistant Secretary Mary Miller, she mentioned that the Financial Stability Oversight Council is coordinating Dodd-Frank rule-writing across agencies.

Does the Council's coordination of agency rulemaking include attempting to understand the cumulative costs of all the Dodd-Frank rules? If so, how is this being done? If it is not being done, why not?

A.4. The Administration has stressed the importance of regulations that strike the right balance between a financial system that is safer and more resilient and one that is innovative and dynamic.

The Administration is leading a Governmentwide effort to streamline, simplify, and review the costs and benefits of new and existing regulations. For example, in January, the President issued an Executive Order directing executive agencies to develop a plan to streamline regulations. In June, Secretary Geithner wrote a memo to members of the Council, encouraging the members that are independent agencies to adopt the principles and guidelines of the President's Executive Order. And in July, the President encouraged all independent regulatory agencies, to the extent permitted by law, to follow the key provisions of his January Executive Order.

The Council does not conduct cost-benefit analyses on rules proposed by independent rulemaking agencies. However, Treasury believes that it is important for agencies to consider the economic effects of significant rulemakings. Analyzing new regulations' costs and benefits, both in terms of individual rules and rules in aggregate, is an important part of getting the balance right. Because not all the costs and benefits of potential regulations may be quantified with precision, agencies must retain the ability to balance quantitative and qualitative factors as they implement their statutory obligations under the Dodd-Frank Act.

Q.5. Secretary Wolin, in a Politico op-ed earlier this month, you stated that "For years, regulators in Washington failed to make use of their authority to protect the system."

- Which regulators failed to properly use their authority to prevent the financial crisis?
- What action has the Administration taken to hold these regulators accountable for their failures?

A.5. In the years leading up to the financial crisis, regulators failed to use fully the authority they had both to constrain risk in the financial system and to protect consumers. Moreover, in critical areas there were significant gaps in legal authority to set standards or respond to a financial shock. Because of these factors, excessive risk taking and harmful practices in consumer lending by financial companies, which were central to the financial crisis, were not effectively monitored or prevented.

While Federal regulators had authority to better monitor risk taking by large financial institutions, no regulator had authority to comprehensively regulate the over-the-counter derivatives markets, or to impose tough prudential standards on companies like Lehman Brothers or AIG's Financial Products unit. Before Dodd-Frank, each financial regulator had authority to oversee particular institutions and markets, but regulators did not have an effective forum to work together to understand issues such as the risks in the securitization of subprime mortgages, which cut across multiple agencies' jurisdictions. The Financial Stability Oversight Council, which was created by Dodd-Frank, provides the financial regulators with a forum to coordinate across agencies and instill joint accountability for the strength of the financial system.

Similarly, prior to the passage of Dodd-Frank, seven different Federal agencies had responsibility for Federal consumer financial protection. Increasing accountability by consolidating authority for consumer financial protection is one of the reasons for creating the Consumer Financial Protection Bureau. Consumer financial protection had not been the primary focus of any Federal agency, and no agency had effective tools to set the rules for and oversee the whole market. The supervisory framework for enforcing consumer protection regulations had significant gaps and weaknesses and generally did not cover as well as it should have the nonbank financial companies that make up a significant segment of the consumer finance market.

The Administration has taken important, concrete actions to address regulatory accountability. Most notably, the Administration worked with Congress to enact the Dodd-Frank Wall Street Reform and Consumer Protection Act, which reformed the supervisory framework by:

- Establishing and supporting the Financial Stability Oversight Council, which enables unprecedented coordination between regulators and has responsibility to identify gaps in regulation that could pose risks to the financial stability of the United States;
- Establishing consolidated prudential supervision of federally chartered depository institutions and supporting the transfer of the prudential responsibilities from the Office of Thrift Supervision to the Office of the Comptroller of the Currency; and
- Establishing and supporting the Consumer Financial Protection Bureau, with the authority and accountability to ensure that Federal consumer financial protection regulations are written fairly and enforced vigorously.

RESPONSE TO WRITTEN QUESTION OF SENATOR CRAPO FROM NEAL S. WOLIN

Q.1. The SEC proxy access rule is the first Dodd-Frank rule that has been successfully challenged in the courts for failing to adequately analyze its economic costs and benefits. In the unanimous decision to vacate the rule, U.S. Circuit Judge Douglas Ginsburg wrote:

> The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

How do you intend to ensure that the rules that your agency adopts under Dodd-Frank are supported by rigorous economic analysis?

A.1. Unlike the primary Federal banking and market regulators, Treasury has a very limited rulemaking role under the Dodd-Frank Act. However, Treasury believes that it is important for Federal rulemaking agencies to consider the economic consequences of significant rulemakings. To that end, Treasury has a demonstrated history of compliance with applicable Federal requirements to consider the costs and benefits relating to significant rulemakings. Treasury is subject to the requirements of Executive Order 12866, which among other things, sets forth principles for Federal agency rulemaking, including that Federal agencies assess both the costs and the benefits of an intended regulation and, recognizing that some costs and benefits are difficult to quantify, propose or adopt regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs. Treasury also complies with the requirements of the Regulatory Flexibility Act, under which it considers the economic impact of rules on small entities. Finally, Treasury is subject to the President's January 18, 2011, Executive Order entitled "Improving Regulation and Regulatory Review" that reemphasizes the principles of cost-benefit analysis, which the Office of Management and Budget applies as part of its review process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM NEAL S. WOLIN

Q.1. I understand that the International Association of Insurance Supervisors (IAIS) has submitted questions to certain insurance companies in order to determine whether to designate them as G–SIFIs. Many U.S. insurers are concerned about the IAIS process, including confidentiality and their authority to demand such data. What is the United States position on the IAIS process, and how does the IAIS process fit within the FSOC process which also is charged with designating SIFIs? How will you ensure there are not duplicative or even inconsistent requests for data and designations?

A.1. Treasury is working to ensure that the international process around designations of systemically important insurance institutions (G–SIII) does not disadvantage U.S.-based insurance companies. To that end, the Federal Insurance Office (FIO) is participating in the IAIS to help develop a consensus approach with respect to the designation process and methodology that meets the goals of consistency and alignment between domestic and international designation processes. As part of this process, FIO is working to ensure data confidentiality at both the domestic and international levels. Also, FIO will help streamline data requests by working with domestic regulators and coordinating future international efforts to collect data from U.S.-based insurers.

Q.2.a. The Office of Financial Research (OFR) along with FSOC member agencies will have access to significant amounts of proprietary and other sensitive information about financial institutions.

How do you plan to protect that information from unauthorized disclosures, leaks, hacking or someone who is trying to steal the data for competitive purposes?

A.2.a. The Office of Financial Research (OFR) is developing robust plans to protect information and data.

First, the OFR uses the best available information technology security processes for protecting against unauthorized access to information through hacking, malware or other cyber-attacks.

1. The OFR builds on existing, secure IT infrastructure. We follow the National Institute for Standards and Technologies' standards required for high confidentiality, high integrity and high availability.
2. In the future, the Office of Financial Research's information security architecture will allow IT/Data security personnel to customize access to data consistent with their sensitivity.
3. At the individual level, OFR laptops are protected from accidental or intentional tampering. Users do not have administrative rights and all updates and changes are reviewed by IT security. Office of Financial Research email and system access is monitored at multiple levels. These controls are commonly audited as part of Treasury's normal acquisition processes, and a maintenance audit takes place at a minimum once a year.

Second, the OFR will strictly limit the scope of data and information collected to those needed to fulfill its mission.

Third, the OFR is working with FSOC member agencies to develop procedures and protocols to share data appropriately while limiting distribution to those who require it. Authorized participants in unique access programs or institutional agreements will be trained to manage the data at the level of confidentiality required by the originating agency. The OFR will avoid retaining records or allowing access beyond the mission needs for timely analysis, audits, evidentiary purposes, and in order to comply with records requirements.

Finally, post-employment restrictions will reinforce the OFR's security processes. No employee of the OFR who has had access to particularly sensitive data maintained by the OFR about financial entities required to report to the OFR may be employed by or provide advice or consulting services to a financial company for a period of 1 year after possessing access to such data or business confidential information. For employees whose access to confidential business information was sufficiently limited, the regulations may provide, on a case-by-case basis, for a shorter period of postemployment prohibition.

Q.2.b. What processes are you developing to govern who has access to information, under what circumstances it will be shared and penalties for unauthorized disclosures?

A.2.b. A robust, complete and mature data management discipline lies at the core of the OFR Operational Plan and will provide the backbone for its access policies. Data management is multifaceted. Proper enterprise data management entails establishing and implementing proper policies and procedures that address data through the entire data lifecycle—from acquisition to processing, storage, maintenance, validation, and finally access and distribution.

The framework for the governance of sensitive data at the OFR has several aspects:

- Proper identification of sources,
- Understanding the technical and business processes by which this information will be captured,
- Understanding the quality of these data and ensuring that information is properly "labeled" with correct and complete metadata that describes the data,
- Storing this data in an appropriate technology platform built to highest possible industry specifications regarding controlled access, and
- Defining the policies and procedures of entitlements—the business processes that define who in the community of the OFR can have access to data and through what authority, and how appropriate access can be made available to the designated oversight authorities.

Further, OFR governance processes will provide for requirements-based and role-defined access to data. Gates will be established at multiple levels, with associated audit trails.

The OFR will also collaborate with other FSOC members in establishing a governance framework for sharing financial information. That information sharing will be facilitated in part by the OFR efforts to standardize types and formats of data. The OFR is also exploring employing a data management maturity model to demonstrate its adherence to best practices in information management and to encourage best practices in other financial agencies.

The Office of Financial Research will refer suspected misuse of confidential information, bank secrecy information, credit information, or otherwise privileged information to Treasury's Office of the Inspector General. The OFR will also refer information related to gaining or providing unauthorized access to protected data to Treasury's Office of the Inspector General.

Q.2.c. What processes are in place now to protect systemic risk information that the SEC and CFTC have proposed to begin collecting early next year?

A.2.c. The SEC and CFTC are member agencies of the Financial Stability Oversight Council. In that capacity, the OFR will collaborate with the SEC and CFTC on data issues, including newly collected systemic risk information, where appropriate. Such information would be subject to the OFR data security and governance processes described above.

Q.3. I am concerned that U.S. institutions will bear a significant competitive burden *vis-a-vis* their foreign competitors. While U.S. commercial banks will be subject to the full weight of Dodd-Frank's heightened prudential standards and new systemic resolution regimes, large overseas competitors will be subject only to a systemic capital surcharge (sometimes called a G–SIFI or G–SIB surcharge) and the new Basel III capital requirements (both of which U.S. institutions will also have to meet).

How have U.S. regulators accounted for the competitive impact of our heightened domestic requirements for U.S. banks when they negotiated the recent G–SIFI surcharge with foreign regulators?

A.3. Treasury and U.S. financial regulators are working through international forums, such as the Basel Committee and Financial Stability Board (FSB), to build a global regulatory framework to ensure a level playing field. Recently, the FSB agreed on systemic capital surcharges for large banks that will help ensure additional loss absorbency requirements will be implemented fairly and evenly across institutions.

U.S. banking regulators are developing enhanced prudential standards for U.S. financial institutions that will take into account Basel III capital rules and their implications for domestic firms. In addition, Treasury and financial regulators have worked through international fora to develop standards for resolution regimes, similar to our own, to be applied globally. These efforts will help ensure an internationally level playing field for U.S. firms.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM BEN S. BERNANKE

Q.1. Chairman Bernanke, at the hearing I asked you about the Inspector General's claim that the Federal Reserve Board is using an antiquated methodology for conducting its cost benefit analysis. You stated that you did not believe that to be correct. On June 13, 2011, the Office of Inspector General, in its Response to a Congressional Request Regarding the Economic Analysis Associated with

Specified Rulemakings, included a recommendation "that the Board update the Rulemaking Procedures Policy Statement and broadly disseminate it to all employees involved in rulemaking activities." This recommendation stemmed from the Inspector General's finding that the only written policy related to economic analysis in Board rulemaking is more than 30 years old. If there is a more recent policy governing economic analysis in Board rulemaking, please provide it. If there is not a more current policy, do you agree that the Board should update its policy to reflect developments in the past three decades, including the President's recent executive orders with respect to economic analysis?

A.1. The IG's report included a positive review of our rulemaking activities. For example, the report notes that "the Board conducts the economic analysis required by statute and the discretionary economic analysis necessary to support rulemaking."[1] The IG's discussion of the qualitative and quantitative methodologies the Board employs in rulemaking was also generally positive.[2]

The Board has long been committed to considering the costs and benefits of its rulemaking efforts and the policies incorporated in the Board's Rulemaking Policy Statement reflect both that longstanding commitment and the principles recently enumerated in Executive Order 13563, issued on January 18, 2011. For example, like our guidance, the new Executive Order emphasizes the importance of public participation in the rule writing process, and a preference for allowing 60 days of public comment for proposed rules. Like our guidance, the new Executive Order also seeks to promote coordination among agencies, the reduction of regulatory burdens and an active consideration of alternatives. And like our guidance, the new Executive Order calls for retrospective, periodic review of existing regulations. Like the Executive Order, the Board's policy does not incorporate a specific formulaic approach to computing costs and benefits, and expects that methods used to determine costs and benefits will reflect the technologies and data available at the time.

The Board also recognizes that its policies can be improved. In keeping with the IG report, the Board will consider expanding its written procedures to include a documentation standard, and to provide more explanation regarding the Board's philosophy and principles supporting our rulemaking activities and our preferred practices. We have begun to review the guidance with this suggestion in mind, will revise it if necessary, and disseminate it to all staff involved in rule writing.

Q.2. Some analysts have suggested that the availability of mortgage credit is likely to be restricted as a result of Dodd-Frank. Specifically, they point to the interaction of laws and regulations such as the new Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM), as well as changes to the Home Ownership Equity Protection Act (HOPEA) triggers. Are any of you concerned about how these regulations may adversely impact the availability of

[1] *Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings,* Office of Inspector General, Federal Reserve Board, June 2011, p. 18. *See also,* p. 15.

[2] *Id.,* at 14–17, (questions 7A and 7B).

credit? If so, can these difficulties be handled administratively, or do they require legislative solutions?

A.2. Several provisions of the Dodd-Frank Act are intended to ensure that mortgage markets are sustainable and avoid the excesses and misaligned incentives that led to the housing and mortgage market difficulties that have been experienced over the past few years. In particular, the risk retention requirement, the ability-to-pay standards at the core of the definition of a Qualified Mortgage (QM), and the changes in the triggers that are established for the Home Ownership Equity Protection Act (HOEPA) seek to address some of the problems in lending practices that contributed to the financial crisis and the severe downturn in the housing and mortgage markets.

Addressing incentive problems in these markets and establishing rules to ensure lenders carefully consider a borrower's ability-to-pay in extending credit are two important goals of the Qualified Residential Mortgage (QRM) and QM rulemakings. Ensuring access to credit to well-qualified applicants is also an essential consideration in these rulemakings. Under the current statutory framework, the Board and a number of other agencies must jointly define the QRM triggers, and the Consumer Financial Protection Bureau (CFPB) must define QM.

When developing regulations that may impact mortgage lending, the Board routinely considers the potential for unduly constraining credit supply to qualified borrowers, including through regulation. The Board also routinely asks for comment on the extent that proposed mortgage regulations would constrain credit supply or increase costs for borrowers.

The Board is currently reviewing comments received on the proposal to implement QRM. There are various issues involved in developing the definition of QRM and the Board will carefully consider feedback from the public as the rulemaking moves forward, including comments related to costs and impact on access to credit. Access to credit is an area of great importance to the Board and issues related to both access to, and the cost of, credit will be a focus of the Board's consideration of the comments and views on further development of the rulemaking.

In the case of QM and HOEPA, responsibility for the rule-making has shifted from the Federal Reserve to the CFPB, which is reviewing comments received on the Board's proposal to implement QM. Because the QRM cannot be broader than the QM under the Dodd-Frank Act, the final QM definition will have an effect on how the final QRM may be defined.

Q.3.a. A number of studies that purport to examine the tradeoff between increased bank capital and economic growth have been conducted by bankers, regulators and academics. Some of these studies argue that increasing bank capital standards will result in substantially lower economic growth. Others argue that the tradeoffs are very small, and some argue that there is no tradeoff.

Do we face a tradeoff between increased bank capital and economic growth?

A.3.a. Bank capital standards affect economic growth in several ways, some positive and some negative. On the positive side, requiring banks to hold more capital increases their capacity to absorb losses and withstand adverse economic conditions. Moreover, well-designed capital standards can force banks to internalize to a greater extent the risks they take on, including the externalities associated with the failure of systemically important financial institutions. Both the increased capacity for loss absorption and the greater incentive to internalize risks should lead to a reduction in the likelihood and severity of financial instability and financial crises. At the same time, it is likely that there are also costs associated with increasing bank capital. For example, equity is a relatively expensive source of funding for banks. Unless the required return on bank equity falls sufficiently in response, requiring banks to fund themselves with more equity may both raise the cost of bank credit and lower the interest rate that banks pay to depositors. To the extent that the cost of bank credit rises, this is likely to result in lower investment by bank-dependent firms. In addition, to the extent that higher capital standards act as a "tax" on regulated financial institutions, there is a concern that financial activities could shift to the "shadow banking" sector, which would defeat the purpose of the higher standards and could have unintended consequences.

Some observers have contended that these concerns are exaggerated because, as banks de-lever, their equity becomes less risky and investors will be satisfied with a lower rate of return. However, the conditions needed for such a benign adjustment may not always be present. That said, it is possible that some adjustment in the expectations of investors regarding required return on bank equity could occur and mitigate the effect of higher capital standards on the cost of credit.

While it is difficult to know precisely what level of capital requirements would maximize the net benefits, an increase in capital standards relative to those prevailing before the financial crisis is desirable. Indeed, the reforms in Basel III strengthen capital standards, and promote a higher quality and quantity of capital across countries.

Q.3.b. Which specific studies led you to that conclusion?

A.3.b. The Financial Stability Board and the Basel Committee on Banking Supervision have published two studies examining the macroeconomic impact of strengthening capital standards.[3] These studies find net long term economic benefits from increasing the minimum capital requirements from their pre-crisis levels, coupled with modest costs during the transition phase to the new standards. In addition, there are several empirical studies that directly examined the link between bank capital and lending. These are

[3] See "An assessment of the long-term economic impact of stronger capital and liquidity requirements Basel III: A global regulatory framework for more resilient banks and banking systems," Basel Committee on Banking Supervision, Bank for International Settlements, August 2010, and "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements," Macroeconomic Assessment Group, Bank for International Settlements, August 2010. The former focuses on the long-term impact, while the latter considers the shorter-term transition phase. For related work, see also "The Welfare Cost of Bank Capital Requirements" by Skander J. Van den Heuvel, *Journal of Monetary Economics,* 55, 298–320, March 2008, and "Financial Capital and the Macroeconomy: Policy Considerations" by Michael T. Kiley and Jae W. Sim, Finance and Economics Discussion Series, 2011–28, Board of Governors of the Federal Reserve System.

generally supportive of the view that negative shocks to bank capital lead to lower lending.[4]

Q.3.c. Several prominent academics have argued that banks could be required to maintain capital ratios as high as 15 percent, or even 25 percent, of total assets (not risk weighted assets) without adversely affecting economic growth. Do you agree with them? Please explain.

A.3.c. As described above, there remains substantial uncertainty about the precise magnitude of both the benefits and the costs of a given increase in bank capital. The studies cited above are broadly supportive of somewhat higher standards. However, some observers claim that even greater increases in capital requirements are desirable.[5] It is difficult to know precisely at what level of capital requirements the costs of raising them further start to outweigh the benefits to economic growth. Given this uncertainty and, as described above, the fact that many of the idealized assumptions used by some of these observers do not hold in practice, the more modest approach taken in Basel III seems appropriate, particularly since implementation is occurring during a time of inadequate economic growth and financial market fragility.

Q.4. Along with the FHFA and HUD, each of you had a hand in writing the proposed risk retention rule. Dodd-Frank exempted FHA-insured loans from these risk retention requirements. However, the proposed QRM section of the rule does not exempt loans insured by private mortgage insurance. As private mortgage insurance and FHA are sometimes direct competitors, are any of you concerned that Dodd-Frank's risk retention requirements may shift more business towards the FHA at a time when many experts believe that it should be trying to reduce its market share?

A.4. The Federal Reserve and the other agencies involved in writing the QRM section of the risk retention Notice of Proposed Rule (NPR) carefully considered how to define the QRM to meet the Dodd-Frank Act's requirement that the definition "[take] into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default . . . ". Although the Dodd-Frank Act listed mortgage guarantee insurance as one factor that the regulatory agencies could take into account, we were not able to find data that supported the view that private mortgage insurance lowered the risk of default. Mortgage insurance has certainly protected lenders from losses when borrowers do default, but it does not appear to substantially lower the risk of default. Lenders, investors and other mortgage market participants will likely continue to value the protection offered by mortgage insurance, so even without being tied to QRM, demand for mortgage

[4] Examples include "The Credit Crunch" by Ben S. Bernanke and Cara S. Lown, *Brookings Papers On Economic Activity,* 2, pp. 205–239, 1991; "Bank Capital and the Credit Crunch: The Roles of Risk-Weighted and Unweighted Capital Regulations" by Diana Hancock and James A. Wilcox, *American Real Estate and Urban Economics Association Journal,* 22, no. 1: 59–94, 1994; "The International Transmission of Financial Shocks: The Case of Japan" by Joe Peek and Eric S. Rosengren, *American Economic Review,* 87, no. 4: 495–505, 1997.

[5] See, for example, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive" by Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig and Paul Pfleiderer, Working Paper, Stanford University, 2011; and "Optimal Bank Capital" by David Miles, Jing Yang and Gilberto Marcheggiano, Discussion Paper 31, Bank of England, 2011.

insurance should continue. Indeed, the definition of the QRM was narrowly drawn with the intent that the non-QRM market would remain large and robust, resulting in little difference in mortgage rates between the QRM and the non-QRM markets. If this outcome is realized, the relative standing of the FHA is unlikely to be greatly influenced by the QRM definition. That said, the agencies asked for comment on several issues related to mortgage insurance in the risk retention NPR. The comment period for the NPR closed on August 1, and the Federal Reserve, along with the other agencies, will carefully consider all comments we received on QRM and private mortgage insurance.

Q.5. Over a month ago, the Inspectors General from each of your agencies released reports that deepened my concern your agencies are not undertaking the type of economic analysis that is necessary to reveal how Dodd-Frank will affect our economy. What specific steps have each of you taken, in response to the IG reports, to improve the amount and type of analysis that your agencies are conducting in implementing Dodd-Frank?

A.5. See the response to Question 1.

RESPONSE TO WRITTEN QUESTION OF SENATOR CRAPO FROM BEN S. BERNANKE

Q.1. The SEC proxy access rule is the first Dodd-Frank rule that has been successfully challenged in the courts for failing to adequately analyze its economic costs and benefits. In the unanimous decision to vacate the rule, U.S. Circuit Judge Douglas Ginsburg wrote:

> The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

How do you intend to ensure that the rules that your agency adopts under Dodd-Frank are supported by rigorous economic analysis?

A.1. Since the enactment of the Dodd-Frank Act, the Federal Reserve, both independently and in conjunction with other agencies, has made considerable progress toward adopting regulations designed to promote financial market stability, strengthen financial institutions, and reduce systemic risk to the financial system and the economy.

The Board is committed to avoiding any disruption to the functioning of the financial system and the broader economy that might be caused by its rules. Each rulemaking proposal issued by the Board is drafted carefully to ensure that the congressionally prescribed mandates of the Dodd-Frank Act and other applicable laws are followed. Before issuing a final rule, the Board assesses the economic effects of the new rule and considers carefully the information provided by commenters through the rulemaking process. While this process may require significant staff resources, the Board values the public comment process and finds it very helpful in identifying and resolving issues raised by the proposed rules.

For every rule, the Board also conducts an assessment and takes appropriate account of the potential impact that its rule may have on small businesses, small governmental jurisdictions, and small organizations as required under the Regulatory Flexibility Act ("RFA") (5 U.S.C. 601 *et seq.*). The Board prepares and makes available for public comment in the Federal Register an initial regulatory flexibility analysis for any rule that will have a significant economic impact on a substantial number of small entities. A final regulatory flexibility analysis is prepared for every rule that may have a significant economic impact on a substantial number of small entities and published in the Federal Register.

The Board also complies with its obligation under the Paperwork Reduction Act ("PRA") (44 U.S.C. 3501 *et seq.*) to estimate the paperwork burden (specifically recordkeeping, reporting, and disclosure requirements) imposed by the Board's rules, and to keep this burden as low as possible. As required under the PRA, the Board seeks public comment on the paperwork burden imposed by its rules by providing notice in the Federal Register. The level of burden estimated under the PRA is then described, in detail, in the Federal Register notice for each final rule adopted by the Board, after taking account of the comments received during the public comment process. These Federal Register notices and final burden estimates are best evaluated in the context of each statutorily required rule and can be found on the Board's public Web site.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM BEN S. BERNANKE

Q.1. Under the proposed rule, loans insured by FHA are automatically exempt from the risk retention requirements. However, loans insured by private mortgage insurance, the private sector alternative to FHA, are not. Over the past 3 years, private mortgage insurers, using private capital, have blunted the loss of taxpayer dollars by absorbing approximately $25 billion in foreclosure losses that would have otherwise been borne by taxpayers. Meanwhile, taxpayers are on the hook for over $1 trillion in loans purchased by Fannie Mae and Freddie Mac and insured by FHA. Shouldn't the risk retention rule be designed to minimize taxpayer exposure by increasing the role of private capital by including loans insured by private mortgage insurance in the QRM definition?

A.1. The Federal Reserve and the other agencies involved in writing the qualified residential mortgage (QRM) section of the risk retention NPR carefully considered how to define the QRM to meet the Dodd-Frank Act's requirement that the definition "[take] into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default . . . ".

While the Dodd-Frank Act listed mortgage guarantee insurance as one factor that the regulatory agencies could take into account, the agencies did not see data that supported the view that private mortgage insurance lowered the risk of default by the borrower on the mortgage, which is the standard set by the statute for defining QRM. The agencies asked for comment on this and several other issues related to mortgage insurance in the risk retention NPR.

The comment period for the NPR closed on August 1 and the Federal Reserve, along with the other agencies, will carefully consider all comments we received on QRM and private mortgage insurance. The agencies have received several studies during the comment period regarding private mortgage insurance and are carefully reviewing them.

Q.2. The Office of Financial Research (OFR) along with FSOC member agencies will have significant amounts of proprietary and other sensitive information about financial institutions.

- How do you plan to protect that information from unauthorized disclosures, leaks or hacking or someone trying to steal data for competitive purposes?
- What processes are you developing to govern who has access to information, under what circumstances will it be shared and penalties for unauthorized disclosures?
- What processes are in place now to protect systemic risk information that the SEC and CFTC have proposed to being collecting next year?

A.2. The Board routinely receives highly confidential information from an array of sources, including market participants, regulated firms, and other agencies. Because the Board recognizes that the protection of this information is pivotal not only to the successful accomplishment of the Board's mission but also to those that provide the information to the Board, information security is of paramount importance. Accordingly, the Board protects proprietary and other sensitive information through appropriate security controls. In this respect, the Board has in place specific requirements for access, handling, transmission, and storage of nonpublic information that vary depending on the sensitivity of the information. These requirements are consistent with the Federal Information Security Management Act (FISMA) (44 U.S.C. §§ 3541 *et seq.*), which mandates that Federal agencies provide information security protections commensurate with risk and magnitude of harm from unauthorized access, use, disclosure, modification, or destruction for their information and information systems. These requirements mean, for example, that the most sensitive confidential business information may be shared only with staff with a specific need to know who are on an approved access list. Further, the Board also ensures that its information systems, including those that store or process proprietary and other sensitive information, have in place information security controls that meet the standards set forth by the National Institute of Standards and Technology. In addition, the Board's Office of Inspector General conducts an annual review of the effectiveness of the Board's information security program. The Board will apply its existing processes to protect the proprietary and other sensitive information that is provided by OFR, the CFTC or the SEC and will modify those processes as necessary to ensure that information provided by these entities is appropriately protected.

As for penalties for unauthorized disclosures, the protections provided by existing law also extend to information provided to the Board by the OFR, the SEC or the CFTC. For example, the Trade

Secrets Act, 18 U.S.C. § 1905, makes it a criminal violation for officers and employees of the U.S. Government to disclose confidential business information without authorization. Bank examiners are subject to additional requirements, including the prohibitions under 18 U.S.C. § 1906 that make it a crime for a bank examiner to disclose the names of borrowers or collateral for loans without authorization. Further, if confidential business information were stolen or misused, the person who misappropriates the information may be subject to prosecution under 18 U.S.C. § 641 which makes it a crime to, among other things, embezzle, steal, sell or knowingly convert anything of value of the Government to personal use without authorization. The Board would also apply its internal administrative processes and take appropriate action against any employee who discloses proprietary or other sensitive information without authorization.

Q.3. I am concerned that U.S. institutions will bear a significant competitive burden *vis-a-vis* their foreign competitors. While U.S. commercial banks will be subject to the full weight of the Dodd-Frank's heightened prudential standards and new systemic resolution regimes, large overseas competitors will subject only to a systemic capital surcharge (sometimes called a G–SIFI or G–SIB surcharge) and the new Basel II capital requirements (both of which U.S. institutions will also have to meet).

How have U.S. regulators accounted for the competitive impact of our heightened domestic requirements for U.S. banks when they negotiated the recent G–SIFI surcharge with foreign regulators?

A.3. While the Federal Reserve Board has been working domestically to implement the enhanced prudential standards required by the Dodd-Frank Act, it has (together with other U.S. Government regulatory agencies) also been working with the Financial Stability Board, the Basel Committee on Banking Supervision, and other international groups to harmonize and implement enhanced standards for internationally active banks. These enhanced standards should improve the banking sector's ability to sustain shocks that may arise in a stressed environment, strengthen the stability of the global economy, and address competitive considerations. In seeking to preserve a level playing field that will continue to allow U.S. companies to compete effectively and fairly in the global economy, the Board has been a strong proponent of international alignment with regard to implementation of strengthened prudential requirements, such as capital standards (including capital surcharges applicable to G–SIFIs) and living wills, and strengthening cross-border resolution capabilities.

Additionally, the enhanced prudential standards of section 165 of the Dodd-Frank Act not only apply to U.S. bank holding companies but also foreign banking organizations (FBO) that have operations in the United States and more than $50 billion in global assets. The Federal Reserve Board is still determining how to apply the enhanced standards of section 165 to these FBOs, but in its analysis the Board will consider the national treatment, competitive equality and the strength of the home country's supervisory regime, as required by the statute. Consistent with existing U.S. processes for issuing regulations, the Board will issue proposed rulemakings to solicit public comments prior to finalizing any regulatory requirements implementing section 165 of the Act. This will give domestic and foreign banking organizations the opportunity to comment on issues of cross-border competitiveness and the appropriateness of the Board's proposed rulemaking.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MARY L. SCHAPIRO

Q.1. Along with the FHFA and HUD, each of you had a hand in writing the proposed risk retention rule. Dodd-Frank exempted FHA-insured loans from these risk retention requirements. However, the proposed QRM section of the rule does not exempt loans insured by private mortgage insurance.

As private mortgage insurance and FHA are sometimes direct competitors, are any of you concerned that Dodd-Frank's risk retention requirements may shift more business toward FHA at a time when many experts believe that it should be trying to reduce its market share?

A.1. In developing the rules that will establish risk retention requirements under section 941(b) of the Dodd-Frank Act, the agencies were mindful of the statutory exemption granted by section 941(b) to FHA-insured loans, as well as the fact that private mortgage insurance historically has served as a form of credit enhancement accepted by Fannie Mae and Freddie Mac for mortgages with higher loan-to-value ratios that allows such mortgages to be securitized through mortgage-backed securities guaranteed by the Enterprises. As noted in the notice of proposed rulemaking (NPR), the risk retention requirements are intended to help address problems in the securitization markets by requiring that securitizers, as a general matter, retain an economic interest in the credit risk of the assets they securitize, thereby providing securitizers an incentive to monitor and ensure the quality of the assets underlying a securitization transaction, and also helping to align the securitizer's interests with those of investors.

Section 941(b) provides that in defining a qualified residential mortgage (QRM), the agencies must take into consideration "underwriting and product features that historical loan performance data indicate result in a lower risk of default.". With respect to private mortgage insurance, the agencies carefully considered the credit risk mitigation effects both of this insurance and other credit enhancements obtained at the time of origination. As noted in the NPR, the agencies considered a variety of information and reports relative to such insurance and other credit enhancements. While private mortgage insurance protects creditors from losses when borrowers default, at the time the agencies issued the proposed rules, the agencies had not identified studies or historical loan performance data adequately demonstrating that mortgages with such credit enhancements are less likely to default than other mortgages, as required by section 941(b).

The NPR includes many requests for comment on this aspect of the proposal, and specifically requested the public's input on whether private mortgage insurance obtained at the time of origination would or would not reduce the risk of a residential mortgage default that meets the proposed QRM criteria except for a loan to value ratio that is higher than the limits of the proposed requirements. The NPR also requests that commenters provide historical loan performance data or studies and other factual support for their views.

The comment period for the proposed rule formally ended on August 1, 2011, and we are carefully considering all comments as we move forward with this interagency rulemaking process. As we work collaboratively with our fellow regulators in developing final risk retention rules, we will continue to take into consideration the role that FHA-insured loans have in the marketplace, as well as the concerns that demand for these loans could increase if borrowers do not have available alternatives in the private marketplace.

Q.2. Over a month ago, the Inspectors General from each of your agencies released reports that deepened my concern your agencies are not undertaking the type of economic analysis that is necessary to reveal how Dodd-Frank will affect our economy.

What specific steps have each of you taken, in response to the IG reports, to improve the amount and type of analysis that your agencies are conducting in implementing Dodd-Frank?

A.2. After reviewing cost benefit analyses included in six of our Dodd-Frank Act rulemaking releases, the SEC's Inspector General issued a report in June of this year. While the Office of Inspector General ("OIG") is continuing to review the Commission's cost benefit analyses, this report concluded that "a systematic cost-benefit analysis was conducted for each of the six rules reviewed. Overall, [the OIG] found that the SEC formed teams with sufficient expertise to conduct a comprehensive and thoughtful review of the economic analysis of the six proposed released that [the OIG] scrutinized in [its] review." *See* U.S. SEC Office of the Inspector General, *Report of Review of Economic Analyses Performed by the Securities and Exchange Commission in Connection with Dodd-Frank Rulemakings* (June 13, 2011) *http://www.sec-oig.gov/Reports/AuditsInspections/2011/Report_6_13_11.pdf* at 43. We look forward to continuing to work with the OIG as it conducts a further review.

That said, I have asked the staff to improve the process for integrating economic analysis into its decisionmaking throughout the course of a rulemaking. Commission staff from the division or office responsible for a rule already work closely with the Commission's economists in the Division of Risk, Strategy, and Financial Innovation ("Risk Fin") in identifying and analyzing the economic impacts of our rules. However, we can and should make even better use of Risk Fin's economic expertise in our rulemaking. In fact, improving the agency's economic analysis capabilities was one of my primary goals in creating Risk Fin in September 2009. My view continues to be that the goal of a revised process should be to capitalize on that expertise by making sure that our economic experts are included at the earliest stages of policy development. This early involvement will allow them to provide initial economic analyses to inform policy choices, and will better position them to perform any additional data gathering and analysis needed to help the Commission prepare more complete economic analyses of proposed rules. In short, we are committed to doing what is necessary to perform robust economic analyses in furtherance of effective rulemaking for our pending rule proposals.

Q.3. Chairman Schapiro, the SEC has interpreted Dodd-Frank's municipal advisor registration requirement very broadly. For example, it would require banks to register even though they are already regulated by prudential bank regulators. The municipal advisor provision was intended to cover unregulated entities, not impose duplicative regulations.

- How will applying the registration requirement to entities that already are regulated help investors?
- Will dual regulation merely increase the cost of banking services for municipalities without providing any additional benefits?

A.3. The Commission has not finalized rules delineating the application of the municipal advisor registration requirements to banks at this time. As you know, on December 20, 2010, the Commission proposed for public comment rules that would govern the registration of municipal advisors and, among other things, proposed guidance and solicited comments on the provision of traditional banking activities within the context of the definition of "investment strategies." We have received over 1,000 comment letters on the proposal, including approximately 300 letters that address this important issue, and we are reviewing them carefully.

The lack of a proposed exclusion from the definition of "municipal advisor" for banks is consistent with the statutory definition of "municipal advisor," which does exclude certain federally regulated entities, such as investment advisers, but does not exclude banks. That said, the proposing release does not specifically define any traditional bank products and services as constituting municipal advisory activities. For example, the proposing release notes that "money managers providing advice to municipal entities with respect to their bank accounts could be municipal advisors." (emphasis added).

The proposing release asks numerous questions as to which, if any, of a wide variety of traditional bank activities and services would constitute municipal advisory activity. With respect to what extent banks should be excluded from the proposed municipal advisor registration requirements, in addition to reviewing the many comments received on this issue, Commission staff is consulting with staff at the Federal banking regulators regarding the appropriate scope of any such possible exclusion. This consultation should help promote a more effective and efficient implementation of the requirements of the Dodd-Frank Act that works to protect investors, municipal entities, obligated persons, and the public interest.

Commission staff is currently preparing drafts of final rulemaking for Commission consideration that will discuss the comment letters the Commission received concerning these topics. The Commission will consider the costs and benefits to investors, municipal entities, obligated persons, and the public before finalizing the municipal advisor registration rules required by the Dodd-

Frank Act. I expect that the final rule will provide clarity on this issue while striking an appropriate balance between ensuring that parties engaging in municipal advisory activities are registered, without unnecessarily requiring banks and bank employees already under the jurisdiction of Federal and State banking agencies to comply with additional regulation, examination and inspection burdens.

Q.4. Chairman Schapiro, in your testimony, you state that you "look forward to implementing" the recommendations made by the staff in a study of the obligations of broker-dealers and investment advisors. Two of your fellow Commissioners have called for additional work to determine whether there is a problem that needs to be solved and, if there is, whether the staff's recommended solution was the right one.

- Has the staff completed this additional work? If so, please provide it to the Committee. If not, isn't it premature to call for implementation of the staff's recommendations?

A.4. As you may be aware, in light of the Commission's concerns over the potential economic impact of any rulemaking under Section 913 of the Dodd-Frank Act, I requested that a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation study, among other things, available data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes, including any data addressing Commissioners Casey's and Paredes' concerns. Since the Commission issued the study required under Section 913 (the "Study"), this team of economists has been studying these issues, and staff has been reviewing public comments and meeting with interested parties to discuss their concerns and request additional data to inform the staff's economic analysis. This work will help to inform any future rulemaking. As you know, with any rulemaking, the Commission is required to conduct an economic analysis regarding the costs and benefits of any rules it proposes and consider, among other things, public comment on any such proposal, including public comment on the Commission's economic analysis, before adopting any final rule. I believe investors would be well served by the Commission moving forward in a studied and measured way, taking into account the work of our team of economists and other staff, to consider a rule proposal to implement the staff's recommendations to better protect investors as set forth in the Study.

Q.5. Chairman Schapiro, last week, Judge Rakoff issued an opinion in which he questioned the SEC's decision to litigate on "its home turf" by filing an administrative action, rather than a district court action, against one of the defendants in the Galleon insider trading cases. The SEC relied on the retroactive application of a Dodd-Frank provision to do so.

- Why is the SEC retroactively applying Dodd-Frank in a manner that could compromise an important enforcement action?

A.5. On March 1, 2011, the Commission instituted public administrative and cease-and-desist proceedings pursuant to Section 8A of the Securities Act of 1933, Sections 15(b) and 21C of the Securities

Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 against Rajat K. Gupta. In these proceedings, the Commission sought to determine whether it was appropriate to enter a cease-and-desist order, and to order disgorgement, civil penalties, and a bar against Mr. Gupta serving as an officer or director of a public company. The request for civil penalties relied, in part, on Dodd-Frank amendments to the securities laws that enable the Commission to seek civil penalties in administrative cease-and-desist proceedings. The Commission also sought civil penalties against Mr. Gupta, however, under other provisions of the securities laws that existed and authorized such penalties prior to the enactment of Dodd-Frank.

On March 18, 2011, Mr. Gupta filed a lawsuit against the Commission in the U.S. District Court for the Southern District of New York challenging the institution of these proceedings. His complaint challenged the Commission's action on due process grounds and also alleged impermissible retroactive application of the Dodd-Frank amendments to the securities laws. The court denied the Commission's motion to dismiss Mr. Gupta's complaint, but limited the theory of his complaint to one of equal protection, and ordered discovery and a hearing to determine whether the Commission's attempt to apply the civil penalty provisions in Dodd-Frank retroactively amounted to a denial of equal protection.

On August 4, 2011, the Commission announced that it had determined that it was in the public interest to dismiss the administrative proceedings against Mr. Gupta. Subsequently, on October 26, 2011, the Commission filed a civil action in the U.S. District Court for the Southern District of New York against Mr. Gupta based on the same factual allegations as had underpinned the prior administrative proceeding. The Commission also asserted new insider trading claims against Raj Rajaratnam in the same action, based on material nonpublic information that Mr. Gupta allegedly provided to Mr. Rajaratnam. The Commission's action against Mr. Gupta and Mr. Rajaratnam remains pending.

The Commission does not believe the request for civil penalties based on Dodd-Frank amendments to the securities laws made in the original administrative proceeding against Mr. Gupta was an impermissible retroactive application of the new provisions, nor does the Commission believe it was improper for any other reason. Nevertheless, the issue has become moot in light of the Commission's dismissal of the administrative proceeding and filing of a civil action against Mr. Gupta. Moreover, the Commission does not believe that the filing of the administrative proceeding compromised the enforcement action against Mr. Gupta in any way.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY L. SCHAPIRO

Q.1. The SEC proxy access rule is the first Dodd-Frank rule that has been successfully challenged in the courts for failing to adequately analyze its economic costs and benefits. In the unanimous decision to vacate the rule, U.S. Circuit Judge Douglas Ginsburg wrote:

> The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

How do you intend to ensure that the rules that your agency adopts under Dodd-Frank are supported by rigorous economic analysis?

A.1. When engaging in rulemaking, we analyze the direct and indirect costs and benefits of the Commission's proposed decisions against alternative approaches, including, the effects on competition, efficiency and capital formation. We invite the public to comment on our analysis and provide any information and data that may better inform our decisionmaking. In adopting releases, the Commission responds to the information provided and revises its analysis as appropriate. This approach helps ensure a regulatory framework that strikes the right balance between the costs and the benefits of regulation.

As you note, however, the Court of Appeals vacated the SEC's proxy access rule for certain deficiencies that they found in our economic analysis of the rulemaking. We are carefully considering the court's criticisms and are taking appropriate steps to respond to those that may bear on pending and future rulemakings.

I have asked the staff to improve the process for integrating economic analysis into its decisionmaking throughout the course of a rulemaking. Commission staff from the division or office responsible for a rule already work closely with the Commission's economists in the Division of Risk, Strategy, and Financial Innovation ("Risk Fin") in identifying and analyzing the economic impacts of our rules. However, we can and should make even better use of Risk Fin's economic expertise in our rulemaking. In fact, improving the agency's economic analysis capabilities was one of my primary goals in creating Risk Fin in September 2009. My view continues to be that the goal of a revised process should be to capitalize on that expertise by making sure that our economic experts are included at the earliest stages of policy development. This early involvement will allow them to provide initial economic analyses to inform policy choices, and will better position them to perform any additional data gathering and analysis needed to help the Commission prepare more complete economic analyses of proposed rules. In short, we are committed to doing what is necessary to perform robust economic analyses in furtherance of effective rulemaking for our pending rule proposals.

Q.2. SEC Commissioners Kathleen Casey and Troy Paredes issued a statement calling for rigorous economic analysis on the SEC staff study on Investment Advisers and Broker-Dealers. The two commissioners stated:

> Indeed, the study does not identify whether retail investors are systematically being harmed or disadvantaged under one regulatory regime as compared to the other and, therefore, the study lacks a basis to reasonably conclude that a uniform standard or harmonization would enhance investor protection.

Have you requested that the SEC staff follow-up on this request before considering any potential rule changes?

A.2. Yes. In light of the Commission's concerns over the potential economic impact of any rulemaking under Section 913, I requested that a core team of economists from the Commission's Division of Risk, Strategy and Financial Innovation study, among other things, available data pertaining to the standards of conduct in place under the existing broker-dealer and investment adviser regulatory regimes, including any data addressing Commissioners Casey's and Paredes' concerns. Since the Commission issued the study required by Section 913 of the Dodd-Frank Act (the "Study"), staff has been reviewing public comments and meeting with interested parties to discuss their concerns and request additional data to inform the staff's economic analysis. I believe investors would be well served by the Commission moving forward in a studied and measured way, taking into account the work of our team of economists and other staff, to consider a rule proposal to implement the staff's recommendations to better protect investors as set forth in the Study.

Q.3. One of the results of the recent securities subcommittee hearing on swap execution facilities was a bipartisan agreement that the SEC and CFTC need to provide greater coordination and harmonization to get the rules right. How do you intend to achieve harmonization between your two agencies on the treatment of request for quotes, block trades, and real time reporting?

A.3. We are cognizant of the goal of harmonization of our rules with those of the CFTC in these and other areas under Title VII, to the extent practicable. In drafting the SEC's rules relating to security-based swap execution facilities ("SB SEFs") and trade reporting and dissemination for security-based swaps, SEC staff has met regularly with their counterparts at the CFTC. We have consulted extensively with CFTC staff and market participants as well, regarding Dodd-Frank Act implementation, and we continue to be guided by the objective of achieving consistent and comparable regulation, to the extent possible, as we move toward final rules.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM MARY L. SCHAPIRO

Q.1.a. The Office of Financial Research (OFR) along with FSOC member agencies will have access to significant amounts of proprietary and other sensitive information about financial institutions.

- How do you plan to protect that information from unauthorized disclosures, leaks, hacking or someone who is trying to steal the data for competitive purposes?

A.1.a. The SEC has invested in technologies to protect and monitor proprietary and otherwise sensitive data that resides on our systems and are transmitted to and from our systems. These technologies will allow the SEC to manage access to these data, prevent or detect changes and maintain an audit trail. Additional technology will allow the SEC to monitor when sensitive data are being sent out of, or retrieved from, its systems.

The Dodd-Frank Act contemplates that the SEC will share certain of the data it gathers with the Office of Financial Research (OFR), Financial Stability Oversight Council (FSOC) and members of FSOC, and we expect that these agencies will each have their own information technology systems and controls for protecting proprietary and otherwise sensitive data. Under Exchange Act section 24(c) and rule 24c–1 thereunder, the SEC's practice is to require "such assurances of confidentiality as the [SEC] deems appropriate" prior to sharing nonpublic information with other regulators.

Q.1.b. What processes are you developing to govern who has access to information, under what circumstances it will be shared and penalties for unauthorized disclosures?

A.1.b. Under the Dodd-Frank Act, the SEC is required to collect information from hedge fund and other private fund advisers for FSOC's use in monitoring systemic risk. In a joint release with the CFTC, the SEC recently adopted the new Form PF, which these advisers will use to report information regarding the funds they manage. The Dodd-Frank Act established heightened confidentiality protections for this information, much of which is nonpublic. Reporting on Form PF will begin in the third quarter of 2012, though most advisers will not submit their initial reports until the spring of 2013.

In advance of receiving Form PF data, SEC staff is working to design controls and systems for the use and handling of that data in a manner that reflects the sensitivity of these data and is consistent with the confidentiality protections established in the Dodd-Frank Act. The SEC recently announced that the Financial Industry Regulatory Authority (FINRA) will develop and maintain a filing system to receive Form PF data, and this system will be programmed with security features designed to limit access and maintain the confidentiality of these data. SEC staff is also studying whether multiple access levels can be established so that SEC employees are allowed only as much access as is reasonably needed in connection with their duties.

The Dodd-Frank Act contemplates that Form PF data may be shared with other Federal agencies or with self-regulatory organizations, in addition to FSOC, for purposes within the scope of their jurisdiction. In each case, the heightened confidentiality protections that the Act establishes for these data continue to apply when the data are shared.

Unlike the data that the Dodd-Frank Act contemplates the Commission will collect from hedge fund and other private fund advisers for FSOC's use in monitoring systemic risk, data with respect to transactions or positions in security-based swaps ("SBS") will be collected and maintained by security-based swap data repositories ("SDRs") that will register with the Commission under Title VII of the Dodd-Frank Act. In 2010, the Commission proposed rules implementing the Dodd-Frank Act requirement for SDRs to maintain the privacy of SBS transaction information. In particular, the Commission's proposed rules would require SDRs to establish and maintain safeguards, policies and procedures reasonably designed to prevent the misappropriation or misuse of confidential information, material nonpublic information, and intellectual property, including limiting access to such information and intellectual property by associated persons of SDRs. The Commission's proposed rules also would require an SDR to establish, maintain, and enforce policies and procedures designed to ensure its automated systems have adequate levels of security.

In addition, the Dodd-Frank Act authorizes SDRs, on a confidential basis pursuant to Section 24 of the Exchange Act, upon request and after notifying the Commission, to make available to the FSOC and certain other U.S. and foreign regulators all data obtained by the SDR, including individual counterparty trade and position data. The Act requires SDRs to obtain a written agreement from the FSOC or regulator stating that it shall abide by the confidentiality requirements described in Section 24 relating to the information on security-based swap transactions that is provided and an agreement to indemnify the SDR and the Commission for any expenses arising from litigation relating to the information provided under Section 24. Commission staff is contemplating alternatives to provide the FSOC (and other appropriate authorities) with access to SBS data collected and maintained by SDRs, subject to assurances of confidentiality as required by Section 24.

Q.1.c. What processes are in place now to protect systemic risk information that the SEC and CFTC have proposed to begin collecting early next year?

A.1.c. As noted above, in a joint release with the CFTC, the SEC recently adopted Form PF to collect systemic risk information from hedge fund and other private fund advisers. Reporting on Form PF will begin in the third quarter of 2012, though most advisers will not submit their initial reports until the spring of 2013. In preparation for these filings, the SEC is working with FINRA to develop the Form PF filing system, including programming it to reflect the heightened confidentiality protections created for Form PF filing information under the Dodd-Frank Act and allow for secure access by FSOC and other regulators as permitted under the Dodd-Frank Act.

Certain aspects of the Form PF reporting requirements will also help to mitigate the potential risk of inadvertent or improper disclosure. For instance, because data on Form PF generally could not, on its own, be used to identify individual investment positions, the ability of a competitor to use Form PF data to replicate a trading strategy or trade against an adviser is limited. In addition, the deadlines for filing Form PF have, in most cases, been significantly extended from the proposal, meaning that the filings will generally contain less current, and therefore less sensitive, data.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM GARY GENSLER

Q.1. Along with the FHFA and HUD, each of you had a hand in writing the proposed risk retention rule. Dodd-Frank exempted FHA-insured loans from these risk retention requirements. However, the proposed QRM section of the rule does not exempt loans insured by private mortgage insurance.

- As private mortgage insurance and FHA are sometimes direct competitors, are any of you concerned that Dodd-Frank's risk retention requirements may shift more business toward FHA at a time when many experts believe that it should be trying to reduce its market share?

A.1. The question is most appropriately answered by others on the panel.

Q.2. Over a month ago, the Inspectors General from each of your agencies released reports that deepened my concern your agencies are not undertaking the type of economic analysis that is necessary to reveal how Dodd-Frank will affect our economy.

What specific steps have each of you taken, in response to the IG reports, to improve the amount and type of analysis that your agencies are conducting in implementing Dodd-Frank?

A.2. The Administrative Procedure Act (APA) requires the CFTC to provide notice and an opportunity to comment before finalizing rules that will impose new obligations on any person or group of persons. The CFTC considers all of the comments it receives to inform its final rulemaking. To ensure that its final rulemakings have reasoned bases, the CFTC and its staff review all estimates of costs and benefits that are received from commenters and any data supporting them. This enables the Commission to adopt rules as required by the Dodd-Frank Act while ensuring that they do not impose unnecessary costs on market participants and the public.

Through meetings with industry and the public and through the receipt of public comments, the Commission obtained the views of informed parties to improve its understanding of costs and benefits before many of the CFTC's more significant Dodd-Frank rulemakings to date were proposed. CFTC staff has hosted public roundtables to assist in preparation of proposed rules in line with industry practices. This has allowed us to mitigate compliance costs whenever possible, while fulfilling the CFTC's obligation to promote market integrity, reduce risk and increase transparency under the Dodd-Frank Act. Information about each of these meetings, as well as full transcripts of the roundtables, is available on the CFTC's Web site and has been factored into applicable rulemakings.

On May 13, 2011, the Commission's Chief Economist and General Counsel jointly issued guidance to CFTC rulemaking teams. Under that guidance, the Office of the Chief Economist (OCE) assigns a staff person to each rulemaking team to provide quantitative and qualitative input on costs and benefits of the final rulemaking. Under the guidance, the OCE representative employs price theory economics or similar methodology to assess associated costs and benefits.

CFTC economists have been playing an integral role in the formation and analysis of cost-benefit considerations. The Commission is dedicated to maintaining the integrity and functioning of derivatives markets without imposing undue burdens on market participants and the broader economy.

Q.3. Chairman Gensler, this month the CFTC has adopted a number of final rules under Dodd-Frank. Some of these rules use the terms "swap," "swap dealer," and "major swap participant." Dodd-Frank directed the CFTC to adopt a rule further defining these terms. The CFTC has not done this yet.

How can you adopt final rules that apply to people and products that you have yet to define?

A.3. In December 2010, the CFTC and the SEC jointly issued a proposed rule to further define the terms “swap dealer” and “security-based swap dealer” as well as “major swap participant” and “major security-based swap participant.” In May, the agencies jointly proposed rules further defining products covered by Title VII of the Dodd-Frank Act. With the substantial completion of the proposal phase of rule-writing, the public earlier this summer had the opportunity to review the whole mosaic of proposed rules. The CFTC reopened or extended comment periods for most of our proposed rules for an additional 30 days—allowing the public to submit comments after seeing the entire mosaic at once.

Q.4. Chairman Gensler, two of your fellow Commissioners expressed their frustration at the CFTC’s rush to get final rules done without a plan for getting them done in a logical manner. In your testimony, you state that you want public input on implementation, but do not mention anything about a sensible plan for finalizing the rules.

Why are you ignoring the pleas of your colleagues for a public plan for rule adoption?

A.4. The Dodd-Frank Act provides the Commission with ample flexibility to phase in implementation of requirements. The CFTC and SEC staff held roundtables on May 2 and 3, 2011, on this issue and have solicited comments from the public regarding such concerns. This important input informs the final rulemaking process.

We’ve also reached out broadly on what we call “phasing of implementation,” which is the timeline for rules to take effect for various market participants. This is critically important so that market participants can take the time now to plan for new oversight of this industry.

On September 8, the Commission approved two proposed rulemakings seeking additional public comment on the implementation phasing of swap transaction compliance that will affect the broad array of market participants. The proposed rulemakings provide the public an opportunity to comment on compliance schedules applying to core areas of Dodd-Frank reform. One proposal would provide greater clarity to market participants regarding the timeframe for bringing their swap transactions into compliance with the clearing and trade execution requirements. The second proposal approved on September 8 would provide greater clarity to swap dealers and major swap participants regarding the timeframe for bringing their swap transactions into compliance with new documentation and margining rules. These proposed rules will make the market more open and transparent while giving market participants adequate time to comply. Their purpose is to help facilitate an orderly transition to a new regulatory environment for swaps.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM GARY GENSLER

Q.1. The SEC proxy access rule is the first Dodd-Frank rule that has been successfully challenged in the courts for failing to adequately analyze its economic costs and benefits. In the unanimous decision to vacate the rule, U.S. Circuit Judge Douglas Ginsburg wrote:

> The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

How do you intend to ensure that the rules that your agency adopts under Dodd-Frank are supported by rigorous economic analysis?

A.1. The Commission takes very seriously the consideration of costs and benefits of the rules it considers under the Dodd-Frank Act as required under section 15(a) of the Commodity Exchange Act. The economic costs and benefits associated with regulations, especially as they pertain to commenters' concerns, are of utmost importance in the Commission's deliberation and determination of final rules.

As noted in the guidance for cost-benefit considerations for final rules memorandum to rulemaking teams from the Chief Economist and General Counsel dated May 13, 2011, the rulemakings will involve quantified costs and benefits to the extent it is reasonably feasible and appropriate. For rules that do not have quantifiable costs, the Commission seeks to explain why such costs are not quantifiable and to explain the reasoning and supportive explanation of its predictive judgments using qualitative measures.

The Commission further recognizes the significance of meaningful issues raised by commenters regarding costs or benefits and takes those comments seriously as it is working on final rules. For those comments which persuade the Commission to modify its proposed rule, the Commission seeks to explain why the proposed alternative more effectively furthers the goal(s) of the statute in light of the section 15(a) factors, not only in the cost-benefit section but throughout the rule's preamble. In contrast, for those comments which do not persuade the Commission to modify its proposed rule, the Commission seeks to explain its adoption of the proposed rule as the most effective means to further the goal(s) of the statue in light of section 15(a). The Commission seriously considers commenters' concerns regarding costs or benefits and evaluates the alternatives presented.

Through the Commission's rulemaking process and its cost-benefit considerations, the agency is committed to enhancing market transparency, which will improve the integrity of the derivatives market without imposing unwarranted costs on the marketplace or financial system.

Q.2.a. Chairman Schapiro testified that we must continue to evaluate carefully the international implications of Title VII.

> Rather than deal with these implications piecemeal, we intend to address the relevant international issues holistically in a single proposal. The publication of such a proposal would 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.

Do you intend to coordinate with SEC on ,this single proposal for the purpose of assuring regulatory consistency and comparability?

A.2.a. The CFTC's 31 Dodd-Frank staff rulemaking teams and the Commissioners are all working closely with the SEC and all fellow regulators. CFTC staff have held more than 600 meetings with their counterparts at other agencies and have hosted numerous public roundtables with staff from other regulators to benefit from the open exchange of ideas. Commission staff will continue to engage with their colleagues at the SEC and other agencies as we proceed to develop and consider final rules and ensure harmonization among agencies. Our international counterparts also are working to implement needed reform. We are actively consulting and coordinating with international regulators to promote robust and consistent standards and to attempt to avoid conflicting requirements in swaps oversight. Section 722(d) of the Dodd-Frank Act states that the provisions of the Act relating to swaps shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce" of the United States. We are developing a plan for application of 722(d) and are hoping to seek public input this fall. The Commission will continue to coordinate closely with the SEC and fellow regulators.

Q.2.b. Will you submit proposed rules on the application of Title VII rulemakings to inter-affiliate transactions, which are necessary for sound risk managements of global financial firms? In European markets, the treatment of inter-affiliate transactions may be different than the U.S. approach. How will global firms implement these conflicting regulatory requirements?

A.2.b. The CFTC's proposed rulemaking (jointly with the SEC) to further define the term "swap dealer" includes a discussion of how swaps between affiliates would be considered when determining if one of the affiliates is a swap dealer and specifically seeks public comment on that topic. The proposal does note that one hallmark of the definition that refers to holding oneself out as a dealer is that the entity has considerable interaction with unaffiliated counterparties.

The CFTC has received comments in response to various proposed rulemakings and advance notices of proposed rulemaking that raise questions regarding whether and to what extent inter-affiliate transactions should be subject to the clearing, trading and/or reporting requirements of the Dodd-Frank Act.

The Commission will take into account all comments it has received in determining further action.

Q.3. One of the results of the recent securities subcommittee hearing on swap execution facilities was a bipartisan agreement that the SEC and CFTC need to provide greater coordination and harmonization to get the rules right. How do you intend to achieve harmonization between your two agencies on the treatment of request for quotes, block trades, and real-time reporting?

A.3. The CFTC and SEC consult and coordinate extensively to harmonize our rules to the greatest extent possible. These continuing efforts began with the enactment of the Dodd-Frank Act. This close coordination will continue and will benefit the rulemaking process.

With regard to the SEF rulemakings, the CFTC's proposed rule would provide all market participants with the ability to execute or trade with other market participants. It will afford market participants with the ability to make firm bids or offers to all other market participants. It also will allow them to make indications of interest—or what is often referred to as "indicative quotes"—to other participants. Furthermore, it will allow participants to request quotes from other market participants. These methods will provide hedgers, investors and Main Street businesses the flexibility to trade using a number of methods, but also the benefits of transparency and more market competition. The proposed rule's approach is designed to implement Congress' mandate for a competitive and transparent price discovery process.

The proposal also allows participants to issue requests for quotes, with requests distributed to a minimum number of other market participants. For block transactions, swap transactions involving nonfinancial end-users, swaps that are not "made available for trading" and bilateral transactions, market participants can get the benefits of the swap execution facilities' greater transparency or, if they wish, choose execution by voice or other means of trading.

In December 2010, the CFTC published a notice of proposed rulemaking regarding real-time public reporting of swap transaction data. The proposal would implement a new framework for the real-time public reporting of swap transactions and pricing data for all swap transactions. Additionally, the proposed rules address the appropriate minimum size and time delay relating to block trades on swaps and large notional swap transactions.

In the futures world, the law and historical precedent is that all transactions are conducted on exchanges, yet in the swaps world many contracts are transacted bilaterally. While the CFTC will continue to coordinate with the SEC to harmonize approaches, the CFTC also will consider matters associated with regulatory arbitrage between futures and swaps. The Commission has received public comments on its SEF rule and is evaluating those comments in developing a final rule.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM GARY GENSLER

Q.1. The CFTC recently released data showing that well over 90 percent of daily futures trading volume in the most popular products comes from "day trading" accounts, not from "large traders." For example, only 5.5 percent of crude trading volume on the New York Mercantile Exchange involved net changes in large traders' positions.

How will the CFTC's proposed position limits reduce volatility in the markets, given that the proposed limits will only impact large traders and not the active day traders that are actually affecting the long-term equilibrium of the futures markets?

A.1. The proposed rule would establish uniform position limits and related requirements for all economically equivalent derivatives for physical commodities. Without position limits, a leveraged market participant can take a very large speculative position across multiple venues. The proposed position limit framework would reduce the ability of such leveraged entities to take such positions. In developing the CFTC's proposed position limits rule, the agency adhered to Section 4a(a)(3) of the CEA—position limits are to address excessive speculation and market manipulation, while taking into consideration the need to protect market liquidity for bona fide hedgers and price discovery. However, the proposed position limit framework would not impose restrictions on trading activity and, thus, would not restrict active day traders who do not maintain large positions.

Q.2. A number of market participants have expressed concerns related to the implementation of the derivative title of Dodd-Frank. Many experts have suggested that the lack of logical order to the rulemaking process and the lack of final definitions for key terms like "swap" and "swap dealer" have created a lack of confidence in the new regulatory regime being established by the CFTC. Can you update the Committee on how you are going to sequence these rules so that the market can adjust to these changes?

A.2. The Dodd-Frank Act provides the Commission with ample flexibility to phase in implementation of requirements. The CFTC and SEC staff held roundtables on May 2 and 3, 2011, on this issue and have solicited comments from the public regarding such concerns. This important input informs the final rulemaking process.

We've also reached out broadly on what we call "phasing of implementation," which is the timeline for rules to take effect for various market participants. This is critically important so that market participants can take the time now to plan for new oversight of this industry.

On September 8, the Commission approved two proposed rulemakings seeking additional public comment on the implementation phasing of swap transaction compliance that will affect the broad array of market participants. The proposed rulemakings provide the public an opportunity to comment on compliance schedules applying to core areas of Dodd-Frank reform. One proposal would provide greater clarity to market participants regarding the timeframe for bringing their swap transactions into compliance with the clearing and trade execution requirements. The second proposal approved on September 8 would provide greater clarity to swap dealers and major swap participants regarding the timeframe for bringing their swap transactions into compliance with new documentation and margining rules. These proposed rules will make the market more open and transparent while giving market participants adequate time to comply. Their purpose is to help facilitate an orderly transition to a new regulatory environment for swaps.

Also on September 8, the Commission released an outline of final rules to be considered in the remainder of 2011 and next year.

Q.3. The Office of Financial Research (OFR) along with FSOC member agencies will have access to significant amounts of proprietary and other sensitive information about financial institutions.

- How do you plan to protect that information from unauthorized disclosures, leaks, hacking or someone who is trying to steal the data for competitive purposes?

- What processes are you developing to govern who has access to information, under what circumstances it will be shared and penalties for unauthorized disclosures?
- What processes are in place now to protect systemic risk information that the SEC and CFTC have proposed to begin collecting early next year?

A.3. The CFTC protects information from unauthorized access and improper use through comprehensive administrative, technical and physical security measures in compliance with the Federal Information Security Management Act (FISMA) and the Privacy Act of 1974. The CFTC's technical security measures include restricted computer access, required use of strong passwords that are frequently changed, encryption for certain data types and transfers, and regular review of security procedures and best practices to enhance security. Physical measures include restrictions on building access to authorized individuals and maintenance of records in lockable offices and filing cabinets. Administrative measures include: a strong security and privacy governance structure, policies and procedures for safeguarding confidential information and immediately reporting incidents of actual or suspected loss or compromise of information, annual mandatory training for all CFTC personnel, clearly defined roles for personnel with security and privacy responsibilities, and appropriate background checks for personnel with access to sensitive confidential information.

CFTC information may be shared with the FSOC and OFR in accordance with Section 112(d) of the Dodd-Frank Act and the Privacy Act of 1974. Such information may be shared with the FSOC and OFR as necessary to monitor the financial services marketplace to identify potential risks to the financial stability of the United States or to otherwise carry out any of the provisions of Title I of the Dodd-Frank Act. The CFTC is working closely with the FSOC, OFR, and other member agencies to assure compliance with the requirements to maintain the confidentiality of data, information, and reports submitted under Title I. Penalties for unauthorized disclosure include disciplinary action, civil and criminal penalties.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN WALSH

Q.1. Some analysts have suggested that the availability of mortgage credit is likely to be restricted as a result of Dodd-Frank. Specifically, they point to the interaction of laws and regulations such as the new Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM) standards, as well as changes to the Home Ownership Equity Protection Act (HOEPA) triggers.

Are any of you concerned about how these regulations may adversely impact the availability of credit? If so, can these difficulties be handled administratively, or do they require legislative solutions?

A.1. The QRM and QM provisions of Dodd-Frank are related in that they are both designed to address problems that led to the mortgage crisis, albeit in different ways, and both could impact credit availability depending on the form of the final rules.

We have received comment letters on the proposed risk retention rules that argue that the combination of changes to mortgage standards required by Dodd-Frank (the QRM and QM provisions) and changes to HOEPA triggers and coverage may cause lenders to restrict their residential mortgage lending. The thrust of the argument is that, in order to avoid strict TILA liability and to be eligible for the exemption from the Dodd-Frank risk retention requirement, lenders will have a strong incentive to make only those mortgages that meet the criteria that satisfy both standards so the loan is both QRM- and QM-compliant, without becoming subject to HOEPA restrictions.

The QRM and QM rules have not yet been finalized. The rulemaking agencies for the QRM standard are the OCC, Federal Reserve, FDIC, SEC, HUD and FHFA. For the QM standard, only the Consumer Financial Protection Bureau (CFPB) has rulemaking authority. It will be critically important that these two rulemaking initiatives are coordinated so that the net end result is not an unnecessary impediment to credit availability for credit-worthy borrowers.

Q.2.a. A number of studies that purport to examine the tradeoff between increased bank capital and economic growth have been conducted by bankers, regulators, and academics. Some of these studies argue that increasing bank capital standards will result in substantially lower economic growth. Others argue that the tradeoffs are very small, and some argue that there is no tradeoff.

Do we face a tradeoff between increased bank capital and economic growth?

A.2.a. As the question indicates, there are many studies on either side of this issue. The tradeoff in which increases in bank capital beyond some level constrains economic activity and growth certainly is a complex question, but one that should not be ignored when setting standards for minimum regulatory capital.

Q.2.b. Which specific studies led you to that conclusion?

A.2.b. The possibility of a tradeoff follows from two bodies of economic research: one concluding that bank capital and capital requirements affect bank lending, and a second concluding that bank lending affects real economic activity.

With regard to the first of these—the connection between capital and lending theoretical analyses such as Diamond and Rajan (2000) demonstrate that an increase in capital requirements can result in a withdrawal of credit from some borrowers and an increase in the price of credit for others.[1] VanHoose (2007) summarizes the theoretical work.[2] These theoretical predictions are supported by real-world empirical studies. For example, Peek and Rosengren (1995) identify a significant relationship between regulatory capital requirements and lending.[3] They find that increases in required bank capital not only cause bank loan portfolios to shrink, but have

[1] Douglas W. Diamond and Raghuram G. Rajan, "A Theory of Bank Capital," *The Journal of Finance,* Vol. 55, No. 6 (Dec. 2000), pp. 2431–2465.

[2] David VanHoose, "Theories of bank behavior under capital regulation," *Journal of Banking & Finance,* 31 (2007), pp. 3680–3697.

[3] Joe Peek and Eric Rosengren, "Bank regulation and the credit crunch," *Journal of Banking & Finance,* 19 (1995), pp. 679–692.

a pronounced effect on the flow of new bank credit; they note that "a large share of the shrinkage occurs in the bank-dependent loan category" (such as small businesses) and that "this shrinkage is not only statistically, but economically, significant" (Peek and Rosengren, p. 691). Note that recent proposals for a "countercyclical capital buffer" from the Basel Committee on Banking Supervision presume the existence of this type of connection between capital standards and bank credit.

An extensive body of macroeconomic research demonstrates that a reduction in bank credit can affect economic activity. This literature generally addresses the role of bank credit as an important channel for the transmission of the effects of monetary policy, and includes Bernanke (1983), Bernanke and Blinder (1988), and many others.[4] Research in this area frequently finds that the primary impact of this channel is on small firms with limited access to capital markets—a reduction in bank credit leaves such firms with few alternative sources of funding, and forces them to scale back, with negative consequences for broad measures of real economic activity.

Q.2.c. Several prominent academics have argued that banks could be required to maintain equity capital ratios as high as 15 percent, or even 25 percent, of total assets (not risk-weighted assets) without adversely affecting economic growth. Do you agree with them? Please explain.

A.2.c. It is important to note that the academic community itself is far from unified on this issue. A paper that has received significant popular attention is a manuscript by Admati *et al* (2011), arguing that banks could be required to hold much more capital with little economic cost.[5] However, for a critical discussion of that paper by a leading banking scholar, see Flannery (2011); Flannery concludes that while Admati *et al* make many valid points, "the analysis fails to provide suitable guidance for the ongoing debate about how much capital is sufficient.[6] Given the lack of agreement within academia, it would be dangerous to make significant changes to policy without more careful analysis and consideration of all available evidence.

Q.3. Along with the FHFA and HUD, each of you had a hand in writing the proposed risk retention rule. Dodd-Frank exempted FHA-insured loans from these risk retention requirements. However, the proposed QRM section of the rule does not exempt loans insured by private mortgage insurance.

As private mortgage insurance and FHA are sometimes direct competitors, are any of you concerned that Dodd-Frank's risk retention requirements may shift more business toward FHA at a time when many experts believe that it should be trying to reduce its market share?

[4] Bernanke, Ben S. "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review,* Vol. 73, June 1983, pp. 257–276; Ben S. Bernanke and Alan S. Blinder, "Credit, Money, and Aggregate Demand," *American Economic Review,* Vol. 78, May 1988, pp. 435–439.

[5] Anat R Admati, Peter M. DeMarzo, Martin F. Hellwig, Paul Pfleiderer, "Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive," Stanford Graduate School of Business Research Paper, No. 2065, August 2011.

[6] Commentary by Mark Flannery on "Why Bank Equity is Not Expensive," for *International Journal of Central Banking,* Third Financial Stability Conference, London, May 2011.

A.3. As you note, the statute itself, and not the proposed rule, exempts the FHA from risk retention, presumably because the FHA has the power to set its own underwriting standards to control its risk exposure under the FHA's guarantee. While private mortgage insurers and the FHA both guarantee higher loan-to-value ratio loans, it is difficult to say they are direct competitors. The FHA's underwriting standards cover higher loan-to-value ratios than typically are covered by private mortgage insurers at a comparable premium cost to the borrower.

To include private mortgage insurance in the QRM criteria, the statute requires the Agencies to determine that it lowers the risk of *default.* Private mortgage insurance clearly has the benefit of reducing the risk of *loss* to investors in the event of default, but this is a separate question from whether it reduces the risk of *default* in the first place. The OCC will be interested in information provided by commenters on this topic, and the data they have provided.

Q.4. Over a month ago, the Inspectors General from each of your agencies released reports that deepened my concern your agencies are not undertaking the type of economic analysis that is necessary to reveal how Dodd-Frank will affect our economy

What specific steps have each of you taken, in response to the IG reports, to improve the amount and type of analysis that your agencies are conducting in implementing Dodd-Frank?

A.4. On June 13, 2011, the Department of the Treasury's Office of Inspector General (IG) issued a report on the economic analyses performed by the OCC with respect to three rules that implemented provisions of Dodd-Frank. The IG report was positive in its findings and identified a few issues that we are addressing. Specifically, the report summarized its conclusions as follows:

> In brief, we found that OCC has processes in place to ensure that required economic analyses are performed consistently and with rigor in connection with its rulemaking authority. Furthermore, we found that those processes were followed for the three proposed rules we reviewed.

The report also recommended that the OCC develop procedures to facilitate coordination among the groups calculating administrative burden for various analyses and to update the OCC's internal rulemaking guidance to reflect statutory and other changes from the last version.

In response to the IG report, the OCC has updated its Guide to OCC Rulemaking Procedures, which provides guidance to staff involved in the rulemaking process, to assist further coordination among the OCC groups addressing burdens for applicable regulatory analyses. The regulatory handbook will be made available to all departments in the OCC that work on rulewriting projects. This update includes changes to reflect recent statutory amendments.

RESPONSE TO WRITTEN QUESTION OF SENATOR CRAPO FROM JOHN WALSH

Q.1. The SEC proxy access rule is the first Dodd-Frank rule that has been successfully challenged in the courts for failing to adequately analyze its economic costs and benefits. In the unanimous decision to vacate the rule, U.S. Circuit Judge Douglas Ginsburg wrote:

> The commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantifIed; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.

How do you intend to ensure that the rules that your agency adopts under Dodd-Frank are supported by rigorous economic analysis?

A.1. The OCC currently conducts economic analyses, as applicable, under the Unfunded Mandates Act, Regulatory Flexibility Act, and Congressional Review Act. Our Policy Analysis Division has established procedures to address situations where the OCC is required to conduct an economic analysis. These procedures have been incorporated into revisions to the Guide to OCC Rulemaking Procedures and include, among other things, specific steps for preliminary impact assessments and the relevant statutory standards for review. These procedures also address coordination with other relevant OCC divisions involved in the rulewriting process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM JOHN WALSH

Q.1. Under the proposed rule, loans insured by FHA are automatically exempt from the risk retention requirements. However, loans insured by private mortgage insurance, the private sector alternative to FHA, are not. Over the past 3 years, private mortgage insurers, using private capital, have blunted the loss of taxpayer dollars by absorbing approximately $25 billion in foreclosure losses that would have otherwise been borne by taxpayers. Meanwhile, taxpayers are on the hook for over $1 trillion in loans purchased by Fannie Mae and Freddie Mac and insured by FHA. Shouldn't the risk retention rule be designed to minimize taxpayer exposure by increasing the role of private capital by including loans insured by private mortgage insurance in the QRM definition?

A.1. As you know, the statute itself, and not the proposed rule, exempts the FHA from risk retention, presumably because the FHA has the power to set its own underwriting standards to control its risk exposure under the FHA's guarantee. To include private mortgage insurance in the QRM criteria, the statute requires the Agencies to determine that it lowers the risk of *default.* Private mortgage insurance clearly has the benefit of reducing the risk of *loss* to investors in the event of *default,* but this is a separate question from whether it reduces the risk of default in the first place. The OCC will be interested in information provided by commenters on this topic, and the data they have provided.

Q.2.a. The Office of Financial Research (OFR) along with FSOC member agencies will have access to significant amounts of proprietary and other sensitive information about financial institutions.

How do you plan to protect that information from unauthorized disclosures, leaks, hacking or someone who is trying to steal the data for competitive purposes?

A.2.a. There is a Memorandum of Understanding (MOU) in place between the FSOC and its members to address the sharing and treatment of nonpublic information in connection with the Dodd-Frank functions and activities of the FSOC or the OFR. The MOU was drafted to insure the protection of the sensitive, nonpublic information that will be potentially shared with the FSOC, the OFR and among members of the FSOC. The MOU sets forth the following general principles: (1) any data, information or reports shared among the Parties in connection with the functions and activities of the FSOC or OFR are "nonpublic information;" (2) Any nonpublic information transferred from one party to another under the MOU shall not be disclosed by the receiving party other than as permitted by the MOU; (3) nonpublic information may be shared internally by a receiving party only on a need-to-know basis; (4) any official, employee or individual under the supervision of the receiving party must be advised that as a condition of their access to the nonpublic information, they must be advised of and bound by the terms of the MOU and must comply with its terms; (5) nonpublic information may not be shared by a receiving party with any third party without the written permission of the providing party, except under limited circumstances provided in the MOU; (6) the receiving parties must take all steps reasonably necessary to preserve, protect, and maintain all privileges and claims of confidentiality related to nonpublic information subject to the MOU; (7) the parties intend that sharing of nonpublic information pursuant to the MOU does not constitute public disclosure nor a waiver of confidentiality or any applicable privilege; and, (8) any nonpublic information provided to a receiving party under the MOU remains nonpublic and confidential even if the receiving party is no longer a party to the MOU or the MOU is terminated as to all parties.

Additionally, the MOU places certain notice and cooperation requirements on the parties in the event of a FOIA request, subpoena or other request to a receiving party by a third party for nonpublic information not belonging to that receiving party. The OCC may share nonpublic supervisory information with the FSOC, OFR and member agencies pursuant to confidentiality provisions in the MOU.

The OCC also has robust internal security measures already in place for the protection of sensitive and proprietary information. The OCC routinely uses and protects information that is similar to what the OCC may receive in the context of FSOC activities. Such information includes, but is not limited to documents, records, data, and information created or used by the OCC in the course of conducting official business.

The OCC utilizes the security standards established by the Federal Interagency Security Committee (ISC) to choose the location of its offices and the minimum physical security posture that will be implemented for each facility. Access to each OCC office is strictly controlled with each of OCC's primary facilities being protected by a combination of security guards, Homeland Security Presidential Directive-12 compliant physical access control systems, intrusion detection alarms, closed circuit television monitoring and strict physical security policies and procedures.

Every employee and contractor granted employee-like access to OCC facilities or information assets undergoes a comprehensive background investigation for suitability that must be favorably adjudicated. All visitors to OCC facilities are required to be escorted at all times and areas containing sensitive information assets or equipment such as file rooms or Local Area Network (LAN) rooms are protected by access control systems and other protective measures such as locked cages.

The OCC maintains a comprehensive Information Security Program that was created in response to Federal and departmental directives, as well as to meet its fiduciary responsibilities to its customers to protect the confidentiality, integrity and availability of its information and supporting technology. In support of this objective, the *OCC Information Security Program: Policies, Standards, and Required Controls* document establishes comprehensive, uniform information security policies and standards, that are implemented through a combination of management, operational, and technical controls. The policies and standards in this handbook augment national and Treasury directives, adapt them to OCC's specific circumstances, and where warranted, supply additional direction. Taken together, the policies, standards, controls, and roles and responsibilities presented in the handbook represent a comprehensive and uniform approach to protecting against loss, misuse, unauthorized access, and unauthorized modification of information and information systems essential to the OCC's mission.

The OCC prohibits unauthorized access to or use of its sensitive information and information resources. Only OCC-authorized users are allowed to access sensitive information and access to that information is only granted on a need-to-know basis. Prior to being granted access to sensitive information, all OCC employees and contractors must sign a nondisclosure statement and satisfactorily complete a security and privacy awareness training session.

The OCC maintains a Computer Incident Response Center (CIRC) that constantly monitors OCC networks and computers to detect, prevent and respond to external attacks and operate antivirus systems. In addition, every OCC computer hard drive is encrypted to prevent unauthorized access to sensitive information on the drives and the OCC maintains the ability to remotely send a freeze signal to any OCC computer that falls into the wrong hands or a wipe signal to completely erase the contents of the hard drive. The OCC also utilizes an application that automatically encrypts any portable storage media, such as memory sticks or external drives that is plugged into an OCC computer to ensure the protection of any sensitive information transferred to the portable device.

Q.2.b. What processes are you developing to govern who has access to information, under what circumstances it will be shared and penalties for unauthorized disclosures?

A.2.b. The OCC has developed the internal security processes described above to control who has access to information. The MOU described above also addresses who has access to information shared with the OFR, FSOC or FSOC member agencies. In addition, the OCC also has robust internal policies and procedures, as well as regulations (12 C.F.R. Part 4) in place which govern the sharing of nonpublic OCC information, as well as nonpublic third-party information in the possession of the OCC. The OCC's delegations and policies require that the decisionmaking be made at a high-level when the OCC discloses or shares nonpublic information. Nonpublic OCC information may only be disclosed in consultation with the OCC's law department and in accordance with applicable law, including 12 C.F.R. Part 4. Nonpublic third-party information in the possession of the OCC may only be disclosed with the express consent of the OCC's First Senior Deputy Comptroller and Chief Counsel or her designee, and in accordance with applicable law (with certain exceptions where the law requires disclosure). Part 4 specifically prohibits the unauthorized disclosure of nonpublic OCC information by anyone who is granted access to the information, and by any OCC employee. There are numerous statutory civil and criminal penalties in place for the unauthorized disclosures of nonpublic information. Perhaps most relevant in this context is 18 U.S.C. § 641, which provides that, among other things, anyone who without authority conveys a record belonging to an agency of the United States may be subject to fines or imprisonment.

Q.2.c. What processes are in place now to protect systemic risk information that the SEC and CFTC have proposed to begin collecting early next year?

A.2.c. It is our understanding that the CFTC and SEC are currently in the process of developing rules governing data collection. We defer to those agencies to comment on how they are addressing protection of this information.

Q.3. I am concerned that U.S. institutions will bear a significant competitive burden *vis-a-vis* their foreign competitors. While U.S. commercial banks will be subject to the full weight of Dodd-Frank's heightened prudential standards and new systemic resolution regimes, large overseas competitors will be subject only to a systemic capital surcharge (sometimes called a G–SIFI or G–SIB surcharge) and the new Basel III capital requirements (both of which U.S. institutions will also have to meet).

How have U.S. regulators accounted for the competitive impact of our heightened domestic requirements for U.S. banks when they negotiated the recent G–SIFI surcharge with foreign regulators?

As I have noted in past testimony before the Senate, the OCC is very cognizant of the need to consider the competitive implications and the cumulative effects of the various mandates under the Dodd-Frank Act and the need to coordinate the implementation of key provisions of the Act with the capital and liquidity reforms announced by the Basel Committee. While I support strong capital, strong liquidity, and enhanced supervision of systemically important institutions, I have cautioned that we should not regard capital as the sole regulatory tool, nor should we set the capitals levels, including the surcharge for systemically important banks, at such a level that it forces banking activities into other less regulated sectors. I believe the surcharge ranges of 1 to 2.5 percent that the Basel Committee recently updated attempts to balance these considerations.

Domestically, the Federal Reserve Board is required to consult with the OCC as it develops and implements the heightened prudential standards for bank holding companies with total consolidated assets over $50 billion. In our discussions with the FRB, the OCC has stressed the need to ensure that these provisions and the Basel III reforms are carried out in a coordinated, mutually reinforcing manner, so as to enhance the safety and soundness of the U.S. and global banking system, while not damaging competitive equity or restricting access to credit.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Regulatory Reform Principles

Systemic Risk Regulation

We do not believe that "systemic risk" can be defined and therefore it can not be effectively regulated. The Dodd and Administration proposals permit the regulators to define "systemic risk" which effectively grants them extremely broad authority. We do not believe this is an appropriate task for regulators. It is Congress's responsibility to determine what risks it believes should be addressed and to establish the framework for addressing those risks. The regulator's responsibility should be to implement the Congressional plan. Without having determined what systemic risk is, or even whether it is subject to effective regulation, we do not believe there is currently any basis for creating a systemic risk regulator at this time.

In the alternative, we believe that Congress should:

- Enhance the prudential regulatory structure;
- Create a resolution mechanism through which institutions deemed systemically important can be wound-down;
- Address derivatives regulation to reduce capital and counter party risks and enhance market transparency;
- Enhance the crisis management capabilities of the Department of the Treasury to give it the staff and resources to respond to financial crises and play the lead role in the resolution of systemic firms;
- Address the financial regulation of insurance firms;
- Address the future of Fannie, Freddie and the Federal Home Loan Banks; and
- Address systemic reliance on credit ratings.

Systemic Risk Resolution

We believe that Congress needs to end "too big to fail." We recognize, however, that the failure of certain firms could be problematic for the financial system and the national economy. Rather than bailing out such firms, we believe that Congress should create a resolution mechanism that allows such firms to be wound down where shareholders would be wiped out, management replaced, and certain creditors could be compelled to take losses. This resolution regime would not be available on a regular basis. Rather, it would be invoked on an *ad hoc* basis upon a joint determination. Any Federal funds used to provide assistance to creditors or critical market activities should be recouped after the fact through assessments.

Chairman Dodd's proposal attempts to achieve some of the same goals, but it does not sufficiently address many details regarding the actual operation of a resolution regime. We are continuing to discuss these details with the regulators and the nation's leading legal experts in this area.

Any systemic risk resolution regime should:

- End "too big to fail";
- End open bank assistance;
- Eliminate government bailouts to shareholders; and
- Limit the use of the new regime to exceptional circumstances, otherwise use bankruptcy/bank resolution rules.

Prudential Regulation

Broad changes to the regulatory structure must be considered. The structure needs to be modernized and streamlined. There needs to be greater accountability demanded of the regulators. Any changes should preserve the dual-banking system and recognize its diverse nature (8,000 banks) and the range of credit and intermediation needs of the broader economy. The Federal Reserve should have a limited range of responsibilities that would include 1) monetary policy, 2) payment systems oversight, and 3) lender of last resort function.

A new prudential regulatory structure should:

- Demand greater accountability from regulators;
- Contain fewer regulators;
- Preserve the dual banking system and recognize the needs of all 8,000 banks; and
- Limit the role of the Federal Reserve.

Consumer Protection

Consumer protections need to be enhanced. Such enhancements need to be targeted to the specific areas where breakdowns occurred. In order to do so, there needs to be greater examination of the causes of the crisis. Where new authorities are necessary, they should be enacted by Congress. Where regulators failed to use existing authorities, they should be held accountable. Where firms operated beyond the reach of regulators, they should be brought within some regulatory scheme.

Consumer protection and safety and soundness regulation can be enhanced and achieved simultaneously. For example, the Federal Reserve operates under a dual mandate to achieve price stability and full employment. As part of the new prudential regulatory structure, a clear mandate requiring safety and soundness and consumer protection oversight could be employed. Consideration of mortgage underwriting underscores the logic of this approach. For example, proper underwriting protects the financial institution and consumers.

Congress should, to the maximum extent possible, determine whether and how industry practices need to be addressed. A framework for addressing them can then be enacted. In contrast, the Administration/Dodd plan empowers the regulator to design and implement its own framework.

Finally, national financial markets provide consumers with the greatest choices and help enhance the safety and soundness of the financial system. Preemption rules must accommodate these facts.

Any new consumer protection regime should:

- Not separate consumer protection and safety and soundness regulation;
- Recognize that substantive consumer protection laws must be developed by Congress and be implemented by regulators. Regulators should not be given the ability to promulgate free standing consumer protection regulations tethered only to a broad grant of authority;
- Recognize that the safe and sound operation of competitive national markets requires preemption rules that allow consistent national standards; and
- Be designed to cover all similar products regardless of what type of firm (state/federal) is selling them.

Derivatives

The infrastructure for the derivatives market needs to be modernized to increase transparency, standardization, and competition. Such changes, however, must allow customized risk management transactions to continue without significant increase in cost or burden. The goal should be to limit risks to the financial system while preserving the ability of companies to manage the particular risks to their firms. The optimal regulatory and economic outcome may require a merger of the CFTC and the SEC.

Any new derivatives regulation should:

- Address counter-party risk exposure by increasing the amount of centralized clearing and requiring additional data reporting; and
- Preserve the ability to engage in bilateral customized transactions.

Written Statement of Hal S. Scott

Director of the Committee on Capital Markets Regulation;
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at Harvard Law School[1]

to the

Committee on Banking, Housing, and Urban Affairs

United States Senate

July 21, 2011

* * *

One year ago today, the Dodd-Frank Act was signed into law. I would like to take this opportunity to review progress toward achieving the goals of the Act. I will begin by giving a brief update on the regulators' actions to date, followed by additional comments on the implementation process. I will also discuss what are, in my view, the best and worst substantive features of Dodd-Frank and their effects on the financial system and the U.S. economy, concluding with a warning about how Dodd-Frank affects the competitive position of the U.S. markets. Although much of this statement is based on the past work of the Committee on Capital Markets Regulation (CCMR), these represent my own views, not the views of the Committee.

I. Dodd-Frank Progress

The Dodd-Frank Act requires federal regulators, including the Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Commodity Futures Trading Commission (CFTC), Board of Governors of the Federal Reserve System (Federal Reserve), and the new Financial Stability Oversight Council (FSOC), to write and implement

[1] Biography with disclosures on compensated activities available at http://www.law.harvard.edu/faculty/hscott.

over 300 new rules.[2] The Act requires 122 of these rules to be finalized either today, the one-year anniversary of the Dodd-Frank Act, or sometime last week.[3] It is clear that most of these deadlines will be missed. Some rules with looming deadlines have yet even to be proposed, much less finalized. By tomorrow the regulators will very likely have more than 100 overdue rules. These are just the rules with deadlines before or during July. More than half of the required rules have a deadline after July or no deadline at all, and very few of those have even been proposed yet.

This is not to say the regulators have not been busy—far from it. In the last year the financial regulators have written more than 3 million words published in over 3,500 three-column, small-type pages of the Federal Register.[4] Nor do I mean to criticize the agencies for missing the deadlines. In fact, in testimony I delivered in January before the House Committee on Financial Services, I said, "the most important objective should be to get the rules right, not to act quickly."[5]

Rather, these statistics illustrate that the original statutory deadlines were unrealistic. As I noted in January, the SEC typically issued fewer than 10 new substantive rules a year before Dodd-Frank, and the CFTC issued fewer than 6 a year. Yet the Dodd-Frank Act gave the SEC only a year to write nearly 60 rules, and the CFTC nearly 40.[6] The agencies were not prepared to run a record-setting 2-hour marathon. They were not even prepared to run a 5-hour marathon,

[2] Sec. Industry & Fin. Mkts. Ass'n, *Regulatory Action Database*, http://www.sifma.org/members/dodd-frank.aspx. Note that this count and the ones that follow include multiple instances of a rule if it involves multiple regulators.
[3] DAVIS POLK & WARDWELL, LLP, DODD-FRANK PROGRESS REPORT 4 (July 2011).
[4] Jean Eaglesham, *Overhaul Grows and Slows*, WALL ST. J., May 2, 2011, at http://online.wsj.com/article/SB10001424052748703346704576295873060349068.html.
[5] *Promoting Economic Recovery and Job Creation: The Road Forward: Hearing Before the H. Comm. On Finc. Servs.*, 112th Cong. 14–15 (Jan. 26, 2011) (testimony of Hal S. Scott) (hereinafter January Testimony).
[6] January Testimony, *supra* note 5 at 102.

considering that the rules, which involve a fundamental reshaping of our financial markets, are very complicated and frequently require the coordination of multiple agencies.

II. Implementation Process

It is clear from the regulators' progress that the statutory deadlines were, on the whole, unrealistic. But the implementation problems were not limited to the unrealistic deadlines. The rulemaking process as a whole was opaque, causing uncertainty among market participants. Most regulators did not create a public rulemaking schedule; the public was generally left to guess about which rules were coming when. It does not seem that the regulators really thought much about a sensible schedule, because they proposed rules in scattershot fashion: many important rules came after less important ones, and proposals frequently relied upon rules that had yet to be proposed, such as definitions. Nor did the various regulators coordinate their rulemaking schedules, much less the substance of rules. Under the Dodd-Frank Act, the CFTC is charged with regulating the swaps market and the SEC with the security-based swap market. Yet time and again, the comment period on a proposed rule from one Commission would close before the other had issued its own proposal on the same topic. The timing differences are made more problematic by the divergence between the agencies on substance. The SEC and CFTC have frequently proposed rules on the same topic that are very different, without justifying the differences.

These sequencing and coordination deficiencies made it unnecessarily difficult for the public to comment in a meaningful way. The CFTC helpfully opened up most of its rules for another 30 days of comments, but this was, as they say, a day late and a dollar short. The new comment window was announced only near the end of the process, so it did nothing to assuage the pressures on the public during the initial comment windows, when they were left to comment on an incomplete set of rules without even knowing whether a particular firm or product would be covered by the rules. Moreover, only the CFTC reopened the rules for comments; the SEC and the other regulators have not done so. What should be done is that many of these rules, particularly those relating to derivatives, should have been reproposed as a package, and a further comment period allowed. In retrospect, the CFTC would have been better off proposing a comprehensive set of rules to begin with, taking more time to get the package right rather than operating piecemeal.

For some time now I have been calling attention to the lack of cost-benefit analysis performed by the financial regulators in the rulemaking process. In January of this year, the President issued an Executive Order requiring governmental agencies to issue rules only when their benefits exceed their costs.[7] This Order reiterated the principles from a series of Executive Orders dating back to President Reagan. By its terms, however, the Obama Executive Order does not apply to independent agencies such as the CFTC and SEC. Although the heads of both of those agencies contemporaneously suggested they would comply with the Order's principles, it is clear that they have not.[8]

Just last week the President issued another Executive Order, this time specifically targeted at independent agencies.[9] But it is not binding in any way. Moreover, it is a watered-

[7] Exec. Order No. 13,563, § 1(b), 76 Fed. Reg. 3,821 (Jan. 21, 2011).
[8] *See Public Hearing to Review Implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act: Hearing Before the H. Comm. On Agric.*, 112th Cong. (Feb. 10, 2011) (testimony of Chairman Gary Gensler), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html (CFTC Chairman Gary Gensler: "the CFTC's practices are consistent with the executive order's principles."); *Testimony of Chairman Mary Schapiro Before the Subcomm. on Fin. Servs.: Hearing Before the H. Appropriations Comm.*, 112th Congress (Mar. 15, 2011), http://appropriations.house.gov/_files/031511SECFY12BudgetTestimonyFINAL.pdf (SEC Chairman Mary Schapiro: "while the Executive Order doesn't apply to us, we're trying to act as though it does.").
[9] Exec. Order No. 13,579, 76 Fed. Reg. 41,587 (July 11, 2011).

down version of the January Order, requiring only a "consideration" of a rule's costs and benefits, rather than a requirement that the rule's benefits exceed its costs.[10] This limited action from the Executive branch may be traced to a concern that branch exercising too much control over "independent agencies."[11] But Congress created these agencies, and it can mandate by statute more thorough cost-benefit analysis. I encourage it to do so.

III. Best and Worst Features of the Dodd-Frank Act

A. Best Features

The Dodd-Frank Act made several needed corrections in financial regulation. To start, it contains a broad mandate to centrally clear derivatives.[12] CCMR strongly supported mandatory central clearing in its May 2009 Report.[13] Centralized clearing reduces the potential chain reaction effect of failure by a major counterparty by collectivizing those risks through clearinghouse. Together with the Dodd-Frank Act's execution and reporting provisions,[14] they also contribute to enhancing the liquidity and transparency of the derivatives markets, as well as addressing several processing, settlement, and margining and collateral issues.

The Dodd-Frank Act also made improvements to asset-backed securitizations (ABS). Notably, it improves the disclosure regime to investors and requires securitizers to retain "skin in

[10] *Id.* at § 1(a).
[11] *See* Robert W. Hahn & Cass R. Sunstein, *A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis*, 150 U. PA. L. REV. 1489, 1531–37 (2002); Elena Kagan, *Presidential Administration*, 114 HARV. L. REV. 2245, 2319–31 (2001); Richard H. Pildes & Cass R. Sunstein, *Reinventing the Regulatory State*, 62 U. CHI. L. REV. 1, 24–33 (1995).
[12] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 723, Pub. L. No. 111-203, 124 Stat. 1376 (hereinafter Dodd-Frank Act).
[13] *See* COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM 42 (May 2009), http://www.capmktsreg.org/research.html.
[14] *See* Dodd-Frank Act §§ 727, 729, 733.

the game"—an economic interest in the credit risk of the assets.[15] The regulators are currently accepting comments on a proposal to require 5% risk retention.[16] As proposed, it allows a securitizer to retain risk in a number of different ways, including a first-loss position, a "vertical" slice of each tranche, a mixture of both, and a representative sample. The Dodd-Frank Act also contains an exception from the risk retention provision for "Qualified Residential Mortgages," the definition of which is also out for comment. I believe the housing price bubble was the root cause of the financial crisis, and the bubble depended on easily securitized mortgages. It is therefore appropriate that the Dodd-Frank Act address this process, but do so in a sensible way. We need to revitalize this market if housing finance is to revive.

Credit ratings are of course closely tied to the securitization market and thus to the financial crisis. The Dodd-Frank Act sought to improve the regulation of the credit ratings agencies as well.[17] Many of these improvements, notably increasing transparency about ratings methodology, are steps in the right direction. However, the Act prohibits federal agencies from referencing credit ratings at all. The regulators have yet to divine how to accomplish this in a sound fashion. I think a better approach would be to prohibit *undue reliance* on the ratings. This is a simple statutory fix.[18]

[15] *See id.* §§ 941–46.
[16] Credit Risk Retention, 76 Fed. Reg. 24,090 (proposed Apr. 29, 2011).
[17] *See* Dodd-Frank Act §§ 931–939H.
[18] The fix would replace "reference to or requirement of reliance on credit ratings and" in § 939A(b) with "undue reliance on credit ratings and, if necessary,".

B. Worst Features

1. No consolidation of regulators and lack of co-operation among regulators

In 2009, CCMR called for the reorganization of the U.S. regulatory structure, calling it "an outmoded, overlapping sectoral model."[19] Although other countries have moved toward integrated regulatory structures, the Dodd-Frank Act actually made things worse. Although it did eliminate the Office of Thrift Supervision,[20] it created new regulators, the Bureau of Consumer Financial Protection, the Federal Insurance Office, and the Financial Stability Oversight Council (FSOC).

A fragmented regulatory structure makes supervision and regulation difficult. A single firm may be subject to supervision by several different regulators, each of which has its own priorities and expertise. Each regulator also has its own set of regulations, which are sometimes at odds with those of other regulators. Dodd-Frank did not help in this respect. A total of 43 of the Dodd-Frank rulemaking provisions involve two or more agencies, and a handful involve half a dozen or more.[21] If the agencies' rules about the same topic diverge from each other, as is frequently the case with the SEC's and the CFTC's proposals, market participants who are subject to two different regimes will have to comply with different rules governing similar conduct. Without proper coordination, it will not always be clear whether a particular swap falls within the jurisdiction of the CFTC or SEC—different rules will provide an incentive and opportunity for participants to design derivatives to fit into the scheme that they prefer.

[19] COMM. ON CAPITAL MKTS. REG., *supra* note 13 at 203.
[20] *See* Dodd-Frank Act § 312(b).
[21] *See* Curtis W. Copeland, Cong. Research Serv., R41472, *Rulemaking Requirements and Authorities in the Dodd-Frank Wall Street Reform and Consumer Protection Act* 7 (Nov. 3, 2010).

The newly created FSOC is no solution to this problem, even though Title I of the Dodd-Frank Act empowered it with broad authority to identify and monitor excessive risks to the U.S. financial system. FSOC's ability to effectively reduce systemic risk is limited. First, its members primarily come from other independent federal regulatory agencies, and each will have his or her own agenda. The power of the Secretary of the Treasury as Chairperson is limited. FSOC itself has little direct supervisory authority—authority remains dispersed among the other agencies. For example, although it has the authority to designate nonbank financial institutions as systemically important (with a 2/3 vote), Dodd-Frank places enhanced supervisory authority in the hands of the Federal Reserve.[22] The Council can make recommendations to the Federal Reserve, but it cannot force it to act.[23] Even when serving as an arbiter for disputes between certain agencies, its recommendations are generally nonbinding.[24] In addition, the two-thirds supermajority vote required for many of its actions may be difficult to achieve. To date it has done little.

2. Emergency Action

Several aspects of the Dodd-Frank Act make it more difficult to act in a crisis. The sudden drop in housing prices in 2008 prompted a contagious liquidity crisis, which was stabilized only through the actions of the Fed, FDIC, and Treasury. Yet after the Dodd-Frank Act, none of them can do again what they did in the crisis.

[22] *See* Dodd-Frank Act § 113.
[23] *See id.* § 115.
[24] *See id.* § 119.

Under Dodd-Frank, the Federal Reserve may establish an emergency lending facility only with "the prior approval of the Secretary of the Treasury."[25] CCMR previously explained that this approach "imposes unnecessary procedural hurdles on the Federal Reserve, potentially hampering its ability to act decisively in a crisis."[26] The Federal Reserve should make decisions about emergency lending both because it has the necessary expertise and because it can act quickly and decisively, and is independent. The Secretary of the Treasury may fear the political consequences of his or her decision, particularly if it can be characterized as a bailout. Of course an emergency facility under the Dodd-Frank Act is not a bailout; it must be adequately collateralized (a requirement legitimately strengthened by Dodd-Frank) and is subject to audits by the Comptroller General.[27]

Similarly, under the Dodd-Frank Act the FDIC cannot guarantee deposits above $250,000 (including certain transaction accounts after 2012), or other senior debt, without a joint resolution of Congress.[28] These are actions that can be important in staving off runs. During the crisis, the Treasury used funds from the Economic Stabilization Fund to guarantee money market funds in order to prevent a contagious run after the Primary Reserve Fund broke the buck. The Treasury can no longer do this, this power was removed by the TARP legislation and was not restored by Dodd-Frank Act.[29]

The Dodd-Frank Act also established a new "Orderly Liquidation Authority," which includes a receivership process for the FDIC to use in resolving non-bank financial companies.

[25] Dodd-Frank Act § 1101(a)(6)(B)(iv).
[26] Letter from the Comm. on Capital Mkts. Reg. to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. 6 (June 14, 2010), http://www.capmktsreg.org/pdfs/2010.06.14_CCMR_Reconciliation_Letter.pdf.
[27] Dodd-Frank Act §§ 1101(a)(6), 1102(a).
[28] *See id.* § 335.
[29] *See* 12 U.S.C.A. § 5236(b).

In the process, however, the Dodd-Frank eliminated one of the FDIC's existing powers to act in a crisis, namely the open bank assistance program for banks, and did not provide such a capability for non-banks. It also makes it difficult to preference short-term creditors in a resolution.

All of these changes may actually make the problem of contagion worse because the government will be less able to stop it by injecting much-needed liquidity or support. The changes are largely the result of a popularly inspired bipartisan anti-bailout consensus, although even the consensus is puzzling. On the one hand, the Republicans have characterized the Dodd-Frank Act as a bailout bill,[30] which it is not, and on the other hand the Democrats have asserted that they have ended bailouts,[31] when the hard reality is that in the future, some form of a bailout may very well be necessary. The statutory changes, primarily from the Dodd-Frank Act, will seriously constrain the government's ability to respond effectively to a future crisis. Moreover, they are unnecessary to protect taxpayers. Shortfalls can always be made up in taxes on the industry, and increased deposit insurance costs can be paid for through higher premiums.

3. Funding/Management of CFPB

Under the Dodd-Frank Act, the newly created Bureau of Consumer Financial Protection (CFPB) is funded from the profits of the Federal Reserve.[32] The CFPB receives the amount of funding that its Director determines is "reasonably necessary to carry out [its] authorities,"

[30] THE FIN. SERVS. COMM., ONE YEAR LATER: THE CONSEQUENCES OF THE DODD-FRANK ACT 15–22 (2011), http://financialservices.house.gov/UploadedFiles/FinancialServices-DoddFrank-REPORT.pdf.
[31] Represenative Barney Frank (D-MA), National Press Club Newsmaker Series: A Report from the Front Line of Financial Reform (July 11, 2011), http://press.org/news-multimedia/videos/npc-newsmaker-rep-barney-frank.
[32] *See* Dodd-Frank Act § 1017(a)(1).

subject to a cap of about $550 million.[33] Funding the CFPB through the Fed's profits sets a bad precedent. There is no review or control of the justifications for the money request; budget determinations should be made through the normal appropriations process.

A full year after the Dodd-Frank Act was enacted, the Bureau still does not have an official Director, although President Obama nominated Richard Cordray earlier this week. In the interim the Dodd-Frank Act allows the Secretary of the Treasury to perform certain functions of the Bureau. Secretary Geithner had delegated this responsibility to Elizabeth Warren, who is now serving as Special Advisor to the Secretary.[34] That interim authority is limited, however, particularly after today's "transfer date." The Inspectors General for both the Treasury and the Federal Reserve have concluded that after this date, the Secretary of the Treasury or his delegate can only exercise the CFPB's functions under subtitle F of Title X of the Dodd-Frank Act, which includes the existing authority of *other* regulators that will be transferred to the CFPB. Only a Senate-confirmed Director may exercise the CFPB's new authorities, including the powers to prohibit unfair, deceptive, or abusive practices and to control disclosures about consumer financial products.[35] It is clear that the CFPB needs a confirmed head that is capable of executing the full powers of the office. This is true more than ever now that the transfer date has arrived.

Congress recognized that a tension can arise between the overall goals of safety and soundness of the financial system and the CFPB's goal of consumer protection. As a result, it

[33] *Id.* § 1017(a); *Annual Report, 2009. Board of Governors of the Federal Reserve System* at 475, 491. Note that this cap, which increases slightly for fiscal years 2012 and 2013 and is adjusted for inflation thereafter, does not include the additional appropriations through fiscal year 2014 provided by § 1017(e).
[34] *See id.* § 1066(a); Letter from Eric M. Thorson, Inspector General, Department of the Treasury, and Elizabeth A. Coleman, Inspector General, Board of Governors of the Federal Reserve System, to Hon. Spencer Bachus, Chairman, Committee on Financial Services, and Hon. Judy Biggert, Chairman, Committee on Financial Services, Subcommittee on Insurance, Housing, and Community Opportunity, OIG-CA-11-004, FRB OIG 2011-01 Enclosure at 2 (Jan. 10, 2011) (hereinafter OIG Letter).
[35] OIG Letter at 5–7; *see* Dodd-Frank Act §§ 1066(a) ("The Secretary is authorized to perform the functions of the Bureau under this subtitle until the Director of the Bureau is confirmed by the Senate."), 1031 ("prohibiting unfair, deceptive, or abusive acts or practices"), 1032 (disclosures).

created a review process and veto power over the CFPB's regulations. Unfortunately, this veto power may only be exercised upon a 2/3 vote of FSOC's members.[36] From the perspective of protecting the safety of the financial system, it would be far better to give the Secretary of the Treasury the powers of review and veto. He or she can act decisively, unlike the supermajority of a council of regulators, and has a broader view of the problem.

IV. Competitiveness

The Dodd-Frank Act and new international regulatory standards, including the Basel III capital requirements, are likely to harm the international competitiveness of U.S. financial institutions. International coordination by financial regulators is necessary in order to prevent regulatory arbitrage and competitive inequalities. Although the Dodd-Frank Act wisely allowed U.S. regulators a lot of discretion to minimize some competitive disadvantages, the necessary co-ordination with international regulators and among U.S. regulators has been insufficient.

A. Volcker Rule

The so-called Volcker Rule bans "proprietary trading" in U.S. banking organizations, here and abroad, and limits their sponsorship of private equity and hedge funds to 3% of any fund and 3% of their capital.[37] As I have emphasized many times, proprietary trading was not a cause of the financial crisis and can serve to make banks more financially secure by diversifying their activities beyond risky lending. Indeed, the GAO recently found that the proprietary trading desks of four out of the six biggest banks posted profits during the period 2006–2010.[38] Large

[36] *See* Dodd-Frank Act § 1023.
[37] Dodd-Frank Act § 619.
[38] United States Government Accountability Office, Report to Congressional Committees, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* 14 (July 2011), http://www.gao.gov/new.items/d11529.pdf.

bank losses during the financial crisis primarily came not from proprietary trading, but rather from traditional banking activities such as bad housing loans and investments in pools of those loans. With regard to systemic risk, the Volcker rule is both over-inclusive and under-inclusive as not all banks engaged in proprietary trading contribute to systemic risk, and some non-banks engaged in proprietary trading may contribute to systemic risk.[39]

The scope of the Volcker rule is unclear because the term "proprietary trading" and the various exceptions in § 619 of the Dodd-Frank Act are ambiguous and have yet to be defined by rule. This is of particular importance because the line between permissible market making and possibly impermissible proprietary trading is difficult to draw. Implementation of the Volcker Rule will require extensive agency coordination. As drafted, the Dodd-Frank Act requires the Fed, SEC, CFTC, and certain banking regulators to implement the Volcker Rule, but unlike other sections of the Dodd-Frank Act, which require joint rulemaking, the Dodd-Frank Act requires only "coordinated rulemaking" for the Volcker Rule, with the Secretary of the Treasury, as Chairman of FSOC, having unclear responsibility to coordinate. So far this coordination role has been fruitless.

The Volcker Rule's impact on covered institutions' revenues and profitability is already significant. In order to prepare for the Volcker Rule's implementation, Morgan Stanley, Goldman Sachs, and Bank of America have already made significant business decisions regarding their proprietary trading desks and hedge/private equity fund investments.[40] For

[39] *Implications of the 'Volcker Rules' For Financial Stability: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 111th Cong. 2, 5 (Feb. 4, 2010) (testimony of Hal S. Scott).
[40] FIN. STABILITY OVERSIGHT COUNCIL, STUDY AND RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS 2 (Jan. 2011), http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf. While the study suggests that banks are presently shutting down dedicated proprietary trading desks, hedge funds, and private equity funds "that were a source of losses during the crisis," it is not clear, however, that

example, Goldman Sachs has dismantled almost all of its proprietary trading operations, which analysts estimate will erase about $3.7 billion in revenue and $1.5 billion in profit annually—over 50% of revenues and 15% of earnings per share.[41] Morgan Stanley's divestitures are expected to result in a 14% loss of earnings per share[42] while Citigroup will have to divest its interest in various hedge funds. Such divestitures could force the closing of certain hedge funds despite their strong absolute performances. For example, Citigroup's Mortgage/Credit Opportunity Fund climbed 16% in the first four months of 2011[43] but because 90% of the $395 million invested in the fund is Citibank's own capital, the Fund may have to unwind.

It is important to recognize that the United States is acting alone in banning proprietary trading. Despite Chairman Volcker's hope that other countries would follow, none have done so. Our solitary stand puts our markets and our firms at a competitive disadvantage. Under the Volcker Rule, a U.S. banking organization cannot engage in proprietary trading abroad, but its foreign competitors can.

After the Volcker rule was introduced as part of the Dodd-Frank Act, the U.K. Independent Commission on Banking rejected a similar approach.[44] Rather than limit a banking organization's activities, the U.K. Commission set forth a plan for internal ring-fencing, whereby

banking entities have shut down only money-losing operations.

[41] Lauren T. LaCapra, *Goldman Lobbying Hard to Weaken Volcker Rule*, REUTERS (May 4, 2011), http://www.reuters.com/article/2011/05/04/goldman-volcker-idUSN0418474320110504.

[42] Philip van Doorn, *Fed Issues Volcker Proposal*, THE STREET, http://www.thestreet.com/story/11002447/1/fed-issues-volcker-proposal.html.

[43] "The fund, run by Rajesh Kumar, 41, has posted profits every year since it began in 2008… Kumar's hedge fund is part of Citi Capital Advisors, which oversees about $16 billion in so-called alternative funds, including private equity and venture capital funds…" Donal Griffin, *Citigroup's Hedge-Fund Returns Jump as Volcker Rule Looms*, BLOOMBERG, May 18, 2011, http://www.bloomberg.com/news/2011-05-18/citigroup-hedge-fund-returns-jump-as-ban-on-prop-trading-looms.html; *see also* Donal Griffin, *Citigroup Said to Shut $400 Million Proprietary Fund as Ahmed Has New Role*, BLOOMBERG, June 2, 2011, http://www.bloomberg.com/news/2011-06-02/citigroup-said-to-shut-proprietary-fund-as-manager-has-new-role.html.

[44] INDEP. COMM'N ON BANKING, INTERIM REPORT CONSULTING ON REFORM OPTIONS (Apr. 2011), http://s3-eu-west-1.amazonaws.com/htcdn/Interim-Report-110411.pdf.

wholesale and investment banking activities would be separated from retail banking activities, which will be supported by insured deposits. The retail bank will be required to have higher capital requirements. This is a far better approach than the Volcker rules, an approach already reflected in our approach to Glass-Steagall reform in 1999 when we required that most securities activities be conducted in the holding company rather than the bank.[45]

B. Derivatives Regulation

As I explained earlier, I regard some of the derivatives provisions to be among the best features of the Dodd-Frank Act, especially those pertaining to central clearing and transparency. We are not alone in those endeavors; Europe is enacting similar changes.[46] But the devil is in the details, and it is important to avoid diverging too much on the implementation details in order to avoid disrupting cross-border transactions and creating an opportunity for regulatory arbitrage.

Both the U.S. and E.U. will permit their institutions to participate in a foreign clearinghouse only if the regulations pertaining to that foreign clearinghouse are equivalent to those of clearinghouses in the home country.[47] We may run into problems if the two regimes diverge on important issues. For example, the CFTC has proposed capping minimum capital requirements for clearinghouse membership at $50 million,[48] but the E.U. may set either a higher threshold or none at all. It is not clear whether the E.U. will then permit an E.U. firm to use a U.S. clearinghouse with lower minimum limits because it may be considered riskier. Conversely,

[45] Gramm-Leach-Bliley Act § 111, Pub. L. No. 106-102, 113 Stat. 1338 (1999).
[46] For the E.U. effort, *see Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories*, COM (2010) 484 final (Sept. 15, 2010) (hereinafter E.U. Proposal).
[47] *See* Dodd-Frank Act § 738(a); E.U. Proposal, Article 23.
[48] *See* Risk Management Requirements for Derivatives Clearing Organizations § 39.12, 76 Fed. Reg. 3,698, 3,719 (proposed Jan. 20, 2011) ($50 million requirement); Katy Burne, *U.K.'s FSA Warns US Against Lowering Barriers to Swap Clearing*, FOX BUSINESS, Mar. 25, 2011, http://www.foxbusiness.com/industries/2011/03/25/uks-fsa-warns-lowering-barriers-swap-clearing/.

the CFTC has proposed limiting ownership of clearinghouses by dealers, banks, and other types of institutions, to a combined 40%.[49] Will the CFTC allow a U.S. institution to use an E.U. clearinghouse that is completely owned by dealers? Other differences include the end-user exception, which is narrower in the U.S. than in the E.U. because the U.S. exception applies only to hedging activities, and possible differences between margin required for cleared swaps.

In addition, the U.S. and the E.U. are not moving at the same pace. Although the U.S. regulators will undoubtedly miss today's deadline for the bulk of their rules, they may finish by the end of the year. The E.U., on the other hand, is unlikely to complete its rules before late 2012 or 2013. Different implementation schedules may also create arbitrage opportunities.

To be clear, I am not advocating merely following Europe. Rather, I think it is important to emphasize the need for coordination. It may be that we need to make some changes to our rules, and that the Europeans will have to make some changes to theirs.

C. Capital Requirements

Capital requirements are presently undergoing major changes. The Dodd-Frank Act requires "systemically important financial institutions," or SIFIs to hold as much capital as Basel I required,[50] and the Basel III rules adopted in December 2010, will also have to be implemented. Capital requirements are among the most important regulations for the banking industry, and changes to them will have very large effects. Even though the Basel rules are designed to be international standards, the effects may not be uniform across countries. Indeed, implementing

[49] *See* Dodd-Frank Act § 726(a); *see also* Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest § 39.25, 75 Fed. Reg. 63,732, 63,750 (proposed Oct. 18, 2010) (imposing limits on ownership).
[50] *See* Dodd-Frank Act § 171.

Basel III (by 2019, as planned) may have uneven competitive effects, as will the additional capital requirements in the Dodd-Frank Act that do not apply in other countries.

Basel III makes several changes. It will require banks to hold 4.5% of common equity and 6% of Tier I capital (up from 4%) of risk-weighted assets (RWAs). Basel III will also introduce capital buffers, including a mandatory capital conservation buffer of 2.5% and a discretionary countercyclical buffer of an amount to be decided by national regulators, up to 2.5%. It will also introduce a leverage ratio and two mandatory liquidity ratios. The introduction of the leverage requirement (and its retention in the U.S.) is somewhat odd since the whole Basel capital initiative is premised on the idea that capital should be held in proportion to the riskiness of assets and that leverage ratios (the system *before* Basel) could not achieve this. If a bank has AAA liquid assets, we should care a lot less about leverage. Nonetheless, Chairman Bair and others trumpeted the leverage requirement as the partial savior of the banking system since it in practice required banks to hold more capital than the risk-weighted capital requirements.[51] But this is only an indictment of the Basel's risk-weighted requirements—as before, it makes no sense to judge the adequacy of capital without taking into account the riskiness of assets.

It is impossible to accurately predict how the banking industry will respond to these changes, or how the response will affect the real economy. Indeed, Chairman Bernanke recently admitted that it is too complicated to do an accurate, comprehensive study of the impact of the new capital requirements, Dodd-Frank rules, and other changes.[52]

[51] *See The Interagency Proposal Regarding the Basel Capital Accord: Hearing Before the S.Comm. on Banking, Hous., and Urban Affairs*, 109th Cong. (Sept. 26, 2006) (statement of Sheila C. Blair, Chairman, Fed. Deposit Ins. Corp.).; *see also* Sheila Blair, *Road to Safer Banks Runs Through Basel*, FIN. TIMES, Aug. 23, 2010, http://www.ft.com/intl/cms/s/0/a1dfbd02-aee8-11df-8e45-00144feabdc0.html#axzz1STdl5B8c.
[52] Dealbook, *What Dimon Told Bernake*, NEW YORK TIMES, June 8, 2011, http://dealbook.nytimes.com/2011/06/08/what-dimon-told-bernanke/.

Several organizations have tried to assess the impact of the capital rules. The studies are from groups including the Macroeconomic Assessment Group (MAG), established by the Basel Committee, along with the Financial Stability Board; the Institute of International Finance (IIF); the International Monetary Fund (IMF); the Organization for Economic Co-operation and Development (OECD); and a panel including staff from the Federal Reserve Bank of New York, Bank of Italy, BIS, European Central Bank, European Commission, and IMF.[53] The studies agree on one thing, the direction of the impact on GDP: down. The peak effect of the impact on global GDP of each 1 percentage point increase in bank common equity is expected to have a negative effect of up to 1.1% of global GDP, or up to $748 billion by 2019. IIF estimated the cumulative effects of all of the various provisions in Basel III; they could lead to a decline in U.S. GDP alone of up to $951 billion over the period 2011–2015.

Whether all countries will fully implement the Basel III requirements remains to be seen. Not all countries fully implemented Basel II (including the U.S.), so there is reason to question the commitment of all countries to do so. If they do not, then the decline in output will be larger in some countries than in others. The same is true if countries implement the rules on a different timeline. Further, even if all countries have the same nominal rules, they might enforce them differently. Moreover, some countries may see different effects due to the structure of their economies and importance of banks. For example, the OECD study found that bank lending

[53] MACROECONOMIC ASSESSMENT GROUP, FINAL REPORT: ASSESSING THE MACROECONOMIC IMPACT OF THE TRANSITION TO STRONGER CAPITAL AND LIQUIDITY REQUIREMENTS (Dec. 2010), http://www.bis.org/publ/othp12.pdf; INST. OF INT'L FIN., THE NET CUMULATIVE ECONOMIC IMPACT OF BANKING SECTOR REGULATION: SOME NEW PERSPECTIVES (Oct. 2010), http://www.iif.com/download.php?id=/0eTxourA+A=; SCOTT ROGER & JAN VLCEK, INT'L MONETARY FUND, MACROECONOMIC COSTS OF HIGHER BANK CAPITAL AND LIQUIDITY REQUIREMENTS (May 2011), http://www.imf.org/external/pubs/ft/wp/2011/wp11103.pdf; Patrick Slovik & Boris Cournède, *Macroeconomic Impact of Basel III* (Org. for Econ. Cooperation and Dev., Econ. Dep't Working Paper No. 844, 2011), http://dx.doi.org/10.1787/5kghwnhkkjs8-en; PAOLO ANGELINI ET AL, BANK OF INT'L SETTLMEENTS, BASEL III: LONG-TERM IMPACT ON ECONOMIC PERFORMANCE AND FLUCTUATIONS (Feb. 2011).

spreads in the U.S. are more sensitive to changes in capital ratios than in Japan.[54] Different accounting rules and tax rules can also lead to different outcomes.[55]

D. Systemically Important Financial Institutions

The world's regulators and legislators have come to agree that the largest and most important financial institutions deserve special attention. The failure of any of these SIFIs could seriously damage the economy. The process of designating firms as SIFIs and determining how to regulate them has now begun.

In the U.S., the Dodd-Frank Act subjects banking organizations with total consolidated assets of $50 billion or greater to supervision by the Federal Reserve. In addition, FSOC is charged with designating non-bank financial institutions that should also be supervised by the Fed. The statutory criteria are:

(A) the extent of the leverage of the company;

(B) the extent and nature of the off-balance-sheet exposures of the company;

(C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;

(D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;

[54] Slovik & Cournède, *supra* note 53, at 7–8.
[55] *See* Hal S. Scott & Shinsaku Iwahara, *In Search of A Level Playing Field: The Implementation of the Basle Capital Accord in Japan and the United States* (Group of Thirty Occasional Paper 46, 1994).

(E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;

(F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;

(G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

(H) the degree to which the company is already regulated by one or more primary financial regulatory agencies;

(I) the amount and nature of the financial assets of the company;

(J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and

(K) any other risk-related factors that the Council deems appropriate.[56]

FSOC is required to issue rules concerning how it will designate firms,[57] but it has yet to do so, and has even reportedly postponed its own deadline for making a proposal.[58] Similarly, the Federal Reserve has yet to announce how it will supervise these firms. It is difficult to judge who should be systemically important without knowing the full consequences of a designation.

[56] Dodd-Frank Act § 113.
[57] *See* Advance Notice of Proposed Rulemaking, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 75 Fed. Reg. 61,653 (proposed Oct. 6, 2010); *see also* Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555 (proposed Jan. 26, 2011).
[58] Deborah Soloman & Victoria McGrane, *Financial Oversight Panel to Delay Guidance*, WALL ST. J., July 14, 2011, http://professional.wsj.com/article/SB10001424052702304223804576444192780997846.html.

This process is also proceeding internationally. Last November the G-20 endorsed a framework designed by the Financial Stability Board (FSB), which proposes additional supervision and regulation of SIFIs, and different resolution procedures.[59] Earlier this week, the FSB and the Basel Committee released a Consultive Document proposing a methodology for designating "global systemically important banks (G-SIBs)."[60] The proposed methodology would evaluate five categories:

1. size,
2. interconnectedness,
3. lack of substitutability,
4. global (cross-jurisdictional) activity, and
5. complexity.[61]

The proposal also includes a "SIFI surcharge" in the form of enhanced capital requirements. Designated firms would be required to hold an additional 1% to 2.5% common equity capital, with the possibility of an additional 1% requirement if a bank's systemic importance increases over time.[62]

Although this is only a proposal, the notion of a SIFI surcharge has been gaining momentum and some want to impose higher surcharges than proposed by Basel. The U.K.

[59] FIN. STABILITY BD., INTENSITY AND EFFECTIVENESS OF SIFI SUPERVISION: RECOMMENDATION FOR ENHANCED SUPERVISION (Nov. 2, 2010), http://www.financialstabilityboard.org/publications/r_101101.pdf.
[60] BASEL COMMITTEE ON BANKING SUPERVISION, GLOBAL SYSTEMICALLY IMPORTANT BANKS: ASSESSMENT METHODOLOGY AND THE ADDITIONAL LOSS ABSORBENCY REQUIREMENT 1 (July 2011), http://www.bis.org/publ/bcbs201.pdf.
[61] *Id.* at 5.
[62] *Id.* at 15.

Independent Commission on Banking previously said that 3% is the "minimum credible" SIFI surcharge.[63] Switzerland has proposed that its two largest banks have capital ratios of 19%, more than half of which must be common equity. In a June speech, Fed Governor Daniel Tarullo asserted that the Federal Reserve is contemplating using a methodology that could result in a U.S. SIFI surcharge of up to 7%.[64]

As with capital requirements generally, it is unlikely that SIFI surcharges will be implemented on a uniform basis across countries. If some countries impose higher surcharges than others, then banks in countries with lower SIFI surcharges will have an advantage. Similarly, the approach to designating SIFIs will likely differ across countries, with some countries choosing to designate more firms than others. Indeed, the Dodd-Frank Act considers many things the GHOS criteria do not cover, including leverage, off-balance-sheet exposures, source of credit for low-income and minority communities, and activity mix. Moreover, the GHOS criteria apply only to banks, but the Dodd-Frank criteria apply exclusively to nonbanks. All of these differences will distort competition.

V. Conclusion

The political debate that produced the Dodd-Frank Act was largely shaped by the popular and understandable desire to avoid bailouts of irresponsible financial institutions. The record shows, however, that increased Fed lending and TARP injections were profitable. Shortfalls can always be covered by a tax on financial institutions (as the Obama Administration has proposed)

[63] INDEP. COMM'N ON BANKING, *supra* note 44, at 70–71.
[64] Daniel K. Tarullo, Governor, Fed. Reserve Sys. Bd. of Governors, Speech at the Peter G. Peterson Institute for International Economics: Regulating Systemically Important Financial Firms (June 3, 2011), http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.

or, in the case of deposit insurance, by an increase in premiums. Thus, taxpayers need not be put at risk by bailouts.

Of course, this does not deal with the issue of moral hazard, the fact that institutions knowing they will be bailed out will take more risk. To some extent, this will be controlled by analysts and the ratings agencies whose negative evaluations will increase the cost of funds for banks. While no bank may be "too big to fail," no creditor can be assured of being made entirely whole in the event of a failure, thus the debt of even the largest banks (and countries) will become more expensive if the market perceives increased risk.[65] While this may not be ideal, since the *full* cost of risk will not be imposed on creditors, it may be as good as we can do. We should do everything in our power to help the market impose penalties on overly risky banks, such as requiring more disclosure and more accurate accounting.

In the end, however, the hard reality is that bubble-induced and other financial crises will unfortunately continue—and regrettably Dodd-Frank makes containing them more difficult. The hope that Dodd-Frank and Basel will avoid future crises is merely that, a hope. When the next crisis quickly leads to severe depression, due to our inability to stop contagion, will we all congratulate ourselves because we did not bailout irresponsible financial institutions? We need a Plan B.

[65] *See* Julapa Jagtiani, George Kaufman, & Catharine Lemieux, *Do Markets Discipline Banks and Bank Holding Companies? Evidence From Debt Pricing* (Emerging Issues Series, Supervision and Regulation, Department Federal Reserve Bank of Chicago, S&R-99-3R, June 2000).

Council of Institutional Investors

Via Hand Delivery

July 21, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: Hearing on Enhanced Investor Protection After the Financial Crisis

Dear Mr. Chairman and Ranking Member Shelby:

I am writing on behalf of the Council of Institutional Investors (Council) a nonpartisan, nonprofit association of public, union and corporate employee benefit plans with combined assets exceeding $3 trillion.[1] Council members are responsible for investing and safeguarding assets used to fund retirement benefits of millions of participants and beneficiaries throughout the U.S. They have a significant commitment to the U.S. capital markets, with the average Council member investing approximately 60 percent of its entire portfolio in U.S. stocks and bonds.[2]

Today, on the one-year anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), we applaud you, your counterparts in the House of Representatives and the leadership of both houses of Congress for crafting and passing the most sweeping overhaul of U.S. financial regulations since the 1930's. We also congratulate you on the Committee's successful July 12 hearing on the enhanced investor protections provided by the Dodd-Frank Act. As stated during the Chairman's opening remarks, the "financial crisis highlighted the need for stronger investor protections."[3]

The Council believes that the Dodd-Frank Act "represents a significant step toward closing the gaps in regulation and corporate governance that fueled the worst financial crisis since the Great Depression" and that it has already helped to begin to restore trust in U.S. markets.[4] We strongly agree with the Chairman that the provisions of the Dodd-Frank Act must be given "a

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[1] For more information about the Council of Institutional Investors (Council), see the Council's website at http://www.cii.org/.
[2] Council of Institutional Investors, Asset Allocation Survey 2010 at 4 (on file with the Council).
[3] Enhanced Investor Protection After the Financial Crisis: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs, 112th Cong. 1 (2011) (Statement of Sen. Tim Johnson, Chairman, Senate Committee on Banking, Housing, and Urban Affairs).
[4] Press Release, Council of Institutional Investors, CII Statement on the Impact of the Dodd-Frank Act 1 (July 18, 2011), http://www.cii.org/UserFiles/file/07-18-11%20Dodd-Frank%20one%20year%20later%20presser.pdf.

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chance to work to protect investors and American families who depend on our financial system."[5]

One of the most vital investor protections supported by provisions of the Dodd-Frank Act is that of proxy access.[6] We, therefore, were disappointed that the discussion on proxy access at the Committee's hearing included the repetition of talking points of those corporate lobbyists whose clients do not support the fundamental right of shareowners to nominate, elect and remove directors. More specifically, in our view, it has been conclusively disproven that the Securities and Exchange Commission's (SEC or Commission) proxy access rule would somehow empower special interest groups to take actions detrimental to the long-term interests of public company shareowners as some at your hearing suggested. The following reasons support the view of the Council and other long-term shareowners on this issue:[7]

First, the corporate director election process itself would prevent proxy access abuse. Under the SEC's rule, each shareowner nominee ultimately has to win the approval of investors in order win a seat on the board. Therefore, a duly nominated and elected director under the Commission's proxy access rule is one who presumably reflects the views and interest of a majority of shareowners; otherwise, he or she would not have been elected. Furthermore, the rule's disclosure requirements would inform shareowners to the narrow interests of a nominating shareowner group, thus allowing shareowners to cast their votes in favor of the nominee who will best serve the interests of all shareowners.[8] Any shareowner candidate who wins a seat on the board, moreover, owes fiduciary duties "to serve the interests of all shareholders."[9]

Second, the rule's requirement that nominating shareowners hold at least 3 percent of eligible voting securities for at least three years is by no means easy to satisfy, neither by so-called special interest candidates nor by institutional investors. For example, "CalSTRS—one of the country's largest pension funds—generally owns only about 0.3 percent of the outstanding stock of any company."[10]

Likewise, a Council analysis of the issue demonstrated that "the holdings of the ten largest public pension funds in a sample of five accelerated filers and five non-accelerated filers indicate[d] that if a group of the ten largest holders were to aggregate shares, they . . . would be unlikely to meet even a three percent threshold," as "[t]he holdings by the ten largest public pension funds in those companies ranged from 0 percent to 2.69 percent, with an average of 0.872 percent."[11] Therefore, even large investors would have to band together in large numbers to meet the 3 percent threshold. Such alliances will rarely occur unless they reflect widely-held, share-value maximizing interests. Furthermore, the 3 percent holding requirement is a powerful disincentive to behavior that might damage company performance in that declines in a stock's value will prove especially costly to shareowners meeting the 3 percent threshold.

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[5] *Id.*
[6] Dodd-Frank Wall Street Reform and Consumer Protection Act § 971 (July 21, 2010), http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/content-detail.html.
[7] Richard Hall, *Roper: CFA No Longer Opposed to SRO for Investment Advisers*, BNA Daily Report for Executives, July 13, 2011, at EE-13.
[8] Brief of Council of Institutional Investors et al. as Amici Curiae in Support of Respondent at 19, Business Roundtable et. al. v. Securities and Exchange Commission (D.C. Cir. Jan. 27, 2011) (No. 10-1305), http://www.cii.org/UserFiles/file/CII%20TIAA-CREF%20et%20al%20%20amicus%20brief%2001-27-11.pdf.
[9] *Id.*
[10] *Id.* at 20.
[11] *Id.*

Third, proxy access has been a reality in many other countries that have similar union and government pension funds as the U.S. Abuse of proxy access "has not taken place in [those] foreign markets."[12] Opponents of the SEC's rule have to-date simply been unable to provide evidence that special interest groups have burdened companies with unreasonable demands in countries with proxy access.

Finally, if the myth were true that the proxy access rule would promote the agendas of special interest shareowners at the expense of all shareowners, one would expect most investors to oppose the rule. The facts are to the contrary. In addition to the Council's general members, other investors, including TIAA-CREF, Relational Investors and many more profit-driven investment companies, strongly support implementation of the SEC's rule providing long-term shareowners the opportunity to nominate and elect directors.

We again want to congratulate the Committee on holding a successful hearing on a critically important issue to Council members and the millions of American fund participants and beneficiaries they serve. We would respectfully request that this letter be included as a part of the hearing record.

If you have any questions about our views, please do not hesitate to contact me at laurel@cii.org or 202.261.7086, or General Counsel Jeff Mahoney at jeff@cii.org or 202.261.7081.

Sincerely,

Laurel Leitner

Laurel Leitner
Senior Analyst
Council of Institutional Investors

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[12] *Id.* at 19.