S. HRG. 113–306

OVERSIGHT OF FINANCIAL STABILITY AND DATA SECURITY

HEARING

BEFORE THE

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

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING REGULATORY EFFORTS TO IMPROVE FINANCIAL STABILITY AND DATA SECURITY REGULATORY STANDARDS, UPDATING THE FINALIZATION OF THE "VOLCKER RULE", AND RECEIVING A PROGRESS REPORT ON OTHER RULES REQUIRED BY THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

FEBRUARY 6, 2014

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C O N T E N T S

THURSDAY, FEBRUARY 6, 2014

OVERSIGHT OF FINANCIAL STABILITY AND DATA SECURITY

THURSDAY, FEBRUARY 6, 2014

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

The Committee met at 10:14 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. I call this hearing to order.

Today, the Committee continues its oversight of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. There has been good progress since our last hearing, including the completion of the long-awaited Volcker Rule. I believe our economy is on much more stable footing, in part due to the efforts of our witnesses and their staffs.

However, there is still work to be done, and oversight will continue to be a top priority for this Committee. Some of the pending work includes enhanced capital, leverage, and liquidity rules for the largest banks, a new regulatory framework for nonbank financial companies designated as SIFIs, QRM, and the new derivatives rules. I have asked the witnesses to outline their timeline for completing these and other rules and to provide information on how each agency's rules will reduce systemic risk and enhance financial stability.

To date, the regulators have been thoughtful and responsive. For example, they worked quickly to address a concern raised by community banks that the Volcker Rule unintentionally could have resulted in large, unexpected losses for some. I ask that the agencies continue to monitor the impact of their actions and to coordinate their ongoing work. Agency implementation of Wall Street Reform should also continue to be focused on institutions and activities that pose the greatest systemic risks. Final rules should not be one-size-fits-all for banks and insurance companies, nor should they impose unnecessary burdens on community banks and credit unions.

In recent weeks, American consumers have been victims of large data breaches at national retailers, their personal information exposed to identity theft and fraud. Those responsible must be held accountable, and we must examine what more can be done to better safeguard consumer information going forward. I have asked each agency to detail its coordination with other regulators and law enforcement on data breaches, as well as each agency's role in the retail payment system.

Wall Street Reform created an important financial stability watchdog, the FSOC. In its most recent annual report, the FSOC identified securities threats in cyberspace as a potential systemic risk. I want to hear what each agency testifying today is doing to mitigate cyber and other data security risks, as well as protect consumer data at the agencies they regulate.

I now turn to Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman.

I have repeatedly stressed the need for the U.S. banking system and capital markets to remain the preferred destination for investors throughout the world. While it is too early to tell the extent to which our overall Dodd-Frank rules will make our financial system more stable, Federal regulators must ensure that we do not tip the balance of the scales with too heavy a hand. Otherwise, the cumulative effect of the rules and their interaction with each other may burden the economy far more than any stabilizing benefit.

In addition, it is paramount that the regulators understand the full spectrum of the rules they are implementing and any consequences before finalizing the rules. This was evident in December when the regulators issued the final Volcker Rule and, as the Chairman mentioned, did not realize that the accounting rules would force community banks to recognize unrealized market losses. Regulators worked hard over the holidays to fix this for community banks, but the bigger question is why, after 3 years of promulgating the rule, did no regulator foresee this situation.

This incident with the Volcker Rule only reinforces my belief that we need targeted fixes of various Dodd-Frank provisions. Some of those fixes include the end-user exemption, the swaps push-out, and community banks relief, as identified by Chairman Bernanke last year.

In addition to ensuring that regulators take appropriate actions on the rulemaking front, they must also take necessary steps to ensure that our payment system and financial data are adequately protected. One of the top priorities for this Committee is protection of consumer financial data and the integrity of the U.S. payment system. Even the Financial Stability Oversight Council, FSOC, has identified data security as an emerging threat to our financial stability.

At the Subcommittee hearing on Monday, Members started a discussion about the standards used to protect consumer data, the payment technologies available, and the roles of all parties in the payment system. The U.S. payment system is a shared enterprise. While parties approach the system from different positions, everyone recognizes and benefits from the fast, safe, and accurate transmission of consumer financial data.

Whether we use credit cards at the gas station, the grocery store, or even use our smartphones to purchase a sandwich or a book, everyone expects a safe and secure system for our financial information. Recent data breaches reveal just how much information different entities collect about consumers.

Financial institutions of all sizes face a thorough examination process and oversight by regulators when it comes to data security, but there are many entry points that could be attacked in our payment system. We must answer three key questions.

First, are the existing regulatory tools adequate to protect all actors in the payment system and capable of safeguarding our financial information?

Second, with so many stakeholders affected by recent data breaches, how can we minimize the damage to consumers and make the system less vulnerable?

And, third, should industry participants consider new technologies that may improve the safety of the payment system, and if so, what technologies are most appropriate?

Recent hearings have also unveiled that Federal regulators, including the witnesses before us today, collect vast amounts of consumer financial data and information. Regulators still have not provided a sound rationale, in my opinion, for all of the data they collect. Their data collection needs to be as safe and as secure as possible so consumers will not have to fear a data breach at the Federal Government level, and I will add, so consumers do not have to fear the misuse of that data being collected by the Government.

Today, our witnesses will address some of these issues and their role in protecting consumers' financial information and the stability of our payment system, and I look forward to the discussion.

Thank you, Mr. Chairman, for holding this hearing.

Chairman JOHNSON. Thank you, Senator Crapo.

I would like to allow for more time for questions, but would any Member like to make a brief opening statement? Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman. I will make a very brief opening statement. I have to shortly go to the floor to continue to work for the extension of unemployment benefits for 1.7 million Americans. But, before I do, I wanted to make some very brief comments.

As I have said previously, it is important to finish implementing Dodd-Frank such as the SEC's need to finish its share of the derivatives rules relating to security-based swaps, and I would urge moving as quickly and diligently as possible.

Lastly, in light of the Target data breach and its widespread impact on our constituents, I urge and expect all of the regulators here today to take a fresh and careful look at beefing up their cyber and data security standards to ensure that the regulators themselves and those entities under this jurisdiction are ahead of the curve and do not fall victim to cyber and data breaches.

And with that, thank you, Mr. Chairman, for your consideration.

Chairman JOHNSON. Anyone else?

[No response.]

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now, I would like to introduce our witnesses. Mary Miller is the Under Secretary for Domestic Finance at the U.S. Department of the Treasury.

Dan Tarullo is a member of the Board of Governors of the Federal Reserve System.

Martin Gruenberg is the Chairman of the Federal Deposit Insurance Corporation.

Tom Curry is the Comptroller of the Currency.

Mary Jo White is the Chair of the Securities and Exchange Commission.

Mark Wetjen is the Acting Chairman of the Commodities Futures Trading Commission.

I thank all of you 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.

Under Secretary Miller, you may begin your testimony.

STATEMENT OF MARY J. MILLER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Ms. MILLER. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify today on behalf of the Treasury Department.

I would like to update the Committee on several important regulatory developments since I appeared before you last July, Treasury's role in enhancing cybersecurity in the financial sector, and our 2014 priorities.

From his first day in office, Secretary Lew stressed the importance of finishing work on the Volcker Rule and the importance of having a single, strong final rule that was true to President Obama's proposal and the statute's intent. The final rule adopted in December will protect taxpayers by ending banks' speculative proprietary trading and restricting their investments in private equity and hedge funds, while maintaining deep liquid financial markets and allowing banks to hedge those risks.

We also made progress implementing Title II of Dodd-Frank. All of the firms required to submit living wills have now done so, and the largest bank holding companies submitted their second round of living wills last fall.

In December, the FDIC sought public comment on an important document detailing the single point-of-entry strategy to facilitate the orderly liquidation of a failing financial company.

Last summer, the Financial Stability Oversight Council designated American International Group, General Electric Capital Corporation, and Prudential Financial for enhanced prudential standards and consolidated supervision by the Federal Reserve. In September, the Office of Financial Research released a study of asset management activities to help inform the Council's understanding of potential risks in this sector.

We also continued to make progress on derivatives reform. The CFTC finalized its guidance on how Dodd-Frank applies to cross-border transactions, and the CFTC and European Commission agreed on a path forward, laying out their joint understanding regarding those issues.

In September, an international working group finalized margin standards for noncentrally cleared derivatives transactions. U.S. regulators are now working to adopt these standards domestically and we expect these rules to be finalized this year.

In addition, later this month, trading in several interest rate and credit derivatives markets will be required to take place on new electronic trading platforms.

In December, Treasury's Federal Insurance Office released a report setting out 27 recommendations designed to bring our insurance regulatory system into the 21st century.

Another area of growing concern for Treasury and the Council is the vulnerability of our financial sector infrastructure to cyber events. I want to thank the Committee for choosing to focus part of today's hearing on this topic. The changing nature of these cyber threats prompted the Financial Stability Oversight Council last year to highlight cybersecurity as worthy of heightened risk management and supervisory attention. Under the President's Executive Order on cybersecurity, Treasury also serves as a sector-specific agency for the financial sector, with a leading role in information sharing and a coordinating role in incident response.

Finally, I would like to highlight for the Committee a few areas where Treasury intends to direct significant attention this year to complete outstanding pieces of financial reform. We will take steps to promote consistent implementation of global capital and liquidity standards. We have forged ahead in implementing key derivatives reforms, and we need to make sure similar reforms are put in place around the globe. Treasury and the regulators will continue to closely collaborate with our international counterparts through forums like the Financial Stability Board and on a bilateral basis to address obstacles to resolving large cross-border firms.

Of course, there is still much to be done domestically, as well. As was the case with the Volcker Rule, Secretary Lew, as Chairperson of the FSOC, is responsible for coordinating the joint rulemaking to implement the risk retention rule. The rule was re-proposed last year, and completion of these regulations in 2014 is a key priority for the Treasury.

The last year was a busy one and we made substantial progress in financial regulatory reform. These reforms have made our financial system stronger, more stable, and more focused on fulfilling its core function of facilitating growth of the broader economy. That does not mean we will be able to relax our guard. The crisis revealed that regulation and oversight failed to keep pace with an evolving financial system and demonstrated why we must always remain vigilant to potential emerging risks in financial institutions and markets.

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

Chairman JOHNSON. Thank you.

Governor Tarullo, you may proceed.

STATEMENT OF DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Senator Crapo, and other Members of the Committee.

Let me make four quick points in beginning today. First, with respect to the rulemaking agenda, in a hearing before this Committee just about a year ago, I expressed the hope and the expectation that 2013 would be the beginning of the end of the major portion of rulemakings implementing Dodd-Frank and strengthening capital rules. Specifically, at that time, I anticipated, first, that we would issue final regulations on the Volcker Rule, capital rules, Section 716, some of the special prudential requirements for systemically important firms, and, second, that we would issue proposed rules on the capital surcharge for systemically important banks and the liquidity coverage ratio.

In the event, we did get final rules on Section 716, the Volcker Rule, and the LCR proposal done in 2013. We also issued a final rule implementing Section 318, which requires an assessment on large financial institutions for supervisory expenses. We did not get the additional Section 165 final rule or the SIFI surcharge proposed rule out, but these, along with completion of the additional leverage ratio for systemically important firms, are the priorities to be taken up in the near term.

Second, we continue to refine our stress testing and our annual comprehensive capital analysis exercise. We have broadened the nature of risks incorporated into the scenarios we develop. We have issued a policy statement describing our approach to scenario development. And we have issued a paper covering expectations for internal capital planning at large firms. These and other refinements which have been informed by the extensive commentary and advice we get from banks, technical experts, and policy analysts, continue to improve what I think is the single most important change in supervisory practice since the financial crisis.

Third, as I have said before, we need to address more comprehensively the systemic risks potentially posed by heavy reliance on short-term wholesale funding, both by the largest institutions and more generally in financial markets, particularly those arrangements for securities finance transactions. We have been discussing internally ideas for doing so, some of which I have sketched out in some recent speeches. I do not want to give a timeframe for when we may have proposals in this area, but I do want to reiterate the importance we attach to this issue.

Finally, with respect to cybersecurity, I would make a few general observations. First, the recent data breaches at some retailers and Internet service providers underscore the extent to which the effective scope of the payment system involves many more intermediaries than just regulated depository institutions. The weakest links in any part of that chain will be exploited by criminals and other malefactors.

Second, while the recent episodes involve data security breaches resulting in the theft of card and other consumer information, they should also remind us that cybersecurity is an even broader concern, implicating the integrity of our financial system and the rest of the economy. You all remember, I am sure, the denial of service attacks on numerous U.S. banks over the past couple of years.

Third, we should not think of either the recent data breaches or any other cybersecurity problems as discrete problems susceptible to solutions, but rather as new conditions of continuing vulnerability that will require adaptive, dynamic responses by both Government and the private sector.

Thank you for your attention. I would be pleased to answer any questions you might have.

Chairman JOHNSON. Thank you.

Chairman Gruenberg, please proceed.

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

Mr. GRUENBERG. Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to testify today on the FDIC's actions to implement the Dodd-Frank Act and to provide oversight of financial institutions' data integrity efforts.

The adoption of the final Volcker Rule in December by the agencies testifying today was a significant milestone in the implementation of the Dodd-Frank Act. The purpose of the Volcker Rule, as you know, is to limit certain risky activities of banking entities that are supported by the public safety net, whether through deposit insurance or access to the Federal Reserve's discount window. In general, the rule prohibits banking entities from engaging in proprietary trading activities and places limits on the ability of banking entities to invest in or have certain relationships with hedge funds and private equity funds. The proprietary trading restrictions of the rule seek to balance the prudential restrictions of the Volcker Rule while preserving permissible underwriting, market making, and risk-mitigating hedging activities.

In response to concerns raised by commentors, the final rule provides compliance requirements that vary based on the size of the banking entity and the amount of covered activities it conducts. For example, the final rule imposes no compliance burden on banking entities that do not engage in activities that are covered by the Volcker Rule. Most community banks will not need to make changes to their policies and procedures and will have no new reporting requirements, provided they do not engage in activities covered by the rule.

We also recognize that clear and consistent application of the final rule across all banking entities will be extremely important. To help ensure this consistency, the five agencies have formed an interagency Volcker Rule Implementation Working Group. The Working Group has begun meeting and will meet regularly to address reporting, guidance and interpretation issues to facilitate compliance with the rule.

The FDIC has made additional progress in other areas of the Dodd-Frank Act that are described in my written statement, including the risk retention requirement, which seeks to ensure that securitization sponsors have appropriate incentives for prudent underwriting.

In addition, the FDIC continued to make progress on the provisions of the Dodd-Frank Act relating to the resolution of systemically important financial institutions, or SIFIs. Using the standards provided in the statute, the FDIC and the Federal Reserve are currently reviewing the revised resolution plans required under Title I of Dodd-Frank for the largest most systemically significant financial institutions.

The FDIC also issued a Federal Register notice for public comment providing a detailed description of the Single Point of Entry strategy developed by the FDIC to implement the Title II resolution authorities under the Act.

Finally, we have continued our active engagement with foreign jurisdictions that will be important to the cross-border resolution of a SIFI, including the United Kingdom, Germany, Switzerland, Japan, and the European Commission.

The FDIC also joined with the Federal Reserve and the OCC in issuing rules that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III international accord. The agencies also issued an NPR that would significantly strengthen the supplementary leverage capital requirements in the Basel III rulemaking for the eight largest bank holding companies and their insured banks. Completion of this NPR is a top priority for the FDIC.

In regard to the issue of data integrity, the FDIC treats data security as a significant risk area due to its potential to disrupt bank operations, harm consumers, and undermine confidence in the banking system and the economy. The FDIC's most direct role in ensuring cybersecurity within the financial sector is through its onsite examination programs of financial institutions and third-party service providers. These examinations are designed to ensure that financial institutions protect both bank and customer information.

The FDIC is actively providing our supervised banks with assistance in planning and training for cyber threats. This includes a new program directly designed to assist community banks in planning for cyber threats. We are also working with our FFIEC colleagues through the Cybersecurity and Critical Infrastructure Working Group to strengthen examination policy, training, information sharing, and incident communication and coordination.

Mr. Chairman, that concludes my remarks. I would be glad to respond to questions.

Chairman JOHNSON. Thank you.

Comptroller Curry, please proceed.

STATEMENT OF THOMAS J. CURRY, COMPTROLLER OF THE CURRENCY, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CURRY. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear before you today.

Your invitation asked for our thoughts on a range of important issues, and my written testimony covers those matters in detail. In the time I have now, I would like to speak briefly about what the OCC is doing to improve the security of consumer financial information held by banks, implement the Dodd-Frank Act, and improve our own supervisory processes.

First, let me say that there are few issues of greater concern to me or to the OCC than the increasing risk of cyber attacks. The data breaches at Target, Neiman Marcus, as well as recent denial of service attacks on some banks, are more than just an inconvenience for banks and their customers. The affected customers pay a price in terms of the time lost monitoring accounts as well as the very real expense incurred in restoring their credit information, even though they are generally protected against fraudulent charges by their financial institutions. Banks bear the expense of replacing cards, providing credit monitoring services, and reimbursing customers for fraud losses.

Moreover, every data breach raises questions about the security of our retail payment systems, which can diminish public confidence. Further, I am concerned that these cyber attacks are becoming increasingly sophisticated and may impair our financial sector's critical infrastructure.

The banking sector is highly regulated and subject to stringent information security requirements. Banks and their service providers must protect both their own systems and their customers' data and respond promptly when any breach of customer information occurs. Moreover, the OCC regularly updates our supervisory practices and industry guidance to keep pace with the rapidly changing nature of cyber threats. For example, we recently issued updated guidance on third-party vendors to stress our expectation that banks have appropriate risk management practices in place for these relationships. We also encourage ongoing outreach to bankers to share information on emerging threats.

One of my first initiatives as Chairman of the Federal Financial Institutions Examination Council was to establish a working group on cybersecurity issues. This group has already met with intelligence, law enforcement, and homeland security officials to share information and is exploring additional actions we can take to ensure that banks of all sizes have the ability to safeguard their systems.

We have also made great progress in implementing the Dodd-Frank Act and in strengthening the resiliency of the banking system by requiring enhanced capital reserves and liquidity. For example, we finalized a rule requiring that an institution's lending limit calculation account for credit exposure arising from derivatives and securities financing transactions.

Last year, the OCC along with the other rulemaking agencies adopted final regulations implementing the Volcker Rule, which bars banks from engaging in proprietary trading and limits their ability to invest in or sponsor hedge funds or private equity funds. Throughout the interagency rulemaking, the OCC worked to minimize the compliance burden on community banks that are engaged in limited activities while ensuring that the largest banks are subject to robust compliance and reporting requirements.

But, while Congress gave us a number of important tools to help preserve the stability of the banking and financial system, it would be a mistake to overlook the important role of supervision to the health of the banking industry. Since the crisis, the OCC has taken a number of steps to help ensure the future strength of the industry.

For example, we developed a set of heightened standards for large bank management and boards of directors. We expect large banks to meet the highest standards for risk management and corporate governance. We have proposed to include these standards as enforceable guidelines in our Part 30 regulation, which will improve our ability to enforce them.

At the same time, we have also taken a hard look at our own supervision program. Last year, I asked a team of senior international supervisors to provide a frank and independent assessment of the way we supervise large institutions. Their thoughtful response notes strengths in our program and identifies areas in which we can improve. We are evaluating how best to implement their recommendations.

This is not an easy thing for an agency to do, and I have been impressed with the willingness of OCC staff to embrace every opportunity to improve. That attitude is the mark of a healthy organization, and it is one of the reasons I believe that the OCC continues to be ready to meet the challenges of supervising a rapidly changing industry.

Thank you, and I look forward to your questions.

Chairman JOHNSON. Thank you.

Chair White, please proceed.

STATEMENT OF MARY JO WHITE, CHAIR, SECURITIES AND EXCHANGE COMMISSION

Ms. WHITE. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify about the SEC's ongoing implementation of the Dodd-Frank Act and the important issue of data security.

The Dodd-Frank Act significantly expanded the regulatory responsibilities of the SEC. It enhanced the SEC's authority over credit rating agencies and clearing agencies and strengthened our regulation of asset-backed securities. It gave the SEC new responsibilities over municipal advisors and hedge fund and other private fund advisors, and required a new oversight regime for over-the-counter derivatives. It also created a whistleblower program and provided the SEC with additional enforcement tools, which we are using.

Implementing the Dodd-Frank Act has required the SEC, as you know, to undertake one of the largest and most complex agendas in the history of the agency, with more than 90 provisions requiring rulemaking and more than 20 others requiring studies or reports. In addition, the Dodd-Frank Act and the financial crisis that preceded it have focused the SEC's efforts more directly on enhancing financial stability and reducing systemic risks.

While certainly more work remains, we have made substantial progress implementing this agenda. Since I arrived at the Commission in April 2013, we have advanced rules and other initiatives across the wide range of regulatory objectives set by the Dodd-Frank Act for the SEC.

We have adopted final rules for the registration of municipal advisors. We have analyzed the first complete set of data from registered advisors to private funds so that the SEC and Financial Stability Oversight Council can better assess their impact on financial stability. We have issued a comprehensive rule proposal for the cross-border application of our regulatory framework for security-based swaps. We have adopted a rule to further safeguard customer funds and securities held by broker-dealers.

We have removed references to credit ratings in our broker-dealer and investment company regulations. We have proposed a rule to disclose the ratio of compensation a public company pays its CEO relative to what it pays its median employee. We have finalized a rule disqualifying felons and other bad actors from an important private securities offering exemption.

We and others have re-proposed a rule concerning the retention of certain credit risk by securitizers of asset-backed securities. And, we and others here today have adopted a final Volcker Rule that is consistent with the language and purpose of the Dodd-Frank Act and that preserves the benefits of diverse and competitive markets.

These measures are in addition to the rules we have advanced and reports we have completed to implement the JOBS Act, including by permitting the use of general solicitation in certain private offerings, crowdfunding, and updating and expanding Regulation A, and they are also in addition to other significant initiatives, including our proposals to reform money market funds and to enhance the responsibilities of key market participants over their technological systems. Completing the rulemakings and studies mandated by the Dodd-Frank and JOBS Act remains among my top priorities for 2014.

Under the Dodd-Frank Act, the Commission also has taken additional steps to protect customer data. Last April, the SEC and CFTC jointly adopted Regulation SID, which requires certain regulated financial institutions and creditors to adopt and implement policies and procedures designed to identify and address red flags signaling the possible theft of a customer or client's identity. Regulation SID built upon the SEC's existing Regulation SP, which requires registered broker-dealers, investment companies, and investment advisors to adopt written policies and procedures instituting safeguards for the protection of customer records and information.

The SEC monitors and enforces compliance with these rules and regulations through our examination and enforcement programs. Examinations of registrants relating to data protection and information security continues to be an exam priority for the SEC's National Exam Program, and in recent years, the SEC has also brought enforcement actions for a registrant's failure to adopt reasonable policies and procedures to protect customer information from imminent threats and for failure to respond or follow up on security threats despite red flags. There is no question that data protection is a critical national and global priority on which both the private and public sectors must continue to closely focus.

Thank you again for the opportunity to testify today. I would be pleased to answer any questions.

Chairman JOHNSON. Thank you.

Chairman Wetjen, please proceed.

STATEMENT OF MARK P. WETJEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. WETJEN. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I am pleased to join my fellow regulators in testifying today, and it is great to be back in the Senate.

As this Committee is well aware, the Commodities Futures Trading Commission was given significant new responsibilities through the passage of the Dodd-Frank Act. The Commission has substantially met those responsibilities with only a few rulemakings remaining. As a result, nearly a hundred swap dealers and major swap participants have registered with the Commission and become subject to new risk management and business conduct requirements. Counterparty credit risk has been reduced through the Commission's clearing mandate. And pre- and post-trade transparency in the swaps market exists where it did not before.

The Commission also has adopted cross-border policies that account for the varied ways that risk can be imported into the United States. Congress recognized in Dodd-Frank that even when activities do not obviously implicate U.S. interests, they can still create less obvious but legally binding obligations that are significant and directly relevant to the health of a U.S. firm and that, in aggregate, could have a material impact on the U.S. financial system.

In a matter of days, the compliance date for one of the remaining hallmarks of the financial reform effort will arrive, as well, the effective date of the swap trading mandate. The Commission also is working to complete in the coming months rulemakings for capital and margin requirements for uncleared swaps, rulemakings intended to harmonize global regulations for clearinghouses and trading venues, and rules establishing final position limits under the Commission's newest proposal.

Looking forward, the agency will continue its efforts to ensure an orderly transition to the new market structure for swaps. The agency staff is presently exploring whether to recommend a number of new proposals to address remaining end-user concerns.

In recent weeks, the Commission also finalized the Volcker Rule. Through this effort, the market regulators went beyond the Congressional requirement to simply coordinate. In fact, the Commission's final rule includes the same substantive rule text adopted by the other agencies. The rule strikes an appropriate balance in prohibiting the types of proprietary trading that Congress contemplated while protecting liquidity and risk management through legitimate market making and hedging activities.

Compliance with the Volcker Rule, including the reporting of key metrics, will provide the Commission important new information that will buttress its oversight of swap dealers and Futures Commission merchants, which are banking entities under Dodd-Frank that are subject to the Commission's registration rules.

To ensure consistent, efficient implementation of the Volcker Rule, the agencies have established an implementation task force. One of the Commission's goals for this task force will be to avoid unnecessary compliance and enforcement efforts by the agency. Indeed, this goal is one of necessity for the Commission. Our agency remains resource constrained and cannot reasonably be expected to effectively police compliance to the fullest extent. The Commission is also analyzing whether it can leverage the use of self-regulatory organizations, such as the National Futures Association, to assist with its responsibilities under the rule.

Regarding the interim final rule relating to TruPS, the Commission last month quickly and unanimously adopted the measure in an effort to protect liquidity and markets that are important to community banks. In doing so, the agency sought to avoid what could have been significant capital and funding consequences for community banks. This is another example of the Commission responding promptly to compliance challenges presented to it and also demonstrated the enduring commitment of all the agencies here to ongoing coordination.

Related to the Committee's concerns about customer data breaches, the Commission takes seriously its responsibility to protect against the loss or theft of customer information. I must note that the Commission's limited examinations staff has an impact on its ability to examine and enforce critical rules that protect customer privacy and ensure firms have robust information security and other risk management policies in place.

Nonetheless, the Commission has taken several steps in this area, including jointly adopted with the SEC the final rules requiring our registrants to adopt programs to identify and address the risk of identity theft. The Commission also adopted new risk management requirements for firms, including policies addressing risks related to retail payment systems, including identity theft, unauthorized access, and cybersecurity.

Additionally, the agency staff is poised to release a staff advisory outlining best practices for compliance with provisions of Gramm-Leach-Bliley designed to ensure financial institutions protect customer information. In light of recent events, the Commission also is presently considering implementing rules under Gramm-Leach-Bliley to expand upon our current customer protection regulations with more specificity regarding the security of customer information.

Thank you for inviting me today. I would be happy to answer any questions.

Chairman JOHNSON. Thank you for your testimony.

As we begin questions, I will ask the Clerk to put 5 minutes on the clock for each Member.

Secretary Miller, what steps will Treasury take to promote cooperation between industry, law enforcement, the intelligence community, and regulators so that American consumers' financial information is better protected from threats, including cyber attacks and data breaches?

Ms. MILLER. Thank you for the question and for the focus on that issue at this hearing today. I think I would mention a few things.

First of all, as you have recognized, the FSOC has highlighted this issue in its annual report to call attention to the operational risks of financial sector infrastructure in cybersecurity attacks, and I think the FSOC will continue to focus on that in terms of bringing it to the attention of all of its members.

At the Treasury, we are the sector-specific agency for the financial sector on this issue. As such, we have an important role in coordinating incident responses, but also making sure there is very strong information sharing between the private sector itself and between the private sector and regulators, and Treasury has stepped up to make sure that we can translate information from the intelligence and the security agencies to the private sector.

One of the ways we have done that this year is to make sure that we have current security clearances for people both in the Government and in the private sector so we can very quickly share information to make sure that there are no delays in responding to a cybersecurity incident.

Finally, we work with the Executive Order that the President has put out on this issue, but we also think it would be very valuable to have comprehensive legislation on cybersecurity. Thank you.

Chairman JOHNSON. Comptroller Curry, as current Chair of the FFIEC, is there more than can be done to help financial regulators better protect Americans' financial information regardless of where they bank or shop?

Mr. CURRY. Thank you, Mr. Chairman. One of the major focuses of our cybersecurity effort at the FFIEC is to make sure that the regulated financial institutions are up to the task in the area of cybersecurity. The FFIEC is a unique forum that has present in it the Federal banking agencies, the consumer protection agency, as well as State bank supervisors. So, our focus has been on making sure that all financial institutions, including community banks and credit unions, are meeting our expectations from a regulatory standpoint.

As part of our program, we are making an assessment of whether the overall regulatory structure is effective, from communicating awareness of cyber threats, making sure our examination procedures, our enforcement authorities, which would also include the statutory framework, are effective, given the nature of the ongoing cyber threats. We will also be, given the incidents relative to the data security breaches, focusing on whether or not existing regulatory standards for technology for data security are sufficient and whether or not there is a need for greater coordination with other players in the ecosystem. Thank you.

Chairman JOHNSON. Chair White and Chairman Wetjen, in your testimony, you highlight a lack of resources as significant challenges to your agency. So, specifically, how would the current funding levels impact your efforts to protect data and implement and enforce Wall Street Reform? Chair White.

Ms. WHITE. Yes. We do have significant budget challenges which impacts a number of our very important IT initiatives. There is nothing we value more importantly, however, than data security. I think the sophistication of the perpetrators continually evolves, and threats to both governments and market participants alike increase in complexity, really, on a daily basis. And so we do want to keep pace with those challenges.

We clearly will prioritize our resources so as not to compromise on data security, but it does present quite a challenge. You know, clearly, we are also devoting resources to our examination program directed at data security, and to our enforcement program, as well, in that space, and the FY 2014 budget request actually asked for 450 additional positions in enforcement and examination, so, obviously, not receiving funding for that, that has an impact. But, we intend to keep data security very much in the forefront of our priorities.

Chairman JOHNSON. Chairman Wetjen.

Mr. WETJEN. Thanks, Mr. Chairman. I would echo what Chair White said. The main tool that we have is to examine the practices of our registered entities. They have a variety of risk management requirements that relate to keeping customer information safe and secure, and because we are resource constrained, it is very likely we are not going to be able to review and examine those systems that the registered entities have in place and so we cannot be sure that the data that is being kept by our registered entities is going to be as secure as we would like. So, that is the real world explanation or reason why the challenges we continue to face on the resource front could have an impact on consumers.

Chairman JOHNSON. Chairman Gruenberg, I commend you and your fellow regulators for acting quickly to fix a Volcker Rule issue that could have unintentionally harmed community banks. As you analyze other rules, what are you doing to minimize unintended consequences and monitor the impact on community banks?

Mr. GRUENBERG. Thank you, Mr. Chairman. I think it is fair to say that in all of the rulemakings we have been undertaking, the agencies across the board have paid particular attention to the impact on community banks. In the two major rulemakings we did last year on the Basel III capital accord as well as the Volcker Rule, we made significant changes in the final rulemakings to be responsive to comments and concerns raised by community banks. We made three significant changes in the Basel III rules responsive to the comments. As I noted, in the Volcker Rule, we made adjustments in the final rule so that for the large majority of community banks that do not engage in activities subject to the Volcker Rule, that large majority of community banks will have no compliance requirements under Volcker.

I would note the importance of the cybersecurity issue to community banks, and perhaps it has been less appreciated because most of the focus on cybersecurity has been on the large institutions. But, I can tell you, we have an advisory committee of community banks from around the country that our board meets with three times a year, and when we went through issues of concern to them, cybersecurity was near the top of their list. All of them related incidences that their institutions experienced. As the larger institutions have strengthened their defensive positions, there really has been a movement down the system.

So, this, I think, is really an area that needs particular concern, and we have developed a number of tools to assist community banks in this area.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Under Secretary Miller, I have a lot of questions that relate to Dodd-Frank implementation and data security, but I would be remiss if I did not first raise the issue of housing finance reform that is a critical issue before this country.

As you know, in the State of the Union, the President called on Congress to send him legislation that protects taxpayers from footing the bill for a housing crisis ever again and keeps the dream of home ownership alive for future generations. I just want to ask you, as a representative of the Administration here, to confirm that the President has, indeed, called on Congress to send him housing finance reform legislation and that this is a top priority which we need to handle now.

Ms. MILLER. Thank you for the question. I could not agree with you more. This has been a priority of the Treasury since the day I arrived, to make sure that we are planning for a safe and stable housing finance system. As you know, last summer, the President articulated four important points: One, that we need to design a system that brings more private capital back into the housing finance market; two, that we design something that winds down the GSEs as they performed and make sure that we are protecting the taxpayers in a future housing finance system; that we provide broad access to credit for creditworthy borrowers who want to own a home; and that we also make sure that we provide adequate financing for rental options in this country.

We are very heartened that the improvement in the housing market, the recovery we are seeing in housing prices, the slowing or diminution of loan delinquencies and foreclosures is giving us the opportunity and the platform now to move forward with housing finance reform, and we very much look forward to working with Members of this Committee on a bipartisan piece of legislation. Thank you.

Senator CRAPO. Well, thank you, and I just wanted to get that out there so that it is clear that this is a priority, and I appreciate your emphasis on that and your work on this.

My next question really is not a question, it is more of a statement about the Volcker Rule, and the reason is because there is so much that I want to ask, there is just not time for me to get into it right here, so I am simply going to make a statement and then I will, with follow-up questions on the record, engage with each of you on the Volcker Rule and what we have seen.

The concern I have is one that I know was raised yesterday in hearings and that has been raised significantly, which is that I think we are just beginning to see the unintended consequences of the Volcker Rule. And, as I mentioned in my opening statement, I am a little bit baffled that after 3 years of work on the Volcker Rule, none of the agencies foresaw the unintended consequence related to CDOs that was fixed, but I am not sure it has been completely resolved and properly yet, but at least the issue is the concern about unintended consequences with the Volcker Rule and the problems that we are now seeing highlighted there with the multiple regulators having to coordinate with each other and fully consider all of the dynamics of a very major rule such as this.

So, I am going to leave it at that right now and not ask you to engage with me right now, because I have got a lot of other questions to try to get to, but I will, with questions on the record, be engaging with you.

For the next question, Chair White, I would like to turn to you. I understand that FSOC is evaluating whether and how to consider asset management firms for designation as SIFIs. As a part of that evaluation process, the FSOC asked the Office of Financial Research to draft a study of the asset management industry, and unfortunately, the OFR report failed to fully take into account the perspectives of and the data from the SEC and market participants, as I see it. The asset management industry is squarely within the SEC's jurisdiction and core expertise.

What additional work and data gathering do you believe should be done to further understand the asset management industry and to achieve the right result in this context?

Ms. WHITE. I should say, I guess, at the outset, the SEC is very actively working in the FSOC setting with our fellow agencies in following up on concentrating exactly on those issues. We provided technical assistance to OFR before that study was completed, commented extensively, some of those comments taken, some of those not, as is usual, but agreed to disagree on a number of things. So, I think it is very important that we have complete data, complete expertise applied to all these issues and focus on what differences there are in terms of asset managers, which are obviously based on an agency model, business model. But, I think that discussion is going on.

Senator CRAPO. Thank you very much.

And one more question. This goes to both Chairman White and Chairman Wetjen. I have a lot more questions, but this will be the last one I get to get at here, and that is that over the last year, I have repeatedly expressed my view that the SEC and the CFTC, to move in a more coordinated way with regard to Dodd-Frank implementation and cross-border initiatives for derivatives. Some argue that the CFTC's implementation is largely complete, while the SEC has a fair amount of work left to be done.

As the landscape for Title VII continues to develop, what are the concrete steps that your agencies are taking to ensure coordination from both rulemaking and compliance perspectives?

Ms. WHITE. Let me just, I guess, take that first, which is that, A, we are prioritizing the completion of our rules in 2014 for Title VII. Our staffs are in pretty much constant contact about implementation issues. We are also actually looking at the possibility of accelerating on some issues that do not require full rulemaking, and we are also engaged at the principal level, which I think is very important, as well.

Senator CRAPO. Thank you.

Mr. Wetjen.

Mr. WETJEN. Thanks, Senator Crapo. I agree with Chair White. It is a priority for our agency to coordinate closely with the SEC. At a personal level, I have been involved in that since joining the agency. Of course, as you alluded to, our cross-border guidance is currently in place, but there are still some issues that continue to arise related to it and we continue to consult with the SEC as those arise.

And to give you a specific example, there is some interest in some subsequent staff advisories concerning our guidance. We are hosting a Global Markets Advisory Committee meeting at the Commission next week and the SEC will be participating in that meeting, as well as some foreign regulators from both the FCA in the United Kingdom and the European Commission in Brussels. So, we will have regulators from around the globe, including the SEC, providing their input, all in an effort to, as you say, coordinate as best we can.

Senator CRAPO. Thank you.

I have a number of additional questions, but I will submit those for the record, Mr. Chairman, and I look forward to working with the witnesses here on those. Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, and thank you for adding data security to today's topics.

I would like to ask those who I understand are most involved in this, but anyone who feels that they have a role, as well, Governor Tarullo and Chairman Gruenberg and Comptroller Curry, and exactly what roles are your agencies playing as it relates to data security standards that in my understanding are largely set by the industry? I get the sense that your role is generally outlining general principles and leaving the private sector to fill in the details, or maybe if I am wrong, I would be interested in what you are doing beyond that.

This past Monday, we had a Subcommittee hearing that Senator Warner held with the retailers, the banks, the card industry, consumer advocates, and what not, and I am wondering, should we not be establishing a Federal standard, one that does not lock in a specific technology, because that can be eclipsed in time, but one that certainly looks at the question of a regulatory standard based on performance. For example, could we not say that at some point, it has to be considered an unreasonable security risk for a company not to be using, for example, chip and PIN technology, or something that performs equivalently, if that is the highest standard that exists in the marketplace at a given time, so that at least companies would understand what that standard is that they are being held accountable to and we could respond accordingly with the FTC or others as it relates to violating that standard on behalf of consumers.

Mr. CURRY. Senator, I think the basic framework is in place for the financial institutions regulated by the banking agencies. We have standards for information security. We have an ongoing oversight program in terms of examining the individual institutions under our jurisdiction. And we also supervise certain institution-affiliated parties, independent service organizations. The agencies, the OCC, in particular, has also set out detailed expectations with respect to third-party vendors that are used by those service providers.

Senator MENENDEZ. Do those standards serve us well in the data breaches in Target and Neiman Marcus and others?

Mr. CURRY. Well, in that particular instance, the breaches did not occur at the bank end, and I think what you pointed out correctly is there are different standards between different players within the system. The banking industry does have basic standards in place that are not necessarily existing in the merchant or retail space, so that in order to provide a consumer with the same breach notification rights, it may be necessary to impose legal or other requirements on retailers or merchants, and that is the situation.

Senator MENENDEZ. Governor Tarullo.

Mr. TARULLO. Senator, let me supplement a bit. I agree with Comptroller Curry, obviously, about the mechanisms the three banking regulators have put in place. But, I think your question gets to a broader issue, and I agree with what I think is the premise of your question, which is we cannot look at just the banks right now. I think we need to think in terms of a consumer who uses a credit card, and at that point, her information starts on a trail which may go through a retailer and a processor and one or more banks before the final payment is eventually made. And I think right now, we do not have any mechanism for taking that view of what I would characterize as a very extended payment system and making sure that the kind of standards which would assure protections at each step of the way are actually realized. As I said in my introductory remarks, the weakest link in the chain is where the attention is going to be directed by criminals or others.

You know, there are a lot of people doing a lot of work throughout the U.S. Government on this——

Senator MENENDEZ. So——

Mr. TARULLO.——but I think you are going to need some more general standards. Let me just give you one example, which is sort of helpful. I think we probably need some uniform requirements on disclosure when breaches have actually taken place. You know, the three banking agencies require remediation, particular remediation efforts and notification and the like, but that is not true generally. And until the banks and customers are assured that they know whenever anything has happened with their data, it is going to be hard for people to respond.

Senator MENENDEZ. Well, we look forward to your work on what I think should be a standard that we can—across the universe of those who ultimately hold consumer information.

If I may, one final question, Mr. Chairman.

Chairman JOHNSON. Yes.

Senator MENENDEZ. Again, to the three of you, we have seen reports in the press of regulated financial institutions purchasing credit protection, often using credit default swaps, from unregulated entities like hedge funds or entities formed offshore to avoid regulation in order to reduce the amount of capital that they need to hold an investment on the book. And, in fact, these trades are transferring risk from a regulated entity, institution, that are subject to capital requirements, to unregulated entities that are not subject to capital requirements. And instead of raising equity to pay for an investment, the bank is taking an exposure to an entity that may or may not be able to pay up if the investment goes bad. And if that story sounds familiar, it is because it is very strikingly similar to what we saw happen with AIG before the financial crisis.

So, the question is, when a regulated financial institution purchases credit protection, can you describe how you take into account counterparty credit risk when determining how much credit the financial institution gets toward its capital calculations and what is required of banks to monitor their counterparties' ability to perform on a trade, because otherwise, I just see us, as we are talking about financial security here and stability and systemic risk, we are almost back in this element to the same type of risk possibility that we were before Dodd-Frank.

Mr. CURRY. Senator, we share your concerns from a supervisory standpoint on the risks from credit transfer transactions, as you have described them. So, as a result, it is something that we scrutinize carefully from an examination standpoint at the OCC. Our position is that we are looking to see that it is actually a true transfer, and if it is not, we will not accord it the more favorable capital treatment.

Senator MENENDEZ. Chairman.

Mr. GRUENBERG. Senator, I would just comment. We have not approved requests for these kind of arrangements for our supervised institutions, and I would note that under the leverage ratio, firms would not receive any capital benefits from these kinds of interactions, which underscores the value of the strong leverage ratio requirement, as well.

Senator MENENDEZ. Well, we look forward to your continuing work in that regard.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Governor Tarullo said in his testimony that, quote, "work remains to be done to address the problems of too-big-to-fail and systemic risk." I would like to ask each of you to give me a simple yes or no, starting with you, Ms. Miller, if you believe that too-big-to-fail—if you agree with Governor Tarullo, that we have not ended too-big-to-fail. A simple yes or no, if each of you would do that. Ms. Miller.

Ms. MILLER. I do not think we have ended the perception of too-big-to-fail, but I think we have gone a long way to ending too-big-to-fail with the regulations.

Senator BROWN. Governor Tarullo, I assume you agree with Governor Tarullo's statement.

Mr. TARULLO. [Nodding head.]

Senator BROWN. OK.

[Laughter.]

Senator BROWN. Mr. Gruenberg.

Mr. GRUENBERG. Yes, I agree.

Senator BROWN. I am sorry?

Mr. GRUENBERG. Yes, I agree with the question that you raised.

Senator BROWN. OK. Mr. Curry.

Mr. CURRY. Yes, I also agree. Thank you.

Senator BROWN. We have not ended it. OK. Ms. White.

Ms. WHITE. Too soon to tell. I agree.

Senator BROWN. Mr. Wetjen.

Mr. WETJEN. I also agree with Under Secretary Miller's comments.

Senator BROWN. OK. If too-big-to-fail is not over, and most of you agree with that—some of you, I am not sure on either end where you sit exactly—I want to ask about two ways to address it. One is living wills. Yesterday, Chairman Gruenberg and Governor Tarullo answered Representative McHenry, you are willing to say living wills are deficient as you evaluate the second round submitted by the biggest banks. Both Ms. Miller and Chairman Gruenberg note that bankruptcy is the standard against living wills are supposed to be measured. I doubt that all of the largest banks, those with more than—those 8 to 10 banks that are $250 billion up in assets—I doubt that those largest banks can be resolved through an orderly process, so it is clear we all have work to do.

The other issue of the other of the two ways to address too-big-to-fail is the supplemental leverage ratio. I was encouraged a number of months ago when OCC, FDIC, and the Fed proposed their supplemental leverage ratio requiring the largest insured banks and bank holding companies to have the ability to produce tens of billions of dollars, to have initial tens of billions of dollars in capital to protect against failure. Governor Tarullo notes that the Basel Committee's revisions for measuring bank assets under Basel III leverage ratios will be incorporated into your proposed leverage ratio.

So, my question is about how soon and how we do this. For Governor Tarullo and Comptroller Curry and Chairman Gruenberg, how do you do this? Will the United States finalize its supplemental leverage ratio first and then revise the asset definitions once Basel has completed its process, or will you wait until there is an international standard in finance, an international standard to finalize the leverage ratio? In other words, are we going to move first or are we going to continue to wait? Ms. Miller.

Ms. MILLER. I think I would actually prefer to defer to the regulators to talk about the work that they are doing in this particular area because I think it is really their charge to adopt these standards and put them into——

Senator BROWN. There is no Treasury recommendation here?

Ms. MILLER. No, we certainly support the proposals on supplemental leverage ratio and making sure that we have a very effective regime here in terms of——

Senator BROWN. But you do not have a position on the timing of these rules?

Ms. MILLER. The only thing that I think we have been clear about is we want to make sure that we are coordinating well with our international counterparts. So, for example, some of the meetings that took place in January were quite helpful, I think, in articulating common standards. So, I think we would like to make sure we are moving in concert with our international partners, but we would like to see these things done as quickly as possible——

Senator BROWN. I hope that "in concert" and "working with" does not imply an abdication of leadership and we will not go first. But, the three regulators. I think Ms. Miller is right. Governor Tarullo, if you would go first.

Mr. TARULLO. I think the redefinition of the denominator, which was basically what the international work was about, is essentially done. I mean, we know where they have come out. The question that remains is what is the required minimum ratio going to be given that work. And as I think you know, because you alluded to the proposed regulation, it is the intention of the three bank regulatory agencies to have a higher minimum ratio than that that prevails in the international forum right now.

So, what we have been able to do is to move toward a point where we have got our definitions harmonized, but we will independently put in a higher leverage ratio than the international standard. And as I said in my opening remarks, for us, that is one of the three regulatory initiatives that is the top priority in the near term.

Senator BROWN. Chairman Gruenberg, timing and action and what are you going to do.

Mr. GRUENBERG. Yeah. I think—I am hopeful we can move forward quickly to finalize the supplementary leverage ratio proposal, and we will need to also act to incorporate the changes to the denominator, as Governor Tarullo indicated, that were finalized by the Basel——

Senator BROWN. And that means we are going to move first?

Mr. GRUENBERG. Yes, I believe so.

Senator BROWN. Comptroller Curry.

Mr. CURRY. Yes. I think Chairman Gruenberg described the process. My own view of what should happen is that we should adopt both provisions, the final version of the NPR and the supplemental leverage ratio, and also adopt the—consider adopting the changes in the denominator coming out of the Basel Committee and do that as quickly as possible. It is a real high priority for me and the OCC.

Senator BROWN. Good. Last July, in response to my question, Chairman Bernanke told this Committee that he believes the United States has a leadership position and other countries are likely to follow our example. You can cite—he did not, but you can cite a number of issues. The EU just proposed its own version of the Volcker Rule. It is important we lead, and I urge all of you in positions to do this to move quickly and decisively.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you.

Governor Tarullo, we have been talking about—I was gone a few minutes, but the Senator from Ohio was talking about, I think, the Volcker Rule and the implementation, at least that is what I got. Let us go back just a minute. How will the Volcker Rule when it is fully implemented differ from what we had under Glass-Steagall?

Mr. TARULLO. So, under Glass-Steagall, Senator, there could not be an affiliation, that is, a corporate affiliation, between a commercial bank, an insured depository institution, on the one hand, and, for example, a broker-dealer trading generally, doing underwriting of equities and trading in equities and——

Senator SHELBY. Separation of commercial banking from investment banking?

Mr. TARULLO. Exactly. That is sort of the distilled version of what Glass-Steagall was.

Senator SHELBY. OK.

Mr. TARULLO. The Volcker Rule prohibits the proprietary trading activity within any part of a bank holding company——

Senator SHELBY. We understand that.

Mr. TARULLO.——but it does not require that there be a separation between investment banking and——

Senator SHELBY. They can still trade from their customers, can they not?

Mr. TARULLO. Correct. Full agents——

Senator SHELBY. But they could not trade proprietary for themselves.

Mr. TARULLO. That is correct.

Senator SHELBY. And risk—the idea was to risk capital to the bank, right?

Mr. TARULLO. That it is kind of a moral hazard——

Senator SHELBY. And ultimately to the taxpayers.

Mr. TARULLO. It is a moral hazard motivation, exactly, Senator.

Senator SHELBY. OK. What can, say, a commercial bank do now, including the Volcker Rule, what can they do that they could not do before Glass-Steagall was——

Mr. TARULLO. Oh, what can the commercial bank do——

Senator SHELBY. Yes. What can they do that they could not——

Mr. TARULLO. So——

Senator SHELBY.——including the restrictions put on them by proprietary trading by the Volcker Rule.

Mr. TARULLO. Right. There was a parallel movement over the time the Glass-Steagall was in effect whereby banks got more powers. They were allowed to do things that they had not been allowed to do in 1933. Neither Glass-Steagall nor Gramm-Leach-Bliley really changed that so much. So, I do not actually think that either Gramm-Leach-Bliley or the Volcker Rule has basically changed what national banks can do, and Comptroller Curry may want to weigh in on this. All it has done is put a constraint on——

Senator SHELBY. And you emphasized national banks, did you?

Mr. TARULLO. No, it would—well, so no——

Senator SHELBY. Or all banks?

Mr. TARULLO.——under the FDI Act——

Senator SHELBY. OK.

Mr. TARULLO.——no bank can do—no insured depository institution——

Senator SHELBY. Right.

Mr. TARULLO.——can do as principal anything that a national bank——

Senator SHELBY. Right. Right. On the European banks that do business in this country, and a lot of them do, the big ones, they, as I understand it, will come under the Volcker Rule, too, here.

Mr. TARULLO. Here in the United States, yes, sir.

Senator SHELBY. Now, how is that coming along?

Mr. TARULLO. Well, of course——

Senator SHELBY. Because in Europe, they have got a different deal, have they not?

Mr. TARULLO. That is right. We are just——

Senator SHELBY. Like, if it was a Deutsche Bank, an HSBC, the Volcker Rule in the European Union there does not apply to them, but it would apply to them doing business in the United States.

Mr. TARULLO. That is right. The rules enacted by the five agencies would apply to any banking organizations within the United States, and so they would apply. There is, as you know, an exception in the Volcker Rule for activity done solely outside the United States by a foreign bank, and so there are standards for meeting that. As you suggest, the European Union is now thinking about their own version of the Volcker Rule, but that is a proposal at this juncture, so we do not know exactly how it would line up.

Senator SHELBY. I know all of you watch what is going on in Europe, and you should. They have a number of so-called stress tests coming up. How do those stress tests compare to the stress tests that you folks put our banks through? We have always thought and heard and read that they are not as stringent or strict.

Mr. TARULLO. Well, as you can tell, we have paid a lot of attention to our stress tests in the United States and we try to improve them every year. I think what you are seeing in Europe now is a somewhat different approach to the stress testing exercise, and importantly, it is now being done at the European Central Bank, and the European Central Bank is doing it as the soon-to-be umbrella supervisor for all the large banks in Europe. They have the capacity to do scenarios the way we do, and so I think we are going to see a somewhat different approach.

They do have a big task, though. You know, we do about 30 of our institutions and they have got over 100 that they have to cover. So, it is a big task and it is going to take them about a year to do it. But I think here, as in many other areas, we are starting to converge more on practice.

Senator SHELBY. I will direct—this is my last question—to both you and the Chairman, Marty, of FDIC. Today, 2014, how do you feel about the capitalization of our banking system overall? First, Marty, I will ask you, and then—that is very important. And how far has it come, and is it where you want it or are you going—they are going to have to jump through some more hoops?

Mr. GRUENBERG. I would say, Senator, we are getting there.

Senator SHELBY. Mm-hmm.

Mr. GRUENBERG. We have made real improvements.

Senator SHELBY. Absolutely.

Mr. GRUENBERG. I think, it is fair to say as a general proposition over these last 4 years since the crisis, our banks across the board, from large to small, have significantly rebuilt their balance sheets and are in a stronger capital position today. I also think, and Governor Tarullo certainly will comment on this, that we are moving, in particular, to strengthen the capital requirements for our largest, most systemically significant institutions. That is still a work in progress, but I think we are moving in the right direction.

Senator SHELBY. Governor.

Mr. TARULLO. Senator, with respect to the smaller banks, which I would say is all but the biggest 30, the expectations that we have with respect to the new capital rules, I think those are all now in place and most banks already meet those, and those that are not, do not, I think will be coming up to do so.

As Chairman Gruenberg mentioned, we are still focused on the largest institutions, and it will not surprise you to hear me say that I am particularly focused on institutions that have a heavy reliance on short-term wholesale funding. And I believe that we need to think in terms of potentially more capital at the very largest institutions which have that vulnerability to runs from short-term wholesale funding.

The second thing I would say is, what the stress tests do is give us a dynamic capital measure as opposed to a static one. We give a scenario. We project forward what losses will be rather than just rely on backward-looking measures. And the continued improvements on that, the rigor in the scenario, the taking into account new things like interest rate shocks are a way to assure that, regardless of the capital ratios required on the books, that we do have the kind of resiliency in the system which we have all been striving for.

Senator SHELBY. What about flexibility of capital? How important is that? You can have the capital, but you have got to be able to use it at stressful times, have you not?

Mr. TARULLO. That is correct, Senator, and that is why the emphasis that all three of us have had on common equity, which is the most loss absorbent form of capital. You know, over the years—we should just call it as it was—there were some games played with the kind of things that could qualify as capital.

Senator SHELBY. Sure.

Mr. TARULLO. I think we saw in the crisis that when stress hits, the markets will see right through those sorts of things, and that is why common equity needs to be at the center of our calculation.

Senator SHELBY. But you ought to be able to see through it first, as a regulator, right?

Mr. TARULLO. That is correct, Senator.

Senator SHELBY. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

All of our regulators have conceded that our largest banks are still too-big-to-fail. Perhaps this is a time to note that a 21st century Glass-Steagall would reduce both the size of the financial institutions, so there would not be so many that are too big, and reduce the risk by separating their banking activities and help us bring too-big-to-fail under control. I do not think we should be waiting longer to do this.

But, I also want to talk about another part while we have got you here, and that is in 2013 alone, J.P. Morgan spent nearly $17 billion to settle claims with the Federal Government, claims relating to its sale of fraudulent mortgage-backed securities, its illegal foreclosure practices, like robo-signing, its manipulation of energy markets in California and the Midwest, and its handling of the disastrous London Whale trade. And at the end of the year, J.P. Morgan gave its CEO, Jamie Dimon, a 75 percent raise, bringing his total compensation to $20 million.

Now, you might think that presiding over activities that resulted in $17 billion in payouts for illegal conduct would hurt your case for a fat pay bump, but according to the New York Times, members of the J.P. Morgan Board of Directors thought that Jamie Dimon earned the raise, in part, and I am quoting here, "by acting as chief negotiator as J.P. Morgan worked out a string of banner government settlements." I think this raises questions about whether our enforcement strategy is working or whether it is actually so bad that we are making it more likely for big banks to break the law.

Neil Weinberg, the Editor-in-Chief of the American Banker magazine, said that in the current environment, quote, "Bank executives would be crazy to hold back. If they get caught, they can pay their way out of the problem with shareholders' money. And if their misdeeds pay off as expected, the profits will goose their pay." I will add, even if they do get caught, the executives might still get a raise.

So, here is my question. Does anyone on this panel seriously think that the Government's current enforcement system for financial crimes is actually working in the sense of deterring future law breaking? Anyone?

Mr. TARULLO. Well, I think we are going to have to wait and see, Senator, as to whether the magnitude of those fines will, in fact, have a deterrent effect going forward. As you noted, any dollar paid in compensation to any employee comes out of the capital available for distribution to shareholders.

Senator WARREN. I am not quite sure I am following the last point, though, Governor Tarullo. Jamie Dimon got a raise after he negotiated $17 billion to pay off for activities that were illegal that he presided over. So, I am not quite sure how this is a deterrent for other CEOs.

Mr. TARULLO. Again, I am not going to comment on the specifics of that case other than to make the point that I do not know whether it is going to be a deterrent. I can say from our point of view, we are concerned with the healthy capitalization of the firm and the question in making sure that no payment of executive compensation or distribution to shareholders threatens that. The issue is between the shareholders and the executive, as long as it does not run afoul of those kind of safety and soundness considerations, that is not something that we get directly involved in. I do not know if you are asking whether you think the fines need to be even larger.

Senator WARREN. So, no, the question I am asking is whether or not there is adequate deterrence to prevent the largest financial institutions in this country from breaking the law, and I am just reading what evidence we have to go on right now.

You know, in the criminal system, we try to defer future misconduct by sending people to jail. In the civil system, we try to deter future conduct, bad conduct, by having treble damages and other things that will be sufficient deterrents. But right now, if financial institutions can just settle their claims out of court and get a raise for settling them, then where is the deterrent? That is the part I am having trouble understanding. Anyone?

Mr. WETJEN. Senator, I will make one observation in the context of the LIBOR settlements that the CFTC has engaged in. It has been brought to the attention of the agency that a lot of modifications of behavior have resulted in the wake of those settlements and in the wake of those enforcement actions, which collected more than a billion dollars for the taxpayer. I am not suggesting that there might not be other ways to enhance our enforcement program or the enforcement program of other regulatory agencies, but there does seem to be some modification of behavior that is very, very positive for the markets.

Senator WARREN. Well, I am glad to see there is some modification of behavior, but we have to worry about this. You know, I want to say, I thought that SEC Chairwoman Mary Jo White took the right step when she changed the SEC's "no admit, no deny rule" so that there was at least less room for financial institutions.

I guess we can stop this now, but I think the public has little confidence in regulators' willingness to seek the kind of penalties that will actually deter future financial crimes, and I do not blame them. I know that many of your agencies have been starved for the financial resources that you need to be aggressive in your enforcement actions.

I know it is tough to go up against a big financial institution that seems to have unlimited resources. But Jamie Dimon himself said on CNBC a couple of weeks ago that J.P. Morgan could never afford a public trial. He said—I am quoting here—"Banks have a very tough time doing that. That would have been criminal for me to subject our company to." If Jamie Dimon sees that he could not go to trial and it is totally up to him, this should enhance your leverage.

It tells me that if regulators are even slightly willing to take a large financial institution to trial, that will have an impact on future behavior of these financial institutions and on the meaningfulness of any settlement. Until that time comes, I am not confident that our enforcement system is doing nearly enough to protect the public from financial crimes.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Menendez, and then Senator Shelby to wrap it up.

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate the opportunity again.

I understand totally what Senator Warren is raising, and the question of the terms—I just want to go back to the three witnesses that I was talking to—data breach again, because it is the same concern about making sure that there is a deterrence. When you look at a financial institution's data security measures, to what extent are you evaluating based on risk of harm to the financial institution versus risk of harm to the consumer?

Mr. CURRY. Senator, I think it is both. In terms of the risk to the system, that is part of the examination and supervision that we do. I mean, it is critically important that the financial plumbing works, so that is one of our focuses. We are enforcing, basically, consumer protection laws with respect to notification, assistance if there are breaches and making sure that controls and systems are in place to prevent future incidences. So, I would say it is both. The focus is to protect the consumer as well as to protect the system itself.

Senator MENENDEZ. Mm-hmm. Do any of you have a comment?

Ms. WHITE. I could just add, Senator Menendez, I think that is why enforcement and examination is so important in this space, too, in order to make sure that you at least are bringing to bear maximum deterrence. It is really for the benefit of the client or the customer where you have the authority to act, even though your jurisdiction is over the entity.

Senator MENENDEZ. Chairman, do you——

Mr. GRUENBERG. Senator, I agree with the points that have been made. It both goes to the financial institution and to the customer. I think the authorities in this area are strong for the financial institution. One area that may be worth some review is the Bank Service Company Act, which was enacted in 1961. It goes to the third-party service providers, which have become a more important factor in this whole system and may be worth some attention. I think the gap here is for the nonbanking sector that needs focus and attention.

Senator MENENDEZ. Well, at the hearing the other day, we had the banks, the retailers, and the card companies, and it was interesting to see the bankers and the retailers pointing to each other as the ones who should be requiring greater liability consequences. The only problem with that is they are going like this. The consumer is in the middle and not being protected. So, going back to the Governor's comments, I really do believe we need to create a standard that has a common thread across all of this universe to protect the consumer at the end of the day.

Finally, on a different topic, Under Secretary Miller, I recently asked Treasury nominee Sarah Bloom Raskin in her confirmation hearing about the tasks that financial regulators set in setting capital requirements for new types of companies under the Wall Street Reform legislation. And as I asked her in her hearing, I said, I support strong capital requirements and believe they are an important component for both safety and soundness and systemic risk regulation, but I have heard concerns from, for example, insurance companies about regulators applying bank-specific capital requirements to them, despite the fact that many insurance companies have very different business models, balance sheets, and risk profiles from banks.

And in her hearing, Ms. Bloom Raskin agreed that capital standards for insurance companies have to be properly tailored, saying a one-size-fits-all is not going to work, and recognizing that they have a very different set of asset liability structures than banks do. Do you agree with her statement, and what is Treasury doing in its role on the Financial Stability Oversight Council to ensure that we do not mistakenly take a one-size-fits-all approach, that we use the right tool for the right circumstances?

Ms. MILLER. Thank you, Senator Menendez. I am not sure I can add a lot to what Governor Raskin elucidated in her response to you before, but I would say, at the FSOC, in the process of designating nonbank financial institutions, a lot of attention has been paid to the business models. A lot of attention has been paid to the fact that you cannot have that one-size-fits-all approach to capital. I think that the Federal Reserve is charged with the appropriate calibration of rulemaking to these institutions, and I think that we have given them all the support we can to make sure that we get this right.

Senator MENENDEZ. Yes, but you have a role at FSOC.

Do you want to comment, Governor? I know this is an area where——

Mr. TARULLO. Yes. Thank you, Senator. We share your view that the liability structure on the financial institution affects the amount of capital it needs. It does not affect how risky a particular asset is. It does not matter who holds it. An asset is an asset. But the liability structure does affect how much capital is needed.

Both with respect to the savings and loan holding companies, which are owned in some cases by insurance companies, and with respect to any institutions designated by FSOC as systemically important, including AIG and Prudential, we are trying to tailor, as best we can, the capital requirements to take account of, A, the particular products that insurance companies offer that banks do not, and, B, the different business model.

A is pretty straightforward. Sometimes, it is technically complex, but conceptually, it is pretty straightforward and we are in the process of doing that. It is a little harder to do with B, in some cases, because of the Collins Amendment, which does place a bank-generated floor under capital requirements for all institutions.

So, we are continuing to work as best we can. That is one of the reasons we delayed the capital requirements for S&L holding companies, because we want to take as much time as we can to use the authority we do have to tailor these provisions as best we can.

Senator MENENDEZ. Well, we look forward to hopefully getting it right, because it is going to make a big difference in terms of the consequences to not only insurance companies, but that as a product for Americans to be able to create both security for themselves and time and opportunity.

So, thank you, Mr. Chairman.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Yes. I would like to direct this, first, to Chairman White. It seems in recent months that the SEC has become a lot more aggressive on its enforcement, which I think is more than welcome in this country. Of course, you bring unique qualifications as a former U.S. Attorney to the SEC. What has bothered a lot of people in this country for a long time, that when you enforce something and people pay huge fines—huge—and they do it without admitting any wrongdoing, either criminal or civil, you know, sometimes. And sometimes, I know, you punish people by fines. We understand that. It hurts.

But sometimes it seems to me that people, if they are guilty of wrongdoing, criminal or civil, that that should be part of the deal in your law enforcement, because at the beginning of the day and end of the day, the financial system, the banking system, securities, everything that goes with it, the integrity of that system is so important, not just the perception, but a lot of times reality, too.

How are you working—I know you set a different tone over there yourself, and I commend you for that. How are you working with the other regulators in ferreting out wrongdoing——

Ms. WHITE. We work—I am sorry.

Senator SHELBY.——jurisdiction, dealing with securities, because it overlaps everywhere.

Ms. WHITE. Yes, it does overlap. We have very close working relationships, I think, with all of the criminal enforcement agencies as well as civil enforcement agencies where there is that overlapping jurisdiction, because you certainly can get synergies and do more.

As you know, Senator, shortly after I got to the Commission, I did change our settlement protocol to, in appropriate cases—I could talk about parameters, but in certain cases where I think public accountability is particularly important, that we will require admissions, because it does give that public accountability, particularly in cases of egregious conduct, that I think the public deserves and, frankly, is important to the credibility of law enforcement and deterrence. I think——

Senator SHELBY. And for the justice system of America.

Ms. WHITE. Yes, and for the justice system, and I come from that——

Senator SHELBY. Because if the perception is, if you are so rich and you are so powerful that you can get by with this and that, that undermines everything, does it not?

Ms. WHITE. I think that it certainly can do that, without question.

Senator SHELBY. Mm-hmm.

Ms. WHITE. We still, in many cases, and I think wisely so, do follow the “no admit, no deny” protocol to settle cases. It results in returning monies to harmed shareholders more quickly. It does eliminate litigation risk. But at the same time, we have to be cognizant of, I think, in all cases, frankly, is this one where there will be no settlement unless there is that admission of wrongdoing.

Senator SHELBY. OK. Thank you very much.

Chairman JOHNSON. Senator Schumer.

Senator SCHUMER. Thank you. Thank you, Mr. Chairman. I thank the witnesses.

My first question is for Governor Tarullo. It is a general question. It a little bit relates to what Senator Menendez was saying.

Now, I know we have Collins and the $15 billion and the Volcker Rule, and I know how that passed at the last minute and all of that. But, it is a more general problem, and that is there all too often, both here and in the regulatory world, sort of a cutoff that is a numerical number, even when it does not apply to the Collins rule.

And what I am finding is there are a good number of banks that are fairly large but are pretty much plain vanilla banks, and this is, in general, how they are regulated. In other words, they are not the huge banks in New York City that do all kinds—they are investment banks as well as regular banks, and having high capital requirements and making sure the mistakes of 2007 and 2008 are not repeated, making sure the Volcker Rule applies and all of that, I have no problem with.

But, oftentimes, it is also applied to banks that might have $30, $40, $50 billion in assets but are plain vanilla banks. They do not do all of the investment banking activities, the trading activities that the largest banks do, and yet they seem regulatorily often to be lumped in with them And some of these institutions are in Upstate New York and they are really good for the economy. They are doing lending to businesses, small business lending, just what a traditional bank was.

And I was just wondering, do you think that, too often, the regulators and even the rulemaking process—look, we just had it here. Senator Merkley had an amendment on conflict of interest in flood insurance, if the bank—banks below $15 billion were exempt. Well, conflict of interest could occur in a small community bank just as easily in the largest bank in the country. There was no reason to exempt all the community banks from this or to treat them differently than the larger banks.

So, my question is, how is the Fed and how are the regulators, since you are the bank regulation guy, differentiating and not treating larger banks who are plain vanilla banks and do the same types of activities as smaller banks like the ones that do the much riskier types of activities? I am hearing this complaint constantly, not just from New York, but from around the country.

Mr. TARULLO. So, I think a couple of things, Senator. One, as you know, Section 165 of the Dodd-Frank Act put into law the proposition that with the increasing size and complexity of banks, there should be increasingly stringent regulation. It sounds simple, but that has not always been a precept of financial regulation, and I think it is quite central to what we should be trying to do.

A second point which builds on that is at the Fed, we have created a special mechanism, including the Large Institution Supervision Coordinating Committee—for the very largest, most complex banks, and many of the regulations which we talked about earlier in the hearing—I know you were not present for it, but many of the regulations we are proposing to do now, some of the ones in my prepared testimony, we will be applying only to those institutions, things like the requirement for a minimum amount of subordinated debt, things like the supplementary leverage ratio.

So, having said that, though, coming to the third point. It is the case that as we adapt and make more stringent and more horizontal and more interdisciplinary our regulation and supervision of the very largest institutions, I have noticed there is an unintentional trickle down effect, which is to say supervisors may look and say, gee, you know—they are requiring the biggest banks to do this. That must be state-of-the-art supervision.

And I have tried to impress on people that I think we need to develop a state-of-the-art supervision for the largest institutions. We need to develop a state-of-the-art supervision for community banks and for the regionals and the super-regionals, each of which is not a paler or stronger version of the other but is instead customized to those institutions.

And it is something that I have been thinking about more and more over the last year because I keep hearing it, and it is—you know, we have seen it with stress testing, that we are supposed to have different expectations for the different size institutions, and I realize that the senior people in our Banking Supervision and Regulation Division need to keep making clear they are different expectations. So, it is almost a natural instinct of people to say, we want the best or the toughest.

So, I agree with the premise behind your question. You know, my perspective on banks that are essentially lending institutions of a traditional sort is that strong capital, good examination, and some of the traditional activities restrictions are really the core of what we need. And some of the other things, if I can put it in cost-benefit terms, Senator Crapo, cost more than they are worth——

Senator SCHUMER. Right.

Mr. TARULLO.——in terms of increased safety.

Senator SCHUMER. Good. I am glad to hear that from you. As you said, it is size and complexity. None of these institutions will bring down the country if, God forbid, they were to fail. So, it is not size alone. It is complexity that ought to be playing a role here. Thank you.

Chairman JOHNSON. I want to thank today's witnesses for testifying about oversight of both financial stability and data security. Both are incredibly important to today's economy.

This hearing is adjourned.

[Whereupon, at 11:57 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF MARY J. MILLER

UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

FEBRUARY 6, 2014

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for inviting me to testify today on behalf of the Treasury Department.

Just over three and a half years ago, Congress passed and President Obama signed into law a historic set of reforms to make our financial system stronger and more stable. We have made considerable progress toward achieving those objectives through implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and related reforms. The crisis revealed that regulation and oversight failed to keep pace with an evolving financial system, and demonstrated why we must always remain vigilant to potential emerging risks in financial institutions and markets.

Most of the foundational reforms laid out in the Dodd-Frank Act have now been finalized, and intensive work on the remaining pieces continues. The new Consumer Financial Protection Bureau has taken up its mission quickly, acting to strengthen consumer protections in the mortgage market; establish Federal supervision over large payday lenders and debt collectors for the first time; and provide assistance to the elderly and military families who are so often targeted by unscrupulous lenders. Last year, the bank regulatory agencies finalized key rules strengthening the quality and quantity of capital that banks are required to hold, and proposed new rules that will require the largest firms to decrease their leverage. A new framework for regulatory oversight of the over-the-counter derivatives market is largely in place, for those swap dealers registering with the Commodity Futures Trading Commission (CFTC) and certain interest-rate and credit-index swap transactions moving to central clearinghouses, reducing overall risk to the financial system. Starting this month, new classes of swaps transactions will begin to be traded on swap execution facilities, bringing much-needed transparency to these markets.

The United States has moved quickly to put these critical reforms in place, and the American people are beginning to feel the benefits of reform through a safer and stronger financial system and a broader economic recovery. Although financial markets have recovered more quickly than the overall economy, the economic recovery is gaining traction. Private sector payrolls have increased by more than 8 million jobs from the low point in February 2010, and December marked the 46th consecutive month of private-sector job growth. The unemployment rate, while still too high at 6.7 percent, has fallen to 3.3 percentage points since its October 2009 peak of 10.0 percent, and almost a full percentage point since my last testimony before this Committee. The recovery in the housing market appears to be taking firm hold as measured by rising home prices, and a declining number of delinquencies and defaults.

Although we have made good progress, we must continue our efforts to complete the remaining pieces of financial reform and stand ready to identify and respond to new threats to financial stability. We must also continue to work with our international counterparts to promote strong and consistent global approaches to financial regulation and encourage them to move swiftly toward the completion and implementation of key reforms in their jurisdictions, preventing firms from evading reforms through regulatory arbitrage.

I would like to update the Committee on several important regulatory developments since I appeared before you last July.

Secretary Lew, in his capacity as Chairperson of the Financial Stability Oversight Council, was responsible for coordinating the regulations issued by the five rulemaking agencies—the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC), and the CFTC—to implement Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule. Starting from his first day in office, Secretary Lew stressed the importance of finishing work on the Volcker Rule, and the importance of having a single, strong final rule that was true to President Obama's proposal and the statute's intent. The final rule adopted in December will protect taxpayers and the Federal safety net by ending banks' speculative trading activities for their own benefit rather than for the benefit of their customers, and restricting their investment in private equity and hedge funds, while preserving banks' ability to maintain deep, liquid financial markets and hedge their risks. The rule's requirement that the largest firms' CEOs attest to the maintenance and enforcement of compliance programs will help foster a "tone at the top" for a culture of compliance. The rule also contains a tiered compliance regime, to help ensure that smaller banks that do not engage in impermissible proprietary trading or private fund activities do not face unnecessary compliance burdens.

Our progress in 2013 was not limited to completion of the Volcker Rule. Last summer, the Federal Reserve, FDIC, and OCC finalized an important set of rules implementing the Basel Committee's risk-based capital standards, which will increase both the quantity and quality of capital held by banks and bank holding companies. The banking regulators also proposed complementary enhanced leverage standards that will act as a backstop to the risk-based capital requirements, and will require the largest banks and bank holding companies to reduce their overall leverage. An international group of regulators recently made significant progress toward consistent application of the leverage requirement across different jurisdictions by agreeing on a global framework for calculating the leverage ratio. The United States continues to lead international efforts to raise regulatory standards around the world.

The Federal Reserve is also poised to issue additional enhanced prudential standards that will increase safety and soundness at the largest and most complex banks and designated nonbank financial companies.

The bankruptcy process, aided by the Dodd-Frank Act's living wills requirement, continues to be the primary method for resolving failing financial companies. All of the firms that are required to submit living wills have done so, and the largest bank holding companies submitted their second round of living wills last fall, providing a more refined tool to facilitate their orderly resolution through bankruptcy should they fail.

However, in the case where bankruptcy cannot be relied on to resolve a failing financial company without imposing serious adverse effects on U.S. financial stability, the Dodd-Frank Act's orderly liquidation authority provides critical new authorities so that firms can safely be allowed to fail, no matter how large and complex.

In December, the FDIC issued and sought public comment on an important document detailing its strategy for resolving a financial company using its orderly liquidation authority. The document provides greater detail on the FDIC's "single point-of-entry" strategy that the FDIC developed to implement its authority. The single point-of-entry strategy is designed to accomplish the goals of orderly liquidation by allowing critical operating subsidiaries of a failing firm to remain in business during the resolution, while also preserving market discipline in accordance with the law's requirements—that losses are borne by shareholders and creditors, that culpable management are held accountable and removed, and that taxpayers bear no losses. International cooperation is critical to ensure workability across borders, a topic discussed in more detail below.

The Financial Stability Oversight Council (Council) remains focused on its authority to determine that certain large, complex nonbank financial companies whose material financial distress could threaten U.S. financial stability will be subject to more stringent prudential standards and oversight. This past summer, the Council designated American International Group, Inc. and General Electric Capital Corporation, Inc., subjecting them to enhanced prudential standards and consolidated supervision by the Federal Reserve. And, after company management had a formal hearing with the Council to contest the Council's proposed designation of the company, the Council also finalized its designation of Prudential Financial, Inc. These designations are in addition to the eight financial market utilities that the Council designated in 2012.

The Council's review of nonbank financial companies is an ongoing process, and the Council will continue to evaluate other companies for potential designation.

The progress we have made on instituting a significantly stronger capital regime and creating a credible resolution process, and the expansion of the supervisory umbrella to cover designated nonbank financial companies, are key developments in making the failure of large, complex firms less likely and making our financial system more resilient in the event of such a failure.

We also continued to make progress on derivatives reform in 2013. The implementation of reporting and clearing rules were critical steps forward in improving the safety and transparency of the derivatives market. We understand that for derivative reforms to work correctly, they must align globally. Last summer, the CFTC finalized its guidance with respect to the applicability of the Dodd-Frank Act's derivatives reforms to cross-border derivatives transactions and, together with the European Commission, announced a "Path Forward," laying out their joint understandings regarding the regulation of cross-border derivatives transactions. In September, an international working group, co-chaired by the Federal Reserve and including the SEC and CFTC, finalized margin standards for noncleared derivative transactions. U.S. regulators are now working to adopt these standards domestically, and we expect these rules to be finalized this year. In addition, by the end of last year, 22 swap execution facilities were registered with the CFTC, and the trading volume on those platforms is expected to increase significantly later this month when trading in several interest rate and credit derivatives will be required to take place on SEFs.

Treasury's Federal Insurance Office (FIO) also made significant progress in fulfilling its mission in 2013. In December, the FIO released its report on the modernization and improvement of the system of insurance regulation in the United States. The report made 27 recommendations designed to bring our insurance regulatory system into the 21st century and make it more responsive to the needs of consumers, market participants, and host supervisors in a global environment. The FIO will also release a report on the reinsurance market, and the President's Working Group on Financial Markets, with input from the FIO, will release its analysis of the long-term availability and affordability of terrorism risk insurance this year.

In addition, the FIO continues its work on the international front to represent U.S. interests in the development of international insurance standard-setting and financial stability activities. The FIO has worked and will continue to work closely and consult with other Federal agencies and with State insurance regulators on these efforts. The FIO is involved in the work of the International Association of Insurance Supervisors (IAIS) to develop a common supervisory framework, including a capital standard, for internationally active insurance groups.

Treasury and the Financial Stability Oversight Council also remain focused on emerging threats that might arise outside, or on the periphery of, the traditional banking sector. To that end, the Council is actively analyzing the extent to which there are potential threats to U.S. financial stability arising from asset management companies or their activities, and whether such threats could be mitigated by Council designations or whether they would be better addressed through other regulatory measures. As part of this analysis, the Council requested that the Office of Financial Research conduct a study of asset management activities to help determine whether these activities could create, transmit, or amplify stress through the financial system. The OFR released its study at the end of September following a careful analysis that included discussions with a number of market participants and input from Council member agencies with relevant expertise.

The Council's focus on emerging risks outside the core banking system led it to issue, at the end of 2012, proposed recommendations for money market mutual fund (MMF) reforms. Throughout this process, the Council has made it clear that the SEC is the primary regulator of MMFs and should take the lead in driving reform. Last June, the SEC proposed regulations intended to reduce the risks presented by MMFs, and we expect that the SEC will issue a final rule later this year that will address the vulnerabilities identified by the Council.

Another area of growing concern for Treasury and the Council is the vulnerability of our financial sector infrastructure to cyber events. Cyber threats to financial institutions and markets are growing in both frequency and sophistication. The changing nature of these cyber threats prompted the Council last year to highlight operational risk, and cybersecurity in particular, as worthy of heightened risk management and supervisory attention. Council member agencies are providing guidance to financial firms concerning appropriate governance mechanisms, information security procedures and testing, adequate backup systems, and emergency business continuity and recovery plans.

To maintain data security, safeguard the integrity of markets, and preserve consumer and investor confidence, the U.S. Government and the financial sector have come together to identify financial system vulnerabilities, improve the resilience of our financial system, and refine incident management protocols. A public-private partnership is necessary to combine the resources and capabilities of the Government with those of the private sector. In a public meeting in December, the Council highlighted this partnership by engaging both public sector and private sector leaders to discuss their efforts. They emphasized information sharing, declassification of threat information, and strengthening the resilience of firms outside the financial services sector that are integral to the functioning of the sector.

In addition to its role as a Council member agency, Treasury serves as the sector-specific agency for the financial sector with a leading role in policy development and a coordinating role in incident response. In this role, Treasury has sought to increase engagement, improve coordination, and facilitate information-sharing on cybersecurity issues with colleagues across the Federal Government, particularly those involved with national security, homeland security, and law enforcement. We communicate regularly with senior officials in these areas on matters specific to cybersecurity, both in the context of incidents and on more general operations and policy matters. Importantly, Treasury is focused on protecting the financial sector as a whole, from the largest financial institutions and exchanges to community banks and credit unions. Accordingly, we work to reach institutions of all sizes.

I would also like to highlight for the Committee a few areas where Treasury intends to direct significant attention and resources this year to complete key outstanding pieces of reform. The United States responded to the financial crisis aggressively and on a bipartisan basis to make our domestic system safer and more secure. But given the global nature of our financial system, we must continue working with other regulators to forge compatible rules so that reforms in other jurisdictions are as strong as our own. From the outset of the crisis, the time and energy we put in to domestic regulatory reform have been paired with international efforts to promote high-quality standards, build a level playing field, and reduce risk. We have made considerable progress through the G–20 and the Financial Stability Board in designing a more stable and resilient global financial system. But design is not sufficient. Implementation and follow-through are key.

Later this month, the G–20 finance ministers will meet in Australia and the United States will use that opportunity to call on the world's largest economies to bear down even more forcefully on implementation. And next week I will be making a trip to several countries in Asia to discuss their progress on financial regulatory reform.

In 2014, we will take steps to make sure that global banks meet the high standards we have set. That means moving swiftly to build strong and high-quality capital, properly risk-weight assets, curb leverage, and build strong liquidity buffers to protect themselves in times of crisis. Several years ago, the G–20 recommended that trading, reporting, and clearing of over-the-counter derivatives be in place by now. The United States has forged ahead in getting that done. We need to make sure these recommendations are put in place around the globe. There will be difficult cross-border issues to manage, and these are made more complex because other nations are moving far more slowly than the United States.

One area that will require significant international cooperation is the task of ensuring not only that all derivatives transactions are reported to trade repositories, but that the information collected can be used for the purposes it was intended: bringing transparency to our derivatives markets and helping regulators and market participants develop more insight into the types and levels of exposure throughout the financial system. A great deal of work still needs to be done to ensure that the data reported by industry and collected by regulators will be as useful as possible, or we will be at risk of not achieving that goal. The data are fragmented, with many different trade repositories, within and across jurisdictions, collecting different kinds of information in different ways, keeping us from putting all of that information together to develop a full picture of the market. We need to roll up our sleeves and address any obstacles to making these data useful for market participants and for regulators who are monitoring financial stability.

Treasury will also continue to engage closely with regulators in the United States and abroad to strengthen our ability to wind down failing financial companies while minimizing the negative impact on the rest of the financial system and the global economy. Major financial institutions operate globally, and cross-border coordination is necessary for resolution of these firms to be effective. Our agenda in the coming year will focus heavily on completing the work underway on international arrangements that establish how home and host authorities will cooperate to wind down a globally active firm in an orderly way. Treasury and the regulators will continue to closely collaborate with our international counterparts through forums like the Financial Stability Board and on a bilateral basis to address obstacles to resolving large, cross-border firms.

In addition to this critical international reform agenda, there is still much to be done domestically. As was the case with the Volcker Rule, Secretary Lew, as the Chairperson of the Financial Stability Oversight Council, is responsible for coordinating the joint rulemakings to implement Section 941 of the Dodd-Frank Act, the so-called "risk-retention" rule. This rule generally requires issuers of asset-backed securities to retain an interest in the securities they sell to third parties. The rule was re-proposed last year, and staff from Treasury, the banking agencies, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the SEC have met regularly—including just last week—to review comments, analyze data, and coordinate on drafting the final rule. Completion of these regulations in 2014 is a priority for Treasury.

And finally, in considering risks to financial stability, we cannot ignore fiscal developments at home. Last year, Congress passed a temporary suspension of the debt limit, and that temporary suspension lasts only through February 7, which is tomorrow. After that, in the absence of Congressional action, Treasury will be forced to use extraordinary measures to continue to meet its obligations. We now forecast that we are likely to exhaust these measures by the end of this month. And even though this is an estimate, it is clear that extraordinary measures will not last for an extended period.

It would be a mistake to wait until the 11th hour to get this done. The fact is, simply delaying action on the debt limit can cause harm to our economy, financial markets, and taxpayers. We are already seeing some volatility in Treasury bills that mature after February 7. Around the time of last year's delay, we saw consumer and business confidence drop, and investors and market participants publicly question whether it was too risky to hold certain types of U.S. Government debt. Such a question should be unthinkable.

* * * * *

Given these realities, it is important that Congress move right away to increase our borrowing authority.

The last year was a busy one, and we made substantial progress toward the goal of implementing the reforms set forth in the Dodd-Frank Act and adopting related reforms to make our financial system stronger, more stable and more focused on fulfilling its core function of facilitating the growth of the broader economy. That does not mean we will be able to relax our guard. To quote Winston Churchill: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Constant evolution in the financial system and the activities of financial institutions will require regulators to be flexible and ready to address new threats to the financial system.

PREPARED STATEMENT OF DANIEL K. TARULLO

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 6, 2014

Chairman Johnson, Ranking Member Crapo, and other Members of the Committee, thank you for the opportunity to testify on the Federal Reserve's activities in mitigating systemic risk and implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). In today's testimony, I will provide an update on the Federal Reserve's recent activities pertaining to the implementation of the Dodd-Frank Act and describe our key regulatory and supervisory priorities for 2014. I will also discuss the Federal Reserve's expectations with regard to information security at the financial institutions it oversees. Since testifying before this Committee in July 2013, the Federal Reserve and other banking supervisors have made considerable progress in implementing the congressional mandates in the Dodd-Frank Act and otherwise improving financial stability and mitigating systemic risks. While these efforts have helped to produce a sounder, more stable, and more resilient financial system, work remains to be done to address the problems of "too-big-to-fail" and systemic risk.

Recent Dodd-Frank Act Implementation Milestones

Since your last oversight hearing, the Federal Reserve, often in tandem with some or all of the other agencies represented at this hearing, has made progress on a number of important Dodd-Frank Act reforms.

Liquidity rules for large banking firms

In October, the Federal Reserve and the other U.S. banking agencies issued a proposed rule, consistent with the enhanced prudential standards requirements in section 165 of the Dodd-Frank Act, which would implement the first broadly applicable quantitative liquidity requirement for U.S. banking firms. Liquidity standards for large U.S. banking firms are a key contributor to financial stability, as they work in concert with capital standards, stress testing, and other enhanced prudential standards to help ensure that large banking firms have a sufficiently strong liquidity risk profile to prevent creditor and counterparty runs.

The proposed rule's liquidity coverage ratio, or LCR, would require covered banking firms to hold minimum amounts of high-quality liquid assets, such as central bank reserves and high-quality Government and corporate debt, that could be converted quickly and easily into cash sufficient to meet expected net cash outflows over a short-term stress period. The proposed LCR would apply to internationally active banking organizations—that is, to bank holding companies and savings and loan holding companies with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposures. The proposal would also apply a less stringent, modified LCR to bank holding companies and savings and loan holding companies that are not internationally active, but that have more than $50 billion in total assets. The proposal would not apply to bank holding companies with less than $50 billion in total assets.

The proposal's LCR is based upon a liquidity standard agreed to by the Basel Committee on Banking Supervision, but is more stringent than the Basel Committee standard in several areas, including the range of assets that will qualify as high-quality liquid assets and the assumed rate of outflows for certain kinds of funding. In addition, the proposed rule's transition period is shorter than that in the Basel Committee standard. The proposed accelerated phase-in of the U.S. LCR reflects our objective that large U.S. banking firms maintain the improved liquidity positions that they built following the financial crisis, in part due to our supervisory oversight. We believe the proposed LCR should help ensure that these improved liquidity positions will not weaken as memories of the financial crisis fade.

Stress testing and capital planning requirements

The comprehensive stress testing conducted by the Federal Reserve, pursuant to the Dodd-Frank Act and in connection with the annual Comprehensive Capital Analysis and Review (CCAR), has become a key part of our supervisory efforts for large banking firms, and we are continuing to develop and expand the scope of this exercise. Most recently, the Federal Reserve issued proposed supervisory guidance regarding internal stress testing by banking firms with total consolidated assets between $10 billion and $50 billion as mandated by the Dodd-Frank Act and issued interim final rules clarifying how banking firms should incorporate the revised Basel III regulatory capital framework into their capital projections for the CCAR and Dodd-Frank Act stress testing cycles that began in the fall.

We are continuing to improve the implementation of our stress testing framework by refining the formulation of the hypothetical macroeconomic scenarios that form the basis of the stress tests. In designing coherent stress scenarios, we draw on many of the modeling tools used to inform monetary policy, but also aim to reflect the fact that not all significant risks facing banks arise in typical recessions. As a result, our scenarios now generally incorporate other adverse developments, such as an exceptionally large decline in housing prices, the default of the largest counterparty, and a worsening of global economic conditions more severe than might normally be expected to accompany a deep recession in the United States. In order for our stress testing to remain focused on key vulnerabilities facing the banking system, our stress scenarios will evolve further over time as banking firms' risk characteristics and business models evolve, the relationship between scenario variables and banking firm performance shifts, and the economic and market environment in which banking firms operate changes. Over the past 6 months, the Federal Reserve also has increased the transparency of our capital planning and stress testing work. We have published both a policy statement describing the scenario development process for future capital planning and stress testing exercises and a paper discussing our expectations for internal capital planning at large banking firms and the range of practices we have observed at these companies during the past three CCAR exercises. The transparency of our stress testing processes complements our enhanced transparency around the results of the exercises and our assessments of firms' capital planning, all of which aim to give investors, analysts, and the public valuable information about firms' financial conditions and resiliency to stress.

Volcker Rule

In December, the U.S. banking agencies, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission finalized the Volcker Rule to implement section 619 of the Dodd-Frank Act. As you know, the Volcker Rule prohibits banking entities from engaging in short-term proprietary trading of certain securities and derivatives for their own account. The Volcker Rule also imposes limits on banking entities' investments in, and relationships with, hedge funds and private equity funds. The finalization of this rule took a substantial amount of time and effort in part because of the intrinsic challenges in distinguishing between the proprietary trading that is outlawed by the Dodd-Frank Act and the hedging and market making activities that are allowed by the Act.

The ultimate success of the final rule will depend on how well the implementing agencies supervise and enforce the rule. While the Federal Reserve's supervisory role will be less than that of the Office of the Comptroller of the Currency and the SEC, we will continue to work with the other implementing agencies to develop an effective and consistent supervisory framework and to ensure that the Volcker Rule is implemented in a manner that upholds the aims of the statute, while not jeopardizing important activities such as market making and hedging. In pursuit of this goal, shortly after the adoption of the Volcker Rule, the Federal Reserve and the other implementing agencies agreed to create an interagency working group, which has already begun to meet. In mid-January, the five implementing agencies approved an interim final rule to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities that would otherwise be subject to the Volcker Rule's covered fund investment prohibitions.

Derivatives push-out

In December, the Federal Reserve also approved a final rule clarifying the treatment of uninsured U.S. branches and agencies of foreign banks under section 716 of the Dodd-Frank Act, which is commonly known as the derivatives push-out provision. The provision, which became effective in July 2013, generally prohibits certain types of Federal assistance, such as discount window lending and deposit insurance, to swap entities such as swap dealers and major swap participants. Insured depository institutions that are swap entities may avail themselves of certain statutory exceptions and are eligible for a transition period of up to 2 years to comply with the provision. Under the final rule, uninsured U.S. branches and agencies of foreign banks are treated as insured depository institutions for the purposes of section 716 and therefore qualify for the same statutory exceptions as insured depository institutions and are eligible to apply for the same transition period relief. The final rule also establishes a process for State member banks and uninsured State branches or agencies of foreign banks to apply to the Federal Reserve for the transition period relief.

Federal Reserve emergency lending authority

Also in December, the Federal Reserve issued a proposal relating to its emergency lending authority in section 13(3) of the Federal Reserve Act that would implement sections 1101 and 1103 of the Dodd-Frank Act. As required by these statutory provisions, the proposed rule is designed to ensure that any emergency lending program or facility is adequately secured by collateral to protect taxpayers from loss and is for the purpose of providing liquidity to the financial system, and not to aid an individual failing financial company.

Risk retention

Section 941 of the Dodd-Frank Act generally requires firms to retain credit risk in securitization transactions that they sponsor. In August, the U.S. banking agencies, the Federal Housing Finance Agency, the Department of Housing and Urban Development, and the SEC revised a proposed rule issued in 2011 to implement that statutory provision. The proposed rule would provide securitization sponsors with several options to satisfy the risk retention requirements in section 941 and, as required by the Dodd-Frank Act, would exempt certain securitizations, including securitizations of "qualified residential mortgages" (QRM), from risk retention. The revised proposal would define QRM to have the same meaning as the term "qualified mortgage" established by the Consumer Financial Protection Bureau in January 2013, and, as such, would include a maximum back-end debt-to-income ratio of 43 percent, a 30-year limit on the term of the mortgage, and a 3 percent cap on points and fees. While the revised proposal's definition of QRM has been broadened as compared to that in the original proposal, it continues to exclude many loans with riskier product features, such as home-equity lines of credit; reverse mortgages; and loans with negative amortization, interest-only, and balloon payments. The revised proposal also requested comment on an alternative, stricter definition of QRM that would include a maximum 70 percent loan-to-value ratio requirement and certain credit history standards in addition to the qualified mortgage criteria. The comment period for the revised proposal closed at the end of October, and the agencies are now carefully reviewing comments.

Assessment fees

Section 318 of the Dodd-Frank Act directs the Federal Reserve to collect assessment fees equal to the expenses it estimates are necessary or appropriate for the supervision and regulation of large financial companies. The Federal Reserve issued a final rule implementing this statutory provision in August of last year. The rule, which became effective in October, sets forth how the Federal Reserve determines which companies are charged, estimates the applicable supervisory expenses of the Federal Reserve related to covered companies, determines each covered company's assessment fee, and bills for and collects the assessment fees. Payments for the 2012 assessment period were due in December, and the Board collected approximately $433 million from 72 companies. As required by law, these fees were transferred to the U.S. Treasury.

Key Regulatory Priorities for 2014

The Federal Reserve's regulatory program in 2014 will concentrate on establishing enhanced prudential standards for large U.S. banking firms and foreign banks operating in the United States pursuant to section 165 of the Dodd-Frank Act and on further enhancing the resiliency and resolvability of U.S.-based global systemically important banks, or GSIBs.

Enhanced prudential standards/or large U.S. and foreign banking firms

The Federal Reserve has issued proposed rules, pursuant to section 165 of the Dodd-Frank Act, which would establish enhanced prudential standards for U.S. bank holding companies and foreign banking organizations with total global consolidated assets of $50 billion or more. We anticipate that these rules will be finalized in the near term. For the large U.S. bank holding companies, the outstanding proposed standards include liquidity requirements, risk-management requirements, single-counterparty credit limits, and an early remediation regime. Finalizing these outstanding proposals would complement the capital planning, resolution planning, and stress testing requirements for large U.S. bank holding companies that the Board previously finalized.

The Federal Reserve has also proposed enhanced prudential standards for large foreign banking organizations with a U.S. banking presence. Prior to the financial crisis, the Federal Reserve's approach to regulating the U.S. operations of foreign banks rested on substantial structural flexibility for the foreign bank, substantial reliance by the Federal Reserve on the supervisory and regulatory framework of the foreign bank's home country, and substantial expectations of support by the parent foreign bank of its U.S. operations. A number of developments since the 1990s prompted a reevaluation of this approach to the regulation of foreign banks in the United States, just as the Federal Reserve had in the past reevaluated its approach in response to changes in the size and scope of foreign banking activities and financial market changes. Most notably, the U.S. operations of foreign banks in the years leading up to the financial crisis grew much larger and became much more complex and interconnected with the rest of the U.S. financial system. For example, 5 of the top 10 U.S. broker-dealers are currently owned by foreign banks and together hold almost $1.2 trillion in assets. The U.S. operations of large foreign banks also became much more dependent on the most unstable sources of short-term wholesale funding and established very substantial net credit exposures to the parent foreign bank in the years leading up to the financial crisis. As a result, during the crisis, these banks were heavy users of the Federal Reserve's liquidity facilities.

Under the proposed rule, foreign banking organizations with a large U.S. presence would be required to organize their U.S. subsidiaries under a single U.S. intermediate holding company that would serve as a platform for consistent supervision and regulation. These U.S. intermediate holding companies would be subject to the same generally applicable risk-based capital, leverage, and capital planning requirements that apply to U.S. bank holding companies. In addition, U.S. intermediate-holding companies and the U.S. branches and agencies of foreign banks with a large U.S. presence would be required to meet liquidity requirements similar to those applicable to large U.S. bank holding companies. The Federal Reserve issued the proposed rule to promote the resiliency of the U.S. operations of foreign banking organizations and, in turn, U.S. financial stability.

Other regulatory efforts to improve the resiliency and resolvability of GSIBs

The financial crisis made clear that policymakers must devote significant attention to the potential threat to financial stability posed by our most systemic financial firms. Accordingly, the Federal Reserve has been focused on developing regulatory proposals that are designed to reduce the probability of failure of a GSIB to levels that are meaningfully below those for less systemically important firms and materially reduce the consequences to the broader financial system and economy in the event of failure of a GSIB. Our goal has been to establish regulations that force GSIBs to internalize the large negative externalities associated with their disorderly failure and that aim to offset any remaining too-big-to-fail subsidies these firms may enjoy.

GSIB risk-based capital surcharges

A key component of the Federal Reserve's program to improve GSIB resiliency is our forthcoming proposal to impose graduated common equity risk-based capital surcharges on GSIBs. This proposal will be based on the GSIB capital surcharge framework developed by the Basel Committee, under which the size of the surcharge for an individual GSIB is a function of the firm's systemic importance. We currently are working on the implementing regulation for the Basel Committee

GSIB risk-based capital surcharge framework and expect to issue a proposal fairly soon. By further increasing the amount of the most loss-absorbing form of capital that is required to be held by the firms that potentially pose the greatest risk to financial stability, we intend to reduce the probability of failure of these firms to offset the greater negative externalities their failure would have on the financial system and to offset any funding advantage such firms may have because of their perceived status as too-big-to-fail.

GSIB leverage surcharges

To further bolster the regulatory capital regime for the most systemic U.S. banking firms, the Federal Reserve and the other U.S. banking agencies have proposed to strengthen the internationally agreed-upon Basel III leverage ratio as applied to U.S. GSIBs. This proposal would require U.S. GSIBs to maintain a tier 1 capital buffer of at least 2 percent above the minimum Basel III supplementary leverage ratio of 3 percent, for a total of 5 percent. In light of the significantly higher risk-based capital rules for GSIBs under Basel III, imposing a stricter leverage requirement on these firms is appropriate to help ensure that the leverage ratio remains a relevant backstop for these firms. And we have calibrated the proposed GSIB leverage surcharge thresholds to raise the leverage standards for these firms by an amount that is roughly commensurate with the Basel III increase in the risk-based capital thresholds for these firms. We expect to finalize this proposal in the coming months.

We also intend to incorporate in the United States the revisions to the Basel III leverage ratio recently agreed to by the Basel Committee. These changes would strengthen the ratio in a number of ways, including by introducing a much stricter treatment of credit derivatives.

Resolvability of GSIBs

Our enhanced regulation of GSIBs also includes efforts to improve their resolvability. The Federal Reserve's resolvability efforts include work with the Federal Deposit Insurance Corporation (FDIC) to improve the bankruptcy resolution planning of large banking firms and work to assist the FDIC in making large banking firms more resolvable under the Orderly Liquidation Authority (OLA) of the Dodd-Frank Act.

The Federal Reserve is consulting with the FDIC on a proposal that would require the largest, most complex U.S. banking firms to maintain a minimum amount of long-term unsecured debt outstanding at the holding company level. While minimum capital requirements are designed to cover losses up to a certain statistical probability, in the event that the equity of a financial firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term, unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of debt explicitly identified for possible bail-in on a "gone concern" basis should help other creditors clarify their positions in an orderly liquidation process.

A requirement for long-term debt could have the benefit of improving market discipline, since the holders of that debt would know they faced the prospect of loss should the firm enter resolution. In addition, this requirement should have the effect of preventing the erosion of the current long-term debt holdings of GSIBs, which, by historical standards, are currently at fairly high levels. Absent a minimum requirement of this sort, there likely would be declines in these levels as the flatter yield curve of recent years steepens. We have recently seen some evidence of the beginnings of such declines. At the international level, the Federal Reserve is working through the Basel Committee and the Financial Stability Board (FSB) to develop an international proposal for gone concern loss absorbency requirements for GSIBs.

Regulatory Reform, Shadow Banking, and Short-term Wholesale Funding

"Shadow banking" is a term used to describe a wide variety of activities involving credit intermediation and maturity transformation outside the insured depository system. These activities are often funded through collateralized borrowing arrangements known as "securities financing transactions," a term that generally refers to repos and reverse repos, securities lending and borrowing, and securities margin lending. Some of this activity involves the short-term funding of highly liquid securities, and directly supports the current functioning of important markets, including those in which monetary policy is executed. Securities financing transactions can also directly or indirectly fund less liquid instruments.

In normal times, lending through securities financing transactions, even when backed by less-liquid instruments, appears low-risk because of the fact that the transactions are usually short-term, over-collateralized, and exempt from the automatic stay in insolvency proceedings. But during times of stress, lenders may become unwilling to lend against a wide range of assets, including very high-quality securities, forcing liquidity-strained institutions to rapidly liquidate positions. The rapid constriction of large amounts of short-term wholesale funding and associated asset liquidations in times of stress in the financial markets can result in large fire sale externalities, direct and indirect contagion to other financial firms, and disruptions to financial stability. A dynamic of this type engulfed the financial system in 2008.

While the term "shadow banking" suggests activity outside of the banking system, reality is more complex. In many cases, shadow banking takes place within, or in close proximity to, regulated financial institutions. Most of the largest banking organizations rely to a significant extent on securities financing transactions and other forms of short-term wholesale funding to finance their operations, and if such a firm were to come under stress, the fire sale externalities could be very similar to those we saw during the financial crisis. Banking organizations also participate in shadow banking by lending to unregulated shadow banks, and by providing shadow banks with credit and liquidity support that enhances their ability to borrow from other market participants. In still other cases, unregulated shadow banks are able to operate without coming into contact with the banking system. As prudential requirements for regulated firms become more stringent, it is likely that market participants will face increasing incentives to move additional activity beyond the regulatory perimeter.

Since the crisis, regulators have collectively made progress in addressing some of the close linkages between shadow banking and traditional banking organizations. We have increased the regulatory charges on support that banks provide to shadow banks; for example, by including within the LCR requirements for banks to hold liquidity buffers when they provide credit or liquidity facilities to securitization vehicles or other special purpose entities. Changes have also been made to accounting and capital rules that make it more difficult for banks to reduce the amount of capital they are required to hold by shifting assets off balance sheet.

We are also addressing risks from derivatives transactions, which can pose some of the same contagion and financial stability risks as short-term wholesale funding in the event that large volumes of derivatives positions must be liquidated quickly. Standardized derivatives transactions are currently in the process of moving to central clearing, while nonstandardized trades will be subject to margin requirements. In September 2013, the Basel Committee and the International Organization of Securities Commissions adopted final standards on margin requirements that will require financial firms and systemically important nonfinancial entities to exchange initial and variation margin on a bilateral basis for noncleared derivatives trades. The Federal Reserve and other Federal financial regulatory agencies are now working to modify the outstanding U.S. proposals on noncleared derivatives margin requirements to more closely align them with the requirements in this landmark global agreement.

Still, we have yet to address head-on the financial stability risks from securities financing transactions and other forms of short-term wholesale funding that lie at the heart of shadow banking. There are two fundamental goals that policy should be designed to achieve. The first is to address the specific financial stability risks posed by the use of large amounts of short-term wholesale funding by the largest, most complex banking organizations. The second is to respond to the more general macroprudential concerns raised by short-term collateralized borrowing arrangements throughout the financial system.

One option to address concerns specific to large, complex banking firms would be to pursue modifications to bank liquidity standards that would require firms that have matched books of securities financing transactions to hold larger liquid asset buffers or maintain more stable funding structures. The Basel Committee has recently proposed changes to its Net Stable Funding Ratio that would move in this direction.

A complementary bank regulatory option would be to require banking firms that rely on greater amounts of short-term wholesale funding to hold higher levels of capital. The rationale behind this approach would be that while solid requirements are needed for both capital and liquidity adequacy at large banking firms, the relationship between the two also matters. For example, a firm with little reliance on short-term wholesale funding is less susceptible to runs and, thus, to need to engage in fire sales that can depress capital levels at the firm and impose externalities on the broader financial system. A capital surcharge based on short-term wholesale funding levels would add an incentive for firms to use more stable funding and, where a firm concluded that higher levels of such funding were nonetheless economically sensible, the surcharge would increase the loss absorbency of the firm.

Such a requirement would be consistent with, though distinct from, the long-term debt requirement that the Federal Reserve is developing to enhance prospects for resolving large firms without taxpayer assistance.

Turning to policies that could be used to address concerns about short-term collateralized borrowing arrangements more broadly throughout the financial system, the Federal Reserve is also carefully analyzing proposals to establish minimum numerical floors for collateral haircuts in securities financing transactions. In its most universal form, a system of numerical haircut floors for securities financing transactions would require any entity that wants to borrow against a security to post a minimum amount of excess margin to its lender that would vary depending on the asset class of the collateral. Like minimum margin requirements for derivatives, numerical haircut floors for securities financing transactions would serve as a mechanism for limiting the buildup of leverage at the transaction level, and could mitigate the risk of pro-cyclical margin calls.

In August, the FSB issued a consultative document that outlined a framework of minimum margin requirements for securities financing transactions. The FSB's current proposal has some significant limitations, however, including (1) a scope of application that is limited to transactions in which a regulated entity lends to an unregulated entity against nonsovereign collateral, and (2) a relatively low calibration. If the scope of the FSB's proposal was expanded to cover a much broader range of firms and securities and the calibration of the proposal was strengthened, the FSB proposal could represent a significant step toward addressing financial stability risks in short-term wholesale funding markets.

Information Security at Financial Institutions

Before closing, I would like to discuss briefly the Federal Reserve's expectations with regard to information security at the financial institutions it oversees, as recent events have led to an increased focus on the potential for cyber attacks on the information technology infrastructures of these institutions.

Cyber attacks on financial institutions and the data they house pose significant risks to the economy and to national security more broadly. While some attacks are conducted with the intent of disrupting customer access and normal business operations of financial institutions, other attacks include malicious software implanted to destroy data and systems, intrusions to gain access to unauthorized information, and account takeovers for financial fraud. The varied and evolving nature of these attacks make them a continuing challenge to address.

The Federal Reserve requires the financial institutions it regulates to develop and maintain effective information security programs that are tailored to the complexity of each institution's operations and that include steps to protect the security and confidentiality of customer information. In addition, to address any data breaches that occur, the Federal Reserve requires supervised financial institutions to develop and implement programs to respond to events in which individuals or firms obtain unauthorized access to customer information held by the institution or its service providers. Specifically, when a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused; assess the nature and scope of the incident; identify the types of information that have been accessed or misused; and undertake risk mitigation, which can include notifying customers, monitoring for unusual account activity, and re-issuing credit and debit cards.

The Federal Reserve's approach to information security supervision leverages internal firm expertise, published guidance, and collaboration between the Board, the Reserve Banks, and other U.S. banking agencies to promote effective protection of data and systems by supervised institutions. The Reserve Banks employ examiners specializing in information technology supervision to conduct the bulk of their information security examination activities. Federal Reserve staff has also developed guidance, some collaboratively with other banking regulators, to define expectations for information security and data breach management. Nine significant information security guidance documents have been issued since July 2001. We are continuing to focus on this risk through our participation in the Federal Financial Institutions Examination Council's recently established working group aimed at enhancing supervisory initiatives on cybersecurity and critical infrastructure protection.

Although many agencies throughout the U.S. Government are working to address problems posed by cyber attacks—in part as a result of initiatives such as the executive order issued last February that directed the National Institute of Standards and Technology to develop a cybersecurity framework—we believe there should be increased attention and coordination across the Federal Government to support the security of the Nation's financial infrastructure. In particular, we support efforts to leverage the technical capabilities of law enforcement and national security agencies with respect to cyber threats and attacks at financial institutions. Financial regulators set expectations for security programs and controls at financial institutions, and they help to validate that these expectations are being met. However, financial regulators do not maintain the technical capacity to identify many of the most sophisticated threats, to respond to threats as they occur, or to evaluate the alternatives for immediate and effective responses to new types of viruses or attacks. We appreciate the efforts of U.S. Government agencies to date and encourage continued coordination across agencies to ensure the safety and security of the financial system.

Conclusion

The financial regulatory architecture is considerably stronger today than it was in the years leading up to the crisis, but work remains to complete the post-crisis global financial reform program. Over the coming year, the Federal Reserve will be working with other U.S. financial regulatory agencies, and with foreign central banks and regulators, to propose and finalize a number of the important remaining initiatives. In this continuing endeavor, our goal is to preserve financial stability at the least cost to credit availability and economic growth. We are focused on reducing the probability of failure of systemic financial firms, improving the resolvability of systemic financial firms, and monitoring and mitigating emerging systemic risks.

Thank you for your attention. I would be pleased to answer any questions you might have.

PREPARED STATEMENT OF MARTIN J. GRUENBERG

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

FEBRUARY 6, 2014

Chairman Johnson, Ranking Member Crapo and Members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) actions to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The FDIC has made significant progress in recent months in implementing the new authorities granted by the Act.[1] My testimony will address several topics. First, I will discuss the recently adopted regulation implementing the Volcker Rule and the actions we have taken on the risk retention and qualified mortgage rules. I will then provide an update on our progress in implementing the authority provided to the FDIC to resolve systemically important financial institutions and proposals to improve the quantity and quality of capital. Finally, I will address data integrity issues for the banking industry.

The Volcker Rule

Section 619 of the Dodd-Frank Act, also known as "the Volcker Rule," requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the Federal banking agencies to adopt regulations to prohibit banking entities from engaging in proprietary trading activities and to limit the ability of banking entities to invest in, or have certain relationships with, hedge funds and private equity funds. In general terms, proprietary trading occurs when an entity places its own capital at risk to engage in the short-term buying and selling of securities primarily to profit from short-term price movements, or enters into derivative products for similar purposes.

On December 10, 2013, the FDIC, along with the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the SEC, and the CFTC, adopted a final rule implementing Section 619. The Volcker Rule is designed to strengthen the financial system and constrain the level of risk undertaken by firms that benefit, directly or indirectly, from the Federal safety net provided by Federal deposit insurance or access to the Federal Reserve's discount window. The challenge to the agencies in implementing the Volcker Rule was to prohibit the types of proprietary trading and investment activity that Congress intended to limit, while allowing banking organizations to provide legitimate intermediation in the capital markets.

In finalizing this rule, the agencies carefully reviewed more than 18,000 comments and made changes to the original proposal to address commenters' concerns. The final rule is intended to preserve legitimate market making and hedging activi-

[1] A summary of the FDIC's progress implementing the provisions of the Dodd-Frank Act is attached to this testimony.

ties while maintaining market liquidity and vibrancy. The final rule also is designed to reduce overall burden by focusing requirements on those institutions that are more likely to engage in proprietary trading and covered fund activities.

The final rule is structured around the three main elements of Section 619: 1) the proprietary trading prohibition, 2) the covered funds prohibition, and 3) the compliance requirements.

Proprietary Trading Prohibition

In general, the final rule prohibits proprietary trading by banking entities. However, consistent with Section 619, the final rule includes exemptions for underwriting, market making, and risk-mitigating hedging, among other exemptions provided in the final rule.

The underwriting exemption requires that a banking entity act as an underwriter for a distribution of securities and that the trading desk's underwriting position be related to that distribution. The underwriting position must be designed not to exceed the reasonably expected near-term demands of customers.

The exemption for market making-related activities requires that a trading desk routinely stand ready to purchase and sell one or more types of financial instruments. The trading desk's inventory of these instruments must be designed not to exceed the reasonably expected near-term demands of customers.

Under the final rule, determining customer demand is based on such things as historical demand and consideration of current market factors. A market-making desk may hedge the risks of its market-making activity under this exemption, provided it is acting in accordance with certain risk management procedures required under the final rule.

The requirements of the risk-mitigating hedging exemption are generally designed to ensure that hedging activity is limited to risk-mitigating hedging in purpose and effect. For instance, hedging activity must be designed to demonstrably reduce or significantly mitigate specific, identifiable risks of individual or aggregated positions of the banking entity. In addition, the banking entity must conduct an analysis (including a correlation analysis) supporting its documented hedging strategy, and the effectiveness of hedges must be monitored and, as necessary, recalibrated on an ongoing basis.

Under the final rule, a banking entity would be allowed to hedge individual exposures or aggregate exposures—for example, a specific loan book. However, a banking entity would not be allowed to engage in so-called "macro hedging." The result is to allow cost-effective, risk-reducing hedging while preventing banking entities from entering into speculative transactions under the guise of hedging.

The final rule allows a bank to engage in proprietary trading in certain Government obligations and generally does not prohibit certain trading activities of foreign banking entities, provided the trading decisions and principal risks of the foreign banking entity occur and are held outside of the United States. Such transactions may involve U.S. entities only under particular circumstances. The final rule also clarifies other exclusions and exempts certain other permitted activities.

Covered Funds Prohibition

The final rule prohibits banking entities from owning and sponsoring "hedge funds" and "private equity funds," referred to in the final rule as "covered funds." The final rule follows the statutory definition of covered funds and encompasses any issuer that would be an investment company under the Investment Company Act if it were not otherwise excluded by two provisions of that Act (section 3(c)(1) or 3(c)(7)). The final rule also includes in the definition of covered funds other similar funds such as certain foreign funds and commodity pools, which are defined in a more limited manner than under the proposed rule.

The final rule includes a number of exclusions from the definition of covered funds. These exclusions cover certain entities having more general corporate purposes (such as wholly owned subsidiaries or joint ventures), registered investment companies and business development companies regulated by the SEC and any issue of securities backed entirely by loans subject to certain asset restrictions.[2]

Consistent with the Dodd-Frank Act, the final rule designates certain activities as permissible. The final rule permits a banking entity, subject to appropriate conditions, to invest in or sponsor a covered fund in connection with organizing and offer-

[2] Accordingly, covered funds do not generally include securitizations such as residential mortgage-backed securities (including GSE exposures), commercial mortgage-backed securities, auto securitizations, credit card securitizations, and commercial paper backed by conforming asset-backed commercial paper conduits. Certain other securitizations, such as collateralized loan obligations or collateralized debt obligations, will likely meet the definition of covered funds if they are unable to divest impermissible assets during the conformance period.

ing the covered fund, underwriting or market making-related activities, certain types of risk-mitigating hedging activities, activities that occur solely outside of the United States, and insurance company activities.

The final rule places a number of limitations on permitted ownership interests in covered funds. In general, consistent with the statute, the final rule provides that a banking entity may not have any ownership in a covered fund unless it qualifies for an exemption such as organizing and offering the fund in accordance with requirements of the final rule or acting as a market maker for the fund. A banking entity that organizes and offers a covered fund must limit its total interest in each covered fund to no more than 3 percent of the ownership interests issued by the covered fund, and to no more than 3 percent of the value of the entire covered fund. However, if the covered fund is subject to risk retention requirements that must be satisfied by the banking entity, the final rule provides that the banking entity may retain additional ownership interests in the covered fund in order to satisfy any minimum risk retention requirement that may be established by the agencies by regulation. In addition, the aggregate of all interests the banking entity has in all covered funds may not exceed 3 percent of the banking entity's tier 1 capital. Finally, the banking entity must deduct the value of all of its interests in covered funds and any retained earnings from its capital for purposes of applying the regulatory capital standards.

Certain other securitizations, such as collateralized loan obligations, will be excluded from the definition of a covered fund if they are backed exclusively by loans. However, securitizations that currently include assets other than loans can be excluded from the definition of covered funds if they divest impermissible assets during the conformance period. For securitizations that are covered funds, the conditions for a banking entity to be permitted an ownership interest in these types of securitizations are, with one exception described below, the same conditions that apply to any other covered fund—for instance, it organizes and offers the securitization or engages in underwriting or market making-related activities.

Compliance Requirements

In order to ensure compliance with the final rule, institutions engaged in covered practices will be required to have compliance programs in place commensurate with their size and level of activity. The agencies will monitor compliance through the compliance programs established by the institutions they regulate. To ensure consistent application of the final rule across all banking entities, the FDIC, FRB, OCC, SEC and CFTC have formed an interagency Volcker Rule Implementation Working Group (Working Group). The Working Group will address implementation issues on an ongoing basis and will provide the industry with additional guidance or clarity as necessary. The Working Group has begun meeting and will meet regularly to address reporting, guidance and interpretation issues to facilitate compliance with the rule.

The final rule generally requires banking entities to establish an internal compliance program reasonably designed to ensure and monitor compliance with the final rule. In response to concerns raised by some commenters, the final rule provides compliance requirements that vary based on the size of the banking entity and the amount of covered activities it conducts. For example, banking entities that do not engage in activities covered by the final rule will have no compliance program requirements.

Under the final rule, larger banking entities with $50 billion or more in total consolidated assets must establish a more detailed compliance program as described in Appendix B of the final rule, including requirements that:

- The banking entity adopt a written compliance program approved by the board of directors;
- The board of directors and senior management are responsible for setting and communicating an appropriate culture of compliance and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with the requirements of the final rule; and
- The chief executive officer of the banking entity must annually attest in writing to its primary Federal regulator that the banking entity has in place processes to establish, maintain, enforce, review, test, and modify the compliance program in a manner reasonably designed to achieve compliance with the final rule.

Banking entities with total consolidated assets between $10 billion and $50 billion will be subject to the minimum compliance program requirements included in section 20(b) of the final rule.

Finally, the final rule requires banking entities with significant trading operations to report certain quantitative metrics related to trading activities, in accordance with section 20(d) and Appendix A of the final rule. These metrics are designed to monitor certain trading activities and. will be phased in over a period of time based on the type and size of the firm's trading activities.

Burden Reduction

While the requirements of Section 619 apply to all banking entities regardless of size, the prohibited proprietary trading activities and investments in, and relationships with, hedge funds and private equity funds that are covered by the final rule are generally conducted by larger, more complex banking organizations. As a result, the final rule is designed to avoid placing needless requirements on banks that do not engage in these activities or have only limited exposure.

The final rule focuses compliance requirements on those institutions that are more likely to engage in prohibited proprietary trading and covered fund activities. Under the final rule, a bank is exempt from all of the compliance program requirements, and all of the associated costs, if it limits its covered activities to activities that are excluded from the definition of proprietary trading, such as trading in certain Government, agency, State, and municipal obligations. In particular, the final rule provides that a banking entity is not required to implement a compliance program if it does not engage in activities or investments covered by the rule. This eliminates the compliance burden on banking entities that do not engage in covered activities or investments.

A banking entity with total consolidated assets of $10 billion or less that engages in covered activities can meet the compliance requirements of the final rule simply by including in its existing compliance policies and procedures references to the requirements of section 13 of the Bank Holding Company Act and subpart D of the final rule as appropriate given the activities, size, scope and complexity of the banking entity. This significantly reduces the compliance burden on smaller banking entities that engage in a limited amount of covered activities or investments.

The final rule requires all other banking entities to establish a compliance program designed to ensure compliance with Section 619 and the requirements set forth in the final rule. Even for banking entities that must establish a compliance program, the final rule makes changes from the NPR to reduce the burden of the metrics reporting requirements. For example, the final rule raised the threshold for metrics reporting from $1 billion in trading assets and liabilities threshold originally proposed to $10 billion in trading assets and liabilities, thereby capturing only firms that engage in very significant trading activity. The final rule also reduced the number of mandatory trading metrics required to be reported to the agencies from around 20 in the original proposal to 7 in the final rule. Additionally, the final rule provided for metrics reporting to be phased-in based on the size of the banking entity's trading assets and liabilities, with banks with more than $50 billion in trading assets and liabilities reporting first, following banks with more than $25 billion in trading assets and liabilities, and then banks with more than $10 billion in trading assets and liabilities.

Treatment of TruPS CDOs

Following the issuance of the final rule implementing section 619, a number of community banking organizations expressed concern that the final rule conflicts with the Congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather trust preferred securities (TruPS). On December 19 and December 27, 2013, the banking agencies issued joint statements providing guidance to financial institutions regarding the potential impact of the final rule on the treatment of TruPS held in collateralized debt obligations (CDOs). These statements outlined some of the issues that must be resolved in order to determine whether ownership of an interest in a securitization vehicle that holds primarily TruPS would be subject to the provisions of section 619 of the Dodd-Frank Act and the final implementing rules.[3]

Following additional review, the agencies determined that it is appropriate and consistent with the provisions of the Dodd-Frank Act to exempt certain collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs) from the investment prohibitions of section 619 of the Act. Section 171 of the Dodd-Frank Act provides for the grandfathering of TruPS issued before May 19, 2010, by certain depository institution holding companies with total assets of less than $15 billion as of December 31, 2009, and by mutual holding companies estab-

[3] *http://www.fdic.gov/news/news/press/2013/pr13123.html; http://www.fdic.gov/news/news/press/2013/pr13126a.pdf.*

lished as of May 19, 2010. The TruPS CDO structure was the vehicle that gave effect to the use of TruPS as a regulatory capital instrument prior to May 19, 2010, and was part of the status quo that Congress preserved with the grandfathering provision of section 171.

The interim final rule (IFR) adopted by the agencies on January 14, 2014[4] is consistent with the relief the agencies believe Congress intended to provide community banking organizations under section 171(b)(4)(C) of the Dodd-Frank Act. Under the IFR, the agencies have exempted TruPS CDOs that meet specific criteria from the prohibition on the acquisition or retention of any interest in or sponsorship of covered funds by banking entities. The Federal banking agencies also released a non-exclusive list of issuers that meet the requirements for the exemption.[5] The IFR is clear that banking organizations can rely solely on this list for compliance purposes. The agencies will accept public comment on the IFR for 30 days following its publication in the Federal Register.

Risk Retention

On August 28, 2013, the FDIC Board approved an NPR issued jointly with five other Federal agencies to implement the credit risk retention requirement set forth in Section 941 of the Dodd-Frank Act, which seeks to ensure that securitization sponsors have appropriate incentives for prudent underwriting. The proposed rule generally requires that the sponsor of any asset-backed security (ABS) retain an economic interest equal to at least 5 percent of the aggregate credit risk of the collateral. This is the second proposal under Section 941; the first was issued in April 2011.

The current NPR provides the sponsors of ABSs with various options for meeting the risk retention requirements. As required by the Dodd-Frank Act, the proposed rule defines a "qualified residential mortgage" (QRM), that is, a mortgage which is statutorily exempt from risk retention requirements. The NPR would align the definition of QRM with the definition of "qualified mortgage" (QM) as prescribed by the Consumer Financial Protection Bureau (CFPB) in 2013. The NPR also includes a request for public comment on an alternative QRM definition that would add certain underwriting standards to the existing QM definition. Similar to the prior proposal, the current proposal sets forth criteria for securitizations of commercial real estate loans, commercial loans, and automobile loans that meet certain conservative credit quality standards to be exempt from risk retention requirements.

The FDIC has received approximately 150 comments on the current NPR. A number of comments relate to risk retention issues regarding open market collateralized loan obligations (CLOs).[6] The proposed rule considers an open market CLO manager to be a securitization sponsor and, therefore, the manager would generally be required to retain 5 percent of the credit risk of CLO issuances. As an alternative, managers or sponsors could satisfy the risk retention requirement if the lead arrangers of the loans (typically the main lender) purchased by the open market CLO retained the required risk. Some commenters have argued that the lead arranger option is unworkable and that the proposal would significantly affect the formation and continued operation of CLOs, and that this could reduce the volume of commercial lending. The agencies are continuing to review comments and meet with interested groups to discuss their concerns and will give full consideration to all issues raised before we issue the final rule.

Examination Treatment of Qualified Mortgages

Recognizing that many institutions are assessing how to implement the Ability-to-Repay and QM rules issued by the CFPB, the Federal financial regulators jointly issued interagency statements on their supervisory approach for residential mortgage loans. The agencies emphasize that an institution may originate both QM and non-QM residential mortgage loans. A bank's decision to offer only QM loans, absent other factors, should not elevate a supervised institution's fair lending risk and is compatible with meeting Community Reinvestment Act obligations. The interagency statements emphasize that the agencies will not subject a residential mortgage loan to regulatory criticism—either from a safety and soundness or consumer protection perspective—based solely on the loan's status as a QM or a non-QM.

[4] *http://www.fdic.gov/news/news/press/2014/pr14003a.pdf.*
[5] *http://www.fdic.gov/news/news/press/2014/pr14003b.pdf.*
[6] An open market CLO is defined as one (i) whose assets consist of senior, secured syndicated loans acquired directly from the sellers in open market transactions and of servicing assets, (ii) that is managed by a CLO manager, and (iii) that holds less than 50 percent of its assets, by aggregate outstanding principal amount, in loans syndicated by lead arrangers that are affiliates of the CLO or originated by originators that are affiliates of the CLO.

Resolution of Systemically Important Financial Institutions

Resolution Plans—"Living Wills"

Under the framework of the Dodd-Frank Act, bankruptcy is the preferred option in the event of the failure of a SIFI. To make this objective achievable, Title I of the Dodd-Frank Act requires that all bank holding companies with total consolidated assets of $50 billion or more, and nonbank financial companies that the Financial Stability Oversight Council (FSOC) determines could pose a threat to the financial stability of the United States, prepare resolution plans, or "living wills," to demonstrate how the company could be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company's financial distress or failure. The living will process is an important new tool to enhance the resolvability of large financial institutions through the bankruptcy process.

The 165(d) Rule, jointly issued by the FDIC and the Federal Reserve Board in 2011, implemented the requirements for resolution plans and provided for staggered annual submission deadlines based on the size and complexity of the companies. Eleven of the largest, most complex institutions submitted initial plans in 2012 and revised plans in 2013. During 2013, the remaining 120 institutions submitted their initial resolution plans under the 165(d) rule. In addition, in 2013, the FSOC designated three nonbank financial institutions for Federal Reserve Board supervision. These firms are expected to submit their initial resolution plans in 2014.

2013 Guidance on Living Wills

Following the review of the initial resolution plans submitted in 2012, the agencies developed Guidance for the firms to detail the information that should be included in their 2013 resolution plan submissions. The agencies identified an initial set of significant obstacles to rapid and orderly resolution which covered companies are expected to address in the plans, including the actions or steps the company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. These eleven institutions submitted their revised resolution plans in October 2013.

As required by the statute, the resolution plans submitted in 2013 will be subject to informational completeness reviews and reviews for resolvability under the Bankruptcy Code. The agencies are reviewing how each resolution plan addresses a set of benchmarks outlined in the Guidance which represent the key impediments to an orderly resolution. The benchmarks are as follows:

- Multiple Competing Insolvencies: Multiple jurisdictions, with the possibility of different insolvency frameworks, raise the risk of discontinuity of critical operations and uncertain outcomes.
- Global Cooperation: The risk that lack of cooperation could lead to ring-fencing of assets or other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value, as well as uncertainty in the markets.
- Operations and Interconnectedness. The risk that services provided by an affiliate or third party might be interrupted, or access to payment and clearing capabilities might be lost;
- Counterparty Actions. The risk that counterparty actions may create operational challenges for the company, leading to systemic market disruption or financial instability in the United States; and
- Funding and Liquidity. The risk of insufficient liquidity to maintain critical operations arising from increased margin requirements, acceleration, termination, inability to roll over short-term borrowings, default interest rate obligations, loss of access to alternative sources of credit, and/or additional expenses of restructuring.

The FDIC and the Federal Reserve are charged with reviewing the 165(d) plans and may jointly find that a plan is not credible or would not facilitate an orderly resolution under the Bankruptcy Code. If a plan is found to be deficient in either case, the FDIC and the Federal Reserve must notify the filer of the areas in which the plan is deficient. The filer must resubmit a revised plan that addresses the deficiencies within 90 days (or other specified timeframe). The FDIC and the Federal Reserve currently are in the process of reviewing the plans under the standards provided in the statute.

Orderly Liquidation Authority

In cases where resolution under the Bankruptcy Code may result in serious adverse effects on financial stability in the United States, the Orderly Liquidation Authority set out in Title II of the Dodd-Frank Act serves as the last resort alternative.

Upon recommendations by a two-thirds vote of the Federal Reserve Board and the FDIC Board and a determination by the Treasury Secretary in consultation with the President, a financial company whose failure is deemed to pose a risk to the financial system may be placed into an FDIC receivership. Under the Act, key findings and recommendations must be made before the Orderly Liquidation Authority can be considered as an option. These include a determination that the financial company is in default or danger of default, that failure of the financial company and its resolution under applicable Federal or State law, including bankruptcy, would have serious adverse effects on financial stability in the United States and that no viable private sector alternative is available to prevent the default of the financial company.

In my July 11, 2013 testimony before this Committee, I described how the FDIC is developing a strategic approach, referred to as Single Point-of-Entry (SPOE), to carry out its Orderly Liquidation Authority for resolving a SIFI. Under the SPOE strategy, the FDIC would be appointed receiver of the top-tier parent holding company of the financial group following the company's failure and the completion of the recommendation, determination, and expedited judicial review process set forth in Title II of the Act. The FDIC would organize a bridge financial company into which assets from the receivership estate, including the failed holding company's investments in, and loans to subsidiaries, would be transferred.

The FDIC would oversee operations of the bridge financial company and would retain control over certain high-level key matters of the bridge financial company's governance. Shareholders would be wiped out, unsecured debt holders would have their claims written down to reflect any losses that shareholders cannot cover, and culpable senior management would be replaced. The FDIC would appoint a board of directors and nominate a new chief executive officer and other key managers to operate the bridge financial company under the FDIC's oversight. The plan for restructuring the company could include changing business, shrinking businesses, breaking the company into smaller entities, and liquidating certain assets or closing certain operations. The FDIC also would likely require the restructuring of the firm into one or more smaller nonsystemic firms that could be resolved under bankruptcy.

During the operation of the bridge financial company, the healthy subsidiaries of the company would remain open, allowing them to continue business. In this manner the resolution strategy would protect against contagion in the financial system by maintaining vital linkages among critical operating subsidiaries, ensuring continuity of services, and avoiding the disruption that would likely accompany failure. At the same time, the strategy would protect against moral hazard by holding accountable the failed company's owners and management responsible for its failure.

On December 10, 2013, the FDIC Board approved publication of a Federal Register notice [7] which provides greater detail on the SPOE strategy and discusses the key issues that will be faced in the resolution of a SIFI. The notice seeks public comment and views as to how the policy objectives set forth in the Dodd-Frank Act could better be achieved.

In addition, the Federal Reserve, in consultation with the FDIC, is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of unsecured debt at the holding company level. Such a requirement would ensure that there are creditors at the holding company level to absorb losses at the failed firm.

Cross-border Issues

Advance planning and cross-border coordination for the resolution of globally active SIFIs will be essential to minimizing disruptions to global financial markets. Recognizing that global SIFIs create complex international legal and operational concerns, the FDIC continues to reach out to foreign regulators to establish frameworks for effective cross-border cooperation.

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been developing contingency plans for the failure of a global SIFI that has operations in the United States and the United Kingdom of the 28 G–SIFIs designated by the Financial Stability Board (FSB) of the G–20 countries, four are headquartered in the United Kingdom, and another eight are headquartered in the United States. Moreover, approximately 70 percent of the reported foreign activities of the eight U.S. G–SIFIs emanates from the United Kingdom. The magnitude of these financial relationships makes the U.S.-U.K. bilateral relationship by far the most significant with regard

[7] FDIC, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013).

to the resolution of G–SIFIs. Because of the magnitude of these institutions' operations, our two countries have a strong mutual interest in ensuring that the failure of such an institution could be resolved at no cost to taxpayers and without placing the financial system at risk.

The FDIC and U.K. authorities released a joint paper on resolution strategies in December 2012, reflecting the close working relationship between the two authorities. This joint paper focuses on the application of "top-down" resolution strategies for a U.S. or a U.K. financial group in a cross-border context and addresses several common considerations to these resolution strategies. In December 2013, the FDIC and the Bank of England, including the Prudential Regulation Authority, in conjunction with the Federal Reserve Board and the Federal Reserve Bank of New York, held a staff-level tabletop exercise exploring cross-border issues and potential mitigating actions that could be taken by regulators in the event of a resolution.

The FDIC also is coordinating with representatives from European authorities to discuss issues of mutual interest, including the resolution of European global SIFIs and ways in which we can harmonize receivership actions. The FDIC and the European Commission (E.C.) have established a joint Working Group composed of senior executives from the FDIC and the E.C. to focus on both resolution and deposit insurance issues. The agreement establishing the Working Group provides for meetings twice a year with other interim interchanges and the exchange of detailees. In 2013, the Working Group convened formally twice, and there has been ongoing collaboration at the staff level. The FDIC and the E.C. have had in-depth discussions regarding the FDIC's experience with resolution as well as the SPOE strategy that we are developing. We also have discussed the E.C.'s proposed EU-wide Credit Institution and Investment Firm Recovery and Resolution Directive, the E.C.'s proposed amendment to harmonize further deposit guarantee schemes EU-wide, and the E.C.'s proposal for a Single Resolution Mechanism that would apply to Euro-area Member States, as well as any others that would opt-in. The FDIC and the E.C. also have exchanged staff members for short periods to enhance staff experience with respective resolution authorities. In 2014, at the request of the E.C., the FDIC is planning to conduct a training seminar on resolutions for E.C. staff.

The FDIC continues to foster its relationships with other jurisdictions that regulate global SIFIs, including Switzerland, Germany, and Japan. In 2013, the FDIC had significant principal and staff-level engagements with these countries to discuss cross-border issues and potential impediments that would affect the resolution of a global SIFI. We will continue this work in 2014 with plans to host tabletop exercises with staff from these authorities. We also have discussed developing joint resolution strategy papers, similar to the one with the United Kingdom, as well as possible exchanges of detailees.

In a significant demonstration of cross-border cooperation on resolution issues, the FDIC signed a November 2013 joint letter with the Bank of England, the Swiss Financial Market Supervisory Authority and the German Federal Financial Supervisory Authority, to the International Swaps and Derivatives Association, Inc. (ISDA). This letter encouraged ISDA to develop provisions in derivatives contracts that would provide for short-term suspension of early termination rights and other remedies in the event of a G–SIFI resolution. The adoption of such changes would allow derivatives contracts to remain in effect throughout the resolution process following the implementation of a number of potential resolution strategies.

We anticipate continuation of our international coordination and outreach and will continue to work to resolve impediments to an orderly resolution of a global SIFI.

Capital and Liquidity Requirements

Interagency Rulemakings on Basel III and the Supplementary Leverage Ratio

In July 2013, the FDIC Board acted on two important regulatory capital rulemakings. First, the FDIC joined the Federal Reserve, and the OCC in issuing rulemakings that significantly revise and strengthen risk-based capital regulations through implementation of the Basel III international accord ("Basel III rulemaking"). Second, these agencies also issued an NPR that would strengthen leverage capital requirements for the eight largest U.S. bank holding companies (BHCs) and their insured banks.

The Basel III rulemaking substantially strengthens both the quality and the quantity of risk-based capital for all banks in the U.S. by placing greater emphasis on tier 1 common equity capital. Tier 1 common equity capital is widely recognized as the most loss-absorbing form of capital, and the Basel III changes are expected to result in a stronger, more resilient industry better able to withstand periods of economic stress in the future.

The Basel III rulemaking also includes a new supplementary leverage ratio requirement, an issue agreed in the Basel III international accord. This represents an important enhancement to the international capital framework. Prior to this rule, there was no international leverage ratio requirement. For the first time, the Basel III accord included an international minimum leverage ratio, and consistent with the agreement, the Basel III rulemaking includes a 3-percent minimum supplementary leverage ratio that applies only to the 17 large banking organizations subject to the advanced approaches rule.

As noted above, the NPR would strengthen the supplementary leverage requirements encompassed in the Basel III rulemaking for the eight largest BHCs and their insured banks. The NPR would require covered insured depository institutions (IDIs) to satisfy a 6-percent supplementary leverage ratio to be considered well capitalized for prompt corrective action (PCA) purposes. BHCs covered by the NPR would need to maintain a supplementary leverage ratio of at least 5 percent (a 3 percent minimum plus a 2-percent buffer) to avoid restrictions on capital distributions and executive compensation.

As the NPR points out, maintaining a strong capital base at the largest, most systemically important institutions is particularly important because capital shortfalls at these institutions can contribute to systemic distress and have material adverse economic effects. The agencies' analysis suggests that a 3-percent minimum supplementary leverage ratio contained in the Basel III accord would not have appreciably mitigated the growth in leverage among systemically important institutions in the years preceding the recent crisis. The FDIC views this as problematic because one of the most important objectives of the capital reforms was to address the buildup of excessive leverage.

While the Basel III rulemaking raises risk-based capital requirements significantly, the minimum supplementary leverage ratio provided in Basel III does not raise leverage capital comparably. From a safety and soundness perspective, leverage capital requirements and risk-based capital requirements are complementary. Each offsets the potential weaknesses of the other, and the two working together—as they have in the U.S. for over 20 years—are more effective than either by itself. For example, risk-weighted asset calculations are subject to modeling error, subjectivity, and other uncertainties. These weaknesses can be offset by a more robust leverage ratio. On the other hand, risk-based capital measures are useful because they may better capture the risk posed by different kinds of assets. The NPR is intended to increase leverage capital to maintain rough comparability with the increase in risk-based capital required under Basel III.

Higher capital requirements would help offset systemic risk and would also put additional private capital at risk before the Deposit Insurance Fund (DIF) and the Federal Government's resolution mechanisms would be called upon. This proposed rulemaking is one of the most important steps the banking agencies could take to strengthen the safety and soundness of the U.S. banking and financial systems.

Rule on the Liquidity Coverage Ratio and the Net Stable Funding Ratio Proposal

A number of large financial institutions experienced significant liquidity problems during the financial crisis that exacerbated stress on the banking system, and more broadly, compromised financial stability. In response, the U.S. banking agencies have made a concerted effort, both domestically and internationally, to strengthen liquidity and short-term funding requirements for the largest U.S. banking organizations.

In October 2013, the FDIC, together with the OCC and the Federal Reserve, issued an interagency proposed rule to implement a quantitative liquidity requirement consistent with the Liquidity Coverage Ratio (LCR) developed by the Basel Committee on Banking Supervision on which the U.S. banking agencies serve as members. The LCR rule would apply to large, internationally active banking organizations and their consolidated subsidiary depository institutions with $10 billion or more in total consolidated assets and is an important step in helping to bolster the resilience of these organizations during periods of financial stress. The proposal requires banks to hold a minimum level of liquid assets to withstand contingent liquidity events and provides a standard way of expressing a bank's on-balance sheet liquidity position to stakeholders and supervisors. The proposal establishes a transition schedule under which covered companies must fully meet the minimum LCR by January 1, 2017, 2 years earlier than the Basel deadline. The comment period on this proposal closed on January 31, 2014.

In January 2014, the Basel Committee issued a related proposal to establish a Net Stable Funding Ratio (NSFR). The NSFR proposal complements the LCR by promoting stable funding profiles over the longer term by limiting over-reliance on short-term wholesale funding, improving the assessment of funding risk for on- and off-balance sheet items, and encouraging stable sources of funding. To meet the proposed NSFR requirement, the largest U.S. banks would have to maintain a minimum level of stable funding given the liquidity characteristics of their assets and off-balance sheet exposures. The FDIC strongly supports the Basel Committee's NSFR proposal, and we anticipate that the U.S. banking agencies will develop a similar domestic rule once the Basel Committee's consultation period ends in April of this year.

Data Integrity

Recent highly publicized data breaches have highlighted payment card data integrity issues at merchants. Compromised payment card data can affect millions of consumers and thousands of issuing banks globally. Consequently, payment card data integrity has been, and remains, a concern of the Federal banking regulators. Although the Federal banking agencies do not have the authority to regulate the payment card operations of retail merchants, such as those subject to the recent breaches in the news, the FDIC and the other Federal banking regulators are able to examine merchant acceptance and payment card issuing operations that occur under the direct control of a bank.

The FDIC treats data security as a significant risk area due to its potential to disrupt bank operations, harm consumers, and undermine confidence in the banking system and economy. The failure or misuse of technology can impact the safety and soundness of an institution with sudden and severe losses, directly harm consumers, or both.

In its role as supervisor of insured institutions, the FDIC analyzes emerging cyber threats, occurrences of bank security breaches, and other incidents. The FDIC monitors security issues in the banking industry on a regular basis through onsite examinations and regulatory reports. The FDIC, through its membership in the Financial and Banking Information Infrastructure Committee (FBIIC), works with groups such as the Financial Services Sector Coordinating Council (FSSCC), other regulatory agencies, law enforcement and others to share information regarding emerging issues and coordinate our responses.

Additionally, the Federal Financial Institutions Examination Council formed a Cybersecurity and Critical Infrastructure Working Group in June 2013. This working group will serve as a liaison with the intelligence community, law enforcement and homeland security agencies on cybersecurity and critical infrastructure protection-related issues. It also will conduct programs to create cyber risk awareness and consider additional industry guidance on specific threats. Finally, the group is pursuing an agenda for the member agencies to collaborate on cybersecurity and critical infrastructure issues related to examination policy, training, information sharing and incident communication and coordination.

The FDIC has issued guidance to financial institutions with respect to keeping data secure, protecting customers, and responding to breaches of data security. In 2001, the Federal banking agencies issued *Interagency Guidelines Establishing Information Security Standards,* as required by Section 501(b) of the Gramm-Leach-Bliley Act, requiring every financial institution to have an information security program, approved by the institution's board of directors, to protect customer information.

The FDIC's most direct role in ensuring cyber security within the financial sector is through its onsite examination programs. The FDIC regularly and routinely evaluates all of its regulated financial institutions' information security programs through our information technology (IT) examinations. The Federal banking agencies also conduct IT examinations of major technology service providers that provide services to financial institutions. These examinations are designed, in part, to ensure that financial institutions protect both bank and customer information. Depending on the findings from our examinations, informal or formal enforcement action may be pursued to achieve corrective actions.

The Federal Financial Institutions Examination Council (FFIEC), which includes the FDIC, publishes a series of Information Technology Examination Handbooks. Banks and their service providers are examined by their appropriate Federal banking agency using the standards in the FFIEC books, which includes an assessment of their information security and protection of customer information, among other things. The handbooks address objectives, standards, resources, roles and responsibilities, best practices, and examination procedures. These handbooks are available to examiners, bankers, and the public.

With respect to retail payments in particular, the Federal banking agencies' supervisory programs assess acquiring banks to ensure that appropriate payment operations risk mitigation efforts are in place. Included as part of the FFIEC IT Examination Handbook are two booklets, "Retail Payment Systems" and "Wholesale Payment Systems," to address regulatory expectations for risk management of these systems.

The Federal banking agencies issued guidance in March 2005 for financial institutions to develop and implement a Response Program designed to address incidents of unauthorized access to sensitive customer information.

Recognizing that addressing cyber risks can be especially challenging for community banks, the FDIC is taking steps to assist them with planning and training. At the November 19, 2013 meeting of its Advisory Committee on Community Banking, we shared with members, an exercise that institutions can use to initiate discussions about operational risk and the potential impact of IT disruptions on common banking functions. This exercise, named "Cyber Challenge," provides financial institutions with four exercise scenarios via short videos. Each video represents a standalone scenario so users may choose to consider any number of the scenarios in any order they desire. Each video has associated challenge questions that have been developed to promote discussion on topics relevant to the specific scenarios and to assist institutions in the development of proper responses. Additionally, financial institutions may discuss how they would react to the scenario, how they would handle the situation in their respective institution, and what controls their institution has in place to prevent the situation. Cyber Challenge will be distributed to all FDIC-supervised institutions in the near future.

Conclusion

Thank you for the opportunity to share with the Committee the work that the FDIC has been doing to implement the Dodd-Frank Act and address systemic risk in the aftermath of the financial crisis. I would be glad to respond to your questions.

Status of FDIC Dodd-Frank Act Rulemakings

Completed FDIC-only Rulemakings

FDIC has met all applicable deadlines in issuing those required regulations in the Dodd-Frank Wall Street Reform and Consumer Protection Act for which it is solely responsible. These include:

- Orderly Liquidation Authority (OLA) Regulations
  - Inflation adjustment for wage claims against financial company in receivership;
  - Executive compensation clawbacks and definition of compensation; and
  - Definition of 'predominantly engaged in activities financial in nature' for title II purposes.
- Deposit Insurance Fund Management Regulations
  - Regulations establishing an asset-based assessment base;
  - Regulations implementing permanent $250,000 coverage;
  - Elimination of pro-cyclical assessments; dividend regulations;
  - Restoration plan to increase the minimum reserve ratio from 1.15 to 1.35 percent by Sept. 30, 2020; and
  - Regulations implementing temporary full Deposit Insurance coverage for non-interest bearing transaction accounts (Program expired 12/31/12).

The FDIC has also issued several optional rules, including the following OLA rules:

- Rules governing payment of post-insolvency interest to creditors;
- Rules establishing the proper measure of actual, direct, compensatory damages caused by repudiation of contingent claims;
- Rules governing the priority of creditors and the treatment of secured creditors;
- Rules governing the administrative claims process;
- Rules governing the treatment of mutual insurance holding companies; and
- Rules providing for enforcement of contracts of subsidiaries or affiliates of a covered financial company.

Completed Interagency Rules:

FDIC and its fellow agencies have issued a number of joint or interagency regulations. These include:

- Title I resolution plan requirements;
- Regulations implementing self-administered stress tests for financial companies;

- Minimum leverage capital requirements for IDIs (Collins § 171(b)(1));
- Minimum risk-based capital requirements (Collins § 171(b)(2));
- Capital requirements for activities that pose risks to the financial system (Collins § 171(b)(7)) (as of July 9, 2013);
- Rules providing for calculation of the "maximum obligation limitation";
- Regulations on foreign currency futures;
- Removing regulatory references to credit ratings;
- Property appraisal requirements for higher cost mortgages;
- Appraisals for higher priced mortgages supplemental rule;
- Appraisal independence requirements;
- Volcker Rule Prohibition on Proprietary Trading and Investments in Covered Funds; and
- Interim final rule authorizing Retention of Interests in CDOs backed by Bank-Issued Trust Preferred Securities

Rulemakings in process—FDIC-only:

A few regulations without statutory deadlines remain in process. These include:

- OLA regulations implementing post-appointment requirements and establishing eligibility requirements for asset purchasers; and
- Integration and Streamlining of adopted OTS regulations.

Interagency Rulemakings in process:

- Additional OLA Rules:
  - Orderly liquidation of covered brokers and dealers;
  - Regulations regarding treatment of officers and directors of companies resolved under Title II; and
  - QFC recordkeeping rules;
- Regulations implementing the credit exposure reporting requirement for large BHCs and nonbank financial companies supervised by the FRB;
- Regulations implementing the "source of strength" requirement for BHCs, S&LHCs, and other companies that control IDIs;
- Capital and margin requirements for derivatives that are not cleared OTC;
- Regulations governing credit risk retention in asset-backed securitizations, including ABS backed by residential mortgages;
- Regulations governing enhanced compensation structure reporting and prohibiting inappropriate incentive-based payment arrangements;
- Rulemaking prohibiting retaliation against an IDI or other covered person that institutes an appeal of conflicting supervisory determinations by the CFPB and the appropriate prudential regulator; and
- Additional appraisals and related regulations:
  - Minimum requirements for registration of appraisal management companies and for the reporting of the activities of appraisal management companies to Appraisal Subcommittee;
  - Regulations to implement quality controls standards for automated valuation models; and
  - Regulations providing for appropriate appraisal review.

Other DFA Regulations and Guidance:

- OMWI—Proposed Standards for Assessing Diversity in Regulated Entities;
- Stress Testing Guidance, including:
  - Economic Scenarios for 2014 Stress Testing;
  - Policy Statement on the Principles for Development and Distribution of Annual Stress Test Scenarios (FDIC-supervised institutions); and
  - Proposed Interagency Supervisory Guidance on Implementing Dodd-Frank Act Company-Run Stress Tests for Banking Organizations With Total Consolidated Assets of More Than $10 Billion But Less Than $50 Billion; and

- Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans

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PREPARED STATEMENT OF THOMAS J. CURRY*

COMPTROLLER OF THE CURRENCY

OFFICE OF THE COMPTROLLER OF THE CURRENCY

FEBRUARY 6, 2014

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear before you today. As the national economy continues to improve, so do the balance sheets of the financial institutions that the Office of the Comptroller of the Currency (OCC) supervises. The industry's improved strength is reflected in stronger capital, improved liquidity, and timely recognition and resolution of problem loans. We are mindful, however, of the lessons of the financial crisis, and we have learned from that experience. We have taken a close look at how we supervise national banks and Federal savings associations (collectively, banks) and have devoted considerable time and resources to improving the way we do our job.

With this in mind, I will begin my testimony today by describing the independent peer review study, which was undertaken at my direction, to assess the effectiveness of OCC's supervision of large and midsize banks. I will also discuss the OCC's recently proposed heightened expectations guidelines, designed to strengthen the risk management and governance practices of our large banks. We are setting a high bar for the institutions we supervise, and, as our international peer review project demonstrates, we are asking no less of ourselves.

In addition, as the Committee requested, I will discuss the OCC's expectations of the banks that we supervise with regard to their ability to defend both their systems and their customers' confidential information from cyber threats, as well as our role in supervising the retail payment system activities of banks. While banks are highly regulated, the financial services industry is an attractive target for cyber attacks, and therefore, we recognize the need to ensure that banks are doing everything necessary to protect themselves and their customers' information. To ensure we stay on top of the evolving threats to the financial services industry, the OCC is committed to refining our supervisory processes on an ongoing basis and to participating in public-private partnerships to help keep abreast of and respond to emerging threats.

Finally, my testimony will address our ongoing efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act) and to strengthen bank capital. Specifically, I will discuss the newly finalized risk-based capital rules, as well as the proposed liquidity rules and enhanced leverage capital ratio requirement. I also will provide an overview of the finalized "Volcker" rules and our progress in implementing specific provisions of Title VII of the Act. I will conclude with a summary of other rulemaking projects required by the Act on which we have made substantial progress, including the appraisal and credit risk retention rules.

I. Improving Financial Stability through Enhanced Prudential Regulation and Supervision

A. International Peer Review Study

Throughout our 150-year history, effective supervision of national banks has been the core mission of the OCC. While the scope of that mission has expanded to include Federal savings associations, our focus on quality supervision has not changed.

To do our job effectively, we must maintain controls and a review program that is every bit as rigorous as what we expect of our banks. This proposition underlies the OCC's new Enterprise Governance unit, which will conduct independent reviews of each OCC business line. These reviews will enhance existing processes, including quality assurance programs that each business line maintains.

The financial crisis showed how important supervision is to the soundness of the banking system, and I feel strongly that we need to do everything possible to ensure the effectiveness of OCC supervision. Last year, I brought together a team of senior international regulators to provide an independent and unvarnished assessment of

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*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.

the OCC's supervision program for large and midsize banks. Even the very best organizations have room to improve, and in fact, one of the hallmarks of a healthy culture is an organization's willingness to engage in a process of continual improvement. This is something the OCC has done throughout its 150 years. However, in the wake of the financial crisis, I believed it was particularly important to establish a process to assess our strengths and weaknesses and evaluate where we could do better.

The peer review team was comprised of veteran bank regulators from countries whose financial systems proved to be particularly resilient during the financial crisis. It was chaired by Jonathan Fiechter, a former OCC Senior Deputy Comptroller who, until recently, served as a senior official with the International Monetary Fund, where he headed the Monetary and Capital Markets Department's financial supervision and crisis management group.

In December 2013, I received and released to the public the peer review team's report.[1] Its recommendations cover six key areas: mission, vision, and strategic goals; identification of risk; ratings systems; staffing; scope and consistency of the OCC's supervisory strategies; and our enterprise governance function. I am gratified that the report highlighted a number of areas in which the OCC has been very successful. As the chair of the peer review team noted in his transmittal letter to me, "The OCC is fortunate to have such a highly motivated, experienced, and professional staff dedicated to carrying out the work of the OCC." The report praised the lead expert program[2] in our Midsize Bank Supervision business line, as well as the work of our National Risk Committee.[3] The peer review team also noted that our supervisory staff demonstrated a strong commitment to rigorous supervision of the institutions we regulate and pride in the OCC as a supervisory agency. Further, the team validated a number of initiatives that we had already begun, including eight strategic initiatives to address challenges and opportunities facing the agency. These strategic initiatives focus on retention and recruitment, bank and thrift supervision, leadership, agency funding, technology, internal and external communication, and an enterprise-wide self-assessment process focused on continuous improvement.

While the peer review team found much to praise, its report also highlighted areas in which its members believe the OCC could improve. For example, the report addresses the OCC's resident examination program and the relationship between the OCC's Risk Assessment System and the interagency CAMELS[4] rating system. After receiving the report, I set up senior-level working groups to evaluate and prioritize the recommendations and develop specific implementation plans for areas where the groups conclude that there are opportunities for improvement. I am committed to a full review of the issues and recommendations identified in the report and to continuous improvement in the way the OCC does business.

B. Heightened Expectations

Because of their size, activities, and implications for the U.S. financial system, large banks require more rigorous regulation and supervision. To support this objective, the OCC recently issued a proposal that would provide additional supervisory tools to examiners aimed at strengthening risk management practices and governance of large banks. This proposal codifies and builds on a set of supervisory

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[1] *See* OCC News Release 2013–184 for a copy of the report, available at: *http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184.html.*

[2] The lead expert program assigns an expert to each key risk area. These experts, who are independent from exam staff, review and opine on our annual supervisory strategy and supervisory communications for each large and midsize bank we supervise. This program ensures that the OCC consistently handles issues across the agency's portfolio.

[3] The OCC's National Risk Committee (NRC) monitors the condition of the Federal banking system, as well as emerging threats to the system's safety and soundness. The NRC also monitors evolving business practices and financial market issues and helps to shape supervisory efforts to address emerging risk issues. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from the legal, policy, and economics departments. The NRC helps to formulate the OCC's annual bank supervision operating plan that guides our supervisory strategies for the coming year. The NRC also publishes the *Semiannual Risk Perspective* report to provide information to the industry and the general public on issues that may pose threats to the safety and soundness of OCC-regulated financial institutions.

[4] The OCC's risk assessment system provides a framework that OCC examiners use to measure, document, and communicate the OCC's conclusions about the quantity of risk, quality of risk management, and direction of risk for eight risk categories. The interagency CAMELS rating system integrates six component areas: capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. Evaluations of these component areas take into consideration an institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

"heightened expectations" that embody critical lessons learned from the financial crisis.

The financial crisis taught us the importance of comprehensive and effective risk management; the need for an engaged board of directors that exercises independent judgment; the need for a robust audit function; the importance of talent development, recruitment, and succession planning; and a compensation structure that will not incentivize inappropriate risk taking. In 2010, we began communicating our heightened expectations to the banks through discussions at board meetings and in writing. We continued to refine and reinforce these heightened expectations through our ongoing supervisory activities and frequent communication with bank management and boards of directors. We spent time educating our examiners and bankers to clarify our expectations and specifically noted our requirement for a frank assessment of the gaps between existing and desired practices. The OCC also began to examine each large institution for compliance with the expectations and has included in each bank's Report of Examination an overall rating of how the bank meets these heightened expectations.

Our recent proposal builds upon and formalizes the heightened expectations program in the form of enforceable guidelines that would generally apply to insured national banks, insured Federal savings associations, and insured Federal branches of foreign banks with average total consolidated assets of $50 billion or more.

The proposed guidelines set forth minimum standards for the design and implementation of a bank's risk governance framework and provide minimum standards for the board's oversight of the framework. The bank's risk governance framework should address all risks to a bank's earnings, capital and liquidity, and reputation that arise from the bank's activities. The proposal also sets out roles and responsibilities for the organizational units that are fundamental to the design and implementation of the framework. These units, often referred to as a bank's three lines of defense, are front line business units, independent risk management, and internal audit. Together, these units should establish an appropriate system to control risk taking. Underlying the framework is a risk appetite statement that articulates the aggregate level and types of risk a bank is willing to assume in order to achieve its strategic objectives, consistent with applicable capital, liquidity, and other regulatory requirements.

The proposed guidelines also contain standards for boards of directors regarding oversight of the design and implementation of a bank's risk governance framework. It is vitally important that each director be engaged in order to understand the risks being taken by his or her institution and to ensure that those risks are well managed. Informed directors who exercise independent judgment can better question the propriety of strategic initiatives and assess the balance between risk taking and reward. An effective board also should actively oversee management. Directors should be in a position to present a credible challenge to bank management while fulfilling their duty to preserve the sanctity of the national bank or Federal savings association charter. By sanctity of the charter, I mean that directors must ensure that the institution operates in a safe and sound manner. The national bank or Federal thrift should not simply function as a booking entity for the holding company. It is a special corporate franchise that is the gateway to Federal deposit insurance and access to the discount window.

The guidelines are proposed as a new appendix to Part 30 of our regulations. Part 30 codifies an enforcement process set out in a statutory provision that authorizes the OCC to prescribe operational and managerial standards. If a bank fails to satisfy a standard, the OCC may require it to submit a compliance plan detailing how it will correct the deficiencies and how long that will take. The OCC can issue an enforceable order if the bank fails to submit an acceptable compliance plan or fails in any material way to implement an OCC-approved plan.

Higher supervisory standards for the large banks we oversee, such as those in the proposed guidelines, along with bank management's implementation of these standards, are consistent with the Dodd-Frank Act's broad objective of strengthening the financial system. We believe that this increased focus on strong risk management and corporate governance will help banks maintain the balance sheet improvements achieved since the financial crisis and make them better able to withstand the impact of future crises.

II. Data Security

There are few issues more important to me or to the OCC than the emerging risks posed by the increasing sophistication of cyber attacks. One of my highest priorities is to ensure that banks continue to improve their ability to protect both their systems and their customers' data against cyber attacks. While the banking sector is highly regulated and has been subject to stringent information security requirements for decades, we recognize that both our supervision and our guidance to banks must be regularly updated to keep pace with the rapidly changing nature of cyber threats. For this reason, when I became Chairman of the Federal Financial Institutions Examination Council (FFIEC), I called for the creation of a working group on cybersecurity issues to be housed under the FFIEC's task force on supervision. The working group has already begun to meet with intelligence, law enforcement, and homeland security officials, and it is exploring additional approaches bank regulators can take to ensure that institutions of all sizes have the ability to safeguard their systems.

Recent events, such as the Distributed Denial of Service attacks on banks and the information security breaches at Target and Neiman Marcus, highlight the sophisticated nature of evolving cyber threats, as well as the interdependencies that exist in today's payment systems. They also remind us of the impact that cyber attacks have on consumers and financial institutions. When accounts are compromised, the affected consumers often pay a stiff price in terms of lost time and the expense of restoring their credit information, even though they are protected against fraudulent card charges by their financial institutions. In addition to the inconvenience to and burden on consumers, financial institutions, including community banks that issue credit and debit cards, often end up bearing the costs when bank customer information maintained by merchants is compromised. Banks have borne the expense of replacing cards, providing credit monitoring services, responding to high volumes of customer inquiries, monitoring for fraudulent transactions, and reimbursing customers for fraud losses.

Information security has long been an integral part of the OCC's supervisory process. We have a variety of tools and broad authority to require the banks we regulate and their service providers to protect their own systems and their customers' data and to take steps to identify, prevent, and mitigate identity theft, no matter how a customer's information was acquired. Over the years, the OCC, on its own and through the FFIEC, has published guidance and handbooks that have made clear our expectations about acceptable risk management processes and procedures for safeguarding information.

A. Information Security Guidelines and Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice

Following the 1999 enactment of the Gramm-Leach-Bliley Act, the OCC, in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, the Federal banking agencies) published enforceable information security guidelines that set forth standards for administrative, technical, and physical safeguards financial institutions must have to ensure the security and confidentiality of customer information. These interagency guidelines require banks to develop and implement formal information security programs.

These programs need to be tailored to the bank's assessment of the risks it faces. These risks include internal and external threats to customer information and any method used to access, collect, store, use, transmit, protect, or dispose of the information. Each bank must consider the specific security measures set forth in the guidelines and adopt those that are appropriate for the institution. Given the evolving threat and technology environment, the guidelines require a bank's information security program to be dynamic—to continually adapt to address new threats, changes in technology, and new business arrangements. We also expect banks to routinely test their systems for vulnerabilities and to address the weaknesses they discover.

To ensure effective oversight, the guidelines require that information security programs be approved by an institution's board of directors. The board must also oversee the program's development, implementation, and maintenance, and it must review annual reports that describe the bank's compliance with the guidelines.

Since banks often depend upon service providers to conduct critical banking activities, the guidelines also address how banks must manage the risks associated with their service providers that have access to customer information. This past October, the OCC released updated guidance that emphasizes the importance of risk management practices for critical activities throughout the lifecycle of the third-party relationship.[5] The guidance also stresses our expectation that the board and management ensure that appropriate risk management practices are in place, estab-

[5] *See* OCC Bulletin 2013–29 "Third Party Relationships: Risk Management Guidance" available at: *http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.*

lish clear accountability for day-to-day management of these relationships, and periodically conduct independent reviews of these relationships.

While strong and resilient information security programs are critical, the evolving nature and sophistication of cyber attacks also require banks to have strong and well-coordinated incident response programs that can be put into action when a cyber attack or security breach does occur. Nearly a decade ago, the OCC, in conjunction with the FDIC and Federal Reserve, issued guidance to supplement the information security guidelines titled "Response Programs for Unauthorized Access to Customer Information and Customer Notice." This guidance addresses breaches of customer information maintained by or on behalf of banks and makes clear that the OCC expects each bank to implement an incident response program with specific policies and procedures to address unauthorized access to customer information. We expect a bank's incident response program to include a process for notifying customers and taking appropriate steps, not only to contain and control the incident, but also to prevent further unauthorized access to or use of the customer information. The bank is expected to notify both law enforcement and its primary regulator and to provide customers with information they need, such as how to place a fraud alert on their credit reports.

During and following cyber attacks on the financial sector, the OCC plays an important role in identifying risks to bank systems and bank customer information and conveying appropriate risk management practices to the industry, including defensive strategies and tactics to contain attacks. The OCC gathers information from our affected banks and shares information with other Government agencies. We have participated in briefings for our banks, service providers, and examiners on specific cyber threats. In addition, through our membership in both the Financial and Banking Information Infrastructure Committee and the Financial Services Information Sharing and Analysis Center, which are part of the financial sector's public-private partnerships, we share information regarding cyber threats and discuss various means to improve the security and resiliency of the financial sector.

B. Identity Theft Red Flags

While the information security guidelines require banks to safeguard the customer information that they maintain or that is maintained on their behalf, banks also are required to be on the alert for identity theft involving their customers' information, no matter how and where an identity thief acquired the information. Pursuant to section 114 of the FACT Act, the Federal banking agencies, together with the National Credit Union Administration (NCUA) and the Federal Trade Commission, issued regulations in 2007 titled "Identity Theft Red Flags and Address Discrepancies." The final rules require each financial institution and creditor to develop and implement a formal identity theft prevention program that includes policies and procedures for detecting, preventing, and mitigating identity theft in connection with account openings and existing accounts. The program must cover any consumer account or any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to consumers or to the safety and soundness of the financial institution or creditor from identity theft. In addition, it must include policies and procedures to identify relevant red flags, detect red flags incorporated into the program, respond appropriately to the red flags that are detected, and ensure the program is updated periodically to reflect changes in risks to customers and to the institution from identity theft.

The agencies also issued guidelines to assist covered entities in developing and implementing an identity theft prevention program. The guidelines include a supplement that identifies 26 patterns, practices, and specific forms of activity that are "red flags" signaling possible identity theft. These include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, the presentation of suspicious documents or suspicious personal identifying information, the unusual use of or other suspicious activity related to a covered account, or notice from customers, victims of identity theft, or law enforcement authorities. When a bank detects identity theft red flags, the bank is expected to respond by taking steps that include monitoring accounts, contacting the customer, changing passwords, closing and reopening the account, and notifying law enforcement, as appropriate.

C. Retail Payment Systems

Banks provide essential retail payment transactions and services to businesses and consumers, including the acceptance, collection, and processing of a variety of payment instruments and participation in clearing and settlement systems. From the initiation of a retail payment transaction to its final settlement, banks are exposed to certain risks, such as credit, liquidity, compliance, reputation, and operational risks, including fraud, particularly during settlement activities. These risks may arise from interactions with payment system operators and other third parties.

Recent technological advances are expanding the opportunities for the development of innovative payment products and services. New electronic payment instruments and systems offer gains in efficiency by allowing for the rapid and convenient transmission of payment information among system participants. However, without appropriate safeguards, these new products and services can also permit fraud, money laundering, and operational disruption to occur. In addition, nonbank third parties are increasingly participating in retail payment systems, contributing to innovation but also adding complexity to the transaction chain, which may increase risk in payment processes. Retail payment risk management is increasingly difficult, requiring close attention to the changing nature of risk and robust oversight.

The OCC, on its own and through the FFIEC, has issued guidance on identifying and controlling risks associated with retail payment systems and related banking activities. Risk profiles vary significantly based on the size and complexity of a bank's retail payment products and services, expertise, technology infrastructure, and dependence on third parties. The OCC expects banks engaging in these activities to be aware of the inherent risks of their activities and implement appropriate risk management processes. OCC examiners also assess risk levels and risk management practices at banks and schedule oversight activities based upon the risk profile of the bank and the complexity of the products and services offered.

Banks not only must comply with Federal requirements but also with State laws and regulations relating to payment systems and with the operating rules of clearing houses and bank card networks, such as Payment Card Industry-Data Security Standards (PCI–DSS). In addition, we expect all banks to maintain effective internal controls, including robust fraud detection systems and financial, accounting, technical, procedural, and administrative controls necessary to minimize risks in the retail payment transaction, clearing, and settlement processes. These measures, when effectively employed, reduce payment system risk, ensure that individual transactions are valid, and mitigate processing and other errors. Effective controls also ensure that the retail payments infrastructure operates with integrity, confidentiality, and availability.

D. The OCC's Supervision Program

The OCC's ongoing supervision program addresses information security and identity theft prevention for banks, including with respect to bank participation in the payment system. The supervisory program involves teams of examiners who evaluate information security and identity theft controls and risk management during their examinations of banks. Our most experienced examiners supervise the largest institutions and also participate, with the FDIC and Federal Reserve, in examinations of the largest bank technology service providers. The OCC's supervision, including of information technology, continues to evolve as the risks facing the industry change. Both on our own and through the FFIEC, we update examiner training, regulatory guidance, and examiner booklets. We also issue alerts to address risks stemming from increasingly complex bank operations and third-party relationships, new technologies, and the increasing volume and sophistication of cyber threats.

When necessary, the OCC uses our enforcement process to ensure compliance with our standards. When we have found serious gaps in meeting our supervisory expectations, we have taken enforcement actions that include cease and desist orders and civil money penalties. In some cases, the OCC has also found it necessary to compel banks to notify their customers of breaches involving personal information.

The OCC also has taken enforcement actions against bank insiders who were engaged in identity theft-related activities or were otherwise involved in serious breaches or compromises of customer information. These enforcement actions have included orders prohibiting individuals from working in the banking industry, personal cease and desist orders restricting the use of customer information, significant civil money penalties, and orders requiring restitution.

The OCC is committed to maintaining a robust regulatory framework that requires banks to protect their systems and their customers' information. The volume and sophistication of the cyber threats to our payment systems and other financial infrastructures are evolving rapidly. Furthermore, these systems are dependent on other critical infrastructures that are also vulnerable to these threats, such as telecommunications and energy, which are outside of the industry's direct control. For this reason, we will continue to look for ways to improve our supervisory processes and make the system stronger, through collaboration and cooperation with industry participants, as well as other regulatory and Government agencies, such as law enforcement.

III. Capital and Liquidity

A. Capital

Last year, the OCC, FDIC, and Federal Reserve finalized a rule that comprehensively revises U.S. capital standards. This rule strengthens the definition of regulatory capital, increases risk-based capital requirements, and amends the methodologies for determining risk-weighted assets. It also adds a new, stricter leverage ratio requirement for large, internationally active banks. These revisions reflect enhancements to the international capital framework published by the Basel Committee on Banking Supervision and are a result of lessons learned from the financial crisis. The standards are consistent with and complement the Dodd-Frank Act by strengthening our Nation's financial system. They reduce systemic risk and improve the safe and sound operation of the banks we regulate.

Some of the revisions applicable to large, internationally active banks became fully effective on January 1 of this year. Most revisions, including the narrowing of instruments that count as regulatory capital, will be phased in over several years. For the largest, internationally active banks, this phase-in has already begun. For all other banks, the phase-in will begin in 2015.

Leverage Ratio Capital Requirements

Regulatory capital standards in the United States have long included both risk-based capital and leverage requirements, which work together, each offsetting the other's potential weaknesses while minimizing incentives for regulatory capital arbitrage. Among the more important revisions to the domestic capital rules was the addition of stricter leverage ratio requirements applicable to the largest, internationally active banks.

Under longstanding domestic capital requirements, all banking organizations[6] must meet a minimum leverage ratio. Our recent revisions to the capital rules now require certain large banking organizations also to meet a "supplementary leverage ratio" requirement. Unlike the more broadly applicable leverage ratio, this supplementary leverage ratio incorporates off-balance sheet exposures into the measure of leverage. It is expected to be more demanding because large banking organizations often have significant off-balance sheet exposures that arise from different types of lending commitments, derivatives, and other activities.

To further strengthen the resiliency of the banking sector, in August of last year, the Federal banking agencies published a notice of proposed rulemaking (NPR) that would increase substantially the supplementary leverage ratio requirement for the largest and most systemically important banking organizations. Under the NPR, these banking organizations would be required to maintain even more tier 1 capital for every dollar of exposure in order to be deemed "well capitalized."

In January, the Basel Committee finalized revisions to the international leverage ratio standards upon which the Federal banking agencies based the supplementary leverage ratio NPR.

While some reports have suggested these revisions amounted to a watering down of the international standards, a more accurate depiction of the changes relative to U.S. standards requires more elaboration. Although these standards have been relaxed relative to a Basel Committee proposal issued in June 2013, the committee's final standards are generally comparable to the final U.S. standards published last year and the measure of exposure used in the NPR.

Two areas where the final Basel standards differ from the U.S. standards are the treatment of credit derivatives and off-balance sheet commitments. With respect to credit derivatives, the final Basel standards require a bank to treat a promise to pay a counterparty in the event of a credit default as the equivalent of providing a loan to the counterparty, because both transactions effectively involve the extension of credit. This requirement is more stringent than the current U.S. rules, which focus only on the counterparty credit risk associated with credit derivatives. With respect to off-balance sheet commitments, the Basel leverage calculation includes a portion of the potential exposure amount for certain off-balance sheet commitments, rather than the entire potential exposure amount. This change reduces the exposure measure relative to the current U.S. standards, which generally assume that all of these commitments will be completely drawn at the same time.

[6] The U.S. "banking organizations" subject to minimum capital rules include national banks, State member banks, Federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Federal Reserve's Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C), as well as top-tier savings and loan holding companies domiciled in the United States, except certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities.

Even considering the change to the exposure measure for certain commitments, our preliminary analysis suggests that, in the aggregate, the final Basel standards will generate a larger measure of exposure—and will therefore be more stringent—than the current and proposed U.S. standards. However, this is likely to vary by bank. Banks with large credit derivatives portfolios likely will see greater increases in their exposure measures relative to other banks.

Additionally, when considering the impact of the Basel standards, it is important to keep in mind that the NPR would increase the minimum supplementary leverage ratio requirements for systemically important banking organizations in the U.S. to 6 percent at the bank level and 5 percent at the bank holding company level. While we are still considering comments received on this proposal, the OCC continues to support stronger leverage ratio standards than the 3 percent international minimum. The Federal banking agencies will consider the revisions to the Basel Committee's leverage ratio framework, as well as the comments received in response to the NPR, as we continue with our work. The OCC supports the interagency efforts to ensure that the supplementary leverage ratio will serve as an effective backstop to the risk-based ratios and will work with the FDIC and the Federal Reserve to move forward with the rulemaking process in the near term.

B. Enhanced Liquidity Standards

Adequate and appropriate liquidity standards for the banks we regulate are an important post-financial crisis tool that is central to the proper functioning of financial markets and the banking sector in general. The Federal banking agencies, working together, have made significant progress in implementing the Basel Committee's Liquidity Coverage Ratio in the United States. These liquidity standards will help ensure that banking organizations maintain sufficient liquidity during periods of acute short-term financial distress.

In November of last year, the Federal banking agencies issued a proposal that would require certain large financial companies, including large national banks and Federal savings associations, to hold high-quality liquid assets on each business day in an amount equal to or greater than its projected cash outflows minus its projected inflows over a 30-day period of significant stress. The comment period for the proposed rule ended on January 31, 2014. The agencies are reviewing the comments and will be developing a final rule that I hope can be issued by the end of the year.

The Federal banking agencies also are working with the Basel Committee to develop another liquidity requirement, the Net Stable Funding Ratio, to complement the Liquidity Coverage Ratio and enhance long-term structural funding. The Net Stable Funding Ratio would require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The Basel Committee recently published a consultative paper for comment that defines the requirements for this ratio. Once finalized, the Federal banking agencies will work to implement a U.S. rule, which is planned to go into effect on January 1, 2018.

It is expected that these standards, once fully implemented, will complement existing liquidity risk guidance and enhanced liquidity standards to be issued by the Federal Reserve, in consultation with the OCC, as part of the heightened prudential standards required under section 165 of the Dodd-Frank Act.

IV. Volcker Rule

The statutory provision referred to as the Volcker Rule is set forth in section 619 of the Dodd-Frank Act. Section 619 prohibits a banking entity from engaging in short-term proprietary trading of financial instruments and from owning, sponsoring, or having certain relationships with hedge funds or private equity funds (referred to here, and in the final regulations, as covered funds).[7] Notwithstanding these prohibitions, section 619 permits certain financial activities, including market making, underwriting, risk-mitigating hedging, trading in Government obligations, and organizing and offering a covered fund.

On December 10, 2013, the OCC, Federal Reserve, FDIC, Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC) adopted final regulations implementing the requirements of section 619.[8] In accordance with the statute, the final regulations prohibit banking entities from engaging in impermissible proprietary trading and strictly limit their ability to invest in covered

[7] The statute defines the term "banking entity" to cover generally any insured depository institution (other than a limited purpose trust bank), any affiliate or subsidiary of an insured depository institution, and any company that controls an insured depository institution. *See* 12 U.S.C. 1851(h)(1).

[8] *See* 79 FR 5536 (Jan. 31, 2014). The OCC, Federal Reserve, FDIC, and SEC issued a joint regulation, and the CFTC issued a separate regulation adopting the same common rule text and a substantially similar preamble.

funds. At the same time, the regulations are designed to preserve market liquidity and allow banks to continue to provide important client-oriented services.

In developing the final regulations, the agencies carefully considered the more than 18,000 comments received on the proposed regulations from a diverse group of interests—including banks, securities firms, consumer and public interest groups, Members of Congress, foreign governments, and the general public.[9] Commenters raised numerous significant and complex issues with respect to the proposed regulations, and provided many—sometimes conflicting—recommendations. For example, the agencies heard from various commenters regarding the distinction between impermissible proprietary trading and permitted market making, and with respect to the definition of a covered fund. These comments often highlighted key differences in the markets and asset classes subject to regulation by the respective agencies under the Volcker Rule. In contrast, other commenters urged the agencies to construe the statutory mandate narrowly to avoid the potential for evasion of the proprietary trading and covered fund prohibitions.

To meet these challenges, the agencies worked closely with each other in developing the final regulations, from the principal level down to staff at all the agencies who worked long days, nights, and weekends, to grapple with extraordinarily complex and important policy issues. Though the final regulations have been published, the OCC is continuing to work closely and cooperatively with the other agencies as we work on our supervisory implementation of the final regulations during the conformance period, which runs through July 21, 2015.[10]

The statute applies to all banking entities, regardless of size; however, not all banking entities engage in activities presenting the risks the statute sought to curb. One of my priorities in the Volcker rulemaking was to make sure that the final regulations imposed compliance obligations on banking entities in proportion to their involvement in covered activities and investments. The final regulations appropriately recognize that not all banking entities pose the same risk and impose compliance obligations accordingly. So, a community bank that only trades in "plain vanilla" Government obligations has no compliance obligations whatsoever under the final regulations. Community banks that engage in other low-risk covered activities will be subject to only minimal requirements.

All banking entities, including community banks, will need to divest impermissible covered fund investments under the final regulations. Recently, however, the agencies heard, and promptly responded to, a concern raised by community institutions that the final regulations treated certain investments in a way that was inconsistent with another important provision of the Dodd-Frank Act. Banking entities of all sizes hold collateralized debt obligations backed primarily by trust preferred securities (TruPS CDOs). These TruPS CDOs, originally issued some years ago as a means to facilitate capital raising efforts of small banks and mutual holding companies, would have been subject to eventual divestiture and immediate write-downs under the applicable accounting treatment under generally accepted accounting principles. As a number of community institutions pointed out to the agencies, this result was inconsistent with the Collins Amendment to the Dodd-Frank Act,[11] where Congress expressly protected existing TruPS as a component of regulatory capital for the issuing institution so long as the securities were issued by bank holding companies with less than $15 billion in consolidated assets or by mutual holding companies.

To mitigate the unintended consequences of the final regulations and harmonize them with the Collins Amendment, the agencies, on January 14, 2014, adopted an interim final rule to permit banking entities to retain an interest in or sponsor a TruPS CDO acquired before the final regulations were approved, provided certain requirements are met.[12] Among others, the banking entity must reasonably believe that the offering proceeds from the TruPS CDO were invested primarily in trust preferred securities issued prior to May 19, 2010, by a depository institution holding

[9] Of the 18,000 comment letters, more than 600 were unique comment letters, and the remaining letters were from individuals who used a form letter. The agencies each also met with a number of the commenters to discuss issues raised by the proposed regulations and have published summaries of these meetings.

[10] Section 619 authorized a 2-year conformance period, until July 21, 2014, for banking entities to conform their activities and investments to the requirement of the statute. The statute also permits the Federal Reserve to extend this conformance period, one year at a time, for a total of no more than three additional years. In a separate action, the Federal Reserve has extended the conformance period for an additional year until July 21, 2015, and has indicated that it plans to monitor developments to determine whether additional extensions of the conformance period are in the public interest.

[11] *See* 12 U.S.C. 5371(b)(4)(C).

[12] *See* 79 FR 5223 (Jan. 31, 2014).

company below a $15 billion threshold or by a mutual holding company. To help community institutions identify which CDO issuances remain permissible, the OCC, FDIC, and Federal Reserve have also issued a nonexclusive list of TruPS CDOs that meet the requirements of the interim final rule.

For banking entities that engage in a high volume of trading and covered fund activities, namely, the largest banks, the final regulations will impose some significant changes. These large firms have been preparing for these changes since the statute became effective in July 2012, and have been shutting down impermissible proprietary trading operations. Now that the final regulations have been released, these institutions will need to take steps during the conformance period to bring their permitted trading and covered fund activities, such as market making, underwriting, hedging, and organizing and offering covered funds, into compliance with the requirements of the final regulations. Large banking entities must develop robust compliance programs, and they will be required to compile and report quantitative metrics on their trading activities that may serve as an indicator of potential impermissible proprietary trading or a high-risk trading strategy. Banking entities will not be able to use covered funds to circumvent the proprietary trading restrictions, and they will not be able to bail out covered funds they sponsor or invest in.

Of course, issuing a final regulation is only the beginning of the agencies' implementation process. Equally important is how the agencies will enforce it. The OCC is committed to developing a robust examination and enforcement program that ensures the banking entities we supervise come into compliance and remain compliant with the Volcker Rule. In the near term, our priority is implementing examination procedures and training to help our examiners assess whether banks are taking the necessary steps to come into compliance with the final regulations by the end of the conformance period, and we are actively engaged in these efforts. Using these procedures, examiners will direct banks they examine to identify the range and size of activities and investments covered by the final regulations, and will assess banks' processes and systems for metrics reporting and their project plans for bringing their trading activities and investments into conformance with the final regulations. Moreover, key OCC subject matter experts across our policy and supervision divisions are developing training for our examiners to be held later in 2014. We will build upon these initial procedures and training through the course of the conformance period as we further assess the progress and needs of our examiners.

The agencies also are working to ensure consistency in application of the final regulations. I am pleased to report that the OCC has led the formation of an interagency working group to address and collaborate on developing responses to key supervisory issues that arise under the final regulations. That interagency group held its first meeting in late January and will continue to meet on a regular basis going forward. The OCC is also participating in interagency training on the final regulations this spring and summer under the auspices of the FFIEC.

When fully implemented, I believe the final regulations will achieve the legislative purpose for which the Volcker Rule was enacted. The final regulations will limit the risks the prohibited activities pose to the safety and soundness of banking entities and the U.S. financial system in a way that will permit banking entities to continue to engage in activities that are critical to capital generation for businesses of all sizes, households, and individuals, and that facilitate liquid markets.

V. Derivatives—Title VII

Pursuant to sections 731 and 763 of the Dodd-Frank Act, banks that are "swap dealers" must register with the CFTC, and those that are "securities-based swap dealers" must register with the SEC. The swap activities of banks that must register are subject to substantive requirements under Title VII of the Act. At this time, nine national banks have provisionally registered as swap dealers.

Sections 731 and 763 also require the Federal banking agencies, together with the Federal Housing Finance Agency (FHFA) and the Farm Credit Administration (FCA), to impose minimum margin requirements on noncleared swaps and security-based swaps for swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants that are banks. These agencies published a proposal to implement these requirements on May 11, 2011.

After issuing the U.S. proposal, the Federal banking agencies participated in efforts by the Basel Committee and International Organization of Securities Commissions (IOSCO) to address coordinated implementation of margin requirements across the G–20 nations. Following extensive public comment, the Basel Committee and IOSCO finalized an international framework in September of 2013.

The Federal banking agencies, together with the FHFA and the FCA, have reviewed this framework and the comments received on the U.S. proposal. The Federal banking agencies received more than 100 comments from banks, asset managers, commercial end users, trade associations, and others. Many commenters focused on the treatment of commercial end users, urging the agencies to exempt transactions with such entities from the margin requirements in a manner consistent with the approach taken in the Basel Committee-IOSCO framework. The Federal banking agencies are currently evaluating the changes indicated under the framework and suggested by commenters and expect to issue a final rule in the coming months.

Additionally, banks that are registered swap dealers are subject to the derivatives push-out requirements in section 716 of the Dodd-Frank Act. This provision, which became effective on July 16, 2013, generally prohibits Federal assistance to swap dealers. The statute required the OCC to grant banks it supervises a transition period of up to 24 months to comply. We have granted a 24-month transition period to nine national banks and four Federal branches. We concluded that the transition period is necessary to allow banks to develop a transition plan for an orderly cessation or divestiture of certain swap activities that does not unduly disrupt lending activities and other functions that the statute required us to consider.

VI. Other Dodd-Frank Rulemakings

The OCC has made considerable progress on other Dodd-Frank requirements. In August of last year, we issued a final rule to implement a provision in section 610 of the Act, which requires that an institution's lending limit calculation account for credit exposure arising from derivatives and securities financing transactions. The new rule specifies methods to calculate this credit exposure. In addition, we joined the other members of the FFIEC and the SEC in November to propose Joint Standards for Assessing Diversity Policies and Practices of Regulated Entities. These proposed standards implement a provision in section 342 of the Dodd-Frank Act and are intended to promote transparency and awareness of diversity within these entities.

A. Appraisals

The Dodd-Frank Act contains a number of provisions relating to appraisals, and the Federal banking agencies, along with the NCUA, FHFA, and the Bureau of Consumer Financial Protection (CFPB), continue to work to implement these provisions. As I have previously reported, these agencies issued a final rule last year requiring all creditors, subject to certain exceptions, to comply with additional appraisal requirements before advancing credit for higher-risk mortgage loans. This past December, these agencies issued a supplemental final rule to revise one of the exemptions and include two additional exemptions. These changes reduce regulatory burden and reflect comments the agencies received from the public.

In the coming months, the agencies plan to publish a proposal to establish minimum requirements for State registration of appraisal management companies, known as AMCs, which serve as intermediaries between appraisers and lenders. This rule will ensure that appraisals coordinated by AMCs adhere to applicable quality control standards and will facilitate State oversight of AMCs. The proposal also will implement the Dodd-Frank Act requirement that the States' report to the FFIEC's Appraisal Subcommittee information needed to administer a national AMC registry.

The agencies also are working collaboratively on a proposal to implement specific quality control standards for automated valuation models, which are computer models used to assess the value of real estate that serves as collateral for loans or pools of loans. We expect to issue this proposal later in 2014. Finally, the agencies are considering rulemaking options to complement an interim final rule issued by the Federal Reserve in 2010 that implements statutory appraisal independence requirements.

B. Credit Risk Retention

The Federal banking agencies, together with FHFA, the SEC, and the Department of Housing and Urban Development, continue to work on implementing the credit risk retention requirements for asset securitization in section 941 of the Dodd-Frank Act. In 2011, these agencies proposed a rule to implement section 941 and received over 10,000 comments, which offered many thoughtful suggestions. These agencies concluded that the rulemaking would benefit from a second round of public review and comment, and we reproposed the rule in September 2013. Although the reproposal includes significant changes from the original proposal, its focus is the same—to ensure that sponsors are held accountable for the performance of the assets they securitize.

The comment period for the reproposal has now closed, and we are working on a final rule. While we expect to complete this project in the near future, the interagency group is working through some significant issues. For example, the agencies received a substantial number of comments regarding the definition of "qualified residential mortgage" and the extent to which it should incorporate the CFPB's definition of "qualified mortgage." The agencies also received numerous comments, including some from Members of this Committee, regarding the treatment of collateralized loan obligations. We are carefully considering these and other issues, with the goal of balancing meaningful risk retention with the availability of credit to individuals and businesses.

C. Incentive-Based Compensation Arrangements

Finally, the OCC continues to work on the implementation of section 956 of the Dodd-Frank Act, which requires us to prescribe regulations or guidelines regarding incentive-based compensation. The Federal banking agencies, along with the NCUA and the SEC, proposed a rule that would require the reporting of certain incentive-based compensation arrangements by a covered financial institution and would prohibit incentive-based compensation arrangements at a covered financial institution that provides excessive compensation or could expose the institution to inappropriate risks leading to a material financial loss. The agencies received thousands of comments on this proposal and will address the issues raised by the commenters in the final rule.

Conclusion

Thank you again for the opportunity to appear before you and to update the Committee on the OCC's continued work to implement the Dodd-Frank Act and enhance our efforts to regulate our country's national banks and Federal savings associations.

Testimony on "Oversight of Financial Stability and Data Security"
by
Chair Mary Jo White
U.S. Securities and Exchange Commission

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

February 6, 2014

Chairman Johnson, Ranking Member Crapo, and members of the Committee,

Thank you for inviting me to testify about the Securities and Exchange Commission's ("SEC" or "Commission") ongoing implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act") and our efforts regarding data security.[1]

The SEC's overarching mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The Dodd-Frank Act gave the SEC significant new responsibilities over, among other things, municipal advisors, hedge fund and other private fund advisers, and over-the-counter derivatives. The Act also established a new whistleblower program designed to strengthen the SEC's enforcement functions, enhanced the SEC's authority over credit rating agencies and clearing agencies, and strengthened the regulation of asset-backed securities. Implementing these new responsibilities has required the SEC to undertake one of the largest and most complex rulemaking agendas in the history of the agency, with more than 90 provisions that require SEC rulemaking and more than 20 other provisions that require studies or reports. In addition, the Act and the financial crisis focused the SEC's efforts more directly on enhancing financial stability and the reduction of systemic risk.

The SEC has made substantial progress implementing this agenda. Since I arrived at the Commission in April 2013, we have advanced rules and other initiatives across the wide range of regulatory objectives set by the Dodd-Frank Act, as well as the Jumpstart Our Business Startups ("JOBS") Act. Among other areas, our efforts under the Dodd-Frank Act have covered:

- The registration and regulation of over a thousand municipal advisors;
- The assessment and analytical deployment of the first complete set of data from Form PF filings by registered advisers to private funds, including hedge funds and private equity funds, so that the SEC and the Financial Stability Oversight Council ("FSOC") can better assess the impact of these funds on financial stability;
- The cross-border application of our security-based swap rules in the global swaps market;

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

- Proprietary trading and investments in private funds by banks and their affiliates, under what is commonly called the "Volcker Rule";

- Further safeguarding the custody of customer funds and securities by broker-dealers and the framework under which such custody is independently audited;

- The removal of references to nationally recognized statistical rating organization ("NRSRO") ratings in our broker-dealer and investment company regulations;

- The disclosure of the ratio of the compensation a company pays to its CEO relative to the compensation it pays its median employee;

- The disqualification of felons and other "bad actors" from important private securities offering exemptions;

- The retention of a certain amount of credit risk by securitizers of asset-backed securities; and

- Programs established by broker-dealers, investment companies, and other regulated entities to address risks of identity theft.

These efforts are in addition to the rules we have proposed or adopted to implement the JOBS Act, including rules intended to increase access to capital for smaller companies by permitting the use of general solicitation in certain private offerings, crowdfunding, and updating and expanding the Regulation A exemption. Despite our significant progress, work remains to be done with respect to both statutes. To that end, completing the rulemakings and studies mandated by Congress in these two statutes remains among the top priorities for the Commission.

As requested by the Committee, my testimony today will provide an overview of the Commission's Dodd-Frank Act implementation and discuss those rules which are yet to be completed.[2]

Municipal Securities

The Dodd-Frank Act included several provisions related to the municipal securities market, which encompasses over $3.7 trillion in outstanding municipal securities, over 44,000 municipal issuers, and an average of over 12,000 bond issues annually. The Act created a new class of regulated persons, "municipal advisors," and requires these advisors to register with the SEC. This registration requirement applies to persons who provide advice to municipal entities or obligated persons on municipal financial products or the issuance of municipal securities, or

[2] A list of the rulemaking provisions in the Dodd-Frank Act applicable to the SEC is attached as Appendix A.

who solicit municipal entities or obligated persons.[3] In September 2013, the Commission adopted final rules for municipal advisor registration.[4]

The final rules provide guidance on the statutory definition of the term "municipal advisor," the statutory exclusions from that definition, and certain additional regulatory exemptions. The new registration requirements and regulatory standards are intended to mitigate some of the problems observed with the conduct of some municipal advisors, including "pay to play" practices, undisclosed conflicts of interest, advice rendered by financial advisors without adequate training or qualifications, and failure to place the duty of loyalty to their clients ahead of their own interests. Compliance with the final rules will be required on July 1, 2014,[5] with a phased-in compliance period for registration using the final forms beginning on that day and ending on October 31, 2014.

The Dodd-Frank Act also required the Commission to establish an Office of Municipal Securities ("OMS"), reporting directly to the Chair, to administer the rules pertaining to broker-dealers, municipal advisors, investors and issuers of municipal securities, and to coordinate with the Municipal Securities Rulemaking Board ("MSRB") on rulemaking and enforcement actions.[6] During its first year of operations, OMS devoted its attention primarily to finalizing the municipal advisor registration final rules and presenting these final rules for the Commission's consideration. Over the next year, OMS expects to devote significant attention to implementing these final rules, including providing interpretive guidance to market participants, participating in the review of municipal advisor registrations, and reviewing a significant number of rule filings by the MSRB related to municipal advisor regulation. In addition, OMS also continues to monitor current issues in the municipal securities market (such as pension disclosure, accounting, and municipal bankruptcy issues) and to assist in considering further recommendations to the Commision with respect to disclosure, market structure, and price transparency in the municipal securities markets.[7]

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[3] In September 2010, the Commission adopted, and subsequently extended, an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement. *See* Release No. 34-62824, *Temporary Registration of Municipal Advisors*, (September 1, 2010), http://www.sec.gov/rules/interim/2010/34-62824.pdf. The Commission has received over 1,100 confirmed registrations of municipal advisors pursuant to this temporary rule.

[4] *See* Registration of Municipal Advisors, Release No. 34-70462 (September 20, 2013), http://www.sec.gov/rules/final/2013/34-70462.pdf. *See also* Registration of Municipal Advisors Frequently Asked Questions (issued on January 10, 2014 and last updated on January 16, 2014), http://www.sec.gov/info/municipal/mun-advisors-faqs.pdf. The staff in the Office of Municipal Securities provided this interpretive guidance to address certain questions that arose from municipal market participants relating to the implementation of the final rules.

[5] *See* Release No. 34-71288, *Registration of Municipal Advisors; Temporary Stay of Final Rule,* (January 13, 2014), http://www.sec.gov/rules/final/2014/34-71288.pdf.

[6] *See* § 979 of the Dodd-Frank Act.

[7] *See* recommendations in the Commission's Report on the Municipal Securities Market (July 31, 2012), http://www.sec.gov/news/studies/2012/munireport073112.pdf.

Private Fund Adviser Registration and Reporting

Title IV of the Dodd-Frank Act directed the Commission to implement a number of provisions designed to enhance the oversight of private fund advisers, including registration of advisers to hedge funds and other private funds that were previously exempt from SEC registration. These provisions enable regulators to have a more comprehensive view of private funds and the investment advisers managing those assets.

The SEC's implementation of required rulemaking under Title IV is complete. In June 2011, the Commission adopted rules requiring advisers to hedge funds and other private funds to register by March 2012, addressing what had once been a sizable "blind spot" in regulators' ability to monitor for systemic risk and potential misconduct.[8] As a result of the Dodd-Frank Act and the SEC's new rules, the number of SEC-registered private fund advisers has increased by more than 50% to 4,136 advisers. Even after accounting for the shift of mid-sized advisers to state registration pursuant to the Dodd-Frank Act,[9] the total amount of assets managed by SEC-registered advisers has increased significantly from $43.8 trillion in April 2011 to $55.4 trillion in December 2013, while the total number of SEC-registered advisers dropped only slightly from 11,505 to 10,920. It is also worth noting that the newly-registered private fund advisers typically have investment strategies, potential conflicts, and other regulatory issues that are much more complex than the advisers that switched to state registration.

Concurrently with the rules requiring the registration of private fund advisers, the Commission adopted rules to implement new adviser registration exemptions created by the Dodd-Frank Act.[10] The new rules implemented exemptions for advisers to venture capital funds and for advisers to private funds with less than $150 million in assets under management in the United States. Consistent with the Dodd Frank Act, these exempt reporting advisers are now required to file basic reporting information each year with the Commission, but are not subject to routine examination. Today, there are approximately 2,500 exempt reporting advisers that have filed reports with respect to almost 8,000 private funds with total assets of over $2.4 trillion.

For private fund advisers required to be registered with the Commission, pursuant to the Dodd-Frank Act, the Commission adopted confidential systemic risk reporting requirements on Form PF in October 2011 to assist the FSOC in systemic risk oversight.[11] As required by the

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[8] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

[9] *See* Release No. IA-3221, *Rules Implementing Amendments to the Investment Advisers Act of 1940* (June 22, 2011), http://www.sec.gov/rules/final/2011/ia-3221.pdf.

[10] *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.

[11] *See* Release No. IA-3308, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Joint Final Rule* (October 21, 2011), http://www.sec.gov/rules/final/2011/ia-3308.pdf.

Act, Form PF was designed in consultation with FSOC, and the data filed on Form PF has been made available to the Office of Financial Research within the Department of the Treasury.

As a result of staggered filing dates, the Commission first received a full complement of Form PF filings last year. To date, approximately 2,400 investment advisers have filed reports on approximately 7,000 hedge funds, 66 liquidity funds and 6,000 private equity funds. Consistent with enhanced confidentiality provisions established under the Dodd-Frank Act for information collected on Form PF, filings are made on a secure filing system that encrypts data, and Commission staff has designed and implemented controls for handling of Form PF data across the agency. Commission staff also uses the data in connection with the Commission's regulatory mission, including in examinations, investigations, and investor protection efforts. As required by the Dodd-Frank Act, Commission staff transmitted a report to Congress this past July on these uses.[12] Use of the new Form PF data has been a helpful supplement to the staff's overall efforts to enhance monitoring of the investment advisory industry to identify trends and emerging risks.

We recognize that the Dodd-Frank Act mandates new registration and compliance responsibilities for many private fund advisers. As a result, Commission staff has sought to better understand and take into account private fund business models and the needs of private fund investors. During 2013, Commission staff reviewed the Advisers Act and its rules and provided guidance regarding their application to private fund advisers, including guidance to clarify: when an adviser to an audited private fund may itself maintain custody of private stock certificates instead of holding them at a third party custodian;[13] when certain private fund investors are qualified clients under the Advisers Act;[14] and the application of the venture capital exemption in certain common scenarios.[15]

In addition, Commission staff has launched an initiative to conduct focused, risk-based exams of newly registered private fund advisers. These "presence" examinations are shorter in duration and more streamlined than typical examinations, and are designed both to engage with the new registrants to inform them of their obligations as registered entities and to permit the Commission to examine a higher percentage of new registrants. The initiative includes examinations, outreach, and, where appropriate, written publications highlighting exam findings. SEC examination staff has identified five critical areas that are the focus of these examinations: (1) marketing; (2) portfolio management; (3) conflicts of interest; (4) safety of client assets; and

[12] *See Annual Staff Report Regarding the Use of Data Collected from Private Fund Systemic Risk Reports* (July 25, 2013), http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.

[13] *See* IM Guidance Update, *Privately Offered Securities under the Investment Adviser Act Custody Rule* (August 2013), http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf.

[14] *See* IM Guidance Update, *Status of Certain Private Fund Investors as Qualified Clients* (November 2013), http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-10.pdf.

[15] *See* IM Guidance Update, *Guidance on the Exemption for Advisers to Venture Capital Funds* (December 2013), http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-13.pdf.

(5) valuation. As of early January 2014, staff had completed approximately 250 examinations of newly registered private fund advisers and had over 30 additional examinations underway.

Whistleblower Program

Pursuant to Section 922 of the Dodd-Frank Act, the SEC established a whistleblower program to pay awards to eligible whistleblowers who voluntarily provide the agency with original information about a violation of the federal securities laws that leads to a successful SEC enforcement action in which over $1 million in sanctions is ordered. The SEC's Office of the Whistleblower, which administers the program, filed its third Annual Report to Congress on November 15, 2013.[16] As detailed in the Annual Report, during FY 2013 the Commission received 3,238 tips from whistleblowers in the United States and 55 other countries. The high quality information that we have been receiving from whistleblowers has, in many instances, allowed our investigative staff to work more efficiently and permitted us to better utilize agency resources. In addition, on September 30, 2013, the Commission made its largest whistleblower award to date under the program, awarding over $14 million to a whistleblower whose information led to an SEC enforcement action that recovered substantial investor funds.[17] We expect future payments to further increase the visibility and effectiveness of this important enforcement initiative.

Over-the-Counter Derivatives

The Dodd-Frank Act established a new oversight regime for the over-the-counter derivatives marketplace. Title VII of the Act requires the Commission to regulate "security-based swaps" and to write rules that address, among other things: mandatory clearing; trade reporting and trade execution; the operation of clearing agencies, trade data repositories, and trade execution facilities; capital, margin, and segregation requirements and business conduct standards for dealers and major market participants; and public transparency for transactional information. Such rules are intended to achieve a number of goals, including:

- Facilitating the centralized clearing of security-based swaps, whenever possible and appropriate, with the intent of reducing counterparty and systemic risk;
- Increasing transparency for market participants and regulators in their efforts to monitor the market and, as appropriate, address risks to financial stability;
- Increasing security-based swap transaction disclosure;

[16] *Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2013* (November 2013), http://www.sec.gov/about/offices/owb/annual-report-2013.pdf.

[17] *See In the Matter of Claim for Award*, SEC Release No. 34-70554 (September 30, 2013), http://www.sec.gov/rules/other/2013/34-70554.pdf, and *SEC Awards more than $14 Million to Whistleblower*, SEC Release No. 2013-209 (October 1, 2013), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258.

- Reducing counterparty and systemic risk through capital, margin and segregation requirements for non-bank dealers and major market participants; and

- Addressing potential conflict of interest issues relating to security-based swaps.

The Commission issued a sequencing policy statement in June 2012 describing, and requesting public comment on, the order in which it expects to require compliance by market participants with its final Title VII rules.[18] The policy statement is part of our overall commitment to making sure that market participants know what the "rules of the road" are before requiring compliance with those rules. The statement emphasizes that those subject to the new regulatory requirements from these rules will be given adequate, but not excessive, time to come into compliance with them. As part of this commitment, the Commission also has taken a number of steps to provide legal certainty and avoid unnecessary market disruption pending implementation of Title VII.[19]

Consistent with this policy statement, the Commission has proposed substantially all of the core rules required by Title VII, proposed rules and interpretive guidance addressing the application of Title VII in the cross-border context, and adopted several key final rules and interpretations. In anticipation of additional final rulemakings, the Commission also last year

[18] *See* Release No. 34-37177, *Statement of General Policy on the Sequencing of the Compliance Dates for Rules Applicable to Security-Based Swaps* (June 11, 2012), http://www.sec.gov/rules/policy/2012/34-67177.pdf.

[19] These steps include guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date of Title VII, as well as temporary relief from several other provisions. *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.

In addition, the Commission has provided guidance regarding – and, where appropriate, interim exemptions from – the various pre-Dodd-Frank provisions that otherwise would have applied to security-based swaps on the effective date. *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; Release No. 34-68864, *Order Extending 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* (February 7, 2013), http://www.sec.gov/rules/exorders/2013/34-68864.pdf; Release No. 33-9231, *Exemptions for Security-Based Swaps* (July 1, 2011), http://www.sec.gov/rules/interim/2011/33-9231.pdf; and Release No. 33-9383, *Extension of Exemptions for Security-Based Swaps* (January 29, 2013), http://www.sec.gov/rules/interim/2013/33-9383.pdf.

The Commission has also provided temporary relief for entities providing certain clearing services for security-based swaps. *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.

reopened the comment periods for all of its proposals under Title VII. Continuing to complete Title VII rules is a priority for 2014.[20]

In implementing Title VII, Commission staff has consulted regularly with staff of the Commodity Futures Trading Commission ("CFTC"), as well as the staffs of the Board of Governors of the Federal Reserve System ("Board") and other federal financial regulators. We will continue to consult and coordinate with the CFTC to assure consistency and comparability to the extent possible. The Commission staff also has been actively engaged in ongoing discussions with domestic and foreign regulators regarding the direction of international derivatives regulation and the Commission's efforts to implement Title VII, including participation in the Financial Stability Board and the International Organization of Securities Commissions, and engaging in regulatory dialogues with other countries about our respective regulatory reform efforts.

The Commission's more recent efforts to implement Title VII are discussed below in more detail.

Proposal of Rules Regarding the Application of Title VII in the Cross-Border Context

Given the highly global nature of the derivatives market, the application of Title VII in the cross-border context is a key implementation issue. In May 2013, the Commission issued a comprehensive proposal regarding the application of Title VII to cross-border security-based swap transactions (the "Cross-Border Proposal").[21] The Cross-Border Proposal includes proposed rules and interpretive guidance that, among other things, would inform parties to a security-based swap transaction about which regulatory requirements apply when their transaction occurs in part within and in part outside the United States. In addition, the Cross-Border Proposal provides proposed interpretive guidance regarding when a trading platform or clearing agency is required to register with the Commission.

Under the Cross-Border Proposal, a party may have the ability to comply with Commission requirements in one or more areas covered by the Title VII rules by complying instead with some or all of the requirements of a foreign regulatory regime, provided that those requirements have been determined by the Commission to achieve comparable regulatory outcomes. The Cross-Border Proposal refers to this approach as "substituted compliance." Under substituted compliance, a foreign market participant would be permitted to comply with the requirements imposed by its own home country, so long as those requirements achieve regulatory outcomes comparable with the regulatory outcomes of the relevant provisions of Title VII, as determined by the Commission. If the home country does not have requirements that

[20] *See* Release No. 34-69491, *Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act* (May 1, 2013), http://www.sec.gov/rules/proposed/2013/34-69491.pdf.

[21] *See* Release No. 34-69490, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (May 1, 2013), http://sec.gov/rules/proposed/2012/34-68071.pdf.

achieve comparable regulatory outcomes, substituted compliance would not be permitted and the foreign entity would be required to comply with the applicable U.S. requirements.

The Commission is actively reviewing public input on the Cross-Border Proposal, as well as public comment we have received on other Title VII proposals, including in response to the reopening of the comment periods on those proposals. In addition, we are considering the final cross-border guidance approved by the CFTC on July 12, 2013, public comment on that guidance, and subsequent developments, including a pending legal challenge, related to that guidance.

Adoption of Key Definitional Rules

In July 2012, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII.[22] This effort follows the Commission's work on the entity definition rules, which the Commission adopted jointly with the CFTC in April 2012.[23] The completion of these joint rulemakings was a foundational step toward the complete implementation of Title VII.

Although foundational, these final rules did not trigger compliance with the other rules the Commission is adopting under Title VII. Instead, the compliance dates applicable to each final rule will be set forth in the adopting release for the applicable rule in order to better provide for an orderly implementation of the various Title VII rules.

Next Steps for Implementation of Title VII

The Commission staff continues to work to develop recommendations for final rules required by Title VII that have been proposed but not yet adopted. These final rules will address:

- Application of Title VII in the cross-border context;
- Regulatory reporting and post-trade public transparency;[24]

[22] *See* Release No. 33-9338, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (July 18, 2012) http://www.sec.gov/rules/final/2012/33-9338.pdf.

[23] *See* Release No. 34-66868, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"* (April 27, 2012) http://www.sec.gov/rules/final/2012/34-66868.pdf. *See also* Memorandum from the Division of Risk, Strategy, and Financial Innovation, *Information regarding activities and positions of participants in the single-name credit default swap market* (March 15, 2012) http://www.sec.gov/comments/s7-39-10/s73910-154.pdf (analyzing the level of trading activity and positions in the credit default swap market to assist the Commission in evaluating the impact of alternative approaches to implementing *de minimis* exceptions to certain definitions).

[24] *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; and 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. In 2013, the Commission re-proposed Regulation SBSR. *See* Release No. 34-69490, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and*

- Security-based swap dealers and major security-based swap participant requirements;[25]
- Mandatory clearing and trade execution, and the regulation of clearing agencies and security-based swap execution facilities;[26] and
- Enforcement and market integrity.[27]

As indicated in the Cross-Border Proposal, the Commission is likely to consider certain of the issues presented in that proposal in an initial cross-border adopting release. Under such an approach, this initial cross-border adopting release would likely focus on adopting key definitions relevant to the application of Title VII in the cross-border context; other matters raised by the Cross-Border Proposal would be addressed in subsequent releases. Such an approach would allow the Commission to consider the cross-border application of the substantive requirements imposed by Title VII in conjunction with the final rules that will implement those substantive requirements.

In addition, I expect that the Commission in the short term will consider rules relating to recordkeeping and reporting requirements for security-based swap dealers and major security-based swap participants. I also expect that the Commission will consider the application of

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Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (May 1, 2013), http://www.sec.gov/rules/proposed/2013/34-69490.pdf; and Release No. 34-69491.

[25] *See* Release No. 34-65543, *Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65543.pdf; Release No. 34-68071, *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers* (October 18, 2012), http://www.sec.gov/rules/proposed/2012/34-68071.pdf; 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; and 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.

[26] *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; 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; and *Registration and Regulation of Security-Based Swap Execution Facilities* (February 2, 2011), http://www.sec.gov/rules/proposed/2011/34-63825.pdf.

In March 2012, the Commission adopted rules providing exemptions under the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), and the Trust Indenture Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions. *See* Release No. 33-9308, *Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies* (March 30, 2012), http://www.sec.gov/rules/final/2012/33-9308.pdf.

[27] *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.

mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act.

Clearing Agencies

Title VIII of the Dodd-Frank Act provides for increased regulation of financial market utilities[28] ("FMUs") and financial institutions that engage in payment, clearing, and settlement activities designated as systemically important. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability. In addition, Title VII of the Dodd-Frank Act requires, among other things, that an entity acting as a clearing agency with respect to security-based swaps register with the Commission and that the Commission adopt rules with respect to clearing agencies that clear security-based swaps.

Adoption of Clearing Agency Standards

To further these objectives and promote the integrity of clearing agency operations and governance, the Commission adopted rules in October 2012 requiring all registered clearing agencies to maintain certain standards with respect to risk management and certain operational matters.[29] The rules also contain specific requirements for clearing agencies that perform central counterparty services, such as provisions governing credit exposures and the financial resources of the clearing agency. The rules also establish recordkeeping and financial disclosure requirements for all registered clearing agencies.

These rules benefited from consultations between the Commission staff and staffs of the CFTC and the Board, and take into consideration international standards. The requirements 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.

Systemically Important Clearing Agencies

Under Title VIII, FSOC is authorized to designate an FMU as systemically important if the failure or a disruption to the functioning of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system. SEC staff participates in the interagency committee established by FSOC to develop a framework for the designation of

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[28] 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."

[29] *See* Release No. 34-68080, *Clearing Agency Standards* (October 22, 2012), http://www.sec.gov/rules/final/2012/34-68080.pdf.

systemically important FMUs. In July 2012, FSOC designated six clearing agencies registered with the Commission as systemically important FMUs under Title VIII.[30]

Title VIII also provides a framework for an enhanced supervisory regime for designated FMUs, including oversight in consultation with the Board and FSOC. The Commission is expected to consider regulations containing risk management standards for the designated FMUs it supervises, taking into consideration relevant international standards and existing prudential requirements for such FMUs.[31] The Commission also is required to examine such FMUs annually, and to consider certain advance notices identifying changes to its rules, procedures, or operations that could materially affect the nature or level of risks presented by the FMU in consultation with the Board.[32]

In June 2012, the Commission adopted rules that establish procedures for how it will address advance notices from the FMUs,[33] and it has since considered a significant number of such notices.[34] Commission staff also has completed the first series of annual examinations of the designated FMUs for which it acts as supervisory agency and recently initiated the second series of annual examinations.

Credit Rating Agencies

The Dodd-Frank Act requires the Commission to undertake a number of rulemakings related to NRSROs. The Commission began the process of implementing these mandates with the adoption of a new rule in January 2011[35] requiring NRSROs to provide a description of the

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[30] Clearing agencies that have been designated systemically important are Chicago Mercantile Exchange, Inc., The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, and The Options Clearing Corporation.

[31] *See* § 805(a)(2) of the Dodd-Frank Act. Commission staff also worked jointly with the staffs of the CFTC and the Board to submit a report required under the Dodd-Frank Act to Congress in July 2011 discussing recommendations regarding risk management supervision of clearing entities that are DFMUs. Risk Management Supervision of Designated Clearing Entities, Report by the Commission, Board and CFTC to the Senate Committees on Banking, Housing, and Urban Affairs and Agriculture in fulfillment of Section 813 of Title VIII of the Dodd-Frank Act (July 2011), http://www.sec.gov/news/studies/2011/813study.pdf.

[32] *See* § 806(e)(4) of the Dodd-Frank Act.

[33] *See* Release No. 34-67286, *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* (June 28, 2012), http://www.sec.gov/rules/final/2012/34-67286.pdf.

[34] Advance notices are published on the Commission website at http://www.sec.gov/rules/sro.shtml.

[35] *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. In addition, pursuant to Section 939B of the Act, the Commission issued an amendment to Regulation FD to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. *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.

representations, warranties, and enforcement mechanisms available to investors in an offering of asset-backed securities, including how they differ from those of similar offerings. In May 2011, the Commission proposed a series of rules to further implement the NRSRO provisions of the Dodd-Frank Act,[36] which would require NRSROs to: (1) report on internal controls; (2) protect against potential conflicts of interest; (3) establish professional standards for credit analysts; (4) publicly provide – along with the publication of the credit rating – disclosure about the credit rating and the methodology used to determine it; and (5) enhance their public disclosures about the performance of their credit ratings. I expect that the Commission will consider final rules in the near future.

Additionally, the Dodd-Frank Act requires each federal agency, to the extent applicable, to review its regulations that require use of credit ratings as an assessment of the credit-worthiness of a security, remove these references, and replace them with appropriate standards of credit-worthiness. The Commission has adopted final amendments that remove references to credit ratings from most of its rules and forms that contained such references, including rules adopted in December 2013 removing references to credit ratings in certain provisions applicable to investment companies and broker-dealers.[37] In the short term, I expect that the Commission will vote on new requirements to replace the credit rating references in shelf eligibility criteria for asset-backed security issuers with new shelf eligibility criteria.

The Dodd-Frank Act also mandated three studies relating to credit rating agencies: (1) a study on the feasibility and desirability of standardizing credit rating terminology, which was published in September 2012;[38] (2) a study on alternative compensation models for rating structured finance products, which was published in December 2012;[39] and (3) a study on NRSRO independence, which was published in November 2013.[40] In response to the study on

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[36] *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.

[37] *See* Release No. 34-60789, *References to Ratings of Nationally Recognized Statistical Rating Organizations*, (October 5, 2009) (pre Dodd-Frank Act adopting amendments to remove references to credit ratings in certain Commission rules) http://www.sec.gov/rules/final/2009/34-60789.pdf; Release No. 33-9245, *Security Ratings*, (July 27, 2011) (post Dodd-Frank Act adopting amendments to remove references to credit ratings in certain Commission rules) http://www.sec.gov/rules/final/2011/33-9245.pdf; Release No. 33-9506, *Removal of Certain References to Credit Ratings Under the Investment Company Act*, (December 27, 2013) (post Dodd-Frank Act adopting amendments to remove references to credit ratings in certain Commission rules), http://www.sec.gov/rules/final/2013/33-9506.pdf; Release No. 34-71194, *Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934*, (December 27, 2013) (post Dodd-Frank Act adopting amendments to remove references to credit ratings in certain Commission Rules), http://www.sec.gov/rules/final/2013/34-71194.pdf.

[38] *Credit Rating Standardization Study* (September 2012), http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.

[39] *Report to Congress on Assigned Credit Ratings* (December 2012), http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf.

[40] *Report to Congress on Credit Rating Agency Independence Study* (November 2013), http://www.sec.gov/news/studies/2013/credit-rating-agency-independence-study-2013.pdf.

alternative compensation models for rating structured finance products, the Commission held a public roundtable in May 2013 to invite discussion regarding, among other things, the courses of action discussed in the report. The staff has considered the various viewpoints presented during discussion at the roundtable, as well as in the related public comment letters, and I expect that they will be presenting to the Commission a recommendation for its consideration.

As required by the Dodd-Frank Act, the Commission established an Office of Credit Ratings ("OCR") charged with administering the rules of the Commission with respect to NRSROs, promoting accuracy in credit ratings issued by NRSROs, and helping to ensure that credit ratings are not unduly influenced by conflicts of interest and NRSROs provide greater disclosure to investors.[41] The Dodd-Frank Act requires OCR to conduct examinations of each NRSRO at least annually and the Commission to make available to the public an annual report summarizing the essential exam findings. The third annual report of the staff's examinations was published in December 2013.[42] The staff will continue to focus on completing the annual examinations of each NRSRO, including follow-up from prior examinations, to promote compliance with statutory and Commission requirements. OCR also has established "colleges" of regulators to provide a framework for information exchange and collaboration with foreign counterparts regarding large, globally-active credit rating agencies.[43] The first meetings of the colleges were held in November 2013.

Asset-Backed Securities

The Commission has made significant progress in implementing the provisions of the Dodd-Frank Act related to asset-backed securities ("ABS"). The Commission is working with other regulators to jointly develop the risk retention rules required by Section 941 of the Act, which will address the appropriate amount, form, and duration of required risk retention for ABS securitizers. In March 2011, the Commission joined its fellow regulators in issuing for public comment proposed risk retention rules to implement Section 941.[44] We carefully considered the

[41] OCR's scope for NRSRO examinations includes all eight areas required by the Dodd-Frank Act. OCR conducts annual, risk-based examinations of all registered NRSROs to assess and promote compliance with statutory and Commission requirements, monitors the activities of NRSROs, and provides guidance with respect to the Commission's policy and regulatory initiatives related to NRSROs. OCR also conducts special risk-targeted examinations based on credit market issues and concerns and to follow up on tips, complaints, and NRSRO self-reported incidents.

[42] *2013 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization* (December 2013), http://www.sec.gov/news/studies/2013/nrsro-summary-report-2013.pdf.

[43] *See Supervisory Colleges for Credit Rating Agencies – Final Report* (July 2013), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD416.pdf.

[44] *See* Release No. 34-64148, *Credit Risk Retention* (March 30, 2011), http://www.sec.gov/rules/proposed/2011/34-64148.pdf. Section 941 of the Act generally requires the Commission, the Board, the Federal Deposit Insurance Corporation, the 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 ABS, transfers, sells, or conveys to a third party. It also provides that

many comments received on the original proposal and engaged in further analysis of the securitization and lending markets,[45] ultimately re-proposing the credit risk retention rules with several important modifications in August 2013.[46]

As under the original proposal, a sponsor generally would be permitted under the re-proposal to satisfy its risk retention requirement by choosing from a menu of options designed to provide flexibility while also ensuring that sponsors actually retain credit risk. The re-proposed rules would significantly increase the degree of flexibility that sponsors would have to meet the risk retention requirements. The re-proposed rules also include exemptions from risk retention for certain resecuritizations, seasoned loans, and certain types of securitization transactions with low credit risk. Also, as required by Section 941, the re-proposal provides an exemption from the risk retention requirements for ABS collateralized solely by qualified residential mortgages ("QRMs"). The re-proposal would equate the QRM definition to the definition of qualified mortgage ("QM") adopted by the Consumer Financial Protection Bureau,[47] but also requests comment on an alternative approach to QRM that would add a 70% loan-to-value requirement and certain credit history-related factors.[48] The staff currently is considering the numerous comments received on the re-proposal and working with the other agencies' staff to move forward with appropriate recommendations for a final rule.

In addition, in August 2011, the Commission adopted rules in connection with Section 942(a) of the 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 new rules 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.[49] I expect that in the short term the Commission will consider new requirements for enhanced disclosures for ABS, including requiring standardized asset-level data for certain asset

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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. *See* 15 U.S.C. §78o-11(c)(1)(A).

[45] *See, e.g.*, Division of Economic and Risk Analysis White Paper, *Qualified Residential Mortgage: Background Data Analysis on Credit Risk Retention* (August 2013) (analyzing serious delinquencies among non-GSE securitized mortgages in order to address public comment and to aid in the understanding of potential economic effects related to the definition of QRM), http://www.sec.gov/divisions/riskfin/whitepapers/qrm-analysis-08-2013.pdf.

[46] *See* Release No. 33-34-70277, *Credit Risk Retention* (August 28, 2013), http://www.sec.gov/rules/proposed/2013/34-70277.pdf.

[47] *See* 78 FR 6407 (January 30, 2013), as amended by 78 FR 35429 (June 12, 2013) and 78 FR 44686 (July 24, 2013).

[48] This credit overlay is designed to approximate a 690 FICO score without building into the rule reliance on a private credit rating.

[49] *See* Release No. 34-65148, *Suspension of the Duty to File Reports for Classes of Asset-Backed Securities under Section 15(d) of the Securities Exchange Act of 1934* (August 17, 2011), http://www.sec.gov/rules/final/2011/34-65148.pdf.

classes. If adopted, the new requirements would implement Section 942(b) of the Act, which requires the Commission to adopt regulations to require asset-level information.

In January 2011, the Commission also adopted rules on the use of representations and warranties in the market for ABS as required by the Act's Section 943.[50] The rules require ABS issuers to disclose the history of repurchase requests received and repurchases made relating to their outstanding ABS, and these disclosure filings commenced in February 2012. The disclosure requirements apply to issuers of registered and unregistered ABS, including municipal ABS. The Commission also adopted rules in January 2011 to implement Section 945 of the Dodd-Frank Act, which required an asset-backed issuer transaction registered under the Securities Act to perform a review of the assets underlying the ABS and disclose the nature of such review.[51] Under the final rules, the type of review conducted may vary, but at a minimum must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects.

In September 2011, the Commission proposed a rule to implement Section 621 of the Act, which prohibited entities that create and distribute ABS from engaging in transactions that involve or result in material conflicts of interest with respect to the investors in such ABS.[52] The proposed rule would prohibit underwriters and other "securitization participants" from engaging in such transactions with respect to both non-synthetic and synthetic asset-backed securities, whether in a registered or unregistered offering. The proposal is not intended to prohibit legitimate securitization activities, and the Commission asked questions in the release to help strike the appropriate balance. The Commission received a number of comments on the proposal, and the staff is carefully considering those comments in preparing its recommendation to the Commission.

Investment Advisers and Broker-Dealers' Standards of Conduct

In January 2011, the Commission submitted to Congress a staff study required by Section 913 of the Dodd-Frank Act (the "IA/BD Study"), which addressed the obligations of investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers.[53] The IA/BD Study made two primary recommendations: that the Commission

[50] *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.

[51] *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.

[52] *See* Release No. 34-65355, *Prohibition against Conflicts of Interest in Certain Securitizations* (September 19, 2011), http://www.sec.gov/rules/proposed/2011/34-65355.pdf.

[53] *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.

(1) exercise the discretionary rulemaking authority provided by Section 913 of the Dodd-Frank Act 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.

Shortly before I joined the Commission, the Commission issued a public Request for Data and Other Information (the "Request") specific to the provision of retail investment advice and regulatory alternatives.[54] The Commission sought, among other things, information relating to the potential impacts a uniform fiduciary standard of conduct, or other regulatory approaches, may have on retail customer costs and access to personalized investment advice and product and service offerings, and how such negative impacts could be mitigated.

Serious consideration is being given to the IA/BD Study's recommendations, the views of investors and other interested market participants, potential economic and market impacts, and the information we received in response to the Request in deciding whether, and if so, how, to exercise our rulemaking authority. The Commission staff is also coordinating with, and providing our expertise to, Department of Labor staff as they consider potential changes to the definition of "fiduciary" under the Employee Retirement Income Security Act. I have prioritized the staff's consideration of these inputs and the substantial issues to be decided.

Volcker Rule

On December 10, 2013, the Commission joined the Board, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC") (collectively, the "Federal banking agencies"), and the CFTC in adopting the same rule under the Bank Holding Company Act to implement Section 619 of the Dodd-Frank Act, generally referred to as the "Volcker Rule."[55]

To create the final rule, staffs from each of the five agencies engaged in a wide-ranging and extensive process to address issues and develop approaches related to effective

[54] *See Request for Data and Other Information: Duties of Brokers, Dealers and Investment Advisers* (March 1, 2013), http://www.sec.gov/rules/other/2013/34-69013.pdf.

[55] *See* Release No. BHCA-1, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (December 10, 2013), http://www.sec.gov/rules/final/2013/bhca-1.pdf. The Commodity Futures Trading Commission ("CFTC") adopted the same common rule on the same date. *See* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister121013.pdf. On January 14, 2014, the Commission, together with the federal banking agencies and the CFTC, approved a companion interim final rule that permits banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities. *See* Release No. BHCA-2, *Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds* (Jan. 17, 2014), http://www.sec.gov/rules/interim/2014/bhca-2.pdf.

implementation of the statute. The Commission, like the other agencies, received and reviewed thousands of comment letters on the statutory mandate and the proposed rules that the Federal banking agencies and SEC jointly published to implement the Volcker Rule.[56] The comments covered a wide spectrum of issues, with many expressing concern about potential negative impacts on market liquidity as well as evasion concerns. The Commission, together with the other agencies, responded to these comments by crafting a rule that both reduces the potential impacts on market liquidity while also addressing concerns about proprietary trading through a robust compliance program.

Consistent with Section 619 and the interagency proposal, the final rule generally prohibits "banking entities" – including bank-affiliated, SEC-registered broker-dealers, security-based swap dealers, and investment advisers – from engaging as principal for their own trading accounts by taking positions in various securities and instruments for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short term price movements.[57] At the same time, the statute and final rule preserve certain essential financial services such as market making and underwriting, which are necessary for raising capital and the healthy functioning of the U.S. financial system, including our securities markets. Consistent with the statute, the final rule does not, however, allow for these specified permitted activities if they involve material conflicts of interest or the employment of high-risk assets or trading strategies, or if they threaten the safety and soundness of banking institutions or U.S. financial stability.

The final rule takes a measured but robust approach to implementing the statutory exemptions from the prohibition on proprietary trading for market making and underwriting. This approach benefited from a consideration of commenter views on potential economic impacts, particularly with respect to liquidity in off-exchange markets, while preserving an appropriate separation between prohibited proprietary trading and activities permitted by the statute, and taking meaningful steps to prevent evasion.

The final rule also implements the statutory provisions limiting the ability of banking entities to sponsor or invest in hedge funds and private equity funds. The Dodd-Frank Act defined a "hedge fund" and "private equity fund" by reference to the regulatory exemptions

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[56] *See* Release No. 34-65545, *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds* (October 12, 2011), http://www.sec.gov/rules/proposed/2011/34-65545.pdf. The CFTC issued a substantially similar proposal in January 2012, which was published in the Federal Register in February 2012. *See* 77 FR 8332 (February 14, 2012), http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2012-935.

[57] Section 619 defines "banking entity" as any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (*i.e.*, a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.), and any affiliate or subsidiary of any of the foregoing entities. *See* 12 U.S.C. 1851(h)(1). As set forth in the Dodd-Frank Act, the Commission's final rule applies to banking entities for which the Commission is the primary financial regulatory agency, including, among others, certain SEC-registered broker-dealers, investment advisers, and security-based swap dealers.

under the securities laws commonly used by such funds.[58] The proposal carried forward this definition of a "covered fund," and included in the definition certain commodity pools and foreign funds.

Responding to extensive comments received, the final rule refines the definition of a "covered fund," making clear that certain entities (e.g., entities used for general corporate – rather than investment – purposes; mutual funds and certain foreign funds publicly offered abroad) that should not present the same risks as the covered funds targeted by the statute are excluded. The final rule also takes a tailored approach with respect to foreign funds and commodity pools, and provides an exclusion for loan securitizations to implement the statutory provision regarding the "sale and securitization of loans" by banking entities.

As with any regulatory initiative of this scope and complexity, the final rule demands close attention to the nature and pace of implementation, particularly with respect to smaller banking entities. The final rule's reporting and compliance program requirements are already focusing both the regulatory agencies and firms on implementation. The staged implementation of the required reporting of quantitative trading data will facilitate reporting that is appropriate for the size of the banking entity's trading activities, and allow the agencies to review the merits of the data collected and revise the data collection as appropriate. The threshold for reporting also has been adjusted to help ensure that it will be focused on the largest trading firms. Similarly, the compliance program requirements in the final rule are tiered based on the consolidated size of a firm or its trading activities, and the schedule for compliance will be phased in over time, in order to reduce unnecessary burdens and costs without compromising the objectives of the rule.

Consistent with our experience in other rulemakings, we expect a continued need for guidance regarding questions that will arise as market participants seek to comply with the final rule. We must be alert to both unintended impacts and regulatory loopholes as we move forward. The collaborative relationships among the agencies that developed during the rulemaking process are carrying forward and already are supporting joint and coordinated guidance, such as the recent interim final rule issued by the agencies with respect to the treatment of certain collateralized debt obligations backed by trust-preferred securities.

The agencies have formed an interagency working group that will meet regularly to discuss implementation of the final rule. This interagency group will be instrumental in coordinating the agencies' interpretations and implementation of the final rule on a going-forward basis. The working group's first meeting occurred on January 23 of this year, and the group plans to convene again later this week. Among other things, the group discussed potential methods of coordinating responses to interpretive questions and approaches to supervising and examining banking entities. Such collaboration should carry forward not just in implementing the rule, but also in coordinating the compliance and enforcement of the rule.

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[58] Section 619 of the Dodd-Frank Act defines the terms "hedge fund" and "private equity fund" to mean an issuer that would be an investment company, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or "such similar funds" as the agencies determine by rule.

Broker-Dealer Audit Requirements

The Dodd-Frank Act provided the Public Company Accounting Oversight Board ("PCAOB") with explicit authority, among other things, to establish, subject to Commission approval, auditing standards for broker-dealer audits filed with the Commission. In August 2013, the Commission amended the broker-dealer financial reporting rule to require that broker-dealer audits be conducted in accordance with PCAOB standards and to more broadly provide additional safeguards with respect to broker-dealer custody of customer securities and funds.[59]

Corporate Governance and Executive Compensation

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

- **Say on Pay.** In accordance with Section 951 of the Act, in January 2011 the Commission adopted rules that require 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.[60] Companies (other than smaller reporting companies) began providing these say-on-pay and "say-on-frequency" advisory votes at shareholder meetings occurring on or after January 21, 2011. The rules provided smaller reporting companies a two-year delayed compliance period for the say-on-pay and "frequency" votes, and those companies began complying with the rules on January 21, 2013. The Commission also proposed rules to implement the Section 951 requirement that institutional investment managers report their votes on these matters at least annually.[61]

- **Pay Ratio Disclosure**. As required by Section 953(b) of the Act, in September 2013, the Commission proposed rules that would amend existing executive compensation rules to require public companies to disclose the ratio of the compensation of a company's chief executive officer to the median compensation of its employees.[62] The proposed rules

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[59] *See* Release No. 43-0073, *Broker-Dealer Reports* (Aug. 21, 2013), http://www.gpo.gov/fdsys/pkg/FR-2013-08-21/pdf/2013-18738.pdf.

[60] *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.

[61] *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.

[62] *See* Release No. 33-9452, *Pay Ratio Disclosure* (September 18, 2013), http://www.sec.gov/rules/proposed/2013/33-9452.pdf.

would allow companies flexibility in developing the disclosure required by the Act by allowing companies to select a calculation methodology that is appropriate to the size and structure of their own businesses and the way they compensate employees. The proposed rules also permit the use of statistical sampling. The Commission has received numerous comments on the proposal, and the staff is working to prepare recommendations for the Commission on a final rule.

- **Compensation Committee and Adviser Requirements.** In June 2012, the Commission adopted rules to implement Section 952 of the Act, which requires the Commission, by rule, to 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.[63] The new rules direct the exchanges to establish listing standards concerning compensation advisers and listing standards that require each member of a listed issuer's compensation committee to be an "independent" member of the board of directors. The rules also require disclosure about the use of compensation consultants and related conflicts of interest. To conform their rules governing independent compensation committees to the new requirements, national securities exchanges that have rules providing for the listing of equity securities filed proposed rule changes with the Commission.[64] The Commission issued final orders approving the proposed rule changes in January 2013.[65]

- **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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[63] *See* Release No. 33-9330, *Listing Standards for Compensation Committees* (June 20, 2012), http://www.sec.gov/rules/final/2012/33-9330.pdf.

[64] *See* Release No. 34-68022 (October 9, 2012), http://www.sec.gov/rules/sro/bats/2012/34-68022.pdf (BATS Exchange, Inc.); Release No. 34-68020 (October 9, 2012), http://www.sec.gov/rules/sro/cboe/2012/34-68020.pdf (Chicago Board of Options Exchange, Inc.); Release No. 34-68033 (October 10, 2012), http://www.sec.gov/rules/sro/chx/2012/34-68033.pdf (Chicago Stock Exchange, Inc.); Release No. 34-68013 (October 9, 2012), http://www.sec.gov/rules/sro/nasdaq/2012/34-68013.pdf (Nasdaq Stock Market LLC); Release No. 34-68018 (October 9, 2012), http://www.sec.gov/rules/sro/bx/2012/34-68018.pdf (Nasdaq OMX BX, Inc.); Release No. 34-68039 (October 11, 2012), http://www.sec.gov/rules/sro/nsx/2012/34-68039.pdf (National Stock Exchange, Inc.); Release No. 34-68011 (October 9, 2012), http://www.sec.gov/rules/sro/nyse/2012/34-68011.pdf (New York Stock Exchange LLC); Release No. 34-68006 (October 9, 2012), http://www.sec.gov/rules/sro/nysearca/2012/34-68006.pdf (NYSEArca LLC); Release No. 34-68007 (October 9, 2012), http://www.sec.gov/rules/sro/nysemkt/2012/34-68007.pdf (NYSE MKT LLC).

[65] *See* Release No. 34-68643 (January 11, 2013), http://www.sec.gov/rules/sro/bats/2013/34-68643.pdf (BATS Exchange, Inc.); Release No. 34-68642 (January 11, 2013), http://www.sec.gov/rules/sro/cboe/2013/34-68642.pdf (Chicago Board of Options Exchange, Inc.); Release No. 34-68653 (January 14, 2013), http://www.sec.gov/rules/sro/chx/2013/34-68653.pdf (Chicago Stock Exchange, Inc.); Release No. 34-68640 (January 11, 2013), http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf (Nasdaq Stock Market LLC); Release No. 34-68641 (January 11, 2012), http://www.sec.gov/rules/sro/bx/2013/34-68641.pdf (Nasdaq OMX BX, Inc.); Release No. 34-68662 (January 15, 2012), http://www.sec.gov/rules/sro/nsx/2013/34-68662.pdf (National Stock Exchange, Inc.); Release No. 34-68635 (January 11, 2013), http://www.sec.gov/rules/sro/nyse/2013/34-68635.pdf (New York Stock Exchange LLC); Release No. 34-68638 (January 11, 2013), http://www.sec.gov/rules/sro/nysearca/2013/34-68638.pdf (NYSEArca LLC); Release No. 34-68637 (January 11, 2013), http://www.sec.gov/rules/sro/nysemkt/2013/34-68637.pdf (NYSE MKT LLC).

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 2011, the Commission published for public comment a proposed rule that would address such arrangements.[66] The Commission has received many 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 making a recommendation for Commission consideration.

- **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 in director elections (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. The Commission has approved changes to the rules with regard to director elections and executive compensation matters for all of the national securities exchanges, and these rules are all now effective.[67]

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,[68] and new disclosure requirements about executive compensation and company performance,[69] and employee and director hedging.[70] The

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[66] *See* Release No. 34-64140 (March 29, 2011), http://www.sec.gov/rules/proposed/2011/34-64140.pdf.

[67] *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. 34-64024 (March 3, 2011), http://www.sec.gov/rules/sro/bx/2011/34-64024.pdf (Boston Options Exchange Group, LLC); 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); Release No. 34-65449 (September 30, 2011), http://www.sec.gov/rules/sro/bats/2011/34-65449.pdf (BATS Exchange, Inc.); Release No. 34-65448 (September 30, 2011), http://www.sec.gov/rules/sro/byx/2011/34-65448.pdf (BATS Y-Exchange, Inc.); Release No. 34-65804 (November 22, 2011), http://www.sec.gov/rules/sro/nsx/2011/34-65804.pdf (National Stock Exchange, Inc.); Release No. 34-66006 (December 20, 2011) http://www.sec.gov/rules/sro/nyseamex/2011/34-66006.pdf. (NYSE Amex LLC); Release No. 34-66192 (January 19, 2012), http://www.sec.gov/rules/sro/nysearca/2012/34-66192.pdf (NYSE Arca, Inc.); and Release No. 68723 (January 24, 2013) (MIAX-2013-02).

[68] *See* § 954 of the Dodd-Frank Act.

[69] *See* § 953(a) of the Dodd-Frank Act.

[70] *See* § 955 of the Dodd-Frank Act.

staff currently is in the process of developing recommendations for the Commission concerning the implementation of these provisions of the 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 adopted final rules for the mine safety provision in December 2011,[71] and companies are currently complying with those rules. In addition, the Commission adopted final rules for disclosure relating to conflict minerals and payments by resource extraction issuers in August 2012.[72]

A lawsuit was filed challenging the resource extraction issuer rules, and in July 2013, the U.S. District Court for the District of Columbia vacated the rules.[73] The Commission did not appeal the decision and is considering the Court's decision in determining how to proceed with the rulemaking to implement the statutory mandate.

A lawsuit also was filed challenging the conflict minerals rule, and in July 2013, the U.S. District Court for the District of Columbia upheld the rule.[74] This ruling, however, has been appealed to the U.S. Court of Appeals for the D.C. Circuit. The Court expedited consideration of the case and the oral argument was held last month. A stay of the conflict minerals rule has not been requested, and issuers are expected to provide their initial filings by May 31, 2014.

Exempt Offerings

In December 2011, the Commission adopted rule amendments to 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.[75] Section 413(a) was effective on the date of

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[71] *See* Release No. 33-9286, *Mine Safety Disclosure* (December 21, 2011), http://www.sec.gov/rules/final/2011/33-9286.pdf.

[72] *See* Release No. 34-67716, *Conflict Minerals* (August 22, 2012), http://www.sec.gov/rules/final/2012/34-67716.pdf and *Disclosure of Payments by Resource Extraction Issuers* (August 22, 2012), http://www.sec.gov/rules/final/2012/34-67717.pdf.

[73] *American Petroleum Institute, et al. v. Securities and Exchange Commission and Oxfam America Inc.*, No. 12-1668 (D.D.C. July 2, 2013).

[74] *National Association of Manufacturers, et al. v. Securities and Exchange Commission, Amnesty International USA, and Amnesty International Ltd.*, 12-1422 (D.D.C. July 23, 2013).

[75] *See* Release No. 33-9287, *Net Worth Standard for Accredited Investors* (December 21, 2011) and (March23, 2012), http://www.sec.gov/rules/final/2011/33-9287.pdf and http://www.sec.gov/rules/final/2012/33-9287a.pdf (technical amendment).

enactment of the Dodd-Frank Act and the implementing rules clarify the requirements and codify them in the Commission's rules. Section 413(b)(2)(A) of the Act requires the Commission to undertake a review of the accredited investor definition in its entirety as it relates to natural persons four years after the enactment of the Act. The staff is currently conducting this review and I expect that the Commission will consider whether to propose any changes to the definition once the review is completed.

Section 926 of the Act requires the Commission 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 adopted final rules to implement this requirement on July 10, 2013, and the rules became effective on September 23, 2013.[76]

Office of Minority and Women Inclusion

In July 2011, pursuant to Section 342 of the Dodd Frank Act, the SEC formally established its Office of Minority and Women Inclusion ("OMWI"). OMWI is responsible for matters related to diversity in management, employment and business activities at the SEC. This includes developing standards for equal employment opportunity and diversity of the workforce and senior management of the SEC, the increased participation of minority-owned and women-owned businesses in the SEC's programs and contracts, and assessing the diversity policies and practices of entities regulated by the SEC.

To improve diversity in our workforce and in our contracts, OMWI has deployed a broad outreach strategy where the SEC participates in minority- and women-focused career fairs, conferences, and business matchmaking events to attract diverse suppliers and jobseekers to the SEC. As a result of its outreach efforts, in FY 2013, 28.4% of the total contract dollars awarded by the SEC were awarded to women and minority contractors, an increase of 6.5% over the prior year. In FY 2013, 33% of new hires were minorities and 40% were women, up from 31% and 36% respectively in FY 2012. OMWI and the Commission are committed to continuing to work proactively to increase the participation of minority-owned and women-owned businesses in our programs and contracting opportunities and to encourage diversity and inclusion in our workforce.

As required by Section 342 of the Dodd-Frank Act, OMWI also continues to make progress on the development of standards and policies relating to regulated entities and contracting. On October 23, 2013, pursuant to section 342(b)(2)(C) of the Act, the SEC, along with the OCC, the Board, the FDIC, the National Credit Union Administration, and the Consumer Financial Protection Bureau, issued an interagency policy statement proposing joint

[76] *See* Release No. 33-9214, *Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings* (July 10, 2013), http://www.sec.gov/rules/final/2013/33-9414.pdf. On the same date, the Commission also adopted the final rules to eliminate the prohibition against general solicitation in certain Rule 506 offerings. *See* Release No. 33-9415, *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings* (July 10, 2013), http://www.sec.gov/rules/final/2013/33-9415.pdf.

standards for assessing the diversity policies and practices of the institutions they regulate.[77] The proposed standards are intended to promote transparency and awareness of diversity policies and practices within federally regulated financial institutions. On December 19, 2013, the agencies extended the public comment period from December 24, 2013 to February 7, 2014.[78]

Customer Data Protection

SEC Regulations

On April 10, 2013, to implement Section 1088 of the Dodd-Frank Act, the SEC and the CFTC jointly adopted Regulation S-ID, which requires certain regulated financial institutions and creditors[79] to adopt and implement identity theft programs.[80] Regulation S-ID is effective today and requires covered firms to implement policies and procedures designed to:

- identify relevant types of identity theft red flags;
- detect the occurrence of those red flags;
- respond appropriately to the detected red flags; and
- periodically update the identity theft program.

Regulation S-ID also requires entities to provide staff training, oversight of service providers, and provide guidelines for and examples of red flags to help firms administer their programs.

Regulation S-ID builds upon the SEC's existing rules for protecting customer data, in particular Regulation S-P. That regulation requires registered broker-dealers, investment companies, and investment advisers to adopt written policies and procedures instituting administrative, technical, and physical safeguards for the protection of customer records and information.[81] The policies and procedures must be reasonably designed to ensure the security

[77] *See* Release No. 34-70731, *Proposed Interagency Policy Statement Proposing Joint Standards for Assessing the Diversity Policies and Practices of the Entities Regulated by the Agencies and Request for Comment* (Oct. 23, 2013) https://www.sec.gov/rules/policy/2013/34-70731.pdf.

[78] *See Public Comment on the Proposed Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies of Practices of Entities Regulated by the Agencies*, (Dec. 19, 2013) https://www.sec.gov/rules/policy/2013/comments-joint-standards-diversity.shtml.

[79] Regulation S-ID applies to SEC-regulated entities that meet the definition of "financial institution" or "creditor" under the Fair Credit Reporting Act.

[80] *See* Release No. 34-69359, *Identity Theft Red Flags Rules* (April 10, 2013), https://www.sec.gov/rules/final/2013/34-69359.pdf.

[81] *See* Release 34-42974, *Privacy of Consumer Financial Information (Regulation S-P)* (June 22, 2000), https://www.sec.gov/rules/final/34-42974.htm. In August 2009, the Commission adopted a related rule prohibiting the use of consumer report information received from an affiliate for marketing purposes, unless the consumer has been given notice and an opportunity to opt out of having the information used for this purpose. *See* Release 34-

and confidentiality of customer records and information, protect against any unanticipated threats or hazards to the security or integrity of customer records and information, and protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer. Regulation S-P also provides protections for the proper disposal of consumer report information and records. These regulations operate in conjunction with other state consumer protection laws, including those state laws that require notification to customers in the event of a data breach.

The guidelines accompanying Regulation S-ID state that the policies and procedures should contain responses to red flags commensurate with the degree of risk posed. In determining an appropriate response, entities covered by Regulation S-ID should consider aggravating factors that may heighten the risk of identity theft, such as a data security incident that results in unauthorized access to account records. Appropriate responses may include, among others:

- Monitoring a covered account for evidence of identity theft;
- Contacting the customer;
- Changing any password, security codes, or other security devices that permit access to a covered account; or
- Notifying law enforcement.

The SEC's authority generally relates to securities transactions and not to retail payment systems, on which the authority generally resides with the banking regulators.

SEC Examination and Enforcement

The SEC monitors and enforces compliance with these rules and regulations through our examination and enforcement programs.[82] In 2013, the SEC's National Exam Program conducted examinations of registrants relating to data protection, including compliance with Regulation S-P. The National Exam Program has included information security as an examination priority in 2014.[83]

60423, *Limitations on Affiliate Marketing (Regulation S-AM)* (August 4, 2009), https://www.sec.gov/rules/final/2009/34-60423.pdf.

[82] In addition, in 2011, the Division of Corporation Finance published guidance that expressed its views regarding the disclosure obligations of registrants relating to cybersecurity risks and cyber incidents. *See* Division of Corporation Finance, *CF Disclosure Guidance: Topic No. 2* (October 13, 2011), http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[83] *See* National Examination Program, Office of Compliance Inspections and Examinations, *Examination Priorities for 2014* at 2 (January 9, 2014), http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.

In recent years, the SEC's Division of Enforcement has brought actions for failure to comply with Regulations S-P, including a registrant's failure to adopt reasonable policies and procedures that protect customer information from imminent threats and for failure to respond or follow up on security threats despite red flags.[84]

When the SEC is notified that customer information or records have been compromised, the staff's response will depend on the specific facts and circumstances surrounding the event. SEC staff coordinates its response and any resulting investigation as appropriate with other government agencies and law enforcement authorities.

Other Activities to Protect Customer Data

The SEC participates in a number of multilateral initiatives across and between government agencies and the securities industry that focus on protecting customer data. For example:

- In July 2013, Commission staff participated as host regulator in the Securities Industry and Financial Markets Association's ("SIFMA") Quantum Dawn 2 industry test, a simulation designed to test the cyber resilience and crisis management capabilities of the various entities that make up the securities industry, including the SROs and broker-dealers. This one-day simulation included distributed denial of service attacks, the insertion of cyber viruses and the use of an administrator account to sell off targeted stocks. While this exercise identified instances where the industry has made successful efforts to improve its cyber-security capabilities, the results of the test also demonstrated a need for better coordination of information across the industry.

- The Commission is a member of the Financial and Banking Information Infrastructure Committee ("FBIIC"), chaired by the Treasury Department, and the Commission's staff regularly attends FBIIC meetings to discuss the latest cyber threats and business continuity planning efforts within the banking and securities industry. The Commission staff also participates in classified and unclassified briefings organized by security agencies for FBIIC members and the securities industry (through the Financial Services Sector Coordinating Council for Critical Infrastructure and Homeland Security and SIFMA) regarding cyber threats to the financial sector. In addition, the FBIIC collaborates with the FSSCC and the Financial Services Information Sharing and Analysis Center, to facilitate, among other things, the sharing of information concerning cyber threats, vulnerabilities, incidents, potential protective measures and practices.

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[84] *See, e.g.*, *In the Matter of Stephen Derby Gisclair*, SEC Release No. 34-70742 (October 23, 2013), http://www.sec.gov/litigation/admin/2013/34-70742.pdf; *In the Matter of Frederick O. Kraus*, SEC Release No. 34-64221 (April 7, 2011), http://www.sec.gov/litigation/admin/2011/34-64221.pdf; and *In the Matter of Commonwealth Equity Services, LLP*, SEC Release No. 34-60733 (September 29, 2009), http://www.sec.gov/litigation/admin/2009/34-60733.pdf.

- The Commission is a member of the Financial Services Sector Committee of the Critical Infrastructure Partnership Advisory Council established by the Department of Homeland Security to facilitate the coordination between federal infrastructure protection programs with the infrastructure activities of the private sector and of state, local, territorial and tribal governments.

- The Commission is a member of the President's Identity Theft Task Force that was established by Executive Order 13402.[85] The President's Task Force is comprised of representatives from 17 agencies and was created to coordinate federal agencies' efforts to combat identity theft. It has made several recommendations over the years relating to the prevention of identity theft, assistance to victims of identity theft, deterrence of identity theft, and a call for legislative action to close gaps in federal criminal statutes to more effectively prosecute and punish identity theft-related offenses.

In addition to these efforts to protect individual consumers' data, in March 2013 the Commission proposed new rules to require certain key market participants (e.g., registered national securities exchanges, certain alternative trading systems, FINRA, and certain clearing agencies) to have comprehensive policies and procedures in place to better insulate market infrastructure technological systems from vulnerabilities.[86]

SEC Resources

Under the Dodd-Frank Act, the SEC collects transaction fees that offset the annual appropriation to the SEC. Accordingly, regardless of the amount appropriated to the SEC, our funding level will not take resources from other agencies, nor will it have an impact on the nation's budget deficit. Since FY 2012, the SEC has not received a significant increase in resources to permit the agency to bring on the additional staff needed to adequately carry out our mission.

This is especially true in light of the Dodd-Frank and JOBS Acts' significant expansions of the SEC's jurisdiction, but would remain true had those extensive additional responsibilities not been added. These new responsibilities cannot be handled appropriately with the agency's existing resource levels without undermining the agency's other core duties, particularly as we turn from rulewriting to implementation and enforcement of those rules.

Additional resources will be vital. We need additional staff experts to focus on enforcement, examinations, and regulatory oversight. The SEC also is aiming to continue investing in its technology capabilities to implement the law and police the markets. In particular, we hope to strengthen our ability to take in, organize, and analyze data on the new markets and entities under the agency's jurisdiction. Additional funding will be essential to that

[85] Executive Order 13402, "Strengthening Federal Efforts To Protect Against Identity Theft," 71 FR 93 (May 15, 2006).

[86] *See* Release No. 34-69077, *Regulation Systems Compliance and Integrity* (March 8, 2013), http://www.sec.gov/rules/proposed/2013/34-69077.pdf.

effort. Also critical will be the SEC's continued use of the Reserve Fund, established under the Dodd-Frank Act. The SEC dedicated the Reserve Fund to critical IT upgrades, and, if funding permits, plans to continue investing in areas such as data analysis, EDGAR and sec.gov modernization, enforcement and examinations support, and business process improvements.

If the SEC does not receive sufficient additional resources, the agency will be unable to fully build out its technology and hire the industry experts and other staff needed to oversee and police our areas of responsibility, especially in light of the expanding size and complexity of our overall regulatory space. Our nation's markets are the safest and most dynamic in the world, but without sufficient resources, it will become increasingly difficult for our talented professionals to detect, pursue, and prosecute violations of our securities laws as the size, speed, and complexity of the markets grow around us.

Conclusion

To date, the Commission has made tremendous progress implementing the considerable rulemaking mandated by the Dodd-Frank Act. As the Commission strives to complete the remaining work, I look forward to working with this Committee and other stakeholders in the financial marketplace to adopt rules that protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation – as well as take appropriate measures to enhance financial stability and limit potential systemic risks. Thank you for inviting me to share our progress with you. I look forward to answering your questions.

PREPARED STATEMENT OF MARK P. WETJEN

ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

FEBRUARY 6, 2014

Good morning Chairman Johnson, Ranking Member Crapo and Members of the Committee. Thank you for inviting me to today's hearing on the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and customer information security. I am honored to testify as Acting Chairman of the Commodity Futures Trading Commission ("CFTC"). I also am pleased to join my fellow regulators in testifying today.

Now is a good time for not only this Committee, but all stakeholders in the CFTC to reflect on the agency's progress in implementing financial reform and what the future might bring for this agency and the markets it oversees.

Due to Dodd-Frank and the efforts of my colleagues and staff at the CFTC, today there is both pre-trade and post-trade transparency in the swaps market that did not exist before. The public now can see the price and volume of swap transactions in real-time, and the CFTC's Weekly Swaps Report provides a snapshot of the swaps market each week. The most liquid swaps are being traded on regulated platforms and exchanges, with a panoply of protections for those depending on the markets, and regulators themselves have a new window into the marketplace through swap data repositories ("SDRs").

Transparency, of course, is helpful only if the information provided to the public and regulators can be usefully employed. Therefore, the CFTC also is taking steps to protect the integrity of that data and ensure that it continues to be reliable and useful for surveillance, systemic risk monitoring, and the enforcement of important financial reforms.

These transparency rules complement a number of equally important financial reforms. For example, the counterparty credit risks in the swaps market have been reduced as a large segment of the swaps market is now being cleared—as of last month, about 70 percent of new, arm's-length swaps transactions were being cleared. Additionally, nearly 100 swap dealers and major swap participants ("MSPs") have registered with the CFTC, bringing their swaps activity and internal risk-management programs under the CFTC's oversight for the first time. We also have strengthened a range of futures and swaps customer protections.

As it has put these reforms in place, the CFTC has consistently worked to protect liquidity in the markets and ensure that end users can continue using them to hedge risk as Congress directed.

The CFTC, in short, has completed most of its initial mandate under Dodd-Frank and has successfully ushered in improvements to the over-the-counter derivatives market structure for swaps, while balancing countervailing objectives.

Volcker Rule

In recent weeks, the Commission finalized the Volcker Rule, which was one of our last major rules under Dodd-Frank. The Volcker Rule was exceptional on account of the unprecedented coordination among the five financial regulators.

Congress required the banking regulators to adopt a joint Volcker Rule, but it also provided that the market regulators—the Securities and Exchange Commission ("SEC") and the CFTC—need only coordinate with the prudential banking regulators in their rulemaking efforts. One of the hallmarks of the final rule is that the market regulators went beyond the congressional requirement to simply coordinate. In fact, the CFTC's final rule includes the same rule text as that adopted by the other agencies. Building a consensus among five different Government agencies was no easy task, and the level of coordination by the financial regulators on this complicated rulemaking was exceptional.

This coordination was thanks in no small part to leadership at the Department of the Treasury. Secretary Lew, Acting Deputy Secretary Miller, and others were instrumental in keeping the agencies on task and seeing this rulemaking over the finish line. Along with the other agencies, the CFTC received more than 18,000 comments addressing numerous aspects of the proposal. CFTC staff hosted a public roundtable on the proposed rule and met with a number of commenters. Through weekly inter-agency staff meetings, along with more informal discussions, the CFTC staff and the other agencies carefully considered the comments in formulating the final rule.

Differences with Proposal

The agencies were responsive to the comments when appropriate, which led to several changes from the proposed Volcker Rule I would like to highlight.

The final Volcker Rule included some alterations to certain parts of the hedging—exemption requirements found in the proposal. For instance, the final rule requires banking entities to have controls in place through their compliance programs to demonstrate that hedges would likely be correlated with an underlying position. The final rule also requires ongoing recalibration of hedging positions in order for the entities to remain in compliance.

Additionally, the final rule provides that hedging related to a trading desk's market-making activities is part of the trading desk's financial exposure, which can be managed separately from the risk-mitigating hedging exemption.

Another modification to the proposal was to include under "covered funds" only those commodity pools that resemble, in terms of type of offering and investor base, a typical hedge fund.

CFTC Volcker Rule Implementation and Enforcement

The CFTC estimates that, under its Volcker regulations, it has authority over more than 100 registered swap dealers and futures commission merchants ("FCMs") that meet the definition of "banking entity." In addition, under Section 619, some of these banking entities may be subject to oversight by other regulators. For example, a joint FCM/broker-dealer would be subject to both CFTC and SEC jurisdiction and in such circumstances, the CFTC will monitor the activities of the entity directly and also coordinate closely with the other functional regulator(s).

In this regard, Section 619 of the Dodd-Frank Act amended the Banking Holding Company Act to direct the CFTC itself to write rules implementing Volcker Rule requirements for banking entities "for which the CFTC is the primary financial regulatory agency" as that term was defined by Congress in Dodd-Frank. Accordingly, as Congress directed, the CFTC's final rule applies to entities that are subject to CFTC registration and that are banking entities, under the Volcker provisions of the statute.

To ensure consistent, efficient implementation of the Volcker Rule, and to address, among other things, the jurisdiction issues I just mentioned, the agencies have established a Volcker Rule implementation task force. That task force also will be the proper vehicle to examine the means for coordinated enforcement of the rule. Although compliance requirements under the Volcker Rule do not take effect until July 2015, the CFTC is exploring now whether to take additional steps, including whether to adopt formal procedures for enforcement of the rule. As part of this process, I have directed CFTC staff to consider whether the agency should adopt such procedures and to make recommendations in the near future.

Volcker Rule: Lowering Risk in Banking Entities

The final Volcker Rule closely follows the mandates of Section 619 and strikes an appropriate balance in prohibiting banking entities from engaging in the types of proprietary trading activities that Congress contemplated when considering Section 619 and in protecting liquidity and risk management through legitimate market making and hedging activities. In adopting the final rule, the CFTC and other regulators were mindful that exceptions to the prohibitions or restrictions in the statute, if not carefully defined, could conceivably swallow the rule.

Banking entities are permitted to continue market making—an important activity for providing liquidity to financial markets—but the agencies reasonably confined the meaning of the term "market making" to the extent necessary to maintain a market-making inventory to meet near-term client, customer or counterparty demands.

Likewise, the final rule permits hedging that reduces specific risks from individual or aggregated positions of the banking entity.

The final Volcker Rule also prohibits banking entities from engaging in activities that result in conflicts of interest with clients, customers or counterparties, or that pose threats to the safety and soundness of these entities, and potentially therefore to the U.S. financial system.

The final Volcker rule also limits banking entities from sponsoring or owning "covered funds," which include hedge funds, private equity funds or certain types of commodity pools, other than under certain limited circumstances. The final rule focuses the prohibition on certain types of pooled investment vehicles that trade or invest in securities or derivatives.

Finally, and importantly, the final Volcker Rule requires banking entities to put in place a compliance program, with special attention to the firm's compliance with the rule's restrictions on market making, underwriting and hedging. It also requires the larger banking entities to report key metrics to regulators each month. This new transparency, once phased-in, will buttress the CFTC's oversight of swap dealers and FCMs by providing it additional information regarding the risk levels at these registrants.

TruPS Interim Final Rule

Even with resource constraints, the CFTC has been responsive to public input and willing to explore course corrections, when appropriate. With respect to the Volcker Rule, the CFTC, along with the other agencies, last month unanimously finalized an interim final rule to allow banks to retain collateralized debt obligations backed primarily by trust-preferred securities (TruPS) issued by community banks. The agencies acted quickly to address concerns about restrictions in the final rule, demonstrating again the commitment of the agencies at this table to ongoing coordination. In doing so, the CFTC and the other agencies protected important markets for community banks, as Congress directed.

Implementation Stage of Dodd-Frank

Looking ahead through the lens of what already has been done, it is clear that the Commission and all stakeholders will need to closely monitor and, if appropriate, address the inevitable challenges that will come with implementing the new regulatory framework under Dodd-Frank.

For the CFTC, only a few rulemakings remain to be re-proposed or finalized in order to complete the implementation of Dodd-Frank. Indeed, in just a matter of days, the compliance date for perhaps the last remaining, major hallmark of the reform effort will arrive: the effective date of the swap-trading mandate.

Rules the Commission is working to address in the coming months include capital and margin requirements for uncleared swaps, rulemakings intended to harmonize global regulations for clearinghouses and trading venues, and finalizing position limits.

There are other important matters in the months ahead as well.

Allow me to mention some of these matters before the Commission as we move forward with Dodd-Frank implementation.

Made Available to Trade Determinations

As a result of the trade execution mandate, many swaps will, for the first time, trade on regulated platforms and benefit from market-wide, pre-trade transparency. These platforms are designed to improve pricing for the buy-side, commercial end users, and other participants that use these markets to manage risk. Additionally, SEFs, as registered entities, are required to establish and enforce comprehensive compliance and surveillance programs.

The Commission's trade execution rules complement our other efforts to streamline participation in the markets by doing away with the need to negotiate bilateral credit arrangements and removing impediments to accessing liquidity. This not only benefits the end users that the markets are intended to serve, but also new entrants seeking to compete for liquidity who now are able to access the markets on impartial terms. In essence, the Commission's implementation of the trade execution mandate supports a transparent, risk-reducing swap-market structure under CFTC oversight.

In recent weeks, the "Made Available to Trade Determinations" filed by four swap execution facilities ("SEFs") have been deemed certified, making mandatory the trading of a number of interest rate and credit default swaps on regulated platforms.

There have been some questions in this context about the trading of so-called "package transactions," which often include a combination of financial instruments and at least one swap that is subject to the trade execution requirement. I have directed Division of Market Oversight ("DMO") staff to hold an open-to-the-public roundtable, which will take place February 12, and to further examine these issues so that the CFTC can further consider the appropriate regulatory treatment of basis trades falling within the meaning of a "package transaction."

Data

In order for the Commission to enforce the significant Dodd-Frank reforms, the agency must have accurate data and a clear picture of activity in the marketplace.

Last month, with the support of my fellow commissioners, I directed an interdivisional staff working group to review certain swap transaction data, recordkeeping and reporting provisions under Dodd-Frank. The working group, led by the director of DMO, will formulate and recommend questions for public comment regarding compliance with Part 45 reporting rules and related provisions, as well as consistency in regulatory reporting among market participants.

We have seen an incredible shift to a transparent, regulated swaps marketplace, and this is an appropriate review to ensure the data we are receiving is of the best possible quality so the Commission can effectively oversee the marketplace. I have asked the working group to review the incoming public comments and make recommendations to the Commission in June.

Concept Release on Risk Controls and System Safeguards for Automated Trading Environments

The CFTC's Concept Release on Risk Controls and System Safeguards for Automated Trading Environments provides an overview of the automated trading environment, including its principal actors, potential risks, and responsive measures taken to date by the Commission or industry participants. It also discusses pre-trade risk controls; post-trade reports; system safeguards related to the design, testing and supervision of automated trading systems; and additional protections designed to promote safe and orderly markets. Within the release, the Commission asks 124 questions and is seeking extensive public input.

To give the public more time to provide comments, the CFTC extended the comment period, which continues through February 14.

Position Limits

The futures markets have a long history of embracing speculative position limits as a tool to reduce unwarranted price fluctuations and minimize the risk of manipulation, particularly in the spot month, such as corners and squeezes. Our proposed position limits rule builds on that history, increases transparency, and lessens the likelihood that a trader will accumulate excessively large speculative positions.

The Commission's proposed rule respects congressional intent and addresses a district court decision related to the Commission's new position—limits authority under Dodd-Frank.

The comment period on the re-proposed rule closes February 10, and I look forward to reviewing the public input.

International Coordination

Given that the U.S. has nearly delivered on its G20 commitments to derivatives reform, and the European Union is close behind, financial regulators recently have focused more time on the developing global market structure for swaps.

The G20 commitments were a reaction to a global financial crisis. Although the causes of that crisis are not as clear as some suggest, few would disagree that liquidity constraints at certain firms were at least exacerbated by exposures to derivatives.

The plain truth is that risk associated with derivatives is mobile and can migrate rapidly across borders in modern financial markets. An equally plain truth is that any efforts to monitor and manage global systemic risk therefore must be global in nature.

Risk mobility means that regulators in the United States and abroad do not have the luxury of limiting their oversight to financial activities occurring solely within their borders. Financial activities abroad may be confined to local markets in some cases, but the financial crisis, and more recent events, make clear that the rights and responsibilities that flow from these activities often are not.

Perhaps as important, Congress reacted to the financial crisis by authorizing the CFTC to oversee activities conducted beyond its borders in appropriate cases. It could have limited the CFTC's oversight to only those entities and activities located or occurring within our shores, but it did not. In fact, Congress recognized in Dodd-Frank that even when activities do not obviously implicate U.S. interests, they can still create less obvious but legally binding obligations that are significant and directly relevant to the health of a U.S. firm; and which in the aggregate could have a material impact on the U.S. financial system as a whole.

So it is clear to me that the CFTC took the correct approach in adopting cross-border policies that account for the varied ways that risk can be imported into the U.S. At the same time, the CFTC's policies tried to respect the limits of U.S. law and the resource constraints of U.S. and global regulators. That is in part why, last December, the CFTC approved a series of determinations allowing non-U.S. swap dealers and MSPs to comply with Dodd-Frank by relying on comparable and comprehensive home country regulations, otherwise known as "substituted compliance."

Those approvals by the CFTC reflect a collaborative effort with authorities and market participants from each of the six jurisdictions with registered swap dealers. Working closely with authorities in Australia, Canada, the EU, Hong Kong, Japan, and Switzerland, the CFTC issued comparability determinations for a broad range of entity-level requirements. And in two jurisdictions, the EU and Japan, the CFTC also issued comparability determinations for a number of key transaction-level requirements.

It appears at this time that the substituted compliance approach has been successful in supporting financial reform efforts around the globe and a race-to-the-top in global derivatives regulation. Last month, for example, the European Union ("EU") agreed on updated rules for markets in financial derivatives, or the Markets in Financial Instruments Directive II ("MiFiD II"), reflecting great progress on derivatives reform in the EU. Other jurisdictions that host a substantial market for swap activity are still working on their reforms, and certainly will be informed by the EU's work and the CFTC's ongoing coordination with foreign regulators.

As jurisdictions outside the U.S. continue to strengthen their regulatory regimes and meet their G20 commitments, the CFTC may determine that additional foreign regulatory requirements are comparable to and as comprehensive as certain requirements under Dodd-Frank.

The CFTC also has made great progress with the European Commission since both regulators issued the Path Forward statement last summer, and we are actively working with the Europeans to ensure that harmonized regulations on the two continents promote liquidity formation and sound risk management. Fragmented liquidity, and the regulatory and financial arbitrage that both drives and follows it, can lead to increased operational costs and risks as entities structure around the rules in primary swap markets.

Harmonizing regulations governing clearinghouses and trading venues, in particular, is critical to sound and efficient market structure. Even if firms are able to navigate the conflicts and complexities of differing regulatory regimes, regulators here and abroad must do what they can to avoid incentivizing corporate structures and inter-affiliate relationships that will only make global financial firms more difficult to understand, manage, and unwind during a period of market distress.

Conversely, this translates to open, competitive derivatives markets. It means efficient and liquid markets. A global regime is the best means to avoid balkanization of risk and risk management that may expose the U.S. financial system over time to risks that are unnecessary, needlessly complex, and difficult to predict and contain.

In light of the CFTC's swaps authority, and the complexities of implementing a global regulatory regime, the Commission is working with numerous foreign authorities to negotiate and sign supervisory arrangements that address regulator-to-regulator cooperation and information sharing in a supervisory context. We currently are negotiating such arrangements with respect to swap dealers and MSPs, SDRs, SEFs, and derivatives clearing organizations.

As a final note on cross-border issues, on February 12 the Global Markets Advisory Committee ("GMAC"), which I sponsor, will meet to discuss the November 14, 2013, CFTC staff advisory on applicability of transaction-level requirements in certain cross-border situations.

The CFTC and Customer Information Security

The CFTC takes our responsibility to protect against the loss or theft of customer information seriously. However, the CFTC's funding challenges, and thus our limited examinations staff, have an impact on the agency's ability to examine and enforce critical rules that protect customer privacy and ensure firms have robust information security and other risk management policies in place.

The Gramm-Leach-Bliley Act was enacted in 1999 to ensure that financial institutions respect the privacy of their customers. Part 160 of the CFTC's regulations was adopted pursuant to the Gramm-Leach-Bliley Act and addresses privacy and security safeguards for customer information. Under the law, swap dealers, FCMs and other CFTC registrants must have "policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information." These policies and procedures are designed to protect against unauthorized access to customer records or information.

The CFTC is working to strengthen our registrants' compliance with the law. The agency is poised to release a staff advisory to market participants outlining best practices for compliance. The advisory recommends, among other best practices, that registrants should assess existing privacy and security risks; design and implement a system of procedures and controls to minimize such risks; regularly test privacy and security controls, including periodic testing by an independent party; annually report to the board on these issues; and implement an incident response program that includes notifying the Commission and individuals whose information was or may be misused. In addition, the CFTC has recently issued new customer protection regulations that include, among other regulations, new requirements for risk management by firms. Security safeguards are an element of risk management that needs to be addressed by this new regulation.

Last year, the CFTC also issued interpretive guidance, mirroring that of other financial agencies, clarifying that reporting of suspected financial abuse of older Americans to appropriate law enforcement agencies does not violate the privacy provisions within Part 160 of the Commission's rules.

Though enforcement of CFTC Part 160 rules is a challenge given our limited resources, we have enforced them in the past. In one instance, the CFTC settled a case with an FCM when an employee of that FCM placed files containing sensitive personally identifiable information on a public Web site, and the FCM did not have effective procedures in place to safeguard customer information.

In addition to Part 160, the CFTC's Dodd-Frank rules for DCMs, SEFs and SDRs require these entities to notify the CFTC of all cybersecurity incidents that could potentially or actually jeopardize the security of information.

Last spring, the CFTC and SEC adopted final "red flags" rules under the Dodd-Frank Act requiring CFTC and SEC registrants to adopt programs to identify and address the risk of identity theft. As the law required, our rules establish special requirements for credit and debit card issuers to assess the validity of change of address, but currently, the CFTC entities that must follow these identity theft rules do not issue credit or debit cards. A number of firms, however, do accept credit and debit cards for payment, which presents a different type of risk.

The CFTC also has adopted a rule regarding the proper disposal of consumer information requiring reasonable measures, such as shredding, to protect against unauthorized access.

Retail Payment Systems

The Commission's new customer protection rules on risk management require FCMs to develop risk management policies that address risks related to retail payment systems, such as anti-money laundering, identity theft, unauthorized access, and cybersecurity.

The CFTC currently does not have the resources to conduct any direct examinations of retail payment systems. The CFTC does indirectly look at the risks of retail payment systems through designated self-regulatory organizations (DSRO). The DSRO covers the operational aspects of the money movement through their risk-based programs. Additionally, DSROs perform a review of anti-money laundering at FCMs looking at a number of aspects of a retail payment system—source of funds, cash transactions, customer identity, money laundering and staff training.

For the vast majority of our registrants, the retail payment system is through normal banking channels, such as wire transfers. Only a few of our registrants accept credit or debit cards, and none currently accept virtual currency payment systems. Virtual currency, however, does present new risk, as a firm would be interacting outside of bank payment channels, increasing the risk of hacking or fraud, among other cybersecurity issues. The CFTC is working with registrants that are seeking to accept virtual currencies to educate them about best practices.

Data Breach Response

The CFTC's response to a data breach incident would include immediately assessing the situation with the registrant to understand the magnitude of the breach and its implications on customers and the marketplace. We would coordinate with other regulators and law enforcement and together determine the appropriate course of action. Our response would include an analysis of the data compromised, immediate notification to affected customers (unless law enforcement prohibits that notification), supporting customers by having the firm provide free credit monitoring services, ensuring customers know how to change user IDs and passwords, and having the firm closely monitor customer activity to look for signs of identity theft.

Looking ahead, the Commission is considering implementing rules under Gramm-Leach-Bliley to expand upon our current customer protection regulations with more specificity regarding the security of customer information.

Resources

To be effective, the CFTC's oversight of these registrants requires technological tools and staff with expertise to analyze complex financial information. On that note, I am pleased that the House and Senate have agreed to an appropriations bill that includes a modest budgetary increase to $215 million for the CFTC, lifting the agency's appropriations above the sequestration level that has been challenging for planning and orderly operation of the agency. The new funding level is a step in the right direction. We will continue working with Congress to secure resources that match the agency's critical responsibilities in protecting the safety and integrity of the financial markets under its jurisdiction. We need additional staff for surveillance, examinations, and enforcement, as well as investments in technology, to give the public confidence in our ability to oversee the vast derivatives markets.

Conclusion

For the CFTC, the Volcker Rule was one of the last remaining rulemakings required by Dodd-Frank. Only a few rulemakings remain to be re-proposed or finalized in order to complete the implementation of the legislation. Indeed, in just a matter of days, the compliance date for perhaps the last remaining major hallmark of the reform effort will arrive: the effective date of the swap-trading mandate. Looking forward, the agency will continue working to ensure an orderly transition to, and adoption of, the new market structure for swaps, and adjusting as necessary.

Thank you again for inviting me today. I would be happy to answer any questions from the Committee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY J. MILLER

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. Attacks on retail payment systems have gained heightened attention over the past months, following the widely reported data breach of the Target Corporation. Cyber criminals have taken advantage of cybersecurity vulnerabilities within the networks of retail merchants and financial services firms to unlawfully obtain credit card information and other payment card data from Point-of-Sale terminals. While the theft of credit card information has resulted in fraud against financial institutions, much of the liability for these losses will be borne by the retailers where the original breach took place. This is a result of the structure of contracts between banks and merchants, which rely upon industry imposed standards.

Because technology continues to evolve and malicious actors adapt their techniques, no one security solution is likely to resolve the cybersecurity challenges banks face. As the sector specific agency for financial services, Treasury strongly supports the financial sector's efforts to take a comprehensive approach to cybersecurity, including by using the National Institute of Standards and Technology's Framework for Improving Critical Infrastructure Cybersecurity. This Framework provides firms with a methodology that can be used to review their own risk management activities and could be useful in managing their supply chain vendors. For this reason, we have been working closely with the financial services sector to promote use of the Framework.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. Though Treasury does not have regulatory authority in this area, we closely monitor developments in payments technology. Treasury has observed that many banks have already begun to issue chip cards to better secure payments. In addition, many retailers have purchased terminals that are Europay, MasterCard and Visa (EMV) compliant. Industry participants have expressed that the primary barrier to adoption of these new standards is the cost of conversion.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. Under Section 113 of the Dodd-Frank Act, the Financial Stability Oversight Council (Council) may determine that a nonbank financial company shall be subject to Federal Reserve supervision and enhanced prudential standards if the company's material financial distress, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company, could pose a threat to U.S. financial stability.

The Council provided considerable public transparency into its process for considering nonbank financial companies for designation by voluntarily publishing a rule and guidance outlining how it would apply the statutory criteria and review firms for potential designation. The Council's rule and guidance on nonbank designations benefited from multiple rounds of public comment, even though the Council was not required to conduct a rulemaking process. The Council's public guidance established clear, quantitative metrics that the Council uses to identify firms for evaluation and extensively described the firm-specific analysis that the Council conducts.

The Council's guidance also includes sample metrics the Council may consider in its in-depth analysis of companies for potential designation. However, the guidance notes that a designation decision cannot be reduced to a formula. Due to the diverse types of nonbank financial companies and the unique threats that these nonbank financial companies may pose to U.S. financial stability, the Council's analysis will depend on the particular circumstances of each nonbank financial company under consideration and the unique nature of the threat it may pose to U.S. financial stability.

The Council appreciates the important oversight role of the GAO. We are confident that our process has been consistent with the Council's statutory duties and that the Council has provided the public and affected companies with extensive opportunities for input.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KIRK FROM MARY J. MILLER

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. The Council has provided tremendous public transparency into its process for considering nonbank financial companies for designation by voluntarily publishing a rule and guidance outlining how it would apply the statutory criteria and review firms for potential designation. In addition, the Council has reported to Congress and released to the public explanations of the basis for each of the three nonbank designations that it has completed.

The Council's rule and guidance on nonbank designations benefited from multiple rounds of public comment, even though the Council was not required to conduct a rulemaking process. The Council's public guidance established clear, quantitative metrics that the Council uses to identify firms for evaluation and extensively described the firm-specific analysis that the Council conducts.

Firms under review for potential designation have numerous and extensive opportunities to engage directly with the Council before any designation. First, the Council provides the company with a notice that it is under consideration and an opportunity to submit materials to contest the Council's consideration. This goes beyond what is required by the statute. Second, before any proposed designation, there is extensive interaction between Council staff and the company, including a number of meetings and information requests. After the Council makes a proposed designation, the Council sends the company a written explanation, and the company is entitled to a hearing to contest the proposed designation. To date, there has been only one company that has requested an oral hearing; the Council granted it, and the Council members themselves presided over the hearing and heard directly from the company's representatives.

In addition, any designated company has a right to seek judicial review of the designation. The Council also reviews all nonbank designations annually, based on a process set forth in the Council's rule that allows any designated company to participate in the process.

Due to the preliminary nature of the Council's evaluation of any nonbank financial company prior to a final designation and the potential for market participants to misinterpret such an announcement, the Council does not publicly announce the name of any company that is under review prior to a final designation of the company.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing

CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. The Federal Reserve Board recently announced that it intends to exercise its authority to give banking entities two additional 1-year extensions to conform their ownership interests in, and sponsorship of CLOs covered by, the Volcker Rule. The Federal Reserve Board also noted that the four other agencies charged with enforcing the requirements of the Volcker Rule plan to administer their oversight of banking entities in accordance with the Federal Reserve Board's extension of the conformance period applicable to CLOs. In April 2014, the Federal Reserve Board, in consultation with the other rule-writing agencies, announced that it intends to exercise its authority to give banking entities two additional 1-year extensions to bring into conformance with the Volcker Rule their ownership interests in and sponsorship of CLOs. This relief should reduce pressure on banking entities to sell CLOs before the deadline for conformance.

Q.3. Can you speak to other reports/studies that the OFR may do and if there will be some kind of open/regular process that will be followed for the public to review and comment? In terms of the OFR's Study on Asset Management and Financial Stability, do you know how many comments were received and the general nature/ issues raised in these comments?

A.3. There are no pending requests from the Council to the OFR for reports at this time. However, the OFR Director sets the agenda of the OFR and has the discretion to explore matters that might have an impact on the financial stability of the United States. After the OFR delivered the report to the Council and posted it on the OFR Web site, the Securities and Exchange Commission solicited public comment on the OFR report and posted the comment letters on its Web site.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DANIEL K. TARULLO

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. The presence of numerous and varied participants in payment processing, such as banks, merchants, and service providers, increases the complexity of securing financial and customer information throughout the payment process. The Federal Reserve guidance sets expectations for financial institutions to tailor and implement risk assessment and mitigation plans for material business lines that include processes ranging from layered security architectures to heightened monitoring of customer account activity. Financial institutions are expected to maintain robust and flexible incident response and management programs, with the goal of minimizing the effects, both financial and reputational, of merchant data breaches. When a breach does occur, financial institutions are expected to assess the risks to the institution and its customers and to implement plans to mitigate those risks. Risk mitigation plans typically include enhanced account and systems monitoring and reporting to detect unusual activity and to obtain information to mitigate the effects of the security incident. Depending on the details of a specific incident, additional actions may include customer notification and card reissuance.

When responding to a third-party data breach, participants in the payment system face the challenge of devising an appropriate response with incomplete information about the extent and origin of the particular compromise. For example, information regarding the scope of merchant data breaches, including the extent and type of compromised data, is generally limited initially, requiring decisions regarding the monitoring of customer accounts, notification of customers, and the reissuance of cards based upon minimal and evolving information. Depending upon the characteristics of the specific breach, additional challenges may result from the use of external providers of technology and other services to support payment processing functions.

The Federal Reserve guidance on information security and payment systems outlines expectations for financial institutions regarding information security programs and controls, including ongoing assessments of application and business line needs as business activities evolve and the use of metrics to assess the effectiveness of controls. Financial institutions should address the challenges of merchant data breaches by continuously advancing their risk management capabilities to minimize the risk of breaches occurring and to mitigate the impact of breaches when they do occur. Financial institutions should maintain effective information security programs, including controls, systems, and resources to detect customer data breaches and to mitigate any resulting financial and reputational losses. The Federal Reserve's 2013 *Guidance on Managing Outsourcing Risk,* SR 13–19/CR 13–21, directs financial institutions to appropriately manage risk associated with vendors and subcontractors.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. Regulated entities are moving forward with Europay, MasterCard and Visa (EMV) for payment cards according to their own business needs and strategic plans. EMV cards contain embedded microprocessors that provide transaction security features and other capabilities which cannot be provided with magnetic stripe cards. A card issuer's decision to implement EMV is influenced by the timing of merchant's plans to upgrade their point-of-sale (POS) terminals and systems to read the EMV chip, and, similarly, merchant's decisions to upgrade their systems are influenced by the timing of the issuance of EMV-enabled cards.

One of the largest obstacles to EMV adoption is the cost that card system participants must incur to implement the new standard: merchants must consider the cost of chip-enabled POS terminals and related systems; processors must coordinate with merchants to manage the new transaction format and data stream from EMV terminals; and banks must issue new chip-based credit and debit cards to their customers.

The recent high-profile breaches have generated renewed interest in EMV adoption. Although breaches remind payment system participants that magnetic stripe cards are vulnerable to fraud, there is a low likelihood that more fraud will significantly accelerate EMV migration because of the time and cost required to build out the necessary infrastructure.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. I agree that objective, numerical criteria should be a central part of the systematically important financial institutions (SIFI) designation process. Reliance on such criteria increases the transparency of the process and reduces market participants' uncertainty regarding the potential for a firm's designation as a nonbank SIFI. Such increased certainty improves the efficient functioning of U.S. financial markets and contributes to financial stability.

The SIFI designation process assesses the potential harm to U.S. financial stability from the material financial distress of a firm and whether the nature, scope, size, scale, concentration, interconnectedness, or activity mix of a firm could pose a threat to U.S. financial stability. Many important factors in these assessments, such as a firm's size and leverage, can clearly be measured using objective, numerical calculations that can be replicated by firms and market participants using publicly available data.

However, while some factors may be summarized with measurable metrics, computing these metrics may rely on nonpublic information, such as detailed data on assets, liabilities and counterparty relationships. Further, other factors, such as the potential harm from forced asset sales, may best be summarized using a range of metrics, some of which may rely on somewhat complex, albeit standard, models such as value-at-risk measures. Finally, certain factors, such as the relationship of a firm with other significant intermediaries, may require a measure of judgment that cannot yet be fully captured by any agreed-upon statistic or model.

Q.4. Please explain how and why the agencies failed to foresee the accounting issue with the treatment of the Trust Preferred Collateralized Debt Obligations (TruPS CDOs) in the final Volcker Rule. Did the proposed rule include requisite language seeking public comment on TruPS CDOs, as finalized? If so, please provide that language from the proposed rule. If not, please explain why the proposal did not seek that specific information and whether the agencies believe they satisfied the notice-and-comment requirements under the Administrative Procedure Act.

A.4. In November 2011, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Security Exchange Commission (SEC), and the U.S. Commodity Futures Trading Commission (CFTC) (collectively, the Agencies) issued a proposed rule that asked a number of questions seeking public comment regarding the treatment of securitizations. *See, e.g., Fed. Reg.* 68,846 at 68,898–90, 68,912, 68,914–15. Among other issues, these questions specifically sought comment on the impact of section 13 of the Bank Holding Company Act (BHCA) and the proposal, on securitization vehicles, which includes collateralized debt obligations (CDOs) and Trust Preferred Collateralized Debt Obligations (TruPS CDOs). The proposal also included questions seeking comment about including securitizations within the definition of covered fund, as well as regarding the legal, accounting and tax treatment of interests in securitizations and how debt interests should be treated. In total, the proposal asked approximately 15 questions specifically about these issues related to securitizations. Notwithstanding these questions, no comments were received on securitizations backed by trust preferred securities under the proposed rule.

To address the costs associated with the requirement in the statute and rule requiring divestiture of nonconforming investments in covered funds, the Federal Reserve gave an extended conformance period until July 21, 2015. The accounting rules, which are outside of the purview of the Agencies, brought forward accounting losses for certain investments notwithstanding the Federal Reserve's extension of time to conform the investment.

After approval of the final rule implementing section 13 on December 10, 2013, a number of community banking organizations and trade groups expressed concern that the final rule conflicts with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Collins Amendment). Section 171 (b)(4)(C) specifically permits any community banking organization to continue to rely for regulatory capital purposes on any debt or equity instruments issued before May 19, 2010. This exemption includes trust preferred securities, which are assets held by a number of issuers of CDOs. To address these concerns, on January 14, 2014, the Agencies approved an interim final rule to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities and other instruments identified in section 171(b)(4)(C). Although the Agencies believe the interim final rule addresses the concerns expressed related to TruPS CDOs, the interim final rule invited comment for a period of 30 days after its publication in the *Federal Register*. The Agencies will carefully consider all comments that relate to the interim final rule.

Q.5. What specific efforts are the regulators considering to address the issue with the Collateralized Loan Obligations (CLOs) in the final Volcker rule? In Governor Tarullo's testimony before the House Financial Services Committee, he stated that the CLO issue is "already at the top of the list" for regulators to consider and fix. How many financial institutions are impacted by the final rule's treatment of CLOs?

A.5. In keeping with the statute, the final rule excludes from the definition of covered fund all securitizations backed entirely by loans, including CLOs backed entirely by loans. Data reported by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9–C forms indicate that only about 50 domestic banking organizations held CLOs, including both conforming and nonconforming, as of December 31, 2013. The data also indicate that aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Additionally, new issuances of CLOs in late 2013 and early 2014 appear to be conforming to the final rule, and some CLOS issued before December 31, 2013, are conforming their investments to the provisions of section 13. Based on discussions with industry representatives and a review of data provided by market participants, it appears that the current volume of new CLO issuances is higher as compared to CLOs issued prior to the adoption of the final rule, with U.S. CLO issuances during the 3-month stretch from March through May 2014 increasing to an all-time high of approximately $35.3 billion.

On April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional 1-year extensions of the conformance period under section 13 of the BHC Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations.[1] This would permit banking entities to retain until July 21, 2017 ownership interests in and sponsorship of CLOs that are not backed entirely by loans that were held as of December 31, 2013. All of the agencies charged with implementing section 13 of the BHC Act support the Federal Reserve's statement.[2]

Q.6. Since the final Volcker rule was issued in December, the affected entities have recognized two issues with the final rule (TruPS CDOs and CLOs). What other issues with the final Volcker rule are your agencies aware of that may be raised by affected entities? How do you intend to coordinate efforts on clarifying such issues in the future?

A.6. It is not unexpected that rules implementing a complex statute that require changes in existing activities would raise questions during the implementation process. In part to facilitate resolution of these types of issues, the Federal Reserve exercised authority provided under section 13 to extend until July 21, 2015, the period for banking entities to conform their activities and investments to the statute and implementing rules. The Federal Reserve will work with the other implementing agencies to address questions regarding implementation as they arise.

Q.7. How do you plan to coordinate with other agencies regarding enforcement matters and the final Volcker rule, given that your agencies have varied jurisdictions?

A.7. Authority for issuing regulations and implementing the Volcker rule is by statute allocated between five Federal regulators. As a general matter, the OCC is charged with supervising and enforcing the final rule for national banks and Federal branches of foreign banks, the FDIC for State nonmember banks, the SEC for U.S. broker-dealers and securities-based swap dealers, and the CFTC for futures commission merchants and swaps dealers. The Federal Reserve's primary responsibilities are for depository institution holding companies, State member banks, certain unregulated and foreign subsidiaries of depositor institution holding companies, and State-chartered branches of foreign banks.

Staff of the Federal Reserve will continue to engage with staff of the other Agencies, and the Agencies will work together, to the extent appropriate and practicable, to help ensure consistency in application of the final rule to banking entities covered by the rule. In pursuit of our goals for a consistent application of the rule across Agencies and across banking entities, staffs of the implementing Agencies meet regularly to address implementation issues as they arise.

Q.8. Governor Tarullo, you head the Committee on Supervisory and Regulatory Cooperation at the Financial Stability Board (FSB). There is concern that the FSB will implement bank-centric capital standards on insurance companies that are inconsistent with U.S. risk-based capital standards. What are you doing to ensure that

[1] *See* Board Statement Regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act (Apr. 7, 2014).

[2] *See* Letter to Chairman Hensarling re: CLOs (Apr. 7, 2014).

bank-centric standards are not set for insurance companies, and for other nonbank noninsurance financial institutions more generally?

A.8. One of the lessons learned from the recent financial crisis was the need for appropriate consolidated supervision of systemically important financial firms to ensure that the risks of the overall firms, including those present in both regulated and unregulated financial entities, are appropriately capitalized, measured, and supervised. The primary focus of the FSB is financial stability. It works with international sectoral standard setting bodies such as the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS) to help ensure that regulators are identifying and addressing risks within those sectors with potential financial stability impact. The decision-making and responsibility for the development of appropriate supervisory and regulatory measures rests with the BCBS and the IAIS.

The International Association of Insurance Supervisors (IAIS), an organization comprised of over 130 authorities with responsibilities for insurance supervision from around the world, including the National Association of Insurance Commissioners (NAIC), State insurance regulators, Federal Reserve Board, and Federal Insurance Office, is in the process of developing international capital standards for global systemically important insurers and internationally active insurance groups. The IAIS periodically provides updates on the IAIS capital projects to the FSB.

The capital standards being developed by the IAIS would be designed to measure capital adequacy for relevant firms' financial activities, including their insurance business, as well as other regulated and unregulated financial operations. This IAIS project, staffed by international supervisors with insurance expertise, has, as a goal, the establishment of overall international capital standards that would be appropriate for the risks facing financial companies with substantial insurance underwriting activities. Once the standards are adopted by the IAIS, U.S. regulators, including the Federal Reserve and State insurance regulators, would consider if and how to implement in the United States the standards for the companies that they regulate, consistent with applicable law. Any standards the Federal Reserve would seek to implement would be proposed to the public with opportunity for public comment.

Separately, the Board is considering the appropriate capital framework for savings and loan holding companies (SLHCs) and FSOC designated nonbank financial companies supervised by the Board that are substantially engaged in insurance underwriting activities, consistent with section 171 of the Dodd-Frank Act. Insurance companies that are SLHCs or that are FSOC designated nonbank financial companies have different business models and risks than bank holding companies that are not substantially engaged in insurance activities. However, section 171 of the Dodd-Frank Act requires that the Board establish minimum risk-based and leverage capital requirements on a consolidated basis for bank holding companies and savings and loan holding companies, and for nonbank financial companies that it supervises. Section 171 specifically provides that these minimum requirements be not less than the "generally applicable" minimum risk-based and leverage capital requirements that apply to insured depository institutions (regardless of their asset size or foreign exposure). In addition, these minimum requirements cannot be quantitatively lower than the "generally applicable" minimum risk-based and leverage capital requirements that applied to insured depository institutions when the Dodd-Frank Act was adopted in 2010. Section 171 therefore limits the scope of the Board's discretion in establishing minimum capital requirements for these companies.

Under State law, capital requirements for insurance companies apply on a legal entity basis, and there are no State-based, consolidated capital requirements that cover subsidiaries and noninsurance affiliates of insurance companies. In addition, even among regulated insurance companies (primary insurers, captive insurers, *etc.*) there is a degree in variation of the applicable capital and supervisory standards.

The final rule regarding enhanced prudential standards that the Board adopted on February 18, 2014, does not include requirements for nonbank financial companies, including insurance companies, designated by the Financial Stability Oversight Council for Board supervision. Instead, the Board will apply enhanced prudential standards to designated nonbank financial companies through a subsequently issued order or rule following an evaluation of the business model, capital structure, and risk profile of each designated nonbank financial company, consistent with the requirements of section 171 of the Dodd-Frank Act, as discussed above. The Board plans to implement requirements for designated nonbank financial companies through a transparent process with an opportunity for notice and comment.

The Board continues to carefully consider how to design capital rules for Board-regulated companies that are insurance companies, that have subsidiaries engaged in insurance underwriting, or that are substantially engaged in commercial activities, consistent with section 171 of the Dodd-Frank Act.

Q.9. On January 10, 2014, the Federal Reserve and the FDIC made available the public portions of resolution plans for 116 institutions that submitted plans for the first time in December 2013, the latest group to file resolution plans with the agencies. These living wills are based on a premise that when a financial firm is near the brink, there will be a marketplace where buyers for assets and operations are available, but that may not be the case as was evident with Lehman's 2008 collapse when no one wanted to touch what was perceived as Lehman's "toxic assets." What specifically gives you confidence that these living wills will work in the first place and that there will be willing buyers for the troubled firm's assets?

A.9. The resolution plan regulation jointly issued by the Federal Reserve and the FDIC provides that in preparing its initial resolution plan, a company may assume that its material financial distress or failure occurs under the baseline economic scenario outlined in the Federal Reserve's stress testing rule, 12 CFR Part

252.[3] The baseline economic scenario describes a functioning market where there would likely be available buyers for assets and operations. However, the joint regulation also provides that the next iteration of these plans will also have to take into account that the material financial distress or failure of the company may occur under the adverse and severely adverse economic scenarios outlined in the Federal Reserve's stress testing rule.[4] In preparing future iterations of their plans, currently due in December 2014, the institutions that filed their initial plans in December 2013, will therefore have to take into account that their material financial distress or failure may occur under the adverse and severely adverse economic scenarios, which reflect conditions where buyers for the companies' assets and operations are less likely to be available.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM DANIEL K. TARULLO

Q.1. Are you comfortable with the extent to which the consumer payments industry currently sets its own data security standards? Currently, most standards are set by contract—with the card companies playing a significant role—and an industry body known as PCI determines most of the details and certifies compliance examiners. Should Federal regulators be playing a greater role?

A.1. The Payment Card Industry (PCI) Security Standards Council released version 3 of the Data Security Standard in November 2013. PCI's philosophy has been to drive new compliance requirements as the risk landscape changes. Version 3 includes two new key requirements related to data flows and device inventory, which incrementally enhance the control environment and protect consumers from fraud. The industry relies on the PCI Security Standards Council to balance cost and effectiveness, which it does by assessing threats and identifying controls that most effectively address evolving payment card risks. The Federal Reserve and other financial regulators have relied on the expertise of the PCI Security Standards Council in setting technical data security standards. The regulators approach has been to identify broad, outcome-based security objectives that supervised entities are expected to meet through a mix of technical and nontechnical approaches.

Regarding the role of Federal regulators, the complexity of the regulatory environment mirrors the complexity of the payment processing landscape, with regulators focused within their statutory domains. However, we are aware of the considerable need for, and benefits of, coordination and collaboration across domains in order to effectively mitigate both firm and systemic risks. The Federal Reserve continues to monitor payment system risk and collaborate with the private sector and public-private partnerships such as the Financial and Banking Information Infrastructure Committee (FBIIC), Financial Services Sector Coordinating Council (FSSCC), and Financial Services Information Sharing and Analysis Center (FS–ISAC).

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[3] 12 CFR parts 243.4(a)(4) and 381.4(a)(4). The stress scenarios applicable to the December 2013 resolution plan submissions of the 116 institutions were issued on November 15, 2012. *http://www.federalreserve.gov/newsevents/press/bcreg!bcreg2012111Sa1.pdf.*
[4] Id.

Q.2.a. When a financial data breach occurs with a merchant (as seems to be the case with the current wave of data breaches) or other source outside of a financial institution, financial institutions still very clearly feel the effects. Credit and debit card issuers, for example, must notify affected customers and issue new cards, and will likely end up bearing some portion of the financial losses that occur from fraudulent transactions using stolen card information. In the chain of a retail payment transaction, security is only as strong as its weakest link.

In addition to the examinations the Fed conducts regarding regulated institutions' own data security, can you describe the Fed's oversight with respect to the security of consumer data across the entire chain of consumer payment transactions?

A.2.a. Federal Reserve oversight of consumer payment transactions is limited to our role as a supervisor of financial institutions. Federal Reserve staff examine the data security programs of supervised banks for compliance with the information security standards required by section 501(b) of the Gramm-Leach-Bliley Act (15 U.S.C. 6801(b)) and the identity theft red flags rule required by section 615(e) of the Fair Credit Reporting Act (15 U.S.C. 1681m(e)), as well as with Federal Reserve information security and payment systems guidance. The Federal Reserve's supervisory process includes an assessment of the adequacy of financial institution data security programs in supporting the security and reliability of customer data. Financial institutions are required to address deficiencies in a timely manner to mitigate risks to both the institution and its customers.

Q.2.b. Should Federal regulators be taking a greater interest in the data security standards applicable to other entities that possess consumer financial data, beyond just regulated financial institutions? Are legislative changes necessary or are there legislative changes that would help?

A.2.b. Protecting the safe and sound operation of the Nation's financial systems is a key priority for the Federal Reserve. To accomplish this, the Federal Reserve works with other regulators to promote the implementation of effective information security programs and protocols by supervised institutions. However, sensitive consumer data are frequently collected and stored by nonregulated firms, and these firms may not be held to the same level of information security expectations as financial institutions. As cyber threats become increasingly sophisticated, effective security and fraud-mitigation measures must evolve to include all players in the payment system, including financial institutions, nonfinancial firms, and consumers. The security of the payment system is only as strong as its weakest link and it is the weakest link that criminals will exploit. Given the broad reach of these threats, the Congress would appear to be the appropriate body to address these matters holistically. For example, a national standard that sets forth requirements for protecting sensitive consumer data and tracking and reporting incidents may help to protect consumers and financial systems more broadly. Payment system participants should be encouraged to cooperate with each other in preventing, detecting, and mitigating cyber-attacks. In addition, the Congress may consider investigating ways to leverage the technical capabilities of law enforcement and national security agencies with respect to cyber threats and attacks, and to encourage continued coordination across Government agencies to ensure the safety and security of the financial system. Federal Reserve staff would be available to participate in discussions regarding these matters.

Q.3. In our economy today, companies are collecting and storing growing amounts of consumer information, often without consumers' knowledge or consent. The financial industry is no exception. We have heard reports of lenders, for example, mining online data sources to help inform underwriting decisions on consumer loans. As companies aggregate more data, however, the consequences of a breach or improper use become greater.

The Target breach illustrates the risks consumers face—not just of fraud, but also identity theft and other hardships. Compromised information included both payment card data and personal information such as names, email addresses, and phone numbers. But what if the next breach also involves account payment histories or Social Security numbers?

As the ways companies use consumer information changes, and the amount of consumer data they hold grows, how is the Fed's approach evolving? Are there steps regulators are taking—or that Congress should take—to require stronger protections against breaches and improper use, and to mitigate harm to consumers?

A.3. On an ongoing basis, the Federal Reserve evaluates the need for additional guidance to financial institutions, jointly with other banking regulators, to promote effective information security programs and practices in an environment characterized by rapid technological change. The Federal Reserve participates in the Federal Financial Institutions Examination Councils (FFIEC) efforts to develop and update guidance on a range of information technology topics, including information technology management, security, and payments. In December 2013, the Federal Reserve issued *Guidance on Managing Outsourcing Risk,* SR 13–19/CA 13–21, to address risks related to banks increasing reliance on third-party service providers. In this guidance, the Federal Reserve acknowledges that third-party outsourcing represents a heightened level of risk and complexity and banks must protect against loss of customer data and exploits of networks that may expose financial institutions to data breaches. The.Federal Reserve is monitoring financial institution performance relative to the expectations in the newly released outsourcing risk guidance to ensure that third-party contract oversight includes: 1) an appropriate level of due diligence based on complexity and criticality; 2) business resumption and contingency plans; 3) an assessment of the third-party information security programs; and, 4) incident reporting, management, and response programs.

Given the increasingly broad threats to consumer information, privacy, and security, the Congress may be the appropriate body to address this matter. Potential actions that Congress could consider are discussed above in our response to question 2b.

Q.4.a. A lot of the discussion in the aftermath of the recent data breaches has focused on credit and debit card "smart" chip technology, since the U.S. seems to have fallen behind other parts of the world such as Western Europe in adopting it. But while card chips help to reduce fraud for transactions where a card is physically present, and make it harder for thieves to print fake cards using stolen information, they do little to reduce fraud for online, "card-not-present" transactions.

Are you comfortable with the steps industry is taking to improve security and reduce fraud for "card-not-present" transactions?

A.4.a. The complex and evolving nature of technology and business processes ensures that threat and fraud environments are dynamic and that payment system participants must continue to evolve and enhance security processes over time. Tools, technologies, and procedures employed in the industry to reduce card-not-present (CNP) fraud at this point in time include:

- *Address verification* requires the customer to provide the cardholder's address on record with the card issuer.
- *Card security verification* requires the customer to provide a 3- or 4-digit CVV2 code printed on the card. Requiring this number at checkout helps to ensure that the customer is in possession of the physical card since the number is generally not encoded on a magnetic stripe or chip.
- *Geolocation services* provide information about a device's location during transaction processing based on an IP address (on a computer) or GPS signal (on a mobile device). The device's location can be compared to the customer's billing or shipping address.
- *Neural network technologies* use customer and past transaction data to assess the likelihood that a given transaction is fraudulent.
- *PCI standards* places controls on the storage and handling of cardholder information. In addition to the measures listed above, the industry is developing several promising technologies to address new threats. For example, tokenization solutions could replace a card's primary account number with a proxy number that is valid for a single transaction. End-to-end encryption technologies that transmit encoded card data across the payment chain are also under development. The use of tokenization and end-to-end encryption are potential tools to combat threats, such as data breaches.

The payment card industry is a complex market, and implementing a new security technology may require investments and process changes by merchants, financial institutions, card networks, payment processors, as well as behavioral changes by consumers. These stakeholders often face different incentives when deciding to implement a new technology. Given the constantly changing threat environment, the complexity of the market, and the varying incentives among stakeholders, the Federal Reserve supports a layered, technology-neutral, guidance-based approach to CNP security. Stakeholders should implement several layers of technologies and procedures to mitigate threats. And, as the fraud environment changes, stakeholders should revise their approaches to CNP fraud and implement updated, cost-effective measures to address the latest threats. The Federal Reserve will continue to work with the institutions under its supervision, as well as with other regulators, to encourage payment system participants to improve measures to detect and prevent fraud.

Q.4.b. Banks and other industry participants need to be proactive here, rather than waiting for a major breach to happen before making protective investments. Do you feel that regulated institutions are paying sufficient attention to all areas of data security risk, and are making the necessary investments to protect consumers rather than treating fraud as simply a cost of doing business?

A.4.b. An effective payment system involves many participants, not just depository institutions, and all industry participants should take proactive measures to protect consumer data. The increasing sophistication of cyber threats makes it difficult to ensure that current investments provide adequate protection against new threats. Payment system participants need to employ multiple layers of security as well as nontechnology-based policies and procedures (such as notifying customers of potentially fraudulent transactions) that complement technology-based solutions. Participants need to assess the robustness of their information security infrastructures, policies, and practices on an ongoing basis in light of the evolving threat environment and to make enhancements as appropriate.

The Federal Reserve expects supervised institutions to continually monitor their security systems in the face of evolving threats and to upgrade those systems when necessary. To this end, the Federal Reserve and other bank regulatory agencies have issued several interagency guidance documents that pertain to data breach prevention and incident response. The *Interagency Guidelines Establishing Information Security Standards* (12 CFR part 208, App. D–2 (2013)) summarizes the standards that financial institutions are expected to use in establishing a comprehensive, risk-based program to protect customer information. The *Interagency Supplement to Authentication in an Internet Banking Environment* (June 28, 2011; SR 11–09) sets out expectations about minimum security controls required to prevent loss of customer information by data breach, reflecting banks' increased reliance on internet-based technology and the simultaneous increase in attacker sophistication. The *Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice* (12 CFR part 208, App. D–2 (2013)) describes the incident response program that a financial institution should establish to address unauthorized access to or misuse of customer information. Supervised institutions are expected to review and assess their procedures and technologies on an ongoing basis and to make appropriate changes and investments to ensure an adequate and effective level of data protection.

Based on the results of Federal Reserve examination activities, in general, regulated financial institutions have placed a high priority on securing information, including corporate, customer, and counterparty data. Investments necessary to maintain technology, systems, and staff resources to support effective information security programs are being made. However, where necessary, the Federal Reserve leverages its supervisory processes to promote the correction of deficiencies identified at specific institutions.

RESPONSE TO WRITTEN QUESTION OF SENATOR KIRK FROM DANIEL K. TARULLO

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. The Financial Stability Oversight Committee (FSOC)—chaired by the Secretary of the Treasury and composed of 10 voting members—is charged by Congress with designating systemically important financial institutions. The FSOC has established a robust process, after seeking public notice and comment on an initial and revised proposal, for exercising its designation authority. The process contains three stages during which the FSOC screens companies for review and conducts an in-depth analysis of companies that pass the screen.

In developing this process, the FSOC sought to maximize transparency with respect to the Determination Process by providing a detailed description of (i) the profile of those nonbank financial companies likely to be evaluated by the FSOC for a potential determination, and (ii) the metrics that the FSOC intends to use when analyzing companies at various stages of the Determination Process. There are numerous opportunities during this process for a nonbank financial company to communicate with the FSOC and its staff and submit information regarding the company's activities and its potential to pose a threat to U.S. financial stability.

The FSOC applies quantitative metrics to a broad group of nonbank financial companies in determining whether a firm should be considered for designation. A nonbank financial company will be evaluated in Stage 2 if it meets both a size threshold ($50 billion in total consolidated assets) and any one of five thresholds that measure a company's interconnectedness, leverage, and liquidity risk and maturity mismatch. During Stage 2, a nonbank financial company is analyzed based on a wide range of quantitative and qualitative information available to the FSOC primarily through public and regulatory sources.

A nonbank financial company that is advanced to Stage 3 receives a notice that the company is under consideration for a Proposed Determination, which also may include a request that the nonbank financial company provide information relevant to the FSOC's evaluation. In addition, the nonbank financial company is provided an opportunity to submit written materials to the FSOC. Following a Proposed Determination, a nonbank financial company is provided a written notice of the Proposed Determination, which includes an explanation of the basis of the Proposed Determination. A nonbank financial company that is subject to a Proposed Determination may request a written or oral hearing to contest the Proposed Determination. If the FSOC determines to subject a company to supervision by the Board of Governors and prudential standards, the FSOC will provide the nonbank financial company with written notice of the FSOC's final determination, including an explanation of the basis for the FSOC's decision.

In 2013, the FSOC determined that material financial distress at each of three nonbank financial companies—American International Group, Inc., General Electric Capital Corporation, and Prudential Financial, Inc.—could pose a threat to U.S. financial stability and that those companies should be subject to Federal Reserve Board supervision and enhanced prudential standards. The FSOC released the bases of its determinations on its Web site. The FSOC evaluated these firms using the three-stage process.

The Federal Reserve Board recognizes the critical importance of transparency and will continue to pursue ways to promote further transparency that are consistent with the FSOC's central mission to monitor emerging threats to the financial system.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. In keeping with the statute, the final rule excludes from the definition of covered fund all securitizations backed entirely by loans, including CLOs backed entirely by loans.

Data reported by insured depository institutions, bank holding companies and certain savings and loan holding companies in the Call Report and Y9–C forms indicate that only about 50 banking organizations owned an interest in a CLO that was backed by assets that include assets that are not loans, and thus are covered by the statute and implementing rules. The data also indicate that, as of December 31, 2013, aggregate CLO holdings of these banking entities reflect an overall unrealized net gain, and unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Based on discussions with industry representatives and a review of data provided by market participants, it appears that new issuances of CLOs in late 2013 and early 2014 are conforming to the final rule. Moreover, the current volume of new CLO issuances is higher as compared to CLOs issued prior to the adoption of the implementing rules, with monthly U.S. CLO activity increasing to a post-crisis high of $13.3 billion in April 2014, the third highest monthly total on record.

On April 7, 2014, the Federal Reserve issued a statement that it intends to grant two additional 1-year extensions of the conformance period under section 13 of the Bank Holding Company Act that would allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations. This would permit banking entities to retain ownership interests in and sponsorship of CLOs held as of that date until July 21, 2017. All of the agencies charged with implementing section 13 support the Federal Reserve's statement.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARTIN J. GRUENBERG

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. Responsibility for security of financial institutions' customer information held at third parties is addressed through contractual terms between the two parties. The Federal banking agencies developed the *Interagency Guidelines Establishing Information Security Standards* (12 C.F.R. 364, Appendix B *et al.*) in response to the Gramm-Leach-Bliley Act, Section 501(B). These standards direct all insured financial institutions to require service providers, by contract, to implement appropriate measures to protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer.

Each financial institution is expected to manage financial and reputational risk related to the products they offer and ensure that adequate controls are in place to mitigate that risk. Risk management responsibilities related to potential payment card data breaches are addressed through contractual terms and policies among the issuing banks, acquiring banks (banks that sponsor merchants' access to the payment card networks), and card networks (Visa and MasterCard). The contractual terms and policies describe the responsibility of the parties to implement controls, loss liability of the parties, and loss recovery processes. Issuing banks and acquiring banks receive fees for their participation in this partnership, in part, to offset risks. The extent to which fees and loss recovery models adequately cover card re-issuing costs or costs for protecting data at the merchant also is a contractual arrangement.

The card networks have established notification processes to alert the issuing banks of suspected compromised accounts. Issuing banks are responsible for limiting the potential for fraud on any accounts suspected of being compromised once the issuing bank is notified.

Conversely, the acquiring banks' merchants may be fined by the card network due to misconduct (such as poor security) to support recovery of fraud losses, in addition to direct responsibility for fraud due to card-not-present (online) transactions, or card-present transactions that are not authorized by the issuer. The acquiring bank remains at risk for the merchant's fines and losses to the extent the merchant is unable to meet its responsibilities. The FDIC's role is to ensure the safety and soundness of the issuing banks and acquiring banks, including the ensuring of adequate reserves against losses, appropriate security controls, and protection of customer accounts against unauthorized charges or withdrawals.

A significant challenge that financial institutions face as a result of data breaches is notification to potentially affected customers and the potential for customers to become desensitized by the notices. Given the frequency that data breaches occur and the goal to notify potentially affected customers as soon as possible, customers may discard the notices and fail to follow the instructions provided to protect their credit rating. Financial institutions can address this challenge by providing notices that are written in plain language with clear and direct instructions.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. The FDIC does not mandate specific technologies for data security as technology and threats evolve very rapidly. However, the FDIC expects financial institutions to establish an information security program that will adjust to any relevant changes in technology, the sensitivity of its customer information, and internal or external threats to information. The FDIC welcomes the industry initiative to strengthen card security technology through the implementation of the Europay, MasterCard, and Visa (EMV) global standard for card authentication. However, while the new EMV standard improves the card-present aspect of fraud prevention, it does not make it more difficult to steal the card data from merchant databases, nor does it address online fraud or fraud at merchants still accepting credit cards with customer data stored in the magnetic stripes (commonly referred to as "mag-stripe") for purchases.

As part of the examination process, the FDIC does not identify which financial institutions will offer the new EMV enhanced cards. However, to encourage EMV chip card issuance and acceptance, the card brands/networks (Visa, MasterCard, Discover, and AMEX) have announced that beginning in October 2015, entities, including financial institutions and merchants, that do not use the new EMV standard will face increased liability for fraud. We agree with their assumption that the potential for increased fraud liability will encourage adoption of the technology.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. The current FSOC framework for the designation of nonbank SIFIs addresses the specific statutory considerations set forth in Section 113 of the Dodd-Frank Act Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). It combines measurable, quantitative thresholds and metrics with qualitative analysis to address the nature of the unique threats that FSOC seeks to mitigate. Nonbank financial companies engage in a wide variety of complex activities and possess material differences in operating and financial characteristics. For example, these firms may be holding companies or operating companies, and they may have differing business models, risk profiles, funding sources, capital structures, and interconnections that may make evaluating the systemic risk they pose to the U.S. financial system more difficult using solely quantitative metrics.

In April 2012, after notice and public comment, the FSOC issued interpretative guidance setting forth both quantitative thresholds and qualitative information that the FSOC had determined to be relevant in the designation process in order to provide transparency and clarity to companies, market participants, and the public. The FSOC's interpretative guidance addresses, among other things, the uniform quantitative thresholds that the FSOC uses to identify nonbank financial companies for further evaluation and the six-category framework used to consider whether a nonbank financial company meets either of the statutory standards for a determination, including examples of quantitative metrics for assessing each category. In addition, the interpretative guidance includes a three-stage process for the review of a nonbank financial company, which incorporates quantitative thresholds in the first stage and more qualitative company-specific analyses in the second and third stages.

Generally, as reporting requirements evolve and new information about certain industries and nonbank financial companies become available, the FSOC will be better able to consider whether to establish additional metrics and thresholds.

Q.4. Please explain how and why the agencies failed to foresee the accounting issue with the treatment of the Trust Preferred Collateralized Debt Obligations (TruPS CDOs) in the final Volcker Rule. Did the proposed rule include requisite language seeking public comment on TruPS CDOs, as finalized? If so, please provide that language from the proposed rule. If not, please explain why the proposal did not seek that specific information and whether the agencies believe they satisfied the notice-and-comment requirements under the Administrative Procedure Act.

A.4. It is fair to say that everyone missed the immediacy of the accounting issues associated with CDOs backed by bank-issued trust preferred securities. As part of developing the final rule, the agencies clearly missed the immediacy; however, the industry and other commenters missed the immediacy of this issue as well. For example, throughout the rather extended notice and comment period, none of the over 18,000 comment letters raised this issue.

An important take-away from this episode is how the agencies responded when the issue was identified. The agencies worked closely together and, with input from the industry, developed an effective and timely response to the majority of the bankers' concerns. Importantly, the agencies were able to do so in a manner that reconciled the broader policy objectives of the Dodd-Frank Act without jeopardizing the robustness of the implementation of the Volcker Rule.

As part of the notice-and-comment process, the agencies sought robust public comment on the proposed Volcker Rule. Included in the notice of proposed rulemaking were several questions seeking comments on any concerns or challenges to issuers of asset-backed securities and/or securitization vehicles. For example, Question 227 asked whether certain asset classes, including collateralized debt obligations, are more likely to be impacted by the proposed definition of "covered fund." Question 229 asked if there are entities that issue asset-backed securities that should be exempted from the requirements of the proposed rule. Question 231 stated that many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds, including CDOs, and asked if the proposed definition of "covered fund" were to exempt any entity issuing asset-backed securities, would this allow for interests in hedge funds or private equity funds to be structured as asset-backed securities and circumvent the proposed rule. Commenters did not raise concerns about TruPS CDOs in their responses to the proposed rule.

Q.5. What specific efforts are the regulators considering to address the issue with the Collateralized Loan Obligations (CLOs) in the final Volcker rule? In Governor Tarullo's testimony before the House Financial Services Committee, he stated that the CLO issue is "already at the top of the list" for regulators to consider and fix. How many financial institutions are impacted by the final rule's treatment of CLOs?

A.5. The agencies are carefully considering all requests that have been received related to CLOs. These requests have ranged from the very narrow—requesting a grandfathering of a well-defined, limited number of CLOs issued before publication of the Volcker Rule—to the very broad—requesting a change to the definition of ownership interest that would potentially allow banks to expand their holdings of other types of securitization positions, such as synthetic CDOs and structured investment vehicles (SIVs), which caused significant financial losses during the crisis.

The agencies' staffs jointly have met with representatives of the Loan Syndication Trade Association, the American Bankers Association, the Structured Finance Industry Group, the Financial Services Roundtable, and the Securities Industry and Financial Markets Association. Based on these discussions with the industry representatives, a review of data provided by market participants, and discussions among the staffs of the agencies, the agencies found:

- Banking entities that hold legacy CLOs are undertaking a review of their particular holdings to evaluate where they fit within the treatment of covered funds under the agencies' implementing regulations. Industry representatives have advised the staffs of the agencies that there is a great amount of variation from deal to deal in the restrictions applicable to investments permitted for CLOs and the rights granted to CLO investors. In addition, staffs of the agencies understand from the industry that many legacy CLOs may not satisfy the exclusion from the definition of covered fund for loan securitizations because they may hold a certain amount of nonconforming assets (such as bonds or other securities).
- New CLO issuances have been comparable in volume to the CLOs issued prior to the adoption of the implementing rules and sponsors have revised their new CLO deals to conform to the Volcker Rule's exception for loan securitizations. In particular, market participants have represented that new issuances of CLOs in late 2013 and early 2014 after issuance of the final rule are conforming to the final rule.[1]
- Data contained in the Call Report and Y9–C forms for asset-backed securities or structured financial products secured by corporate and similar loans indicate that U.S. banking entities hold between approximately $84 billion and $105 billion in CLO investments.[2] Of this amount, between approximately 94 and 96 percent are held by banking entities with total assets of $50 billion or more. Holdings of CLOs by domestic banking entities represent between approximately 28 to 35 percent of

[1] According to S&P, the majority of CLOs issued since the final rule have been structured as loan-only securitizations. Year to date, CLO issuance stands at approximately $21 billion, according to Thomson Reuters PLC.

[2] This information is based on data compiled as of December 31, 2013, by the Federal banking agencies, which undertook a review and analysis of CLO holdings of banking entities that are subject to filing Call Report or Y–9C data, including insured depository institutions, bank holding companies and certain savings and loan holdings companies.

the $300 billion market for U.S. CLOs, with these holdings skewed toward the senior tranches.[3] These aggregate holdings reflect an unrealized net gain. Unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Up to 52 domestic insured depository institutions (all charters) reported holdings of CLOs in their held-to-maturity, AFS and trading portfolios.[4]

To address the concerns regarding CLOs, the Federal Reserve Board issued a statement that it intends to grant two additional 1-year extensions of the conformance period under the Volcker Rule that allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final rule for loan securitizations.[5] The FDIC supports the statement issued by the Federal Reserve Board.

Q.6. Since the final Volcker rule was issued in December, the affected entities have recognized two issues with the final rule (TruPS CDOs and CLOs). What other issues with the final Volcker rule are your agencies aware of that may be raised by affected entities? How do you intend to coordinate efforts on clarifying such issues in the future?

A.6. In the agencies' release for community banks that accompanied the Final Rule, the agencies noted that a few community banks held TruPS CDOs and CLOs that would be affected by the rule.[6] The TruPS CDO issue was the most pressing because the TruPS CDOs had lost so much value that the immediate accounting impact was substantial. The agencies worked together on the TruPS CDO issue and approved the January 14, 2014, Interim Final Rule to address bank investments in certain TruPS CDOs. With respect to the CLO issues raised by industry, the agencies conducted extensive analysis and met with a number of banking and financial services industry groups, as described in more detail in the answer to question 5. As a result of this process, the Federal Reserve recently issued a statement which announced its intent to offer two 1-year extensions to the Final Rule conformance period for certain CLOs. The agencies believe that the extension should address the compliance issues for many of the legacy CLOs that do not meet the loan securitization exemption, allowing many of them to mature or be called by investors, and should provide more time for CLO managers to evaluate and possibly change the composition of the underlying assets to bring the CLOs into conformance.

The agencies are committed to continued coordination efforts to clarify any additional issues or concerns that may be raised with respect to the implementation of the Volcker Rule. To better effectuate coordination and help ensure a consistent application of the Final Rule, the agencies have established an interagency Volcker Rule implementation working group consisting of senior-level managers and subject matter experts. This working group has been

[3] OCC supervised institutions hold the majority (95 percent) of this CLO exposure. These positions are concentrated in the largest institutions and are held mainly in the AFS portfolio.

[4] Based on Call Report data as of December 31, 2013.

[5] See Board Statement regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act (April 3, 2014).

[6] *http://fdic.gov/regulations/reforrn/volcker/summary.pdf.*

meeting weekly to discuss coordination matters as well as issues such as those related to technical interpretations and specific activities, like those raised on TruPS CDOs and CLOs.

Q.7. How do you plan to coordinate with other agencies regarding enforcement matters and the final Volcker rule, given that your agencies have varied jurisdictions?

A.7. Each agency is ultimately responsible for its own enforcement of the Volcker Rule; however, as noted previously, the agencies are committed to continued coordination efforts to help ensure a consistent application of the rule. As noted above, the agencies have established a Volcker Rule implementation working group to facilitate interagency coordination on a wide variety of issues.

Q.8. On January 10, 2014, the Federal Reserve and the FDIC made available the public portions of resolution plans for 116 institutions that submitted plans for the first time in December 2013, the latest group to file resolution plans with the agencies. These living wills are based on a premise that when a financial firm is near the brink, there will be a marketplace where buyers for assets and operations are available, but that may not be the case as was evident with Lehman's 2008 collapse when no one wanted to touch what was perceived as Lehman's "toxic assets." What specifically gives you confidence that these living wills will work in the first place and that there will be willing buyers for the troubled firm's assets?

A.8. The 116 plans represent the latest set of institutions to file their initial plans. The FDIC and the Federal Reserve currently are in the process of reviewing these resolution plans (or "living wills"), as we have done for the plans filed earlier in 2013 and in 2012. Under the standards provided in section 165(d) of the Dodd-Frank Act, certain firms, known as "covered companies," are required to submit plans for their rapid and orderly resolution under the Bankruptcy Code in the event of their material financial distress or failure. The resolution plan rule jointly promulgated by the FDIC and the Federal Reserve, which implements the statutory requirement of section 165(d), directs covered companies to include, among other items, a discussion of key assumptions and supporting analysis underlying the covered company's resolution plan and the processes the company employs to assess the feasibility of any sales, restructurings, or divestures contemplated in the resolution plan. Therefore, to the extent that a firm presents a resolution plan in which certain assets of a troubled firm will be sold as a key part of its resolution strategy, the firm would need to provide supporting analysis. In addition, the resolution plans may present options for resolution other than asset sales that are consistent with bankruptcy (such as restructurings, for example). If the FDIC and the Federal Reserve jointly determine that a resolution plan would not facilitate an orderly resolution of the covered company under the Bankruptcy Code, the FDIC and the Federal Reserve will notify the filer of the aspects of the plan that were jointly determined to be deficient. The filer must re-submit within 90 days (or other specified timeframe) a revised plan that addresses the deficiencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MARTIN J. GRUENBERG

Q.1. Are you comfortable with the extent to which the consumer payments industry currently sets its own data security standards? Currently, most standards are set by contract—with the card companies playing a significant role—and an industry body known as PCI determines most of the details and certifies compliance examiners. Should Federal regulators be playing a greater role?

A.1. The FDIC recognizes the importance of effective self-regulatory standards such as PCI data security standards that set expectations between regulated card companies and businesses that handle payment card data, including retailers, payment processors, and others. While such self-regulatory models are an important part of data security, the Federal banking agencies also established data security standards for financial institutions and those companies that do business with financial institutions including payment processors. These regulatory standards require financial institutions to develop and implement effective risk assessment and mitigation processes to protect customer information. These regulatory standards also require financial institutions to ensure that any third-party they do business with is also required contractually to comply with the same security rules for protecting customer information. Further, banking rules such as the Federal Reserve's Regulation E and Regulation Z are designed to protect consumers from payment card fraud, regardless of where a data breach occurs. The setting of standards for other aspects of the consumer payments industry is outside the Federal financial regulatory structure. Whether additional involvement by the Federal banking agencies should be authorized when those standards impact supervised institutions is a fair question for Congress to consider.

Q.2.a. When a financial data breach occurs with a merchant (as seems to be the case with the current wave of data breaches) or other source outside of a financial institution, financial institutions still very clearly feel the effects. Credit and debit card issuers, for example, must notify affected customers and issue new cards, and will likely end up bearing some portion of the financial losses that occur from fraudulent transactions using stolen card information. In the chain of a retail payment transaction, security is only as strong as its weakest link.

In addition to the examinations the FDIC conducts regarding regulated institutions' own data security, can you describe the FDIC's oversight with respect to the security of consumer data across the entire chain of consumer payment transactions?

A.2.a. The FDIC's authority does not span the entire payment network. However, the Federal banking agencies examine a number of nonbank payment processing companies that provide direct services to our regulated financial institutions as authorized by the Bank Service Company Act (12 U.S.C. 1867). Examination of these service providers attempts to identify potential systemic risks to the banking system and potential downstream risks to client banks.

When financial institutions partner with an outside party, they are exposed to additional risks, including reputation and financial risk if their customers' data is compromised. Given these risks, the FDIC seeks to ensure that the financial risk from third-party data breaches does not undermine the safety and soundness of the financial institutions.

Q.2.b. Should Federal regulators be taking a greater interest in the data security standards applicable to other entities that posses consumer financial data, beyond just regulated financial institutions? Are legislative changes necessary or are there legislative changes that would help?

A.2.b. Regulatory standards for protecting customer information (12 C.F.R. 364, Appendix B) address financial institution responsibilities for data security. Our oversight, through onsite examination programs and enforcement authority for compliance failures, is designed to ensure data security standards for customer information are effectively implemented. Similarly, the Federal Trade Commission (FTC) can enforce standards for protection of customer information (16 C.F.R. 314) by all other financial institutions that are not insured depository institutions.

While financial institutions are subject to both industry standards and regulatory standards, others, such as merchants, are not subject to any national regulatory requirements to protect consumer data. If Congress chooses to review the Gramm-Leach-Bliley Act, or any other law, to determine whether customer protections should be expanded to nonfinancial institutions, the FDIC stands ready to assist. Further, the FDIC would recommend a review of the Bank Service Company Act to determine whether additional enforcement authority is necessary for the Federal banking agencies with respect to nonbank financial institutions that provide direct services to banks.

Q.3. In our economy today, companies are collecting and storing growing amounts of consumer information, often without consumers' knowledge or consent. The financial industry is no exception. We have heard reports of lenders, for example, mining online data sources to help inform underwriting decisions on consumer loans. As companies aggregate more data, however, the consequences of a breach or improper use become greater.

The Target breach illustrates the risks consumers face—not just of fraud, but also identity theft and other hardships. Compromised information included both payment card data and personal information such as names, email addresses, and phone numbers. But what if the next breach also involves account payment histories or Social Security numbers? As the ways companies use consumer information changes, and the amount of consumer data they hold grows, how is the FDIC's approach evolving? Are there steps regulators are taking—or that Congress should take—to require stronger protections against breaches and improper use, and to mitigate harm to consumers?

A.3. Many nonbank companies aggregate consumer data, including credit reporting bureaus, tax preparers, health care providers, insurers, universities, and Government agencies. The FDIC concurs that protection of consumer data is critical across all entities. The FDIC is charged with ensuring that banks protect consumer data as authorized by the Gramm-Leach-Bliley Act (GLBA), Section

501(b). In response to GLBA, the FDIC and the other Federal bank regulatory agencies developed the *Interagency Guidelines Establishing Information Security Standards* (12 C.F.R. 364, Appendix B) to protect customer information. With respect to protecting customer information, GLBA limits the FDIC's scope of enforcement authority to insured depository institutions. As discussed above, Congress might wish to review the Bank Service Company Act to determine if the Act adequately addresses third-party risk with respect to companies that provide direct services to banks.

Q.4.a. A lot of the discussion in the aftermath of the recent data breaches has focused on credit and debit card "smart" chip technology, since the United States seems to have fallen behind other parts of the world such as Western Europe in adopting it. But while card chips help to reduce fraud for transactions where a card is physically present, and make it harder for thieves to print fake cards using stolen information, they do little to reduce fraud for online, "card-not-present" transactions.

Are you comfortable with the steps industry is taking to improve security and reduce fraud for "card-not-present" transactions?

A.4.a. As you indicate, card-not-present transactions may pose a higher risk to the merchant and the issuing bank. Absent adequate transaction authorization, the merchant may hold a greater degree of liability should fraud occur. Issuing banks that authorize transactions without sufficient fraud monitoring tools, or fail to respond to suspected compromised account notices from the card networks, could take on greater liability. However, the industry continues to struggle to provide effective security for "card-not-present" transactions. More needs to be done to ensure that there are protections in place to ensure proper authorization for these kinds of transactions, and to ensure that customer data remains protected. As online commerce continues to grow, so does this risk. With the upcoming implementation of the Europay, MasterCard and Visa (EMV) standard, there could potentially be a shift in fraud toward card-not-present transactions. To counter that potential, the industry should consider adopting new standards and technology. Examples include tokenization and end-to-end encryption as potential solutions.

Q.4.b. Banks and other industry participants need to be proactive here, rather than waiting for a major breach to happen before making protective investments. Do you feel that regulated institutions are paying sufficient attention to all areas of data security risk, and are making the necessary investments to protect consumers rather than treating fraud as simply a cost of doing business?

A.4.b. As a general matter, the FDIC believes that the banks it supervises are complying with data security requirements and making necessary investments to protect customers from fraud. The FDIC assesses a financial institution's efforts to protect itself from financial risks such as fraud losses through risk mitigation processes, such as credit risk management and establishing credit risk reserves. Further, the *Interagency Guidelines Establishing Information Security Standards* require financial institutions to implement an information security program that assesses risks to customer information, regardless of the potential for fraud losses. Such a program must assess risks to the confidentiality, integrity, and availability of customer information. The FDIC assesses the effectiveness of this program in banks we supervise as part of the FDIC's onsite examination process.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KIRK FROM MARTIN J. GRUENBERG

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. The FSOC has worked to ensure that the designation of firms follows processes that provide transparency and certainty to companies, market participants, and members of the public and incorporates the specific statutory considerations of Section 113 of the Dodd-Frank Act governing designation of nonbank companies. At the same time, the FSOC is mindful of nonbank financial companies' concerns that sensitive firm-specific nonpublic information be protected from disclosure. To provide transparency and clarity regarding its designation process, the FSOC issued, after notice and public comment, a final rule and interpretative guidance in April 2012. The public comment process helped to ensure that key issues were fully considered and transparent to the public.

The interpretative guidance details the FSOC's analytical framework for designation of nonbank financial companies and includes quantitative metrics. The analysis performed on each individual company considered for designation requires analysis of nonpublic information, which may be provided by the company's regulators and by the company itself in response to requests from the FSOC. The company is provided with the basis for the FSOC's proposed determination and may request a hearing to contest the determination. In addition, the FSOC has adopted policies to ensure that the processes are as transparent as practicable to the public. After a final designation, a document explaining the basis for its determination to designate a company and minutes of the designation votes are posted to the FSOC's public Web site.

Following a firm's designation as a SIFI, the implications and process to be followed are set out in the Dodd-Frank Act. The Federal Reserve, as primary Federal regulator, develops the prudential standards that will be applicable to nonbank designated firms, under section 165 of the Dodd-Frank Act, for its ongoing supervision of these firms. In addition, the FDIC and the Federal Reserve Board meet with the newly designated firms to provide guidance for the preparation of their resolution plans under Title I of the Dodd-Frank Act.

The FDIC, as a member of the FSOC, is committed to the issue of transparency and takes these concerns as well as suggestions for improvement very seriously. As reporting requirements evolve and new information about certain industries and nonbank financial companies become available, the FSOC will be better able to consider whether changes to assure transparency of the designation process are needed.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. The agencies have taken the industry concerns regarding the treatment of CLOs under the Volcker Rule very seriously and, since the issue was first raised, have devoted considerable effort and staff resources to examining the industry concerns. For example, the agencies' staffs jointly have met with representatives of the Loan Syndication Trade Association, the American Bankers Association, the Structured Finance Industry Group, the Financial Services Roundtable and the Securities Industry and Financial

Markets Association. Based on these discussions with the industry representatives, a review of data provided by market participants and discussions among the staffs of the agencies, we have found:

- Banking entities that hold legacy CLOs are undertaking a review of their particular holdings to evaluate where they fit within the treatment of covered funds under the agencies' implementing regulations. Industry representatives have advised the staffs of the agencies that there is a great amount of variation from deal to deal in the restrictions applicable to investments permitted for CLOs and the rights granted to CLO investors. In addition, staffs of the agencies understand from the industry that many legacy CLOs may not satisfy the exclusion from the definition of covered fund for loan securitizations because they may hold a certain amount of nonconforming assets (such as bonds or other securities).
- New CLO issuances have been comparable in volume to the CLOs issued prior to the adoption of the implementing rules and sponsors have revised their new CLO deals to conform to the Volcker Rule's exception for loan securitizations. In particular, market participants have represented that new issuances of CLOs in late 2013 and early 2014 after issuance of the final rule are conforming to the final rule.[1]
- Data contained in the Call Report and Y9–C forms for asset-backed securities or structured financial products secured by corporate and similar loans indicate that U.S. banking entities hold between approximately $84 billion and $105 billion in CLO investments.[2] Of this amount, between approximately 94 and 96 percent are held by banking entities with total assets of $50 billion or more. Holdings of CLOs by domestic banking entities represent between approximately 28 to 35 percent of the $300 billion market for U.S. CLOs, with these holdings skewed toward the senior tranches.[3] These aggregate holdings reflect an unrealized net gain. Unrealized losses reported by individual banking entities are not significant relative to their tier 1 capital or income. Up to 52 domestic insured depository institutions (all charters) reported holdings of CLOs in their held-to-maturity, AFS and trading portfolios.[4]

To address the concerns regarding CLOs, the Federal Reserve Board issued a statement that it intends to grant two additional 1-year extensions of the conformance period under section 619 that allow banking entities additional time to conform to the statute ownership interests in and sponsorship of CLOs in place as of December 31, 2013, that do not qualify for the exclusion in the final

[1] According to S&P, the majority of CLOs issued since the final rule have been structured as loan-only securitizations. First quarter 2014 CLO issuance stands at approximately $21 billion, according to Thomson Reuters PLC.

[2] This information is based on data compiled as of December 31, 2013, by the Federal banking agencies, which undertook a review and analysis of CLO holdings of banking entities that are subject to filing Call Report or Y–9C data, including insured depository institutions, bank holding companies and certain savings and loan holdings companies.

[3] OCC supervised institutions hold the majority (95 percent) of this CLO exposure. These positions are concentrated in the largest institutions and are held mainly in the AFS portfolio.

[4] Based on Call Report data as of December 31, 2013.

rule for loan securitizations.[5] The FDIC supports the statement issued by the Federal Reserve Board.

Q.3. On a related point, we have heard that some are of the view that the guidance being sought by industry in connection with CLO debt securities is too broad. Isn't it the case that all the agencies have to do is issue extremely narrow guidance that states that a CLO debt security that has the right to replace a manager for cause, without any other indicia of ownership, will not be treated as an "ownership interest" under the Volcker Rule? Even if we were to concede (which we do not) that it would be difficult for the agencies to grant the requested relief, couldn't the agencies address the issue of legacy CLO securities by simply agreeing (as they did in the context of CDOs of Trumps) to grandfather all existing CLO debt securities for CLOs issued prior to the publication of the final rules in the Federal Register? Wouldn't this very narrow relief fix the problem for banks that purchased CLO debt securities in good faith prior to the issuance of the final rule but are now facing potentially material losses?

A.3. As noted above in the answer to question 2, the agencies have carefully considered the banking industry's concerns regarding bank CLO investments and their treatment under the Volcker Rule. After extensive interagency review of these issues, the Federal Reserve issued its statement announcing it would extend the conformance period for two additional years for certain CLOs. The agencies believe that the extension should address the compliance issues for many of the legacy CLOs that do not meet the loan securitization exemption, allowing many of them to mature or be called by investors, and should provide more time for CLO managers to evaluate and possibly change the composition of the underlying assets to bring the CLOs into conformance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM THOMAS J. CURRY

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. Banks and Federal savings associations (referenced here as "banks") are required to be on the alert for identity theft involving its customers' information, no matter how and where the identity thief acquired the information, even if the information was acquired from a third party that has no relationship with the bank. Following the enactment of the Fair and Accurate Credit Transactions Act (FACT Act), the Federal banking agencies together with

[5] See Board Statement regarding the Treatment of Collateralized Loan Obligations Under Section 13 of the Bank Holding Company Act (April 3, 2014).

the Federal Trade Commission issued regulations in 2008 titled "Identity Theft Red Flags and Address Discrepancies." The final rules require each financial institution and creditor to develop and implement a written identity theft prevention program that includes policies and procedures for detecting, preventing, and mitigating identity theft in connection with new and existing accounts. The program must cover any consumer account, or any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to consumers or to the safety and soundness of the financial institution or creditor from identity theft. In addition, it must include policies and procedures to identify relevant red flags signaling possible identity theft, detect the red flags incorporated into the program, respond appropriately to the red flags that are detected, and ensure the program is updated periodically to reflect changes in risks to customers and to the institution from identity theft.

The agencies also issued guidelines to assist financial institutions to develop and implement an identity theft prevention program. These guidelines state that when a bank detects identity theft red flags, it is expected to respond appropriately by taking steps that include monitoring accounts, contacting the customer, changing passwords, closing and reopening the account, and notifying law enforcement, as appropriate.

The guidelines also include a supplement that identifies 26 patterns, practices, and specific forms of activity that are "identity theft red flags." These include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, the presentation of suspicious documents or suspicious personal identifying information, the unusual use of, or other suspicious activity related to, a covered account, or notice from customers, victims of identity theft, or law enforcement authorities.

Recent events, such as the information security breaches at Target and Neiman Marcus, highlight the sophisticated nature of evolving cyber threats, as well as the interdependencies that exist in today's payment systems. They underscore the challenges and costs that banks can face when their customers' data is breached through technologies controlled and overseen by a third party such as point-of-sale card readers at a merchant. Banks have borne the expense of replacing cards, providing credit-monitoring services, responding to high volumes of customer inquiries, monitoring for fraudulent transactions, and reimbursing customers for fraud losses.

Because of the interdependencies within retail payment systems, solutions to these issues will require cooperation among multiple entities and oversight bodies. The OCC supports recent efforts by the industry to work with the different stakeholders within the retail payment systems to develop approaches to minimize the risks and address challenges faced by banks. This includes efforts to develop new technologies and tools that will enhance the overall security of the retail payment systems.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. The payment technology discussed in the February 3 hearing is known as EMV, also called "chip and pin" and "chip and signature." While some banks and credit unions already issue chip cards, implementing a fully functioning EMV system is complex and will require a coordinated approach across retail payment systems, and among financial institutions, merchants and consumers. For example, ATM networks and point-of-sale systems must be reconfigured to accept the new cards. In many cases, existing hardware may need to be replaced to accept newer technologies. Given the multifaceted challenges and interdependent systems that must be successfully coordinated across banks and merchants, we understand that full implementation may extend beyond the 2015 timeframe.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. I believe the designation process used by the FSOC strikes an appropriate balance in using a combination of uniform metrics, supplemented with more in-depth quantitative and qualitative assessments to make a designation determination. To provide transparency and clarity, the FSOC published for comment its proposed rule and interpretative guidance that explained the process, factors and key metrics the Council would use in its designation process. The Council's interpretative guidance set forth the Council's three-stage process and analytical framework for analyzing firms. Within that guidance and as part of its stage 1 analysis, the guidance identified a set of measurable, uniform metrics that are used to identify firms that warrant more in-depth review and analysis. Firms that meet the stage 1 metrics laid out in the guidance are subject to further review and analysis based on six key categories of risk factors. Those factors, and examples of metrics that FSOC will use to evaluate those risks factors, were also described in the guidance.

As noted in the preamble to the final designation rule and interpretative guidance, the Council intends to review the quantitative thresholds as reporting requirements evolve and new information about certain industries and nonbank financial data becomes available. While I would support such refinements to the designation process, I believe it would be a mistake to design a framework that relies solely on a set of quantitative metrics or algorithms to make a determination decision. I believe each firm must be evaluated with respect to its individual risk profile and the nature of its operations. This need for a tailored analysis is why the Council's process includes substantial opportunities for communications with, and responses by, firms that are under consideration for determination.

Q.4. Please explain how and why the agencies failed to foresee the accounting issue with the treatment of the Trust Preferred

Collateralized Debt Obligations (TruPS CDOs) in the final Volcker Rule. Did the proposed rule include requisite language seeking public comment on TruPS CDOs, as finalized? If so, please provide that language from the proposed rule. If not, please explain why the proposal did not seek that specific information and whether the agencies believe they satisfied the notice-and-comment requirements under the Administrative Procedure Act.

A.4. The TruPS CDOs that raised the accounting issue were covered by the Agencies' implementing regulations because they have features that bring them within the definition of "ownership interest." The Notice of Proposed Rulemaking (76 Fed. Reg. 68,846) discussed the Agencies' proposed definition of "ownership interest" in covered funds, in connection with implementing the Volcker Rule's prohibition against banking entity holdings of covered funds (p. 68,897). The proposal went on to request comment on whether the proposed definitions of "ownership interest" in covered funds posed unique concerns or challenges with respect to specific classes of instruments, specifically including Collateralized Debt Obligations (p. 68,899). Commenters did not raise concerns about TruPS CDOs.

Q.5. What specific efforts are the regulators considering to address the issue with the Collateralized Loan Obligations (CLOs) in the final Volcker rule? In Governor Tarullo's testimony before the House Financial Services Committee, he stated that the CLO issue is "already at the top of the list" for regulators to consider and fix. How many financial institutions are impacted by the final rule's treatment of CLOs?

A.5. Based on Call Report information for year-end 2013, 51 domestic banks reported CLO holdings. The OCC is the supervisor of 26 of these banks, which hold 95 percent of the CLO holdings reported by all 51 banks in the Call Reports. Holding of CLOs is extremely concentrated in large banks, two of which hold far more than the other banks combined. Although some banks reported unrealized losses on their CLO portfolios, they were the exception to the rule, and the unrealized losses were not significant relative to tier 1 capital or earnings. On April 7, 2014, the Federal Reserve Board issued a statement announcing its intention, consistent with the statute, to grant two additional 1-year extensions of the conformance period—until July 2017—for legacy CLOs. A number of these legacy CLOs will have matured under their own terms and repaid their principal balances by that time. With respect to those that have not matured, the OCC does not anticipate significant adverse effects on capital or earnings overall with respect to the institutions we supervise.

Q.6. Since the final Volcker rule was issued in December, the affected entities have recognized two issues with the final rule (TruPS CDOs and CLOs). What other issues with the final Volcker rule are your agencies aware of that may be raised by affected entities? How do you intend to coordinate efforts on clarifying such issues in the future?

A.6. The Agencies are receiving requests for further guidance on a range of matters. For example, the OCC has received questions regarding the metrics reporting requirements, including about (i) the timeframes for when the largest trading banking entities must begin collecting metrics and filing their first reports; and (ii) the systems necessary for collecting and reporting metrics. The OCC has led the formation of an interagency working group to address and collaborate on developing responses to key supervisory issues that arise under the final regulations. The interagency group held its first meeting in late January and is continuing to meet on a regular basis. The Agencies are working to ensure consistency in application of the final regulations. Through our examination and supervisory staff, the OCC also is working with the institutions we supervise to ensure that they are preparing to conform with the implementing regulations when the conformance period concludes.

Q.7. How do you plan to coordinate with other agencies regarding enforcement matters and the final Volcker rule, given that your agencies have varied jurisdictions?

A.7. As noted in the response to the previous question, through our examination and supervisory staff, the OCC also is working with the institutions we supervise to ensure that they are preparing to conform with the implementing regulations. After the close of the conformance period, we will examine for compliance with the Volcker Rule and, in a case of noncompliance, will take appropriate supervisory or enforcement action. In cases where our work implicates institutions subject to regulation or supervision by other agencies, we will coordinate closely with those agencies.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM THOMAS J. CURRY

Q.1. Are you comfortable with the extent to which the consumer payments industry currently sets its own data security standards? Currently, most standards are set by contract—with the card companies playing a significant role—and an industry body known as PCI determines most of the details and certifies compliance examiners. Should Federal regulators be playing a greater role?

A.1. The OCC sets standards for financial institutions that we supervise. We are following the industry led efforts to respond to the evolving cybersecurity threats. The Payment Card Industry (PCI) Security Standards Council develops, maintains and manages the PCI Security Standards, such as the PCI–Data Security Standards (PCI–DSS). The PCI security standards are detailed and have been recently updated (November 2013). The bank regulators have an important role in evaluating the risk exposure of the banks in the system and consider PCI–DSS compliance in addition to compliance with the Federal Financial Institutions Examination Council (FFIEC) and OCC-related guidance in the examination process.

The OCC is in the process of assessing the existing regulatory structure, enforcement authorities, and statutory authorities to ensure they are adequate for the existing cybersecurity threat.

Q.2.a. When a financial data breach occurs with a merchant (as seems to be the case with the current wave of data breaches) or other source outside of a financial institution, financial institutions still very clearly feel the effects. Credit and debit card issuers, for example, must notify affected customers and issue new cards, and will likely end up bearing some portion of the financial losses that occur from fraudulent transactions using stolen card information. In the chain of a retail payment transaction, security is only as strong as its weakest link.

In addition to the examinations the OCC conducts regarding regulated institutions' own data security, can you describe the OCC's oversight with respect to the security of consumer data across the entire chain of consumer payment transactions?

A.2.a. Banks provide essential retail payment transaction services to businesses and customers; issuing credit and debit cards to customers, authorizing transactions for merchants, and then acquiring those transactions. A few provide clearing and settlement services for merchants. The OCC supervises banks and their services providers. However, the OCC does not oversee the security of consumer data across the entire chain of consumer payment transactions.

The OCC examines banks and their service providers for compliance with the interagency information security guidelines issues by the OCC pursuant to the Gramm-Leach-Bliley Act, in conjunction with the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve) (collectively, the FBAs). These interagency guidelines require each bank to develop and implement a formal information security program. Banks and their service providers are examined for the capacity to safeguard their systems against cyber attacks and their ability to ensure the security and confidentiality of customer information. The OCC also ascertains whether banks have strong and well-coordinated incident response programs that can be implemented if a cyber attack or security breach does occur.

While the guidelines require a bank to safeguard the customer information it maintains or that is maintained by a third party on its behalf, each bank is also required to be on the alert for identity theft involving its customers' information, no matter how and where the information was acquired. The OCC examines banks for compliance with interagency regulations issued by the OCC pursuant to the Fair and Accurate Credit Transactions Act (FACT Act), by the FBAs together with the Federal Trade Commission titled "Identity Theft Red Flags and Address Discrepancies." The final rules require each financial institution and creditor to develop and implement a written identity theft prevention program that includes policies and procedures for detecting, preventing, and mitigating identity theft in connection with new and existing accounts. The program must cover any consumer account, or any other account that the financial institution or creditor offers or maintains for which there is a reasonably foreseeable risk to consumers or to the safety and soundness of the financial institution or creditor from identity theft. In addition, it must include policies and procedures to identify relevant red flags signaling the possibility of identify theft, detect red flags incorporated into the program, respond appropriately to the red flags that are detected, and ensure the program is updated periodically to reflect changes in risks to customers and to the institution from identity theft.

The Agencies also issued guidelines to assist covered entities in developing and implementing an identity theft prevention program. The guidelines include a supplement that identifies 26 patterns, practices, and specific forms of activity that are "red flags." These include alerts, notifications, or other warnings received from consumer reporting agencies or service providers, the presentation of suspicious documents or suspicious personal identifying information, the unusual use of, or other suspicious activity related to, a covered account, or notice from customers, victims of identity theft, or law enforcement authorities. When a bank detects identity theft red flags, the bank is expected to respond appropriately by taking steps that include monitoring accounts, contacting the customer, changing passwords, closing and reopening the account, and notifying law enforcement, as appropriate.

Q.2.b. Should Federal regulators be taking a greater interest in the data security standards applicable to other entities that possess consumer financial data, beyond just regulated financial institutions? Are legislative changes necessary or are there legislative changes that would help?

A.2.b. The OCC recognizes the need to protect critical infrastructure and customer information across all sectors of the economy. We support legislation aimed at achieving these goals, except to the extent that such legislation would weaken or duplicate the existing information security, data protection, and consumer notice requirements already applicable to banks.

Q.3. In our economy today, companies are collecting and storing growing amounts of consumer information, often without consumers' knowledge or consent. The financial industry is no exception. We have heard reports of lenders, for example, mining online data sources to help inform underwriting decisions on consumer loans. As companies aggregate more data, however, the consequences of a breach or improper use become greater.

The Target breach illustrates the risks consumers face—not just of fraud, but also identity theft and other hardships. Compromised information included both payment card data and personal information such as names, email addresses, and phone numbers. But what if the next breach also involves account payment histories or Social Security numbers? As the ways companies use consumer information changes, and the amount of consumer data they hold grows, how is the OCC's approach evolving? Are there steps regulators are taking—or that Congress should take—to require stronger protections against breaches and improper use, and to mitigate harm to consumers?

A.3. Ensuring the industry's defenses against cyber attacks is an important issue for the OCC. While the banking sector is highly regulated and has been subject to stringent information security requirements for decades, we recognize that both our supervision and our guidance to banks must be regularly updated to keep pace with the rapidly changing nature of cyber threats.

The OCC has an information technology (IT) examination program that includes training examiners, updating and implementing IT risk management policy through guidance, alerts, and handbooks, and regular onsite examination of banks' IT programs.

We have also helped coordinate a series of classified briefings for banks, third-party service providers, and examiners. These briefings are an effective way to provide the industry with information needed to anticipate and prepare for attacks. We have also conducted a number of other outreach events, including a security and threat awareness teleconference for community banks and thrifts that attracted over 750 institutions.

When I became Chairman of the FFIEC, I called for the creation of a working group on cybersecurity issues to be housed under the FFIEC's task force on supervision. The working group has already begun to meet with intelligence, law enforcement, and homeland security officials, and it is exploring additional approaches bank regulators can take to ensure that institutions of all sizes have the ability to safeguard their systems. This working group will also consider how best to implement the President's Executive Order on Cybersecurity, as well as how to address recommendations of the FSOC.

In addition, as mentioned above, the OCC recognizes the need to protect critical infrastructure and customer information across all sectors of the economy, especially with respect to sectors upon which banks are dependent, such as telecommunications. We support legislation aimed at achieving these goals, except to the extent that such legislation would weaken or duplicate the existing information security, data protection, and the consumer notice requirements already applicable to banks.

Q.4.a. A lot of the discussion in the aftermath of the recent data breaches has focused on credit and debit card "smart" chip technology, since the United States seems to have fallen behind other parts of the world such as Western Europe in adopting it. But while card chips help to reduce fraud for transactions where a card is physically present, and make it harder for thieves to print fake cards using stolen information, they do little to reduce fraud for online, "card-not-present" transactions.

Are you comfortable with the steps industry is taking to improve security and reduce fraud for "card-not-present" transactions?

A.4.a. The banking industry is looking into a number of new technologies and business processes to improve security and reduce fraud. The largest institutions, in particular, have made significant investments in ways to improve security and reduce fraud. As your question acknowledges, while some technologies such as "chip and pin" may mitigate one source of vulnerability, they could accentuate other vulnerabilities. For this reason, there are additional industry efforts underway to explore other emerging technologies such as biometrics, geolocation and forms of dynamic authentication other than "chip and pin." Some of these potential solutions however, may raise other concerns such as consumer privacy that will need to be carefully considered.

Q.4.b. Banks and other industry participants need to be proactive here, rather than waiting for a major breach to happen before making protective investments. Do you feel that regulated institutions are paying sufficient attention to all areas of data security risk, and are making the necessary investments to protect consumers rather than treating fraud as simply a cost of doing business?

A.4.b. Cybersecurity is an important priority for the OCC and we have been conducting extensive outreach to our institutions to draw their attention to the importance of data security. We emphasize that it is an operational risk that needs to be part of institutions' overall enterprise risk management and receive attention from senior management and the board of directors. From our outreach efforts, we believe that senior financial institution executives understand that addressing cyber risks is a serious priority for their institutions, and, as noted above, they are exploring enhancements to existing technology to help to protect consumers' information. The OCC supports new technologies and tools that will enhance the overall security of retail payment systems.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KIRK FROM THOMAS J. CURRY

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. I believe the designation process used by FSOC strikes an appropriate balance in providing transparency to the public about the factors used by the Council in making its determinations while allowing for a robust evaluation, based on each firm's unique circumstances, that also protects the confidentiality of firm-specific proprietary and supervisory information. For example, to provide transparency and clarity, the FSOC published for comment its proposed rule and interpretative guidance that explained the process, factors and key metrics the Council would use in its designation process. The Council's interpretative guidance set forth the Council's three-stage process and analytical framework for analyzing firms. Within that guidance and as part of its stage 1 analysis, the guidance identified a set of measurable, uniform metrics that are used to identify firms that warrant more in-depth review and analysis. Firms that meet the stage 1 metrics laid out in the guidance are subject to further review and analysis based on six key categories of risk factors. Those factors, and examples of metrics that FSOC will use to evaluate those risks factors, were also described in the guidance.

With respect to the Council's actions for individual firms, a firm that is being actively considered for designation is sent a written notice that it is being considered for designation. That notice provides the firm with a preliminary, in-depth analysis of the Council's assessment of the firm, including key risk factors and metrics that the Council used in its assessment. During this stage, firms have an extensive opportunity to respond to those preliminary assessments through the submission of written materials and meetings and discussions with Council staff. If, at the conclusion of those discussions and analysis, the Council decides to make a determination, the firm is provided with a notice of proposed determination that includes an explanation of the basis for the Council's action and is given the opportunity to request a formal hearing before a final determination is made. To provide transparency of the Council's final decision to designate a firm, the Council's resolution and votes for the decision, along with any dissenting opinion, is posted to the Council's Web site, along with a summary that provides the basis and criteria used and the rationale for the designation.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. On April 7, 2014, the Federal Reserve Board issued a statement announcing its intention, consistent with the statute, to grant two additional 1-year extensions of the conformance period—until July 2017—for legacy CLOs. A number of these legacy CLOs will have matured under their own terms and repaid their principal balances by that time. With respect to those that have not matured, the OCC does not anticipate significant adverse effects on capital or earnings overall with respect to the institutions we supervise. Market participants indicate that new issuances have been structured so as to comply with Volcker Rule requirements for banking entity portfolio investments. I would note that CLO issuances for April were $12.3 billion, the highest monthly volume since the financial crisis, and that the total issuance for 2014 is already $31.7 billion, putting it on pace to exceed last year's total volume.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY JO WHITE

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. The challenges that face financial institutions as a result of a breach at a third party are many and varied. The sophistication of the perpetrators continually evolves, and the threats increase in complexity on a daily basis. Keeping pace with the challenges that we face will take a coordinated Government and industry effort.

Expectations for Regulated Entities When a Breach Occurs at a Third Party

The Commission has in place rules addressing privacy and identity theft to protect investors. Regulations S–P and S–ID work together to require covered firms to implement policies and procedures that are reasonably designed to ensure the security and confidentiality of customer records and information, including the establishment of an identity theft program addressing how to identify, detect, and respond to potential identity theft red flags.[1] Entities covered under these rules are required to implement measures addressing their regulatory obligations, including the oversight of service provider arrangements.

The guidelines contained in Regulation S–ID provide, among other things, that regulated entities that engage a service provider to perform services related to a covered account should take steps to ensure that the service provider has policies and procedures designed to detect, prevent and mitigate the risk of identity theft.

[1] Regulation S–P requires broker-dealers, investment companies and registered investment advisers to establish policies and procedures reasonably designed to safeguard customer information and records. It also limits the ability of these firms to disclose nonpublic personal information to unaffiliated third parties. Last year, to implement Section 1088 of the Dodd-Frank Act, the SEC and the CFTC jointly adopted Regulation S–ID, which requires certain regulated financial institutions and creditors to adopt and implement identity theft programs. Regulation S–ID is in effect today and requires covered firms to implement policies and procedures designed to: identify relevant types of identity theft red flags; detect the occurrence of those red flags; respond appropriately to the detected red flags; and periodically update the identity theft program. Regulation S–ID also requires entities to provide staff training, oversight of service providers, and guidelines for and examples of red flags to help firms administer their programs.

Challenges Faced by Financial Institutions as a Result of a Breach

Possibly the greatest challenge faced by financial institutions and regulators alike is the need to be ever vigilant in guarding against new and unexpected threats. This generally necessitates good communication by all affected, as well as foresight in allocating resources to data and cyber protection. Financial institutions covered under the rules that possess customer data, of course, should, and are required to, take steps to prevent that data from being placed at risk. By way of example, broker-dealers, mutual funds and registered investment advisers are required under Regulation S–P and Regulation S–ID to implement policies and procedures that address safeguarding data and preventing identity theft. Some of the challenges facing entities covered under Regulation S–ID relate to implementing a program that provides for an appropriate response to identity theft red flags commensurate with the risk posed. Guidelines contained in Regulation S–ID note that an appropriate response should take into account aggravating factors that may heighten the risk of identity theft, such as a data security incident that results in unauthorized access to account records, and include a number of examples of appropriate responses that a regulated entity should consider. Appropriate responses may include, among others:

- Monitoring a covered account for evidence of identity theft;
- Contacting the customer;
- Changing any password, security codes, or other security devices that permit access to a covered account; or
- Notifying law enforcement.

Addressing Challenges While Minimizing Consequences and Costs

An entity covered under Regulation S–ID is required to tailor its particular identity theft program to its size and complexity and to the nature and scope of its activities. Allowing an entity to tailor its program to fit its particular circumstances should enable the entity to better balance an appropriate response against any related consequences and costs.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. It is our understanding that the payment systems industry has spearheaded the transition to the use of new, more secure payment technology, and major industry participants are working to finalize this process by October 2015. The SEC's authority, however, generally does not extend to retail payment systems. This authority generally resides with banking regulators. For instance, although some clients of broker-dealers and mutual funds have the ability to obtain debit cards linked to their accounts, the cards themselves are issued directly by a bank, and any unauthorized transactions processed through retail payments systems are subject to the fraud protections of the banking regulations. As a result, the Commission has not been involved in these activities and is not in a position to provide additional details concerning them.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. As a voting member of the Financial Stability Oversight Council (FSOC), I believe it is important to be data-driven and rely on facts throughout the process for consideration of the potential designation of systemically important financial institutions (SIFI). I therefore support the thorough and appropriate use of data and quantifiable, measurable factors in the SIFI designations process. In addition, I would note that the FSOC as a general matter is focused on the issue of transparency and enhancing transparency, which I consider an important area of focus.

Q.4. Since the final Volcker rule was issued in December, the affected entities have recognized two issues with the final rule (TruPS CDOs and CLOs). What other issues with the final Volcker rule are your agencies aware of that may be raised by affected entities? How do you intend to coordinate efforts on clarifying such issues in the future?

A.4. Staffs of the five agencies continue to work together, as they did during the rulemaking process, to share information and coordinate the agencies' implementation of the Volcker rule. The staffs engage in discussions on a regular basis concerning technical and other issues concerning the implementation of the Volcker rule, including interpretive and other issues raised by affected entities, to facilitate coordinated responses by the agencies or their staffs as appropriate. The staffs are not able to predict all of the issues that affected entities may raise with the final Volcker rule, but will continue to evaluate issues identified by affected entities and facilitate the agencies' coordinated consideration of these issues.

Q.5. How do you plan to coordinate with other agencies regarding enforcement matters and the final Volcker rule, given that your agencies have varied jurisdictions?

A.5. Section 13 of the Bank Holding Company Act ("BHC Act") provides each agency with authority to adopt and administer rules with respect to specific types of legal entities. For instance, section 13(e)(2) of the BHC Act authorizes the SEC, the Federal banking agencies, and the CFTC to take specified actions against a banking entity under the respective agency's jurisdiction if there is reasonable cause to believe the banking entity has made an investment or engaged in activity that functions as an evasion or otherwise violates the restrictions of that section. Banking entities within the SEC's jurisdiction include bank-affiliated, SEC-registered broker-dealers, investment advisers, and security-based swap dealers. The SEC is authorized to enforce the requirements of section 13 of the BHC Act only with respect to the types of banking entity under its jurisdiction. The SEC and the other agencies are currently coordinating interpretive guidance and will seek to broaden such coordination to include examiner training and cooperation in connection with enforcing section 13.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM MARY JO WHITE

I greatly appreciate the SEC and CFTC's efforts in implementing key features of Dodd-Frank's swaps reforms. However, I am very concerned about the number and significance of exemptions and no-action letters granted by the CFTC and the SEC's delay in finalizing the rules. While I appreciate the CFTC's commitment to working closely with stakeholders and allowing them an adequate opportunity to come into compliance, I am concerned that any additional delays would be unreasonably exposing Americans to systemic risks and losing invaluable momentum in the effort to build a more stable financial system.

Could you please lay out as of the date of this hearing:

Q.1.a. What percentage of U.S. swaps markets, broken down by swap-type, have been subject to Title VII requirements for clearing, Swap Execution Facility (SEF)-trading, and reporting?

A.1.a. As you know, the Dodd-Frank Act divided regulatory authority over U.S. swaps markets between the SEC and the CFTC, with the SEC having authority over security-based swaps, the CFTC having authority over swaps, and the SEC and CFTC jointly regulating mixed swaps. SEC staff estimates that security-based swaps—principally single-name CDS and equity-related security-based swaps—collectively represent less than 5 percent of the overall swaps markets. The CFTC's rules for clearing, SEF trading, and reporting for the swaps markets are in effect; the CFTC should be better able to provide you with relevant data for the products under its jurisdiction.

To date, the SEC has proposed all of the rules required by Title VII, and we have started the process of adopting Title VII rules. These efforts include a comprehensive set of proposed rules focusing specifically on application of Title VII to cross-border security-based swap activity, mandatory clearing, and rules related to trading on security-based swap execution facility trading and reporting.

Q.1.b. What percentage of the global swaps market, broken down by swap-type, have been subject to Title VII-like requirements for clearing, SEF-trading, and reporting?

A.1.b. The FSB's *OTC Derivatives Market Reforms: Sixth Progress Report on Implementation,* dated September 2013, reported that most G20 jurisdictions had legislation in place that allows for adoption of clearing and trading requirements, but mandatory clearing requirements and requirements to trade on organized trading platforms were only partially in force in a small number of jurisdictions. With respect to reporting, the FSB reported in September that sixteen G20 jurisdictions had legislation and regulations adopted to implement trade reporting, of which twelve jurisdictions had at least some specific requirements in force.

The Commission has access to transaction-level data that we believe provide reasonably comprehensive information regarding single-name CDS transactions and the composition of participants in the market for single-name CDS. Analyses of these data have played a role in shaping the rules we have proposed and adopted under Title VII, and have allowed us to quantify certain economic effects of these rules. Summary statistics that describe the global nature of transactions and market participants are contained on pages 393—through 396 of the SEC's *cross-border proposing release.* We note, however, that our data comes with several limitations. While we observe all reported transactions in single-name CDS involving U.S. underliers, we do not observe CDS transactions involving non-U.S. underliers where neither counterparty is a U.S. entity. The limitation on data involving CDS on non-U.S. underliers means that we do not have access to the type of data on foreign markets that would be necessary to provide you the specific percentages you request both in this question and the questions below.

Based on an analysis of transactions in CDS on U.S. underliers, Commission staff believes that the vast majority of transactions in these CDS involve at least one U.S. or European counterparty, and thus are, or are likely to be, subject to Title VII or European requirements.

Q.1.c. How much will that percentage change when Europe finalizes its rules?

A.1.c. Based on an analysis of data regarding CDS transactions on U.S. underliers, where we believe we have a more complete picture of market participation, Commission staff believes that the vast majority of those transactions involve at least one U.S. or European counterparty and thus are, or are likely to be, subject to Title VII or European requirements. As noted above, however, the Commission does not have access to data necessary to provide a specific percentage for the global market in single-name CDS.

With respect to the specific European requirements, reporting to trade repositories under the European Market Infrastructure Regulation (EMIR) began on February 12, 2014. EMIR also requires counterparties to clear OTC derivative contracts that belong to a class that the European Securities and Markets Authority (ESMA) has declared subject to the clearing obligation and that meet other specified criteria. We understand that ESMA is currently working on draft regulatory technical standards to determine the asset classes that will be subject to this clearing obligation, and that publication of draft standards is expected later this year. Legislation currently under consideration in the EU is expected to address the EU's commitment to require OTC derivatives to be traded on an organized trading platform.

Q.1.d. What part of those markets are made up of foreign affiliates of U.S. persons?

A.1.d. As noted above, the Commission does not have access to the type of comprehensive data about foreign security-based swap market participation that would be necessary to answer your specific question. Based on analysis of CDS transactions on U.S. underliers, however, Commission staff estimates that transactions in which one counterparty is either a foreign affiliate of a U.S. person or a foreign branch of a U.S. person (which is considered part of its U.S.

home office under the SEC's cross-border proposal) constitute a majority of transactions in CDS on U.S. underliers in foreign markets. As with the overall market for CDS on U.S. underliers, the staff estimates that vast majority of these transactions are with European counterparties, and thus are, or are likely to be, subject to Title VII requirements, European requirements, or potentially both.

Please also:

Q.1.e. Set out what temporary exemptions your agencies have granted.

A.1.e. In June 2011, the Commission provided guidance as to which of the requirements of Title VII of the Dodd-Frank Act would apply to security-based swap transactions as of the July 16, 2011 effective date of Title VII, and granted temporary relief to market participants from compliance with certain of those requirements (Effective Date Order).[1] The Effective Date Order was intended to provide legal certainty and avoid unnecessary market disruption while the Commission completes the implementation of Title VII.

The Commission also issued a temporary order and interim final rules that provided temporary exemptive relief from compliance with certain provisions of the Securities Act, the Exchange Act, and the Trust Indenture Act in connection with the revision of the definition of "security" to encompass security-based swaps.[2] The temporary exemptions and interim final rules were directed toward maintaining the status quo while the Commission implemented Title VII and evaluated the implications under the Federal securities laws of including security-based swaps in the definition of "security."

The temporary order generally preserves the application of particular Exchange Act requirements that were already applicable in connection with instruments that became "security-based swaps" following the effective date of the Dodd-Frank Act, but defers the applicability of additional Exchange Act requirements in connection with those instruments explicitly being defined as "securities." More specifically, the Commission's temporary order exempts certain market participants who engage in security-based swap activities from the application of the Exchange Act other than with respect to: (a) certain antifraud and anti-manipulation provisions, (b) all Exchange Act provisions related to security-based swaps added or amended by subtitle B of Title VII of the Dodd-Frank Act, including the amended definition of "security" in Section 3(a)(10), and (c) certain other Exchange Act provisions.

The interim final rules temporarily exempt offers and sales of those security-based swaps that prior to the Title VII effective date

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[1] *See* 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, Exchange Act Release No. 34–34678 (Jun. 15, 2011), 76 FR 36287 (Jun. 22, 2011).

[2] *See* Order Granting Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Pending Revisions of the Definition of "Security" to Encompass Security-Based Swaps, Exchange Act Release No. 64795 (Jul. 1, 2011), 76 FR 39927 (Jul. 7, 2011); Order Extending Temporary Exemptions under the Securities Exchange Act of 1934 in Connection with the Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, Exchange Act Release No. 71485 (Feb. 5, 2014), 79 FR 7731 (Feb. 10, 2014); Exemptions for Security-Based Swaps, Securities Act Release No. 9231 (Jul. 1, 2011), 76 FR 40605 (Jul. 11, 2011); and Extension of Exemptions for Security-Based Swaps, Securities Act Release No. 9545 (Feb. 5, 2014), 79 FR 7570 (Feb. 10, 2014).

were security-based swap agreements from all provisions of the Securities Act (other than the Section 17(a) anti-fraud provisions), the Exchange Act registration requirements, and the provisions of the Trust Indenture Act, provided certain conditions are met. The exemptions apply only to security-based swaps entered into between eligible contract participants (as defined prior to the Title VII effective date).

Q.1.f. Explain your timeline and planning for ending those exemptions and accomplishing full implementation of the Dodd-Frank rules regarding the swaps markets? Please identify any barriers you see that could further slow that implementation.

A.1.f. The temporary exemptions provided under the Effective Date Order generally are set to expire on the earliest compliance date set forth in the related security-based swap rulemaking under Title VII, although in certain cases the expiration is tied to another date, such as the effective date for the related security-based swap rules or the date a person becomes registered under related security-based swap rules. One of the temporary exemptions in the Effective Date Order extends until a date or dates to be specified by the Commission. The approach to this temporary exemption permits the Commission to specify an appropriate date or dates for expiration in the related security-based swap rulemakings.

Similarly, under the temporary order, the exemptions under the Exchange Act that are related to pending security-based swap rulemakings are set to expire on the compliance date for the related security-based swap rules. The temporary exemptions which are not directly linked to pending security-based swap rulemakings are set to expire on the earlier of such time as the Commission issues an order or rule determining whether any continuing exemptive relief is appropriate for security-based swap activities with respect to any of these Exchange Act provisions or until February 11, 2017.[3]

This approach for extending the exemptions related to security-based swap rulemakings is intended to facilitate a timely phased-in determination regarding the application of the relevant provisions of the Exchange Act to security-based swaps based on the development of the relevant rules mandated by the Dodd-Frank Act as the Commission moves toward finalizing those rules. This approach also provides the Commission flexibility while Dodd-Frank Act rulemaking is still in progress to determine whether continuing relief should be provided for any Exchange Act provisions that are not directly linked to specific security-based swap rulemaking.

The Commission is in the midst of rulemaking under the Dodd-Frank Act to provide a robust, comprehensive regulatory regime for security-based swaps. To date, the Commission has proposed all of the rules related to the new regulatory regime for derivatives under Title VII and has begun the process of adopting these rules.

At this point there is not immediately apparent any new barriers that could delay implementation. As you know, the Commission

[3] The exemptions provided by the interim final rules will expire on February 11, 2017. However, if the Commission adopts further rules relating to issues raised by the application of the Securities Act or the other Federal securities laws to security-based swaps before February 11, 2017, the Commission may well determine to alter the expiration dates in the interim final rules as part of that rulemaking.

proposed the rules pertaining to the application of Title VII to cross-border security-based swap transactions and non-U.S. persons engaged in activities implicating Title VII. This was a critical part of the implementation process, given the overwhelmingly global nature of the market for security-based swaps.

In addition, the staff is working on the next set of adoptions under Title VII. The Commission is likely to consider certain of the issues presented in the cross-border proposal in an initial cross-border adopting release. Under such an approach, this initial cross-border adopting release would likely focus on adopting key definitions relevant to the application of Title VII in the cross-border context. Other matters raised in the cross-border proposal would be addressed in subsequent releases. Such an approach would allow the Commission to consider the cross-border application of the substantive requirements imposed by Title VII in conjunction with the final rules that will implement those substantive requirements. In addition, as noted below in response to question 3, I expect the Commission to consider the application of mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act.

Q.2. In particular, at the hearing, Acting Chair Wetjen identified certain cross-border issues that may be near-term challenges—please explain clearly what those might be and why continued delays or further weakenings of U.S. standards would not continue to expose the U.S. to significant financial stability risks, including lack of transparent pricing in the swaps market.

A.2. The swaps markets are predominantly global and, therefore, resolving cross-border issues appropriately is critical to successful regulatory reform of these markets.

As I noted in my testimony, the Commission is actively reviewing public input on its cross-border proposal. The Commission also is working through the issues that were raised, including, among others, the appropriate treatment of foreign affiliates of U.S. persons and how conduct by a non-U.S. person in the United States engaging in security-based swap transactions with another non-U.S. person should impact the application of Title VII requirements.

In addressing these and other issues both in the cross-border area and more generally as we continue to adopt final rules and take other actions to implement Title VII, I continue to believe that we should take a robust and workable approach.

Q.3. Finally, can you share any plans for further speeding coordinated implementation. For example, shouldn't the SEC encourage single-name CDS to be cleared and traded through CFTC-registered clearinghouses and SEFs in the interim before SEC rules are finalized and implemented?

A.3. Since the Dodd-Frank Act was enacted, the staffs of the Commission and the CFTC have consulted and coordinated with each other regularly in the development and implementation of our respective rules, and we continue to do so.

My immediate goal is to continue the finalization of the rules required by Title VII for the security-based swaps market. In the interim, I would emphasize that single-name CDS are already being cleared at SEC-registered clearing agencies under existing SEC rules. With respect to trading of security-based swaps, so long as market participants comply with applicable Federal securities laws, the SEC does not prohibit trading on CFTC-registered SEFs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KIRK FROM MARY JO WHITE

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. While I cannot speak for the Financial Stability Oversight Council, as a voting member of FSOC I believe it is important for FSOC to be mindful of calls for greater transparency and provide ways for the public and other interested parties to have greater insight and input into issues concerning U.S. financial stability. One opportunity for FSOC to provide greater public exposure is through the upcoming Public Asset Manager Conference that FSOC plans to host on May 19, 2014. The Conference will enable the staffs of the member agencies to hear directly from the asset management industry and other stakeholders, including academics and public interest groups. In addition, the Conference will be Web cast live so that it can be viewed by members of the public. I am hopeful that FSOC will look for additional similar vehicles to promote public exposure and input to its work.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. SEC staff, together with staffs of the other agencies, has spent considerable time carefully evaluating the concerns raised post-adoption by several trade groups and industry participants about CLOs. The final rule provides an exclusion for CLOs that hold loans and, in connection with such loans, may also hold certain interest rate or foreign exchange derivatives, cash equivalents, and assets related to holding loans or the servicing or timely distribution of proceeds to security holders. Ownership interests in loan securitizations that fit within this exclusion as of the conformance date may be held by banking entities. In the adopting release, however, the agencies did not expand the definition of excluded loan securitizations to securitizations holding both loans and securities, noting that such an expansion would not be consistent with the provision of the statute that specifically only permitted the "sale and securitization of loans" by banking entities. In light of these concerns, the Federal Reserve Board, after consulting with the staffs of the other agencies, recently announced that it intends to exercise its authority to give banking entities two additional 1-year extensions to conform their ownership interests in and sponsorship of certain CLOs.

It is also worth noting that new CLO issuances have been comparable in volume to the CLOs issued prior to the adoption of the final rule, and market participants have represented that new CLOs are conforming to the loan securitization exclusion under the Volcker Rule.

Q.3. When Director Berner testified before the Economic Policy Subcommittee in January 2014, he emphasized that OFR's report on the asset management industry study focused on activities of asset managers, rather than asset management firms. This is more appropriate because the size of an asset manager's assets under management, which are wholly owned by a fund's investors, doesn't make that manager a systemic risk. If activities are the main focus, then section 120 of the Dodd-Frank Act suggests that the primary regulator—in this case the SEC, is the appropriate agency to address these issues. So, when can we expect the SEC and its expertise to be brought to bear by the FSOC? The current bank centric approach to reviewing asset managers simply isn't productive.

A.3. SEC staff is actively engaging with representatives of other FSOC members in any analysis of potential financial stability risks posed by asset managers or asset management activities and is sharing its expertise on asset management and the ways in which asset management activities differ from banking activities. Separately, the SEC is enhancing its own risk monitoring and oversight efforts with respect to asset managers. Pursuant to Section 965 of the Dodd-Frank Act, the SEC has established a new risk and examinations office (REO) for asset managers. REO monitors trends in the asset management industry and is also assisting in a larger Commission-wide initiative to obtain and analyze data consistent with market trends and operational integrity issues, inform policy and rulemaking, and assist the staff in examinations of registrants.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARK P. WETJEN

Q.1. When a data breach happens at a merchant level, Federal banking regulators generally do not have jurisdiction to investigate and take action. However, collateral consequences of such breaches are that regulated financial institutions are impacted and face reputational and financial setbacks as a result. What are your expectations for the regulated entities when a breach occurs at a third party? What are some of the challenges financial institutions face as a result of the breach? How can those challenges be addressed while minimizing consequences of, and cost for, affected financial institutions?

A.1. The U.S. Commodity Futures Trading Commission ("Commission" or "CFTC") oversees a variety of registrants for which data breaches, either in their own systems or third-party systems, can have serious consequences. In general, the Commission expects its registrants to consider the risks of data breaches and address them appropriately. The actual requirements vary by registrant.

Commission Regulation 39.18 requires each registered derivatives clearing organization ("DCO") to establish and maintain a program of risk analysis and oversight with respect to its operations and automated systems which must include a risk analysis and oversight of information security. The DCO also is required to establish and maintain resources that allow for the fulfillment of each of its obligations in light of any identified risks. The Commission expects a DCO's information security risk analysis to include an analysis of any such risk posed by a third party providing services to the DCO. It also expects the DCO to maintain sufficient resources to allow for the fulfillment of the DCO's obligations in light of such risks and to provide the necessary oversight to manage them.

In addition, Commission Regulation 39.18 requires a DCO to notify the Commission's Division of Clearing and Risk ("DCR") promptly in the event of any hardware or software malfunction, cyber security incident or targeted threat that materially impairs, or creates a significant likelihood of material impairment of automated system operation, reliability, security, or capacity. A DCO would be required to notify DCR of relevant data breaches involving a DCO's third-party service provider pursuant to this provision. We further note that Section 807(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") provides the Commission with additional authority with respect to third-party services provided to a DCO that has been designated as systemically important by the Financial Stability Oversight Council (a "SIDCO"). Specifically, whenever a service integral to the operation of a SIDCO is performed for the SIDCO by another entity, the Commission is authorized to examine whether the provision of that service is in compliance with applicable law, rules, orders and standards to the same extent as if the SIDCO was performing the service on its own premises.

Commission Regulations §§ 38.1050 (DCMs), 37.1400 (SEFs), and 49.24 (SDRs) require each registered DCM, SEF, or SDR to establish and maintain a program of risk analysis and oversight with respect to its operations and automated systems. This program must include risk analysis and oversight of cyber and information security. These registered entities are also required to establish and maintain resources that allow for the fulfillment of their regulatory obligations. The Commission expects DCM, SEF, and SDR analysis of information security risks to include analysis of risk relating to third parties providing services to them.

If a third party that performs services for a DCM, SEF, or SDR is compromised or loses data for which the DCM, SEF, or SDR is responsible, DMO would have oversight concerns. One example might be a data storage provider losing trade data in long-term storage that might be needed for a DMO examination or a DOE investigation. Another example might be loss of login credentials due to a security compromise, such as the one that occurred a year or two ago with respect to two-factor authentication provided by RSA. Still another example could be a security breach at a third-party data center used by a DCM, SEF, or SDR.

If a third-party providing services to a DCM, SEF, or SDR were compromised in a way that affected the regulatory responsibilities of the DCM, SEF, or SDR, CFTC rules would require the registrant to notify DMO immediately concerning the potential data loss and the extent of the breach, and to notify affected parties as appropriate based on the circumstances and the type and extent of information lost.

Challenges that could be faced in such situations might include the incomplete nature of available information; the possible recalcitrance of the third-party provider; or legal issues relating to contracts or service agreements. DMO would advise registrants to address such challenges by seeking to employ reputable third parties that have significant experience, appropriate controls, and effective security measures.

Futures Commodity Merchants ("FCMs") and Registered Foreign Exchange Dealers ("RFEDs"), along with maintaining their customer's trade and account data, also process credit and debit card payments as a source of funds for initial and variation margin, so they are also reliant upon third-party payment systems. A data breach of either their own systems or a third-party payment system could lead to customers' private and proprietary information being compromised. This makes it important for FCMs and RFEDs to monitor their systems and trading activity and be alert for fraudulent activity that might result from compromised customer accounts. For FCMs/RFEDs the biggest challenge is identifying a breach and then evaluating how to recover funds for any unauthorized transactions. Without proper anti-money laundering or know your customer controls, the funds could have been laundered already or there may be a need to liquidate transactions at a loss to the FCM or RFED. While most likely the risk of loss is with the card issuer, if substantial, the FCM or RFED may have to cover the loss until funds are received from the card issuer which may take time.

Q.2. At the Subcommittee hearing on data security and breach held on February 3, 2014, Members learned that the payment networks have set an October 2015 timeframe for moving industry participants to adoption of new, more secure payment technology. Can you discuss how quickly your regulated entities are moving to this technology, and identify some of the obstacles that still exist?

A.2. The Commission does not have a role in regulating specific payment systems or technologies. However, as noted above, the Commission does expect registrants to address risks associated with payment systems.

Q.3. In July of 2013, I requested that the Government Accountability Office (GAO) review the SIFI designation process at FSOC for both transparency and clarity, and to examine the criteria used to designate companies as SIFIs. Would you all be willing to support more reliance on measurable metrics in FSOC's designation process?

A.3. I am always open to considering how improvements to objective metrics could aid the FSOC in its designation process.

Q.4. Since the final Volcker rule was issued in December, the affected entities have recognized two issues with the final rule (TruPS CDOs and CLOs). What other issues with the final Volcker rule are your agencies aware of that may be raised by affected entities? How do you intend to coordinate efforts on clarifying such issues in the future?

A.4. The Commission participates in an interagency working group with the other agencies charged with implementing the Volcker Rule. The interagency group holds weekly conference calls to discuss ongoing implementation issues, and the group coordinates responses to queries from industry and Congress. The group meets regularly with trade groups and industry to better understand and address concerns related to implementation. The agencies have also formed several subgroups devoted to issues such as metrics reporting and examinations that hold regular conference calls and coordinate on guidance documents.

Q.5. How do you plan to coordinate with other agencies regarding enforcement matters and the final Volcker rule, given that your agencies have varied jurisdictions?

A.5. As with any enforcement matter, the Commission places a high priority on promoting coordination of enforcement efforts with other law enforcement agencies to address Commodity Exchange

Act violations and other related financial wrongdoing. The Commission participates in over 20 regional, national and international financial fraud enforcement working groups comprised of Federal, State, and local and criminal and civil authorities. The Commission's participation in these groups provides an opportunity to share information on cooperative enforcement matters and to coordinate joint civil and criminal Federal and/or State prosecutions. The Commission also meets regularly with various agencies to coordinate enforcement efforts and leverage resources, including the Department of Justice Criminal Division, Department of Homeland Security, Department of Treasury, Federal Bureau of Investigation, Federal Reserve, Federal Trade Commission, Internal Revenue Service, Securities and Exchange Commission, and U.S. Attorney's Offices nationwide.

As noted above, the Commission regularly meets with the other agencies charged with implementing the Volcker Rule to discuss issues related to implementation, including enforcement. The compliance period for the Volcker Rule goes into effect in July 2015, subject to further possible extensions by the Federal Reserve Bank. Going forward, as we near the date implementation, the Commission will continue its robust interagency coordination on matters relating to Volcker Rule monitoring and enforcement.

Q.6. I am concerned that the CFTC moved too quickly in implementing the bulk of its Title VII mandates and that we are just starting to see the unintended consequences of such hasty action. Considerable numbers of no-action letters and interpretive guidance have followed CFTC rulemakings, leading to market disruption and uncertainty. Do you agree that more could have been done to consider the implications of rules prior to their adoption, thereby reducing the need for no-action and interpretive relief after the fact? Going forward, what are some things the CFTC should consider to remedy the issues with its rulemaking process?

A.6. Congress set an ambitious deadline for the Commission to complete implementation of Dodd-Frank within a year of enactment of the legislation. As Acting Chair, and previously as a Commissioner, in helping implement Dodd-Frank I have worked to be faithful to Congress' mandate while also carefully considering input from the public and working closely with domestic and international regulators.

Nonetheless, where appropriate, the Commission should determine whether course corrections in its implementation of Dodd-Frank are necessary. For example, Congress made clear that end users were intended to be exempt from Dodd-Frank, yet the end-user community has expressed concerns about compliance issues it faces under Dodd-Frank. As Acting Chair, I held two public roundtables to consider the regulatory issues facing end users under Dodd-Frank. The first roundtable focused on rule 1.35 recordkeeping requirements, the regulatory treatment of forward contracts with embedded volumetric optionality, and the treatment of swap dealing to Government-owned electric utilities. The second roundtable addressed issues related to the position limits proposal, including hedges of physical commodities, the setting of spot month limits, and aggregation. Based on comments received at the first roundtable, I acted by directing staff to provide relief to end users under rule 1.35 relating to certain recordkeeping requirements.[1] Further, I also directed staff to provide no-action relief to utility special entities entering into swaps[2] and, subsequently, the Commission released for public comment a proposal to provide more permanent for such entities.[3]

Going forward, the Commission must continue to work closely with Congress, the public, and market participants to achieve the proper balance of appropriate regulation while ensuring that these markets continue to facilitate job creation and the growth of the economy by providing a means for managing risk, facilitating price discovery, and broadly disseminating pricing information.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM MARK P. WETJEN

I greatly appreciate the SEC and CFTC's efforts in implementing key features of Dodd-Frank's swaps reforms. However, I am very concerned about the number and significance of exemptions and no-action letters granted by the CFTC and the SEC's delay in finalizing the rules. While I appreciate the CFTC's commitment to working closely with stakeholders and allowing them an adequate opportunity to come into compliance, I am concerned that any additional delays would be unreasonably exposing Americans to systemic risks and losing invaluable momentum in the effort to build a more stable financial system.

Could you please lay out as of the date of this hearing:

Q.1.a. What percentage of U.S. swaps markets, broken down by swap-type, have been subject to Title VII requirements for clearing, Swap Execution Facility (SEF)-trading, and reporting?

A.1.a. Commission staff are working to determine these estimates. For those asset classes that are subject to the clearing determination and trade execution mandate, unfortunately, the Commission faces challenges in accurately assessing all the relevant details of specific transactions due to constraints on resources and data quality issues.

To do its job, the Commission must have accurate data in order to have a clear picture of swaps market activity. To help resolve the challenges the Commission faces in assessing swap data, earlier this year, I was joined by my fellow commissioners in announcing the formation of an interdivisional Working Group to review the Commission's swaps transaction data recordkeeping and reporting provisions. The working group formulated and recommended questions for public comment regarding, among other things, com-

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[1] Time-Limited No-Action Relief for Members of Designated Contract Markets and Swap Execution Facilities that Are Not Registered with the Commission from the Requirement to Record Written Communications, Pursuant to Commission Regulation 1.35(a), in Connection with the Execution of a Transaction in a Commodity Interest and Related Cash or Forward Transactions (May 22, 2014), *available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-72.pdf.*

[2] Staff No-Action Relief: Revised Relief from the De Minimis Threshold for CertainSwaps with Utility Special Entities (March 21, 2014), *available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-34.pdf.*

[3] Exclusion of Utility Operations-Related Swaps with Utility Special Entities from De Minimis Threshold for Swaps with Special Entities, *available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister052214-a1.pdf.*

pliance with part 45 reporting rules, and related provisions, and consistency in regulatory reporting among market participants.

The Working Group is currently reviewing all comments that were submitted in response to the request and will be making recommendations to the Commission in the near future.

Q.1.b. What percentage of the global swaps market, broken down by swap-type, has been subject to Title VII-like requirements for clearing, SEF-trading, and reporting?

A.1.b. Currently, the data required for this request is unavailable, primarily, because many other jurisdictions have yet to implement transaction reporting requirements. Most foreign jurisdictions have lagged the United States in finalizing reporting and transactions requirements for swaps. Moreover, even in those jurisdictions where reporting rules have been finalized, there is a lack of harmonization of data reporting standards across jurisdictions. The Financial Stability Board, of which we are a member, has set up a task force to address these and other issues related to global data harmonization. Additionally, please see the response to the previous question regarding efforts to improve data collection and analysis.

Q.1.c. How much will that percentage change when Europe finalizes its rules?

A.1.c. As noted above, the data required to determine the percentage of swaps subject to clearing determination and trade execution mandates is still unclear. As such, we are unable to determine this percentage.

Q.1.d. What part of those markets is made up of foreign affiliates of U.S. persons?

A.1.d. Foreign affiliates that are not U.S. persons that are engaged in swaps trading activity in the EU or other foreign jurisdictions are not required to report their swaps activities to the Commission. Moreover, the Commission does not have access to data reported to European Swap Data Repositories. As a result, the Commission does not have data on the activities of such affiliates. For those foreign affiliates that are U.S. persons, because of data quality issues, the Commission does not have the capability to differentiate between foreign and local affiliates of U.S. persons when assessing the data. As indicated, efforts are underway to improve data analysis capabilities at the Commission.

Please also:

Q.1.e. Set out what temporary exemptions your agencies have granted.

A.1.e. The Commission maintains on its Web site a list of currently effective staff no-action letters related to rules issued under Dodd-Frank. That list can be found at: *http://www.cftc.gov/LawRegulation/DoddFrankAct/ExpiredNoAction/index.htm.*

Q.1.f. Explain your timeline and planning for ending those exemptions and accomplishing full implementation of the Dodd-Frank rules regarding the swaps markets? Please identify any barriers you see that could further slow that implementation.

A.1.f. Staff no-action letters are typically time-limited and temporary, although not always. The expiration of time-limited no-action letters differs depending on rule implementation timing and discussions with market participants, the public, and domestic and international regulators.

I firmly believe that timely, full implementation of Dodd-Frank is essential to ensuring that the derivatives markets are subject to appropriate governmental oversight. In undertaking the implementation of these changes, as Acting Chair, I have also endeavored to ensure that these regulatory changes do not cause unnecessary, potentially harmful disruption of the derivatives markets that so many market participants rely on to manage risk.

Q.2. In particular, at the hearing, Acting Chair Wetjen identified certain cross-border issues that may be near-term challenges—please explain clearly what those might be and why continued delays or further weakening of U.S. standards would not continue to expose the U.S. to significant financial stability risks, including lack of transparent pricing in the swaps market.

A.2. I believe that the CFTC took the correct approach in adopting cross-border policies that account for the varied ways that risk can be imported into the U.S. At the same time, the CFTC's policies tried to respect the limits of U.S. law and the resource constraints of U.S. and global regulators. Attempts to weaken Dodd-Frank have not been contemplated or planned.

In an effort to strengthen our cross-border policies and promote effective global oversight, the Commission is coordinating closely with foreign regulators. Last December, the CFTC approved a series of determinations allowing non-U.S. swap dealers and MSPs to comply with Dodd-Frank by relying on comparable and comprehensive home country regulations, otherwise known as "substituted compliance." Those approvals by the CFTC reflected a collaborative effort with authorities and market participants from each of the six jurisdictions with provisionally registered swap dealers. Working closely with authorities in Australia, Canada, the European Union ("EU"), Hong Kong, Japan, and Switzerland, the CFTC issued comparability determinations for a broad range of entity-level requirements. In two jurisdictions, the EU and Japan, the CFTC also issued comparability determinations for certain transaction-level requirements.

It appears at this time that the substituted compliance approach has had success in supporting financial reform efforts around the globe and a "race-to-the-top" in global derivatives regulation. For example, the EU agreed on updated rules for markets in financial derivatives, the Markets in Financial Instruments Directive II ("MiFiD II"), reflecting great progress on derivatives reform. Other jurisdictions that host a substantial market for swap activity are still working on their reforms, and certainly will be informed by the EU's work and the CFTC's ongoing coordination with foreign regulators. As jurisdictions outside the U.S. continue to strengthen their regulatory regimes and meet their G20 commitments, the CFTC may determine that additional foreign regulatory requirements are comparable to and as comprehensive as certain requirements under Dodd-Frank.

The CFTC also has made great progress with the European Commission since the issuance of the Path Forward statement, and we are actively working with the Europeans to ensure that harmonized regulations on the two continents ensure financial stability and promote sound risk management. Fragmented liquidity, and the regulatory and financial arbitrage that both drives and follows it, can lead to increased operational costs and risks as entities structure around the rules in primary swap markets. Harmonizing regulations governing clearinghouses and trading venues, in particular, is critical to sound and efficient market structure.

Lastly, in light of the CFTC's swaps authority, and the complexities of implementing a global regulatory regime, the CFTC is working with numerous foreign authorities to negotiate and sign supervisory arrangements that address regulator-to-regulator cooperation and information sharing in a supervisory context. We currently are negotiating such arrangements with respect to swap dealers and MSPs, SDRs, SEFs, and derivatives clearing organizations.

Q.3. Finally, can you share any plans for further speeding coordinated implementation. For example, shouldn't the SEC encourage single-name CDS to be cleared and traded through CFTC-registered clearinghouses and SEFs in the interim before SEC rules are finalized and implemented?

A.3. Generally, clearing and mandatory trading can be helpful risk-reducing and competitive enhancements in liquid markets. Because single-name CDS fall under the jurisdiction of the SEC, the CFTC has no authority to mandate the clearing and mandatory trading of single-name CDS on CFTC-registered clearinghouses and SEFs. However, to encourage the clearing of CDS transactions, both the CFTC and SEC have approved the portfolio margining of single-name and index CDS. The SEC has required as a condition to portfolio margining for single-name and index CDS that their registrants submit their customer margin models for SEC approval. The first of these approvals were granted earlier this year. We will continue to monitor market data to see whether these recent approvals have resulted in increased clearing for single-name and index CDS.

The CFTC regularly coordinates with the Securities and Exchange Commission ("SEC") at the staff and Commissioner level regarding the implementation of Dodd-Frank. As the SEC continues with its implementation of its rules under Dodd-Frank, I am always willing to consider regulatory coordination that will enhance the safety and competitiveness of the markets we oversee.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KIRK FROM MARK P. WETJEN

Q.1. FSOC has been in existence for more than 3 years. Since that time, three companies have been deemed systemically significant and a second round of companies appear to be under consideration. Despite the numerous calls from Congress, a number of industry and consumer groups and even the GAO for the FSOC to provide greater transparency about the process used for designation, (including the metrics OFR should measure in their analysis), the criteria followed, as well as the implications and process to be followed after a firm has been designated a SIFI. Can you provide greater details on why more transparency has not been achieved and how the FSOC plans to improve these issues?

A.1. The Financial Stability Oversight Council (Council), of which I am member, has provided public transparency for the nonbank designations process through several measures. The Council voluntarily published a rule and guidance outlining how it would implement the statutory designation provisions and review firms for potential designation. For each of the three nonbank designations made so far, the Council provided the basis for those designations to Congress and the public.

During the development of the Council's rule and guidance on nonbank designations, the Council, even though not required to do a rulemaking, provided multiple opportunities for public comment. The public guidance described the designation process and set forth the quantitative metrics that the Council would use in its consideration of firms for designation.

Under the rule and guidance, firms under review are provided with opportunities at each stage of the process to engage with the Council. Early in the process, the Council provides the company with a notice that it is under consideration and an opportunity to submit materials to contest the Council's consideration. Following this, before any designation is proposed, there are numerous meetings between Council staff and the company and opportunities for the company to submit additional information for the Council's consideration. Following a proposed designation determination by the Council, the Council provides the company the written basis for the proposed designation and provides the firm the opportunity for a hearing. Once a final designation is made, the company designated can seek judicial review of that designation. The designation rules and guidance provide for an annual review of all nonbank designations where the designated companies may again participate.

Due to the preliminary nature of the Council's evaluation of any nonbank financial company prior to a final designation and the potential for market participants to misinterpret such an announcement, the Council does not publicly announce the name of any company that is under review prior to a final designation of the company.

Q.2. I, along with a number of other Republicans, introduced legislation to fix an unintended consequence on collateralized debt obligations (CDOs). In their January 13th interim final rule, regulators crafted a rule that largely mirrored what my bill sought to do; provide relief to a majority of community banks. While we appreciate the agencies' efforts on this issue, one issue that we included in our legislation that the regulators did not address was collateralized loan obligations (CLOs). The CLO market provides about $300 billion in financing to U.S. companies and U.S. banks currently hold between $70 and $80 billion of senior notes issued by existing CLOs and foreign banks subject to the Volcker Rule hold about another $60 billion. Because the final rules implementing the Volcker Rule improperly treat these debt securities as "ownership interests", the banks holding these notes will either have to divest or restructure these securities. Because restructuring well over $130 billion of CLO securities is neither feasible nor under the control of the banks holding these notes, divestment is the most likely result. This, in turn, could lead to a fire sale scenario that could put incredible downward pressure on CLO securities prices leading to significant losses for U.S. banks. If prices decline by only 10 percent, U.S. banks would have to recognize losses of almost $8 billion driven not by the underlying securities but solely because of the overreach of the Volcker Rule. Indeed, the final rules are already wreaking havoc on the CLO market. Since the final rules were announced, new CLO formation was down nearly 90 percent in January 2014, the lowest issuance in 23 months. If this situation is not remedied and CLO issuance remains moribund, corporate borrowers could face higher credit costs. At the hearing of the House Financial Services Committee on January 15, 2014, a number of both Democrats and Republicans asked questions about how to fix the issue with the CLO market that was not addressed in the interim final rule released on January 13, 2014. The representatives of the agencies noted that the CLO issue was at the top of the list of matters to be considered by the inter-agency working group that has been established to review issues such as this and publish guidance. The issue is urgent. Bank CFOs are struggling with how to treat their CLO debt securities. Can you commit to a tight timeframe to issue guidance on CLOs?

A.2. On April 7, 2014, the Federal Reserve Board of Governors (FRB) exercised its authority to allow banking entities two additional 1-year extensions to conform their ownership interests in and sponsorship of certain collateralized loan obligations (CLOs) covered by section 619 of Dodd-Frank. We expect this will allow industry time to come into compliance with the Volcker requirements.