

Testimony on the Financial Stability Oversight Council

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on behalf of Mary L. Schapiro, Chairman
*U.S. Securities and Exchange Commission***

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Subcommittee on Oversight and Investigations**

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Thank you for the opportunity to testify on behalf of the Chairman of the Securities and Exchange Commission¹ regarding the Financial Stability Oversight Council (“FSOC” or the “Council”). FSOC was created by Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and has 10 voting members: the senior officials at each of the nine federal financial regulators² and an independent member with insurance expertise appointed by the President. FSOC’s composition also includes five nonvoting advisory members: three from various state financial regulators³ as well as the Directors of the new Federal Insurance Office and Office of Financial Research (“OFR”).⁴

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

² The senior officials are the Secretary of the Treasury (Chairperson); Chairman of the Board of Governors of the Federal Reserve; Comptroller of the Currency; Director of the Consumer Financial Protection Bureau; Chairman of the Securities and Exchange Commission; Chairperson of the Federal Deposit Insurance Corporation; Chairperson of the Commodities Futures Trading Commission; Director of the Federal Housing Finance Agency; and Chairman of the National Credit Union Administration. *See* Dodd-Frank Act § 111(b)(1).

³ The state financial regulators are a state insurance commissioner designated by the state insurance commissioners; a state banking supervisor designated by the state banking regulators; and a state securities commissioner designated by the state securities commissioners. *See* Dodd-Frank Act § 111(b)(2).

⁴ *See* Dodd-Frank Act § 111(b)(2).

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

- identifying risks to the financial stability of the United States that could arise from the material financial distress or failure – or ongoing activities – of large, interconnected bank holding companies or nonbank financial holding companies, or that could arise outside the financial services marketplace;
- promoting market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the government will shield them from losses in the event of failure (*i.e.*, addressing the moral hazard problem of “too big to fail”); and
- identifying and responding to emerging threats to the stability of the United States financial system.⁵

In fulfilling its responsibilities, FSOC is charged with identifying and designating certain nonbank financial companies as systemically important financial institutions (“SIFIs”) for heightened prudential supervision by the Board of Governors of the Federal Reserve System (“Federal Reserve Board”).⁶ In addition, FSOC may make recommendations to the Federal Reserve Board concerning the establishment and refinement of heightened prudential standards for firms designated under the SIFI process and large, interconnected bank holding companies already supervised by the Federal Reserve Board.⁷ Such recommendations may address, among other things, risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit

⁵ See Dodd-Frank Act § 112(a)(1).

⁶ See Dodd-Frank Act §§ 112(a)(2)(H) and 113.

⁷ See Dodd-Frank Act § 112(a)(2)(I).

exposure reports, concentration limits, enhanced public disclosures and overall risk management.⁸ In addition, FSOC must identify and designate financial market utilities (“FMUs”) and payment, clearing, and settlement activities that are, or are likely to become, systemically important.⁹

The recent financial crisis demonstrated the potential for risks to quickly spread across the financial sector and undermine general confidence in the financial system. To address issues of “siloes” information and the potential for regulatory arbitrage, another key responsibility of FSOC is to monitor the financial markets and regulatory framework to identify gaps, weaknesses and risks and make recommendations to address those issues to its member agencies and to Congress.¹⁰ In addition, by combining the information resources of its member agencies and working with the OFR, FSOC is responsible for facilitating the collection and sharing of information about risks across the financial system.¹¹

FSOC Activities Update

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

⁸ *See id.*

⁹ *See* Dodd-Frank Act §§ 112(a)(2)(J) and 804(a).

¹⁰ *See* Dodd-Frank Act § 112(a)(2)(C)-(G).

¹¹ *See* Dodd-Frank Act § 112(a)(2)(A)-(B).

Designation of Systemically Important Financial Institutions

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

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

On January 26, 2011, FSOC issued a notice of proposed rulemaking regarding the SIFI designation process. The proposed rule describes the criteria that will inform – and the processes and procedures established under the Dodd-Frank Act for – designations by FSOC. Such criteria would be rooted in the eleven (11) statutory considerations set forth in the Dodd-Frank Act for such designations, and would include, among other considerations, a firm’s size, leverage, liquidity risk, maturity mismatch, and interconnectedness with other financial firms. The proposed rule also implements certain other provisions of the designation process, including: (1) the anti-evasion authority of FSOC; (2) procedures for notice of, and the opportunity for a hearing on, a proposed determination; and (3) procedures regarding consultation, coordination, and judicial review in connection with a determination.

Designation of Systemically Important Financial Market Utilities

FMUs are essential to the proper functioning of the nation's financial markets.¹² These utilities form critical links among marketplaces and intermediaries that can strengthen the financial system by reducing counterparty credit risk among market participants, creating significant efficiencies in trading activities, and promoting transparency in financial markets. However, FMUs by their nature create and concentrate new risks that could affect the stability of the broader financial system. To address these risks, Title VIII of the Dodd-Frank Act provides important new enhancements to the regulation and supervision of FMUs designated as systemically important by FSOC ("DFMUs") and of payment, clearance and settlement activities. This enhanced authority in Title VIII should provide consistency, promote robust risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system.¹³ Importantly, the enhanced authority in Title VIII is designed to be in addition to the authority and requirements of the Securities Exchange Act and Commodity Exchange Act that may apply to FMUs and financial institutions that conduct designated activities.¹⁴

FSOC established an interagency DFMU committee to develop a framework for the designation of systemically important FMUs, in which staff from the SEC has actively participated. On December 21, 2010, FSOC published an advanced notice of proposed rulemaking seeking public comment on the designation process for FMUs. In response, FSOC received 12 comment letters from industry groups, advocacy and public interest groups,

¹² 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."

¹³ See Dodd-Frank Act § 802.

¹⁴ See Dodd-Frank Act § 805.

individual FMUs and financial institutions. Among other things, commenters generally encouraged the development of metrics and an analytical framework to further define the statutory considerations for designation contained in Title VIII, and also emphasized the need for FSOC to apply consistent standards for all FMUs under consideration for designation that incorporate both qualitative and quantitative factors.

On March 28, 2011, FSOC published a notice of proposed rulemaking to provide further information on the process it proposed to follow when reviewing the systemic importance of FMUs. FSOC is considering using a two-stage process for evaluating FMUs prior to a vote on a proposed designation by the Council. The first stage would consist of a largely data-driven process to identify a preliminary set of FMUs whose failure or disruption could potentially threaten the stability of the U.S. financial system. In the second stage, FMUs so identified would be subject to a more in-depth review, with a greater focus on qualitative factors and FMU- and market-specific considerations. Under the proposal, the Council expects to use the statutory considerations as a base for assessing the systemic importance of FMUs.¹⁵ Application of this framework, however, would be adapted for the risks presented by a particular type of FMU and business model.

Systemic Risk Assessment

In addition to initiating work on the identification of SIFIs and DFMUs, FSOC has established a Systemic Risk Committee that seeks to identify, highlight and review possible risks

¹⁵ Section 804(a)(2) of the Dodd Frank Act provides that these considerations are: (1) the aggregate monetary value of transactions processed by the FMU or carried out through the PCS activity; (2) the aggregate exposure of the FMU or a financial institution engaged in PCS activities to its counterparties; (3) the relationship, interdependencies, or other interactions of the FMU or PCS activity with other FMUs or PCS activities; (4) the effect that the failure of or a disruption to the FMU or PCS activity would have on critical markets, financial institutions, or the broader financial system; and (5) any other factors that FSOC deems appropriate.

that could develop across the financial system. The Dodd-Frank Act also requires FSOC to report annually to Congress regarding these risks,¹⁶ and we expect the work of this committee will inform that report.

Other Activities

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

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

On October 6, 2010, FSOC published a notice and request for information. In response, it received more than 8,000 comment letters, including approximately 1,450 letters that set forth individual perspectives from market participants, Congress, and the public.

On January 18, 2011, FSOC released its study and recommendations on implementation of the Volcker rule. The study recommends the creation of rules and a supervisory framework that effectively prohibit proprietary trading activities throughout “banking entities” – as defined by the Dodd-Frank Act – and appropriately distinguish prohibited proprietary trading from statutorily described permitted activities. The recommended supervisory framework consists of a programmatic compliance regime, metrics, supervisory review and oversight, and enforcement

¹⁶ See Dodd-Frank Act § 112(a)(2)(N).

procedures for violations for the respective regulatory agencies conducting supervisory review and oversight. In addition, the study identified potential challenges in delineating prohibited proprietary trading activities from permitted activities, including potential difficulties in determining whether a position was taken in anticipation of near term customer demand or for speculative purposes.

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

Next Steps

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