



February 4, 2010

The Honorable Christopher J. Dodd  
Chairman  
United States Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Richard C. Shelby  
Ranking Member  
United States Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable John F. "Jack" Reed  
Chairman  
United States Senate Committee on Banking,  
Housing, and Urban Affairs Subcommittee on  
Securities, Insurance, and Investment  
534 Dirksen Senate Office Building  
Washington, DC 20510

The Honorable Judd Gregg  
United States Senate Committee on Banking,  
Housing, and Urban Affairs  
534 Dirksen Senate Office Building  
Washington, DC 20510

Dear Chairman Dodd, Ranking Member Shelby, Subcommittee Chairman Reed, and Senator Gregg:

I am writing on behalf of the Council of Institutional Investors ("Council"), a nonprofit association of public, union and corporate pension funds with combined assets that exceed \$3 trillion. Member funds are major long-term investors with a duty to protect the retirement savings of millions of American workers. Significantly affected by the financial crisis, Council members have a deep, abiding interest in strong financial regulatory reform.

As you continue to discuss potential revisions to the over-the-counter ("OTC") derivatives provisions of the *Restoring American Financial Stability Act of 2009* discussion draft, we urge you to pursue comprehensive derivatives regulation covering as much of the OTC market as possible. Unregulated OTC derivatives contracts, especially credit default swaps, were at the heart of the financial crisis. Although OTC derivatives have been justified as vehicles for managing financial risk, they also spread and multiplied risk throughout the economy during the crisis, causing great harm. Warren Buffett has dubbed derivatives "financial weapons of mass destruction."<sup>1</sup>

As outlined by the Investors Working Group ("IWG"), specific problems plaguing the OTC derivatives market include lack of transparency and price discovery, excessive leverage, rampant speculation, and inadequate prudential controls.<sup>2</sup> Despite these serious problems, the enormous OTC derivatives market is virtually exempt from all regulation under the *Commodity Futures Modernization Act of 2000* ("CFMA"). Such lax oversight led the IWG to conclude that regulation of the OTC derivatives market is one of a number of "critical gaps that urgently need attention" from policymakers. In order to help close this serious gap in the regulation of the U.S. financial system, the IWG recommended that Congress "enact legislation overturning the exemptive provisions of the CFMA and requiring standardized (and standardizable) derivatives contracts to be traded on regulated derivatives exchanges and cleared through regulated derivatives clearing operations."<sup>3</sup>

<sup>1</sup> Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc., to Berkshire Hathaway Shareholders (Feb. 21, 2003) (available online at [www.berkshirehathaway.com/letters/2002pdf.pdf](http://www.berkshirehathaway.com/letters/2002pdf.pdf)).

<sup>2</sup> Investors Working Group ("IWG"), *U.S. Financial Regulatory Reform: The Investors' Perspective* (July 2009) [Hereinafter *IWG Report*] (available online at [www.cii.org/UserFiles/file/IWGREport.pdf](http://www.cii.org/UserFiles/file/IWGREport.pdf)), at 11.

<sup>3</sup> *Id.*

Consistent with the recommendation of the IWG, the Council opposes any exemption to exchange trading and central clearing requirements for end users of standardized OTC derivatives.<sup>4</sup> In our view, such exemptions would leave a gaping hole in the regulation of derivatives to the detriment of investors and the financial markets generally. Accordingly, we respectfully urge you to consider derivatives reform guided by the following principles:

**All OTC derivative contracts that can clear centrally should be required to be cleared through a regulated clearinghouse.** The *Restoring American Financial Stability Act* discussion draft narrowly limits the clearing requirement to only certain derivative contracts where one party is either a swap dealer or major swap participant. As a result, a large volume of contracts that can be cleared will not be cleared because, as is often the case, one of the parties to the transaction is not a swap dealer or a major swap participant, but rather is a hedge fund, investment fund, or other financial or nonfinancial firm.

Based on statistics from the Bank for International Settlements, Commodity Futures Trading Commission (“CFTC”) Chairman Gary Gensler recently concluded that “an end-user exemption could leave up to 60 percent of standardized transactions out of the transparency and clearing requirements.”<sup>5</sup> This deficiency would leave the entire financial system unnecessarily exposed to systemic risk that could otherwise be reduced if reform legislation simply requires that all clearable contracts be required to clear centrally.

**All standardized and standardizable OTC derivative contracts that can be exchange traded should be required to trade on a regulated derivatives exchange.** While there may be some valid arguments for exempting truly customized contracts required to hedge business risk from central clearing requirements, we are unaware of any valid argument for exempting standardized and standardizable OTC derivative contracts from exchange trading. The transparency provided by exchange trading not only lowers systemic risk and strengthens regulatory oversight, but also, importantly for investors, enhances the price discovery function of derivatives markets. As the IWG concludes, “[a]lthough requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.”<sup>6</sup>

Chairman Gensler has emphasized the important advantages of enhanced transparency for investors and end users of derivatives, including greater liquidity, increased competition, and lower costs “for hedgers, borrowers and, ultimately, their customers.”<sup>7</sup> Despite these benefits, he notes, derivatives dealers unsurprisingly oppose exchange trading as “requiring banks to bring their transactions to trading venues would shift the information advantage from a small group of derivative dealers on Wall Street to the broader market.”<sup>8</sup> Under the status quo investors and the market lose while dealers reap great profits. As Chairman Gensler describes, “It is only dealers that benefit from keeping standardized trades off of transparent trading venues...The banks and dealers profit from access to trading information while businesses, municipalities, consumers and others pay the costs.”<sup>9</sup>

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<sup>4</sup> The Council's membership endorsed the full recommendations of the IWG in fall 2009. For more information about the IWG, please visit [www.cii.org/iwgInfo](http://www.cii.org/iwgInfo).

<sup>5</sup> Gary Gensler, Chairman, Commodity Futures Trading Commission, Address to the American Bar Association, Committee on Derivatives and Futures Law: OTC Derivatives Reform (Jan. 29, 2010) (transcript available online at [www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-26.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-26.pdf)).

<sup>6</sup> *IWG Report*, *supra* note 2, at 11.

<sup>7</sup> Gensler, *supra* note 5.

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

Given the significant benefits of exchange trading for investors, it is imperative that financial regulatory reform legislation mandate that all standardized derivatives trade on regulated exchanges as well as clear centrally. The Council rejects the argument some have made that central clearing alone is sufficient because market forces will naturally move trading onto transparent exchanges. In light of the strong interest Wall Street derivatives dealers have in maintaining the opaque status quo, we find this outcome unlikely.<sup>10</sup> Nevertheless, even if centrally cleared derivative contracts would gradually migrate to exchanges, the costs to investors and risks to the entire financial system during the intervening years are far too great to forgo prompt action requiring exchange trading.

Thank you for consideration of the views of investors and for your leadership in connection with this critical area of financial regulatory reform. We look forward to continuing to work with you to improve the transparency, stability, and oversight of the derivatives market and the entire U.S. financial system. If you have any questions, please feel free to contact me at (202) 261-7096, or [jonathan@cii.org](mailto:jonathan@cii.org), or our General Counsel Jeff Mahoney at (202) 261-7081 or [jeff@cii.org](mailto:jeff@cii.org).

Sincerely,



Jonathan D. Urick  
Analyst  
Council of Institutional Investors

cc: The Honorable Blanche L. Lincoln, Chairman, United States Senate Committee on Agriculture, Nutrition and Forestry  
The Honorable Saxby Chambliss, Ranking Member, United States Senate Committee on Agriculture, Nutrition and Forestry

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<sup>10</sup> Historical precedent supports our view. For example, the New York Stock Exchange ("NYSE") move to decimal pricing in 2000 demonstrates that regulation mandating industry improvements on behalf of investors and customers is sometimes needed when market forces are not sufficient to overcome strong opposition. Despite Congressional estimates that decimalization could save investors as much as \$3 million per trading day, the NYSE and other exchanges only adopted decimal pricing after action by the Securities and Exchange Commission.