February 12, 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:

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 write to highlight the relevant recommendations of the Investors' Working Group (IWG) concerning this important area of regulatory reform.

A blue ribbon panel of industry and market experts, the IWG is an independent, nonpartisan commission sponsored by the CFA Institute Centre for Financial Market Integrity ("CFA Institute") and the Council of Institutional Investors to provide an investor perspective on ways to improve the regulation of U.S. financial markets. After months of deliberations, the findings and specific recommendations of the IWG were published in its July 2009 report *U.S. Financial Regulatory Reform: The Investors' Perspective* ("IWG Report").

Among its various findings, the IWG concluded that 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. Specific problems plaguing the OTC derivatives market identified by the IWG include lack of transparency and price discovery, excessive leverage, rampant speculation, and inadequate prudential controls.

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."

Consistent with this recommendation, the IWG opposes any exemption to exchange trading and central clearing requirements for end users of standardized OTC derivatives. 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:

1. **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 side of the trade is either a swap dealer or major swap participant. As a result, a large volume of OTC contracts that can be cleared will not be cleared because, as is often the case, one of the parties to the transaction is a not a swap dealer or a major swap participant as defined in the discussion draft, but rather is a hedge fund, investment fund, or other financial or nonfinancial firm. This deficiency leaves 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.

2. **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."

We note that a recent survey by the CFA Institute of its membership found significant support for the above principles of derivatives regulation. According to the survey, 68 percent of the CFA Institute's members agree that all standardized derivative contracts that currently trade over the counter should be required to trade on regulated exchange, and 78 percent agree they should be required to clear centrally.[1] More details regarding the basis for the IWG's findings and recommendations regarding OTC derivatives can be found on pages 10-12 of the IWG Report.[2]

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[1] CFA Institute Member Poll: U.S. Regulatory Reforms, Feedback on the IWG Report 2 (Oct. 2009), http://www.cfainstitute.org/centre/news/surveys/pdf/us_iwg_poll_report.pdf.

[2] Available online at www.cii.org/UserFiles/file/IWGreport.pdf.

Thank you for your leadership in connection with this critical area of financial regulatory reform. As always, we would welcome the opportunity to have one or more members of the IWG discuss these issues with you or your staff at your convenience. Please feel to contact Jeff Mahoney at (202) 261-7081 or jeff@cii.org to arrange for such a meeting or if you should have any questions or comments regarding this letter.

Sincerely,

Kurt Schacht, CFA
Managing Director, CFA Institute Centre for Financial Market Integrity
Co-Sponsor, Investors' Working Group

Joe Dear
Chair, Council of Institutional Investors
Co-Sponsor, Investors' Working Group

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