



June 10, 2010

The Honorable Barney Frank
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Spencer Bachus
Ranking Member
House Committee on Financial Services
B371a Rayburn House Office Building
Washington, DC 20515

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

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

Dear Messrs. Frank, Bachus, Dodd, and Shelby:

As financial regulatory reform legislation advances to conference, I am writing on behalf of the Council of Institutional Investors (“Council”) to reiterate our strong support for comprehensive regulation of the over-the-counter (“OTC”) derivatives market. In particular, the Council encourages you to pursue reforms requiring central clearing and exchange trading for as many derivative contracts as possible.

A nonprofit association of public, union and corporate pension funds with combined assets that exceed \$3 trillion, the Council represents major, long-term investors with a duty to protect the retirement savings of millions of American workers. Deeply affected by the financial crisis, our member funds have a strong interest in meaningful regulatory reform. As you know, unregulated OTC derivative contracts, especially credit default swaps, were at the heart of the crisis. Although derivatives can be useful vehicles for managing financial risk, amid the financial turmoil of 2008 the opaque, unfettered OTC market spread and multiplied risk throughout the economy, causing tremendous harm.

As described by the blue-ribbon Investors Working Group (“IWG”), problems in the OTC derivatives market exacerbating the financial crisis include a lack of transparency and price discovery, excessive leverage, rampant speculation, and inadequate prudential controls.¹ Despite these serious flaws, the enormous OTC derivatives market remains virtually exempt from all regulation under the *Commodity Futures Modernization Act of 2000* (“CFMA”). The IWG accordingly concluded that lax regulation of this influential market is one of a number of “critical gaps that urgently need attention” from policymakers.²

In order to help close this serious gap in the oversight 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.”³ Having endorsed the full IWG report in fall 2009, the Council accordingly supports derivatives reform consistent with both aspects of this critical recommendation.

¹ Investors Working Group. “U.S. Financial Regulatory Reform: The Investors’ Perspective” (July 2009), at 11, www.cii.org/UserFiles/file/IWGREport.pdf. For more information, please visit www.cii.org/iwginfo.

² *Id.*

³ *Id.*

All standard (and standardizable) OTC derivative contracts should be required to clear through a regulated derivatives clearinghouse.

As Commodity Futures Trading Commission (“CFTC”) Chairman Gary Gensler recently declared, “The goal of reform should be to move as many standard over-the-counter derivatives transactions into central clearing as possible.”⁴ Consistent with the views of Chairman Gensler and the IWG, the Council strongly opposes *any* end-user clearing exemption for standardized derivatives as a dangerous regulatory gap. Ideally such an exemption should be completely absent from the final version of financial regulatory reform legislation.

Nevertheless, the Senate’s limited exemption for non-financial end-users is significantly less harmful than the House’s broader language further excluding derivatives used by financial players such as hedge funds or insurance companies. Exempting such influential and interconnected market participants would create an especially gaping hole in derivatives regulation putting the entire financial system at undue risk. “Such exemptions will only come back to haunt us in the future,” Chairman Gensler observed.⁵ As the House and Senate work to resolve differences on derivatives reform, the Council encourages you at a minimum to limit any end-user clearing exemption to non-financial firms only, if not eliminate it entirely.

All standard (and standardizable) OTC derivative contracts should be required to trade on a regulated derivatives exchange or equivalent trading vehicle.

As the IWG concludes, “Although requiring central clearing alone would mitigate counterparty risk, it would not provide the essential price discovery, transparency and regulatory oversight provided by exchange trading.”⁶ Improved transparency and price discovery not only lower systemic risk and reduce uncertainty amid periods of unusual volatility such as the recent crisis, they enhance market liquidity and reduce bid-ask spreads—both important for investors. In order to secure these benefits it is crucial that final legislation include as few exemptions from exchange trading and public reporting as possible. The Council thus supports provisions passed by the Senate requiring rapid real time public reporting for all clearable derivatives.

Thank you for considering the views of the Council of Institutional Investors. We look forward to working with you during conference to strengthen regulation of the OTC derivatives market. If you have any questions, please do not hesitate to contact me at (202) 261-7081 or jeff@cii.org, or Council analyst Jonathan Urick at jonathan@cii.org or (202) 261-7096.

Sincerely,



Jeff Mahoney
General Counsel
Council of Institutional Investors

⁴ Gary Gensler, Chairman, Commodity Futures Trading Commission. "Remarks on Regulatory Reform." Sandler O'Neill Global Exchange and Brokerage Conference. Grand Hyatt, New York, NY. 3 June 2010. www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-46.pdf.

⁵ *Id.*

⁶ Investors Working Group, *supra* note 1, at 11.