Via Facsimile

October 29, 2009

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

The Honorable Collin C. Peterson
Chairman
Committee on Agriculture
United States House of Representatives
1301 Longworth House Office Building
Washington, DC 20515

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

The Honorable Frank D. Lucas
Ranking Member
Committee on Agriculture
United States House of Representatives
1305 Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Frank and Peterson and Ranking Members Bachus and Lucas:

As you work to reconcile the differences between the Over-the-Counter Derivatives Markets Act of 2009 reported by the Committee on Financial Services and the Derivatives Markets Transparency and Accountability Act of 2009 reported by the Committee on Agriculture, we write to highlight the relevant recommendations made by the Investors' Working Group ("IWG").

A blue ribbon panel of industry and market experts created by the CFA Institute Centre for Financial Market Integrity ("CFA Institute") and the Council of Institutional Investors to study and report on financial regulatory reform from the viewpoint of investors, the IWG carefully considered the need to improve the regulation of over-the-counter ("OTC") derivatives. That consideration resulted in a number of findings and specific recommendations included in its July 2009 report—*U.S. Financial Regulatory Reform: The Investors' Perspective* ("IWG Report").

A summary of the IWG findings about OTC derivatives include:

- OTC derivative contracts, and particularly credit default swaps, played a significant role in the current financial crisis.
- The global OTC derivatives market is enormous ($592 trillion in notional amount as of December 2008) and was exempted from virtually all federal oversight and regulation by the Commodity Futures Modernization Act of 2000.
- Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm.
- Problems plaguing the OTC derivatives market include lack of transparency and price discovery, excessive leverage, rampant speculation and lack of adequate prudential controls.

The above findings led the IWG to propose the following specific recommendations regarding OTC derivatives:

1. Standardized derivatives should trade on regulated exchanges and clear centrally. Congress and the Administration should 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. Legal requirements based on those established in the Commodity Exchange Act for designated contract markets and derivatives clearing operations should apply to such trading and clearing. These requirements would allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk. 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.

2. OTC trading in derivatives should be strictly limited and subject to robust federal regulation. An OTC market is necessarily much less transparent and much more difficult to regulate than an exchange market. If trading OTC derivatives is permitted to continue, such trading should be strictly limited to truly customized contracts between highly sophisticated parties, at least one of which requires such a customized contract in order to hedge business risk. Congress and the Administration should enact legislation limiting the eligibility requirement for OTC derivatives trades to highly sophisticated and knowledgeable parties and requiring that at least one party to each OTC contract should certify and be prepared to demonstrate that it is entering into the contract to hedge an actual business risk. This limitation to trading on the OTC market would permit entities to continue to hedge actual business risks but would reduce the current pervasive speculation in the market.

A federal regulatory regime is needed for any continuing OTC market. OTC derivatives dealers should be required to register, maintain records and report transaction prices and volumes to the federal regulator. They should be subject to adequate capital requirements and business conduct standards, including requirements to disclose contract terms and risks to their customers. All OTC trades should be subject to federally imposed margin requirements, and all large market participants should be subject to capital requirements. In addition, transaction prices and volumes of OTC derivatives should be publicly reported on a timely basis.

All market participants should be subject to federal fraud and manipulation prohibitions, recordkeeping and reporting requirements, and position limits if imposed by the federal regulator. The regulator should have broad powers to oversee the market and all its participants, including powers to require additional reporting and inspection of records and to order positions to be eliminated or reduced. Federal legal prohibitions should be enacted to prohibit the use of OTC derivatives to misrepresent financial condition or to avoid federal laws.

3. The FASB and IASB should improve accounting for derivatives. A thorough and comprehensive review of accounting rules related to derivative instruments is needed. The goals of this review should be to ensure consistent reporting about these instruments and to ensure full disclosure for the benefit of investors, counterparties and regulators. To make informed decisions, investors and those entering into counterparty relationships need information about these positions.

4. The SEC and the CFTC should have primary regulatory responsibility for derivatives trading. Currently, the SEC and the CFTC each have regulatory responsibilities for certain portions of derivatives trading, depending on the nature of the derivatives product and/or the type of exchange on which it is traded. Those agencies have the experience and sophistication to oversee derivatives markets and should act as the primary regulators of both exchange trading and any continuing OTC market. It is important that federal standards for derivatives trading be comprehensive and consistent and that agency jurisdiction over such trading be clearly delineated. For this reason, the SEC and the CFTC must agree on appropriate regulatory standards and on their respective regulatory responsibilities, and the terms of such agreement should be enacted into law.

5. The United States should lead a global effort to strengthen and harmonize derivatives regulation. Because the OTC derivatives market is global, U.S. financial regulators should work with foreign authorities to strengthen and harmonize standards for derivatives regulation internationally and to enhance international cooperation in enforcement and information sharing.

We note that a recent survey by the CFA Institute of its membership found significant support for many of the above recommendations.[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, available in electronic form at http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).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 N. Schacht

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

Joseph A. Dear

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

cc: The Honorable Nancy Pelosi, Speaker of the House
The Honorable Steny H. Hoyer, House Majority Leader
The Honorable John A. Boehner, House Minority Leader
The Honorable James E. Clyburn, House Majority Whip
The Honorable Eric I. Cantor, House Minority Whip
The Honorable Louise McIntosh Slaughter, Chairwoman, Committee on Rules
The Honorable David T. Dreier, Ranking Member, Committee on Rules

---

[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 ("In consideration of the IWG's proposals on OTC derivatives, 68 percent of 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.").