

Via Facsimile

April 16, 2010

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

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

The Honorable Blanche Lambert Lincoln  
Chairman  
Committee on Agriculture, Nutrition and  
Forestry  
328A Russell Senate Office Building  
Washington, DC 20510

The Honorable Saxby Chambliss  
Ranking Member  
Committee on Agriculture, Nutrition and  
Forestry  
328A Russell Senate Office Building  
Washington, DC 20510

Dear Chairs Dodd and Lincoln and Ranking Members Chambliss and Shelby:

I am writing on behalf of the Council of Institutional Investors (“Council”), a non profit 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 across the country. Council general members include the Arkansas Public Employees Retirement System, the Connecticut Retirement Plans and Trust Funds, and the Coca-Cola Retirement Plan.<sup>1</sup> Significantly affected by the financial crisis, Council members have a deep, abiding interest in strong regulatory reform.

It is our understanding that recently some parties have been urging you and other members of the United States (“U.S.”) Senate to support an explicit exemption from the central clearing requirements of the *Restoring American Financial Stability Act of 2010* for defined benefit plans that use over-the-counter (“OTC”) derivatives.<sup>2</sup> The purpose of this letter is to inform you that the Council does not support such an exemption.

Our views on this issue are informed by the recommendations of the Investor’s Working Group (“IWG”). A blue ribbon panel of industry and market experts, the IWG is an independent, nonpartisan commission sponsored by the CFA Institute and the Council to provide an investor perspective on ways to improve the regulation of U.S. financial markets.

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<sup>1</sup> For a description of the general members of the Council of Institutional Investors (“Council”) see the Council’s website at [http://www.cii.org/about/council\\_members](http://www.cii.org/about/council_members).

<sup>2</sup> Doug Halonen, *Derivatives exemption sought for defined benefit plans*, Pensions and Investments, Apr. 5, 2010, at 1-3, <http://www.pionline.com/article/20100405/PRINTSUB/304059974>.

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").<sup>3</sup> Following its issuance, the IWG Report was reviewed and subsequently endorsed by the Council board and membership.<sup>4</sup>

Among its various findings, the IWG concluded that unregulated trading in OTC derivatives contracts, especially credit default swaps, was at the heart of the financial crisis.<sup>5</sup> 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.<sup>6</sup> Warren Buffett has accordingly dubbed derivatives "financial weapons of mass destruction."<sup>7</sup> Specific problems plaguing the OTC derivatives market identified by the IWG include poor transparency and price discovery, excessive leverage, rampant speculation, and inadequate prudential controls.<sup>8</sup>

Despite these serious problems, as you are well aware, the enormous OTC derivatives market is virtually exempt from all regulation under the Commodity Futures Modernization Act of 2000 ("CFMA").<sup>9</sup> Such lax oversight led the IWG to conclude that regulation of the OTC derivatives market is one of a number of "[c]ritical gaps that urgently need attention" from policymakers.<sup>10</sup> 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>11</sup> Consistent with this recommendation, the Council opposes exemptions to exchange trading and central clearing requirements for *any* users of standardized or standardizable OTC derivatives. In our view, such exemptions would leave a gaping hole in the regulation of derivatives that will likely be exploited to the detriment of the capital markets.

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<sup>3</sup> Investors' Working Group, *U.S. Financial Regulatory Reform: The Investors' Perspective* 1-27 (July 2009), [http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20\(July%202009\).pdf](http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf) [Hereinafter IWG Report].

<sup>4</sup> Investors' Working Group, <http://www.cii.org/iwgInfo> (last visited Apr. 15, 2010).

<sup>5</sup> IWG Report, *supra* note 3, at 10.

<sup>6</sup> *Id.* at 11.

<sup>7</sup> *Id.*

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

<sup>9</sup> *Id.* at 10.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at 11.

We note that our view is shared by Commodity Futures Trading Commission Chairman Gary Gensler.<sup>12</sup> In his remarks to the Council membership early this week, Chairman Gensler explained:

To further lower risk in the over-the-counter derivatives marketplace, all standardized derivatives should be cleared through central clearinghouses. . . . Clearinghouses act as middlemen between two parties to a transaction and guarantee the obligations of both parties. When transactions aren't cleared, they stay on the books of the derivatives dealers for many years. This enables dealers to become dangerously interconnected with each of their counterparties, as we saw with AIG. Clearinghouses move the risk off of the books of the dealers and into robustly regulated central counterparties.

. . . .

It is essential that we move as many over-the-counter derivatives transactions into central clearing as possible. *We should not enact broad exemptions for particular transactions based on which party stands on one side of the trade.* It is important to note that while American taxpayers were not required to cover market exposures on any cleared futures transactions, they had to bail out AIG and others in part to cover uncleared derivatives contracts. Thus, the more transactions that are cleared, the better protected the American public is.<sup>13</sup>

Thank you for your leadership in connection with this critical area of financial regulatory reform. Please feel to contact me at (202) 261-7081 or [jeff@cii.org](mailto:jeff@cii.org) should have any questions or comments regarding this letter.

Sincerely,

Jeff Mahoney  
General Counsel

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<sup>12</sup> E.g., Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Remarks to the Council of Institutional Investors 4 (Apr. 13, 2010) (emphasis added), <http://www.commodities-now.com/component/attachments/download/168.html>.

<sup>13</sup> *Id.*; see also Peter Eavis, *Heard on the Street: Bill on Derivatives Overhaul Is Long Overdue*, Wall St. J., Apr. 14, 2010, at 2, <http://online.wsj.com/article/SB10001424052702304604204575182443683456672.html> ("Putting nearly all derivatives through clearinghouses, with tough margin requirements, could do away with most of the under-collateralization. The IMF says getting there could be a very costly for the banks. But consider it a bill they should have paid years ago.").