November 9, 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 Spencer Bachus,
Ranking Member
House Committee on Financial Services
United States House of Representatives
B371a Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Frank and Ranking Member Bachus:

As the Committee considers the Discussion Draft of the Financial Stability Improvement Act of 2009, 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 address systemic risk posed by large, complex, interconnected institutions, practices and products in the U.S. capital markets. 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 systemic risk include:

- The interconnectedness of complex institutions, practices and products requires the establishment of mechanisms to track and sound early warnings and address the range of significant threats to the financial system.
- This oversight, which must keep up with financial innovation and be able to coordinate with regulators outside of the United States, must also suggest corrective steps before particular risks grow big or concentrated enough to threaten entire markets or economic sectors.
- A macro regulator with the Federal Reserve at the helm would vest far too much authority in an agency whose credibility is already damaged by its shortcomings in its response to the subprime crisis.
- Vesting the Fed with systemic risk oversight authority would also conflict with its primary responsibility for monetary policy.
- A "council" of existing regulators charged with systemic oversight also faces drawbacks in that it would only add a layer of regulatory bureaucracy without closing the gaps that regulators currently have in skills, experience and authority needed to track systemic risk in a comprehensive fashion.
- However, the creation of an independent Systemic Risk Oversight Board to supplement, not supplant the functions of the existing federal financial regulators, would fill an immediate void on systemic issues, and serve a vital role in reporting on risks and systemic vulnerabilities and recommending steps to regulators to reduce those risks.

- Such an Oversight Board would be more able to recognize emerging threats and identify practices designed to escape current regulatory attention and to make appropriate recommendations to existing regulators on how to address those threats.

The above findings led the IWG to propose the following specific recommendations regarding the creation of a Systemic Risk Oversight Board:

1. Congress should create an independent governmental Systemic Risk Oversight Board. To function efficiently, the board should consist of a chair and no more than four other members. All should be presidential appointees confirmed by the U.S. Senate. The board would be accountable primarily to Congress.
2. The board's budget should ensure its independence from the firms it examines. Funding should be adequate and sustainable to attract and retain highly competent board members and staff. Appropriate funding options include an industry assessment fee similar to that of the Public Company Accounting Oversight Board (PCAOB).

3. All board members should be full-time and independent of government agencies and financial institutions. Members should possess broad financial market knowledge and expertise. Collectively, the members should have backgrounds in investment practice, risk management and modeling, market operations, financial engineering and structured products, investment analysis, counterparty matters and forensic accounting.

4. The board should have a dedicated, highly skilled staff. Staffers should have a range of key skills and experiences and work exclusively for the board. They should be experts who understand the components and complexities of systemic risk and how to fully examine critical interconnections between firms and markets. To attract and retain top-notch individuals, staff and board member salaries should be commensurate with those of the PCAOB.

5. The board should have the authority to gather all information it deems relevant to systemic risk. The IWG believes that federal regulators do not currently have the full scope and depth of information they need to understand systemic risks in the U.S. financial system, much less the behavior of those risks in the context of global markets. For the Systemic Risk Oversight Board to have that capability, it should develop a timely way to identify a broad range of threats emanating from institutions, markets, practices, financial instruments and emerging products. Therefore, the board should have the legal authority to gather all the financial information it deems necessary to assess systemic vulnerabilities.

Defining such threats is not a static process. Systemic risks do not lurk only in systemically significant institutions. Highly concentrated market segments or critical financial instruments can threaten the health of the financial system. Risk may be baked into regulation in ways that are not well understood. For example, the financial crisis has revealed the danger to the markets of rules that make credit rating agencies gatekeepers for issuing debt without ensuring that they are independent and accountable for the accuracy of their ratings.

The board would need to develop appropriate procedures for determining which entities to examine and what information to review. It would need a degree of flexibility so that its focus and examinations could adjust to shifts in market conditions. The board and staff should be able to use their professional judgment to determine the scope of analysis for financial institutions, products or practices. The board should also have the authority to hire consultants and other experts as needed.

6. The board should report to regulators any findings that require prompt action to relieve systemic pressures and should make periodic reports to Congress and the public on the status of systemic risks. If appropriate, the board would also report its findings to specific companies and other institutions. The board should take steps to mitigate any severe market reactions or disruptions that could occur as a result of its reports. How the board reports its activities and findings should take into consideration the confidential nature of much of the information it will gather and the potential for market mayhem if information is not dealt with properly.

The board should also provide comprehensive, periodic reports on the state of systemic risks to all relevant regulators and Congress or committees designated by Congress as well as the public. As appropriate, the board should consult with systemic risk overseers outside the United States. The board should consult with regulators and Congress about the nature of any information it releases publicly.

7. The board should strive to offer regulators unbiased, substantive recommendations on appropriate action. As an independent monitor, the board should identify firms and markets that are at risk before significant damage is done. This might entail identifying exposures, modeling potential solutions and communicating those recommendations fully and clearly to regulators. Regulators should determine whether and how to implement the board's recommendations. Where appropriate, the board should coordinate its recommendations with those of overseas systemic risk overseers.

8. Regulators should have latitude to implement the oversight board's recommendations on a "comply or explain" basis. Regulators are generally better positioned to understand the operational and practical implications of a proposed regulatory action, and a regulator may believe that it would be appropriate to refine or modify a recommendation of the board. For this reason, the IWG does not believe that the Systemic Risk Oversight Board should have regulatory authority or other powers to force a regulator to implement a recommendation.

Instead, the recommendations would shift the onus of systemic risk mitigation onto regulators, by requiring them either to 1) adopt and implement the recommendation(s) as suggested, 2) refine and modify the recommendations as they deem necessary, or 3) reject them and take no further action or follow another course. In the case of options 2 or 3 above, the regulator would provide the board a detailed explanation of its response. This should include a discussion of any alternative approach to address the systemic risk the board identified. The regulator should also address any concerns or issues that could emerge if its alternative approach is not consistent with the coordinated response of other regulators. If the board is not satisfied with the regulator's response, it should communicate its concerns to the President and appropriate Congressional authorities.

More details regarding the basis for the IWG's findings and recommendations regarding the Systemic Risk Oversight Board can be found on pages 24-27 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 Linda Rittenhouse at (434) 951-5333 or linda.rittenhouse@cfainstitute.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 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