Meeting between President Dudley and the American Benefits Council and the Committee on Investment of Employee Benefit Assets

June 17, 2011

Participants: William Dudley (Federal Reserve Bank of New York President), Jeanmarie Davis, Wendy Ng, Johanna Schwab, Caren Cox, Rania Perry, Debra Stone (Federal Reserve Bank of New York staff)

Lynn Dudley (American Benefits Council), James Harshaw (GM Asset Management, representing CIEBA), William Donovan and Gary Glynn (United States Steel and Carnegie Pension Fund), Kent Mason (Davis & Harman LLP), Mark Young and Rachel Reicher (Skadden, Arps, Slate, Meagher & Flom LLP)

Summary: The participants identified above, acting on behalf of the American Benefits Council and the Committee on Investment of Employee Benefit Assets ("CIEBA") or certain of its members, met with President Dudley and Federal Reserve Bank of New York staff to discuss questions and concerns relating to certain initiatives of the OTC Derivatives Supervisors Group ("ODSG"), which is chaired by the Federal Reserve Bank of New York. American Benefits Council and CIEBA were invited to meet by the Federal Reserve Bank of New York in order to continue a dialogue that had been initiated by the American Benefits Council and CIEBA in a letter to President Dudley dated March 25, 2011, and to which President Dudley had replied in a letter dated April 4, 2011 (the two letters are attached below). Certain of the questions raised related to how the "commitment letters" signed by firms in connection with the initiatives of the ODSG relate to the rulemaking process under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). In particular, the participants expressed concern with respect to the requirements contained in the "commitment letters" relating to electronic confirmations and noted that the American Benefits Council and CIEBA had submitted a letter containing their comments on this topic to the Commodity Futures Trading Commission ("CFTC") in connection with the CFTC's proposed rules under Title VII of Dodd-Frank. The "commitment letters" are posted on the Federal Reserve Bank of New York's website at http://www.newyorkfed.org/markets/otc_derivatives_supervisors_group.html.

AMERICAN BENEFITS COUNCIL

CIEBA
The Committee on Investment of Employee Benefit Assets

March 25, 2011

The Honorable William C. Dudley
President
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

Re: **Concerns and Questions Regarding the Pending Commitment Letter from Dealers and Certain Asset Managers to the Federal Reserve Bank of New York Regarding Derivatives Activities**

Dear Mr. Dudley:

The American Benefits Council (the "Council") and the Committee on Investment of Employee Benefit Assets ("CIEBA") are concerned about a pending commitment letter ("Commitment Letter" or "Letter") from swap dealers and certain other swap market participants to the Federal Reserve Bank of New York.

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than $1 trillion of defined benefit and defined contribution plan assets on behalf of 15 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who manage and administer ERISA-governed corporate retirement plan assets. CIEBA's recent annual survey of members showed an increased emphasis on managing and reducing plan risks and a corresponding increase in the usage of swaps to address those risks.

The Council and CIEBA understand that the Federal Reserve Bank of New York ("Federal Reserve") has been working with a discrete group of swap market participants, including the majority of the dealer community, on a Commitment Letter with respect to the swap market. It is our understanding that this Letter will be signed by the discrete group of market participants and is intended to reflect commitments by the signatories with respect to the trading, confirmation, clearing, and reporting of their future swap transactions.

We have seen a draft of the Commitment Letter, but we do not know if the draft is up to date. Our purpose for writing is not, however, to address the substance of the Commitment Letter; our purpose is to ask questions regarding the process and regarding the effects of the Letter.

Interaction with the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"). The CFTC and SEC have exclusive jurisdiction over the rulemaking process under Dodd-Frank with respect to swaps. How does the Commitment Letter relate to the CFTC's and the SEC's regulatory processes? For example, the draft of the Commitment Letter we have seen addresses electronic confirmation and sets objective targets regarding achieving widespread use of electronic confirmation. At the same time, the CFTC is reviewing comments it has received on issues related to electronic confirmation, including whether market participants should have a right to determine whether their swaps are electronically confirmed.

If the CFTC determines that market participants that are not swap dealers or major swap participants should have a right not to have their swaps electronically confirmed, we would request that the Federal Reserve confirm that the Commitment Letter will not indirectly affect that right by requiring dealer-signatories to attempt to achieve certain electronic confirmation targets.

This is just one example of the potential conflict between the Commitment Letter and regulations being developed by the CFTC. We are concerned about a secondary regulatory process that could undermine the public regulatory process which is open to all and is subject to public comment.

Effect on Non-Signatories. We understand that the signatory dealers to the Commitment Letter are making a commitment with respect to their future swap transactions. How will this affect non-signatories to the Letter who are counterparties to such dealers? It is our understanding that dealer signatories to prior similar commitment letters have in numerous cases cited those commitment letters as "regulatory obligations" in light of the Federal Reserve's involvement in drafting the commitment letters. Further, many dealer signatories have felt that these "regulatory obligations" compelled them to structure their swap trading in accordance with such letters, even when such dealer signatories were entering into swaps with non-signatories. It has been reported to us that in certain cases, this was done to the detriment of non-signatories. Are steps being taken to prevent that from happening again?

Process. If the Commitment Letter could directly or indirectly affect non-signatories, we believe that all interested parties should have an opportunity to comment. We represent the largest private pension plans in the country and many of the largest private pension plans in the world, and accordingly we and our members have a vital interest in any material developments regarding swaps. We believe that our members, and all other market participants, should be included in discussions regarding how the swap markets should function.

In short, we would like to understand the Commitment Letter more fully. We believe that if the Letter can affect non-signatories in any material way, we believe that the use of a private commitment letter process that is closed to most market participants needs to be examined very closely.

We look forward to a constructive dialogue on these important issues.

American Benefits Council   Committee on Investment of Employee Benefit Assets

cc: Board of Governors of the Federal Reserve System
Commodity Futures Trading Commission
Connecticut State Banking Department
Federal Deposit Insurance Corporation
New York State Banking Department
Office of the Comptroller of the Currency
Securities and Exchange Commission

FEDERAL RESERVE BANK *of* NEW YORK

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WILLIAM C. DUDLEY
PRESIDENT

April 4, 2011

VIA E-MAIL

James A. Klein, President
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Washington D.C. 20005

Committee on the Investment of Employee Benefit Assets
Association for Financial Professionals
4520 East West Highway, Suite 750
Bethesda, MD 20814

Re: Concerns and Questions Regarding the "Commitment Letter" to the Federal Reserve Bank of New York Regarding OTC Derivatives Activities

Dear Mr. Klein,

Thank you for your letter dated March 25, 2011 regarding the "commitment letter" from dealers, certain asset managers and hedge fund managers to the Federal Reserve Bank of New York (NY Fed) about over-the-counter (OTC) derivatives activities. I hope the following will satisfactorily address the concerns of your associations and constituents.

To address the questions you posed in your letter, it will be helpful to provide some background on the current collaborative framework employed by market participants and the supervisors of the OTC Derivatives Supervisors Group (ODSG)[1], including its origins,

[1] Currently, the members of the ODSG are the Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Prudential Supervisory Authority (Autorité de Contrôle Prudentiel - ACP), German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority, United Kingdom Financial Services Authority. The New York Fed has chaired the ODSG since inception and hosts annual meetings with the signatories to the "commitment letters" and supervisors, as well as ongoing coordination calls.

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how it has evolved in response to emerging risks in the OTC derivatives market, and its present role in promoting financial stability. Providing this context will help clarify both the relation of the ODSG to global regulatory reform efforts (including the rulemaking process in connection with the Dodd-Frank Act) and the significance of the "commitment letter" process that has been employed by market participants and supervisors to focus efforts in making collective improvements to the OTC derivatives market infrastructure and related risk management practices.

Background on the Collaborative Framework

The collaborative framework established by supervisors for addressing OTC derivatives-related issues originated in 2005, when the New York Fed hosted a meeting with representatives of major market participants (often referred to as the "G14") and their domestic and international supervisors, in order to address the emerging risks of inadequate infrastructure for the rapidly growing market in credit derivatives. At the time, operational processing of credit derivatives involved manually intensive processes, resulting in growing backlogs of unconfirmed transactions that created potential uncertainties in the status of such transactions and inaccuracies in determining counterparty exposures. In addition to supervisors' concerns about the buildup of unconfirmed trades, it became clear to supervisors that the undisciplined and frequent use of novations (or "assignments") of transactions had led to increased and unmanaged counterparty risk. In both instances, the supervised "G14" institutions were unable to coordinate their actions sufficiently to achieve a beneficial outcome.

Following the above-mentioned meeting in 2005, the supervised "G14" institutions delivered the first "commitment letter" to their supervisors, committing to a set of operational improvements including reducing confirmation backlogs, adopting automated processing (i.e. electronic confirmation), establishing controls around novations, and improving settlements of credit derivatives transactions. In order to monitor future progress, the supervised "G14" institutions established group performance targets and submitted operational metrics to their supervisors.

By 2008, the supervised "G14" institutions had achieved material progress in reducing the risks related to credit derivatives processing through a series of "commitment letters"[2] to their supervisors. The financial crisis, however, highlighted the need for additional structural improvements beyond operational processing efficiency including: increased product and process standardization, more robust counterparty risk management and greater market transparency. Deficiencies in infrastructure, together with weak risk controls and the lack of transparency to regulators, allowed excessive risks to build within interconnected institutions, exacerbated the crisis and contributed to systemic risk. The G20 leaders, comprised of finance ministers and central bank governors, the Financial

[2] http://www.newyorkfed.org/newsevents/otc_derivative.html

Stability Board (FSB), supervisors and regulators responded by demanding improvements to the OTC derivatives market, with a particular focus on managing counterparty credit risk through the use of central clearing.

It had become evident to supervisors that many critical market infrastructure issues (such as those relating to the introduction of central clearing) could be more effectively addressed collectively and with the involvement of a broader group of market participants across the major OTC derivative asset classes. Consequently, the collaborative framework described above was expanded to include major buy-side clients of the supervised "G14" institutions, as well as trade associations including the Securities Industry and Financial Markets Association (SIFMA), Managed Funds Association (MFA) and the International Swaps and Derivatives Association (ISDA). By 2009, at the urging of the ODSG, ISDA in consultation with its members, as well as SIFMA and the MFA, established a governance structure for OTC derivatives market practices and post-trade activities. The governance structure is intended to promote broad-based decision making among the diverse group of market participants and incorporate the various perspectives into the collaborative efforts underway. Critically, the governance structure provides a communication channel to represent those interests in a cohesive and comprehensive manner to the supervisory community.

To date, the governance structure has provided the basis for efficient and effective interaction among supervisors and interested stakeholders (including asset managers, hedge fund managers, trade associations, vendors and the supervised "G14" institutions) for achieving meaningful and risk reducing improvements in a market of systemic importance. The frequent dialogue and practical, problem-solving orientation that characterize the collaborative framework provide a means for market participants and supervisors to identify emerging risks and address them in a prudent, collective, and timely fashion. In addition, the cross-jurisdictional membership of the ODSG has ensured that issues are addressed in a consensus-driven manner and has served as a vehicle to promote consistent supervisory approaches to post-trade and market infrastructure improvements to the global OTC derivatives market.

Risk Reduction for the Benefit of all OTC Derivatives Market Participants

The commitments made by signatories signify their collective agreement to work with other signatories and their counterparties (whether signatories or not) to deliver structural improvements to the OTC derivatives market. To the extent that a supervised "G14" institution is not meeting its commitments, the relevant supervisor will consult with such institution and take steps appropriate to its own supervisory process and authority.

As a general matter, supervisors are supportive of business decisions by signatories to recalibrate their operational or risk management practices to be aligned with the commitments (subject to applicable regulatory and supervisory requirements, and any fiduciary and client-specific duties), since the commitments are intended both to reduce individual institution risk levels and improve the broader market infrastructure.

While the commitments are not binding on non-signatories, supervisors encourage the utilization of risk-reducing practices and technologies by non-signatories with a presence in the OTC derivatives market. Supervisors also encourage a broader set of participants to engage with signatory counterparties, supervisors and others to create a more robust and resilient market that is scalable and contributes to financial stability.

<u>Complementary Process Supporting Global Regulatory Reform</u>

With respect to regulatory reform of the OTC derivatives market across multiple jurisdictions, the ODSG acknowledges the importance of commitments that are complementary to and supportive of regulatory reform without prejudice to jurisdiction. From a U.S. perspective, both the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) are members of the ODSG and have provided insights on areas where the ODSG can be most supportive for purposes of implementing the Dodd-Frank Act. For example, in its proposed rulemaking on Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, the CFTC recognized the ODSG's efforts to improve risk management practices in these areas and noted that "[t]he regulations proposed by the [CFTC] would build upon the ODSG's work."[3] As market participants begin operating in a more regulated environment, the NY Fed believes that supervisors of major market participants must continue to work cooperatively and proactively to drive structural improvements, monitor emerging risks, and support consistent supervisory approaches across jurisdictions.

I hope this letter has sufficiently clarified the important role of this collaborative framework and of the ODSG in promoting financial stability through a process that is complementary to and supportive of global regulatory reform efforts. As with the supervisors' outreach to signatory buy-side institutions in 2008, New York Fed staff encourages broader market participation in these efforts and would be pleased to meet with the American Benefits Council and CIEBA to discuss steps towards future participation in the process. We look forward to further engagement with you on these critical matters.

Sincerely,

William C. Dudley

William C. Dudley

[3] 75 FR 81520, December 28, 2010.