February 18, 2011

By Hand Delivery

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re: Proposed Regulations on Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, RIN 3038 – AD 25

Dear Mr. Stawick:

I. INTRODUCTION

We are pleased to submit this comment letter, on behalf of the undersigned Public Pension Funds (Funds), who in aggregate represent $720 billion in assets under management, regarding the regulations proposed by the Commodity Futures Trading Commission (CFTC) on business conduct standards for swap dealers (SDs) and major swap participants (MSPs) with counterparties.[1] We have concerns with the proposed regulations; but, we have set forth a positive alternative proposal in this letter.

Our Funds are classified as governmental plans under Section 3 (32) of the Employee Retirement Income Security Act of 1974 (ERISA), and therefore come within the definition of a "Special Entity" under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which enacted a new Section 4s of the Commodity Exchange Act (CEA) that will become effective in July to govern the registration and regulation of SDs and MSPs. To fulfill obligations to our members, we invest in a wide variety of asset classes, including alternative investment management, global equity, global fixed income, inflation-linked assets, and real estate. As part of our investment and risk management policies, we have authorized the use of certain derivatives. The authorized derivatives include futures,

[1] 75 Fed. Reg. 80637 (December 22, 2010).

forwards, swaps, structured notes and options. Accordingly, we have an interest in the regulation of the swap market.

II. CURRENT PROPOSALS AND CONCERNS

The objective of protecting vulnerable or gullible parties in the swap market may be well-intentioned. However, the proposed business conduct standards for SDs and MSPs, as they would apply when SDs and MSPs deal with a Special Entity, could be wholly unworkable and adversely affect pension fund members. In particular, we are concerned about the proposed regulations that would require that an SD or MSP that offers to enter into, or enters into, a swap with a Special Entity have a reasonable basis to believe that the Special Entity has a representative who is independent of the SD or MSP and who meets certain other requirements.[2],[3] We are also concerned about the proposed regulations regarding: (1) the

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[2] Under Proposed Regulation 23.450, a SD or MSP must have a reasonable basis to believe that the Special Entity has a representative who is independent of the SD or MSP (although not necessarily independent of the Special Entity) and that:

(1) has sufficient knowledge to evaluate the transaction and risks;
(2) is not subject to statutory disqualification from registration applicable to futures professionals;
(3) undertakes a duty to act in the best interests of the Special Entity;
(4) makes appropriate and timely disclosures to the Special Entity; and
(5) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap.

[3] Proposed Regulation 23.450(d)(2) further proposes that an SD or MSP could rely upon representations made by the Special Entity about the independent representative, provided such representations are sufficiently detailed. Relevant considerations would include:

(1) The nature of the relationship between the Special Entity and the representative and the duties of the representative, including the obligation of the representative to act in the best interests of the Special Entity;
(2) The representative's capability to make hedging or trading decisions, and the resources available to the representative to make informed decisions;
(3) The use by the representative of one or more consultants;
(4) The general level of experience of the representative in financial markets and specific experience with the type of instruments, including the specific asset class, under consideration;
(5) The representative's ability to understand the economic features of the swap involved;
(6) The representative's ability to evaluate how market developments would affect the swap; and
(7) The complexity of the swap or swaps involved.

treatment of recommendations to counterparties, and (2) when SDs will be considered to be acting as an advisor to Special Entities.[4]

Although the CFTC proposals might appear to provide SDs and MSPs that would want to enter into swap transactions with Special Entities a means to do so, the process could be unworkable in some cases. Specifically, there is an inherent conflict of interest for one of the parties to a transaction also to be responsible for determining who might represent the other side of a transaction. The proposed independent representative requirement would give undue influence to an SD or MSP to determine who qualifies to fill that role.[5]

Swaps have not previously been subject to regulation in the United States, so there is a lack of precedents for parties and their counsel to rely upon in deciding whether particular transactions could be lawfully entered into. Certain of the proposed relevant terms, such as "best interests," "fair pricing," and "appropriateness," are quite vague. The SD or MSP would nonetheless be required to make judgments as to the competency of a particular representative, in effect performing functions customarily performed by a regulatory body or self-regulatory organization.

Moreover, the proposed solution to the inherent conflict of interest between an SD or MSP and a Special Entity, requiring the SD or MSP to make a written record of any determination that a person did not qualify as a representative and to submit such determination to its Chief Compliance Officer for review, is inadequate, because such a review will remain in-house at the SD or MSP without any independent analysis. SDs and MSPs would have substantial discretion in determining who qualifies as an independent representative and this could be exercised in a completely arbitrary fashion, leaving a Special Entity without recourse.

Separately, even those SDs and MSPs that would wish to comply with the CFTC's requirements in a conscientious manner may find the requirements vague and intrusive, forcing them to make very difficult judgments. The SDs and MSPs could be expected to at least pass on these extra compliance costs to the Special Entity in the price of their offers or, if they conclude that the potential liability is too great, simply not offer to deal with Special Entities at all with respect to those customized swaps that would not be traded on designated contract

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[4] More specifically, Proposed Regulation 23.431 provides that, in the case of a high-risk bilateral swap, the SD provide a scenario analysis, designed with the counterparty, to allow the counterparty to assess its risks. However, by providing such a scenario analysis, the SD is at risk for running afoul of the requirements contained in Proposed Regulations 23.434 and 23.440, which, taken together, provide that an SD recommending a swap to a Special Entity is acting as an advisor to the Special Entity.

[5] 75 Fed. Reg. 80637, 80653 & n.127.

markets or swap execution facilities.[6] Therefore, in the guise of attempting to protect a Special Entity, the proposed regulations may make it impractical for SDs and MSPs to deal with Special Entities due to the increased and unquantifiable risks, additional costs and other burdens involved. SDs and MSPs would be encouraged to take their business to end users or other entities that are not Special Entities, because off-exchange transactions with entities other than Special Entities would provide greater legal certainty and be less costly and cumbersome to complete. Special Entities would be left to deal with less desirable counterparties, if they could find any at all. In the case of our Funds, this could result in dramatically limiting the ability to enter into certain swaps that may benefit our portfolios and the interests of our members.

Therefore, we respectfully request that the CFTC consider an alternative approach that would achieve the same goal without causing undue hardship to entities like us and our members. The alternative approach is outlined below.

III. ALTERNATIVE APPROACH

We respectfully request that the CFTC consider an alternative approach to the independent representative issue. The alternative approach would provide another, supplemental way to meet the independent representative requirements. Under the proposal that we are putting forward, the Special Entity would be able to elect, on an entirely voluntary basis, whether it relies on the framework set forth in the CFTC proposed regulation or the alternative approach outlined below.

Under the alternative approach, SDs and MSPs would be permitted to enter into off-exchange swap transactions with a Special Entity so long as the Special Entity had a representative, either internally or at a third-party, certified as able to evaluate swap transactions. The SD and MSP would be permitted to rely on the certification broadly for all aspects of the transaction with the Special Entity.[7] Further, this would eliminate possible confusion among

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[6] Proposed Regulation 23.450, pursuant to paragraph (g) thereof, would not apply to a swap that is initiated on a designated contract market or swap execution facility where the SD or MSP does not know the identity of the Special Entity.

[7] For example, as noted previously, by providing the scenario analysis in the case of a high-risk bilateral swap as required in Proposed Regulation 23.431, an SD could run afoul of the requirements contained in Proposed Regulations 23.434 and 23.440, which, taken together, provide than an SD recommending a swap to a Special Entity is acting as an advisor to the Special Entity. Under the alternative approach, the SD would be permitted to rely on the certification of the independent representative for the purposes of these requirements. Consequently, because the representative is able to independently assess the information, communications between the SD and the certified independent representative would not be a recommendation.

SDs and MSPs about the extent to which they can rely upon the representations from a Special Entity.

This certification process would involve passage of a proficiency examination to be developed by the CFTC or by an appropriate self-regulatory organization, such as the National Futures Association (NFA) or another recognized testing organization. To maintain the status of a certified independent representative after passing the examination, the person would be required to complete periodic ethics training, similar to that required of registrants.[8] These requirements are intended to be in furtherance of Dodd-Frank and the proposed regulation.

Under the alternative approach, the requirement to be independent of an SD or MSP would remain. However, persons employed by a Special Entity that have extensive experience in the swaps and other financial markets could presumably qualify for the certification and thus not be blocked from serving as an independent representative by an SD or MSP. The alternative approach would be voluntary, so no person would be forced to take a test to serve as an independent representative.

This alternative approach is within the CFTC's authority. Dodd-Frank Section 731 requires SDs and MSPs to comply with any duty established by the CFTC for an SD or MSP with respect to a counterparty that is an eligible contract participant (ECP) within the meaning of subclause (I) or (II) of clause (vii) of CEA Section 1a(18). That clause of the ECP definition, which was amended by Dodd-Frank, relates to government entities. It is the *preceding* clause of the ECP definition that refers to a government employee benefit plan and other pension plans. Although it is unclear that the CFTC has authority to adopt any requirements with respect to independent representatives of a government plan, the CFTC appears to have relied upon a phrase in the Joint Explanatory Statement of the Committee of Conference on Dodd-Frank that refers to "pension funds" as its authority for the proposals regarding independent representatives of Special Entities. However, even pension funds are separately denoted from government plans under the Dodd-Frank Special Entity definition,[9] and the Joint Explanatory Statement is clearly at odds with the plain and very detailed statutory provision. This statutory construction certainly leaves open to substantial question whether proposed Regulation 23.450 should apply to government plans at all, strengthening the case for an alternative approach.[10] Additionally and by way of background, the CFTC

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[8] *See* Appendix B to Part 3 of the CFTC's Regulations – Statement of Acceptable Practices With Respect To Ethics Training.

[9] CEA Section 4s(h)(2)(C)(iii) and (iv), which are tracked in proposed Regulation 23.401 as paragraphs (3) and (4) under the proposed regulatory definition of the term "Special Entity."

[10] 75 Fed. Reg. 80637, 80651 & nn.106 and 107. As was noted when ERISA was adopted, "State and local governments must be allowed to make their own determination of the best method to protect the pension rights of municipal and state employees. These are questions of state and local sovereignty and the Federal government should not interfere." I Legislative

has similarly provided for an alternative approach in the case of introducing brokers (IBs), which can be analogized to the proposed alternative approach for certification of independent representatives.[11]

We envision our recommendation for a process to certify independent representatives through testing and training, bringing greater legal certainty to the interaction of SDs, MSPs and entities like us without giving any party undue influence over the other.

IV. CONCLUSION

We believe we have outlined a reasonable alternative to what could be unworkable proposals regarding independent representatives for Special Entities. We fully understand that it will take time to create the testing framework discussed above, so should the proposal advance, it may be necessary to delay the effective date of the independent representative provision of the regulations to permit implementation of the alternative approach.

We would welcome the opportunity to discuss this alternative recommendation in greater detail with Commissioners and staff at your convenience. Please feel free to contact Anne Simpson of CalPERS at 1-916-795-9672 if you have any questions or wish to discuss this matter further.

History of the Employee Retirement Income Security Act of 1974, 97th Cong., 2d Sess. 224 (Comm. Print 1976). This rationale was also cited by the CFTC when it excluded governmental plans from the definition of commodity pools under CFTC Regulation 4.5. *Exclusion for Certain Otherwise Regulated Persons from the Definition of the Term "Commodity Pool Operator"; Other Regulatory Requirements*, 50 Fed. Reg. 15868 (April 23, 1985), *reprinted in* [1984-1986 Transfer Binder] Comm. Fut. L. Rep. CCH ¶22,550, at 30,376.

[11] The IB registration category was created by Congress as part of the CFTC's reauthorization in 1982. One aspect of those amendments authorized the CFTC to adopt minimum financial requirements for IBs and, in 1983, the CFTC proposed minimum adjusted net capital requirements for IBs, requiring all IBs to maintain their own amount of highly liquid assets. Many IBs, which had previously operated as "agents" of futures commission merchants (FCMs), commented that they would be unable to meet the proposed requirements and would be forced out of business. Several FCMs that had used extensive networks of these former "agents" suggested that they be permitted to guarantee the obligations of IBs under the CEA in lieu of IBs being required to maintain their own capital. This "alternative" minimum capital requirement resulted in the CFTC developing a standard form guarantee agreement between an FCM and an IB that has proven to be very successful and the preferred method of operation by IBs (approximately two-thirds of IBs conduct business this way). The CFTC could rely upon the resources of FCMs to back up IBs in most cases, and those FCMs that wished to use IBs extensively could do so with a guarantee agreement, which was voluntary for both sides, in effect a win-win-win situation.

Sincerely,

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