California State Teachers' Retirement System
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Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Business Conduct Standards for Swap Dealers and Major Swap Participants (RIN 3038–AD25 (Dec. 9, 2010) 75 Fed. Reg. 80,638 (Dec. 22, 2010))

Dear Mr. Stawick:

This letter is submitted on behalf of the members of the California State Teachers' Retirement System ("*CalSTRS*"). CalSTRS is the second-largest public pension system in the U.S., with nearly $150 billion in assets that are managed on behalf of over 840,000 members and beneficiaries.

Swaps are an important component of the tools used by CalSTRS' investment professionals and third party advisers to protect plan assets as part of a cost-effective and prudent long-term investment strategy. CalSTRS uses these instruments to hedge against market fluctuations, interest rate changes and other factors that create volatility and uncertainty with respect to plan funding. Swaps are also used as a means to effect a rebalancing of an investment portfolio, to enhance investment diversification and as a prudent means by which to gain exposure to particular asset classes without direct investment.

The long-term nature of CalSTRS' liabilities, and CalSTRS' constitutional and statutory responsibilities as a fiduciary to our members and beneficiaries, makes efficacy and efficiency of the global financial markets of significant importance to CalSTRS. We thus support the efforts of Commission to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act to enhance the transparency of the over-the-counter derivatives market and thus protect the financial markets from systemic risk. This is consistent with CalSTRS's statutorily-mandated purpose under the California Constitution and the California Education Code, which is to provide benefits to the members and their beneficiaries who rely on the CalSTRS plans for retirement income, health care and other important benefits.

We appreciate the opportunity to submit this comment letter to address certain aspects of the Commission's proposed rules relating to business conduct standards for swap dealers and major swap participants in the above-cited release (the "*Proposing Release*"). Our primary goal in submitting these comments is to ensure that the proposed rules do not inadvertently adversely affect our ability, as a public pension fund governed by the law of the State of California rather than by the Employee Retirement Income Security Act ("*ERISA*"), to continue to participate in swaps without being subjected to increases costs and regulation that will disadvantage CalSTRS (and our members and their beneficiaries) when compared to other ERISA plans and also to other sophisticated and legally prudent institutional market participants.[1]

Summary

CalSTRS supports the Dodd-Frank Act's efforts to ensure that swap dealers and major swap participants deal fairly with Special Entities (as such term is defined in the Act), including Governmental Plans and other ERISA Plans. CalSTRS is concerned, however, that the proposed rule does not adequately reflect the complex statutory and regulatory requirements under which private-sector employee benefit plans already must operate. CalSTRS is subject to extensive fiduciary obligations under California law.[2] Many of the business conduct standards that apply to swap dealers and major swap participants duplicate protections already in place under existing legislation, and some of the requirements in the proposed rule create a risk that swap dealers and major swap participants will themselves be classified as fiduciaries under ERISA if they transact with CalSTRS.

Many of the business conduct standards confer no benefit on Governmental Plans and other ERISA Plans. The greater danger, however, is that the standards will actually harm these plans by making swap transactions prohibitively expensive, or by discouraging swap dealers and major swap participants from dealing with plans such as CalSTRS. This would constitute a significant detriment to CalSTRS and its members and their beneficiaries and would also be contrary to the clear legislative intent underlying the Dodd-Frank Act.

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1 Section 3(3) of ERISA includes in the definition of "employee benefit plans" governmental plans. 29 U.S.C. §1003(3). Section 3(32) of ERISA defines a "governmental plan" as a "plan established or maintained for its employees by . . . the government of any State or political subdivision thereof . . .." 29 U.S.C. §1003(32). CalSTRS, which was established pursuant to the California Constitution, is a governmental plan as defined under Section 3(32) of ERISA. We adopt herein the Commission's reference to employee benefit plans as so defined under ERISA as "*ERISA Plans*."

For ease of reference herein, and because CalSTRS does not purport to speak for any employee benefit plan other than itself, our analysis herein is focused on CalSTRS as a governmental plan that is subject to fiduciary and prudential standards similar to those imposed by Title I of ERISA (we refer to ourselves and other such prudential governmental plans as "*Governmental Plans*"). These references should not be read to suggest that CalSTRS proposes that the Commission treat such Governmental Plans differently from other ERISA Plans for purposes of the Proposing Release. If, however, the Commission were to consider distinguishing between employee benefit plans that are subject to the fiduciary standards of Title I of ERISA (which we to herein as "*ERISA Title I Plans*") and other ERISA Plans, then CalSTRS does propose that the Commission include within any such exclusion Governmental Plans, such as CalSTRS, that are not capable of being ERISA Title I Plans.

2 *See*, *e.g*., Cal. Const., Art. XVI, §§17 (2d paragraph), 17(a), 17(b), 17(c); Cal. Educ. Code §§22250, 22251, 22252, 22253, 22254 22256.

CalSTRS therefore urges the Commission to modify the rule proposal as follows:

1. The Commission should revise the rules for determining when a swap dealer or a major swap participant is an "advisor" to an ERISA Plan (including a Governmental Plan).[3]

   a. The regulation should permit the parties to any swap to agree in writing that a swap dealer is not an advisor to an ERISA Plan (including a Governmental Plan) so long as appropriate conditions are met to support the contractual non-advisory undertaking.

   b. The regulation should make clear that a swap dealer does not "recommend" a swap transaction to an ERISA Plan (including a Governmental Plan) if the transaction is evaluated and approved by a fiduciary on behalf of the plan.

   c. The regulation should make clear that no conduct other than recommending a swap transaction will cause a swap dealer to be classified as an advisor to an ERISA Plan (including a Governmental Plan).

2. The Commission should revise the qualification requirements for the independent representative of an ERISA Plan (including a Governmental Plan). The regulation should provide that any fiduciary of a public pension plan automatically satisfies the requirements for an independent representative.

1. The Commission Should Revise The Rules For Determining When A Swap Dealer Or A Major Swap Participant Is An Advisor To An ERISA Plan (Including A Governmental Plan)

If a swap dealer acts as an advisor to a Special Entity such as an ERISA Plan (including a Governmental Plan), the Dodd-Frank Act imposes an obligation on the swap dealer to act in the "best interests" of the Special Entity. If a swap dealer is classified as an advisor to a government plan under ERISA, there is substantial uncertainty as to whether the dealer will also be viewed as a fiduciary of the plan under ERISA. Similar uncertainty would extend to advisors to CalSTRS, given the extensive fiduciary duties imposed on CalSTRS and its advisors under California law.

The proposed business conduct rule states that a swap dealer acts as an advisor when the dealer "recommends" a swap or trading strategy to a Special Entity, but not when the dealer merely provides general information or supplies terms in response to a competitive bid. The proposed rule does not otherwise define what it means to be an advisor to a Special Entity. It will be difficult for a swap dealer to be sure that it is not classified as an advisor under this broad standard; and once the swap dealer is classified as an advisor, it must gather a variety of

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[3] For purposes of our herein discussion of advisor status, for ease of reference we will refer to swap dealers, but each such reference should be read to also apply to major swap participants.

information about the Special Entity's circumstances and make a determination that the swap transaction is in the best interest of the Special Entity.

Although a swap dealer might be able to discharge its duty to act in the best interest of other Special Entities, this duty entails substantial uncertainty as to whether the swap dealer will be regarded as a fiduciary of a Special Entity that is an ERISA Plan or a Governmental Plan subject to similar fiduciary duties.

CalSTRS is concerned that no leading swap dealer will enter into a swap transaction with an ERISA Plan (including a Governmental Plan) if there is substantial uncertainty as to whether the swap dealer will be classified as a fiduciary of the plan. Fiduciary status would be incompatible with the swap dealer's role as a counterparty in the transaction, and fiduciary status entails significant potential liability if the dealer is found to be in breach of its duty. Absent a high degree of assurance that it will not be considered an advisor to the plan under the business conduct rules, we fear that major swap dealers will simply exit this portion of the derivatives market. This result would significantly disadvantage CalSTRS and its members and their beneficiaries, as a well-accepted and cost-effective risk management tool for asset managers would no longer be available (or would only be available from suboptimal swap dealers, potentially at significantly higher cost and risk). There is no benefit to the U.S. financial system from such an outcome. This would also run counter to the clear legislative intent of Congress in enacting the Dodd-Frank Act -- that the ability of pension funds to transact in derivatives should not be impaired by the new regulations enacted pursuant to the Act.

CalSTRS therefore urges the Commission to provide that a swap dealer and its Special Entity counterparty may agree as a matter of contract that the swap dealer is not an advisor to the Special Entity. If the ERISA Plan fiduciary concludes that it is in the plan's best interest to make clear that the swap dealer is not an advisor to the plan, and the parties enter into a written agreement to this effect, the swap dealer should not have any responsibility to act in the plan's best interest.

CalSTRS believes that an appropriate prerequisite to such a contractual agreement is that the Special Entity has in place or under negotiation contractual relationships (such as a master agreement or a prior trade confirmation) with more than one swap dealer. This would buttress the contractual assertion that the swap dealer is not acting as an advisor to the Special Entity in that the entity would have the ability to solicit bids from multiple potential counterparties for any trade if it were to elect to do so.[4]

In addition, the Commission also must make clear what conduct causes a dealer to be classified as an advisor, so that the dealer can avoid inadvertently becoming an advisor under the business conduct rules, particularly during the period of time prior to entry into the definitive documentation disclaiming advisor status recommended above. The proposed rule should make

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[4] We do not suggest that the Commission should in fact precondition the entry into any trade on the Special Entity having affirmatively solicited more than one bid for such trade. We believe that this would be an unwarranted intrusion into the transaction execution prerogative of the Special Entity. Instead, we suggest that the Special Entity demonstrate that it has the capability to engage multiple swap dealers in connection with any swap into which the Special Entity proposes to enter. Utilizing multiple dealers is consistent with our understanding of end-user best practices in this market.

clear that a swap dealer is not deemed to "recommend" a swap strategy if the swap dealer describes a particular strategy that might be beneficial to the ERISA Plan (including a Governmental Plan), but an independent fiduciary acting on behalf of the plan evaluates the strategy and reaches the final decision whether the plan should adopt the strategy. In these circumstances, it is clear that the plan is not relying soley on the swap dealer's recommendation, but instead is relying on its own fiduciary to evaluate the merits of the transaction.

Finally, the proposed rule also should make clear that a dealer does not become an advisor through any actions *other than* recommending a swap or trading strategy to an ERISA Plan (including a Governmental Plan). At present, the proposed rule states that recommending swap transactions causes a dealer to be an advisor, but it implies that other conduct not identified in the proposed rule might also confer advisor status. The following language in the preamble appears to confirm this impression:

> The proposed definition does not address what it means to act as an advisor in connection with any other dealings between a swap dealer and a Special Entity.

If there are other types of conduct that might cause a swap dealer to be classified as an advisor to a Special Entity, the Commission should describe them clearly and objectively in the regulation. Significant obligations and potential adverse consequences flow from a swap dealer's status as an advisor to a Special Entity; the Commission should not leave the parties to guess what conduct might cause the swap dealer to be considered an advisor.

2. A Fiduciary Of An ERISA Plan (Including a Governmental Plan) Should Automatically Qualify As An Independent Representative.

The business conduct standards established by section 4s(h) of the Commodity Exchange Act require a swap dealer or major swap participant entering into a swap transaction with a Special Entity to have a reasonable basis to believe that the Special Entity has a qualified independent representative. The statute lists seven criteria that are relevant to this determination:[5]

> The independent representative:
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> (I) has sufficient knowledge to evaluate the transaction and risks;
> (II) is not subject to a statutory disqualification;
> (III) is independent of the swap dealer or major swap participant;
> (IV) undertakes a duty to act in the best interests of the counterparty it represents;
> (V) makes appropriate disclosures;
> (VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the

[5] Dodd-Frank Act § 731 (CEA § 4s(h)(5)(A)(i)).

transaction; and

(VII) in the case of employee benefit plans subject to the Employee Retirement Income Security Act of 1974, is a fiduciary as defined in Section 3 of that Act (29 U.S.C. §1002).

It is not clear whether the representative of an ERISA Plan (including a Governmental Plan) that is acting as a fiduciary must meet all seven criteria, or whether it is sufficient for the representative to comply with section 4s(h)(5)(A)(i)(VII). The Commission has requested comments on this question.[6]

CalSTRS urges the Commission to provide that the requirements for representatives of Special Entities are satisfied with respect to ERISA Plans (including Governmental Plans) as long as the plan is represented by an independent entity that acknowledges it is acting as a fiduciary either under ERISA or, for Governmental Plans such as CalSTRS that cannot be subject to ERISA, under the fiduciary standard of applicable state or local law. The Commission should make clear that a fiduciary representing a plan in a swap transaction is not required to meet the six additional criteria described in section 4s(h)(5)(A)(i)(I)-(VI) of the Commodity Exchange Act and proposed 17 C.F.R. § 23.450(b)(1)-(6) (together, the "***Independent Representative Criteria***").

CalSTRS recognizes that the Commission might believe no harm will come from requiring the representative of a plan to satisfy the six Independent Representative Criteria in addition to satisfying applicable fiduciary standards, even though the Independent Representative Criteria largely duplicate those requirements. CalSTRS is concerned, however, that swap dealers and major swap participants will be unwilling to enter into swap transactions with ERISA Plans (including Governmental Plans), or will substantially increase the cost of these transactions, if they are required to confirm that the six Independent Representative Criteria are satisfied with respect to the fiduciaries of the plans.

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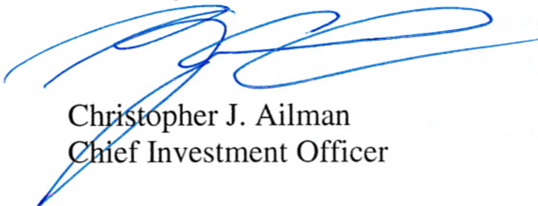
CalSTRS appreciates the opportunity to submit these comments. If we can be of further assistance to the Commission as it considers these important issues, please let us know.

Sincerely,



Christopher J. Ailman
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6 Proposing Release, 75 Fed. Reg. at 80,653.