August 29, 2011

By Electronic Delivery

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Proposed Regulations on Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, File Number S7-25-11

Dear Ms. Murphy:

I. INTRODUCTION

We are pleased to submit this comment letter, on behalf of the undersigned Public Pension Funds (Funds), who in aggregate represent **[$519]** billion in assets under management, regarding the regulations proposed by the Securities and Exchange Commission (SEC) on business conduct standards for security-based swap dealers (SBS Dealer) and major security-based swap participants (collectively, SBS Entities).[1] This letter describes our concerns with the proposed regulations and sets forth a positive alternative proposal.[2]

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 764(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which enacted a new Section 15F of the Securities Exchange Act (Exchange Act) to govern the registration and regulation of SBS Entities. 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

[1] 76 Fed. Reg. 42395 (July 18, 2011).

[2] A similar letter was filed on behalf of several public pension funds in response to the proposed regulations of the Commodity Futures Trading Commission (CFTC) regarding business conduct standards for swap dealers and major swap participants with counterparties. The SEC indicated that it has taken into account the comments filed with the CFTC in developing its proposals and cites to the letter to the CFTC in the preamble of the release. 76 Fed. Reg. 42395, at 42398, 42401 & n.41, 42429 & n.231.

include futures, forwards, swaps, security-based swaps, structured notes, and options. Accordingly, we have an interest in the regulation of the security-based swap market.

II. CURRENT PROPOSALS AND CONCERNS

The objective of protecting vulnerable parties in the security-based swap market may be well-intentioned. However, the proposed business conduct standards for SBS Entities, as they would apply when SBS Entities 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 SBS Entity that offers to enter into, or enters into, a security-based swap with a Special Entity have a reasonable basis to believe that the Special Entity has a representative who is independent of the SBS Entity and who meets certain other requirements.[3,4]

Although the SEC proposals might appear to provide SBS Entities that would want to enter into security-based 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 in one of the parties to a transaction also being responsible for determining who might represent the other side of a transac-

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[3] Under Proposed Regulation 240.15Fh-5(a), an SBS Entity must have a reasonable basis to believe that the Special Entity has a representative who is independent of the SBS Entity (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 securities 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 of material information concerning the security-based swap; and
(5) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the security-based swap.

[4] Although the SEC has not proposed regulatory text on the issue, it states in the preamble of the release that the "reasonable basis" requirement of Regulation 240.15Fh-5(a) could be satisfied through a variety of means, including written representations of the Special Entity. Written representations could be relied upon without further inquiry, absent "special circumstances." Two alternative approaches regarding what would constitute special circumstances are proposed – the SBS Entity could rely upon a Special Entity representation unless the SBS Entity (1) knows the representation is not accurate, or (2) has information that would cause a reasonable person to question the accuracy of the representation. In the latter case, the SBS Entity would need to make further reasonable inquiry to determine the accuracy of the representation. It would not be appropriate for an SBS Entity to rely upon a general representation that merely states that the Special Entity has a "qualified independent representative." 76 Fed. Reg. 42395, at 42424, 42428 & n.225.

tion. The proposed independent representative requirement would give undue influence to an SBS Entity to determine who qualifies to fill that role.[5]

Security-based 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 SBS Entity 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.

SBS Entities would have substantial discretion in determining who qualifies as an independent representative and this could be exercised in an arbitrary fashion, leaving a Special Entity without recourse. Moreover, the SEC is not proposing to require the SBS Entity 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, as the CFTC proposes to do.[6] Even such a requirement, however, would be inadequate, because such a review would remain in-house at the SBS Entity without any independent analysis, as we noted in the comment letter to the CFTC.

Separately, even those SBS Entities that would wish to comply with the SEC's requirements in a conscientious manner may find the requirements vague and intrusive, forcing them to make very difficult judgments. The SBS Entities is likely to 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 security-based swaps that would not be traded on a registered national securities exchange or a registered security-based swap execution facility.[7] Therefore, in the guise of attempting to protect a Special Entity, the proposed regulations may make it impractical for SBS Entities to deal with Special Entities due to the increased and unquantifiable risks, additional costs, and other burdens involved. SBS Entities 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 security-based swaps that may benefit our portfolios and the interests of our members.

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[5] This issue is discussed in the CFTC's release announcing its proposed business conduct standards for swap dealers and major swap participants with counterparties. 75 Fed. Reg. 80637, 80653 & n.127 (December 22, 2010).

[6] *Id*. at 80653, 80661.

[7] Proposed Regulation 240.15Fh-5, pursuant to paragraph (c) thereof, would not apply to a swap that is initiated on a registered national securities exchange or a registered security-based swap execution facility where the SBS Entity does not know the identity of the Special Entity.

Therefore, we respectfully request that the SEC consider an alternative approach that would include a proficiency examination on a voluntary basis and that would achieve the same goal without causing undue hardship to entities like us and our members.[8] The alternative approach is outlined below.

III. ALTERNATIVE APPROACH

We respectfully request that the SEC consider an alternative approach to the independent representative issue. The same alternative approach was outlined in the comment letter to the CFTC in response to its proposed regulations regarding business conduct standards for swap dealers and major swap participants with counterparties.

The alternative approach would provide another, supplemental way to meet the independent representative requirements. Under our proposal, the Special Entity would be able to elect, on an entirely voluntary basis, whether it relies on the framework set forth in the SEC proposed regulation or the alternative approach outlined below.

Under the alternative approach, SBS Entities would be permitted to enter into off-exchange security-based 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 security-based swap transactions. The SBS Entity would be permitted to rely on the certification broadly for all aspects of the transaction with the Special Entity.[9] Further, this would eliminate possible confusion among SBS Entities 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 SEC or by an appropriate self-regulatory organization, such as the Financial Industry Regulatory Association (FINRA) 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 continuing education, similar to that required of registrants.[10] These requirements are intended to be in furtherance of Dodd-Frank and the proposed regulation.

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[8] The SEC included specific questions regarding this issue in the preamble of the release. 76 Fed. Reg. 42395, at 42429 & n.231.

[9] Under the alternative approach, the SBS Dealer would be permitted to rely on the certification of the independent representative for the purposes of determining whether it is acting as an advisor to a Special Entity. *See* Proposed Regulation 240.15Fh-2(a). Consequently, because the representative is able to independently assess the information, communications between the SBS Dealer and the certified independent representative would not be a recommendation.

[10] *See* NASD Rule 1120, which will be superseded by FINRA Rule 1250 effective October 17, 2011.

Under the alternative approach, the requirement to be independent of an SBS Entity would remain. However, persons employed by a Special Entity that have extensive experience in the security-based swaps and other financial markets could presumably qualify for the certification and thus not be blocked from serving as an independent representative by an SBS Entity. 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 SEC's authority. Dodd-Frank Section 764 requires SBS Entities to comply with any duty established by the SEC for an SBS Entity with respect to a counterparty that is an eligible contract participant (ECP) within the meaning of subclause (I) or (II) of clause (vii) of Commodity Exchange Act 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 whether the SEC has authority to adopt any requirements with respect to independent representatives of a government plan, the SEC 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,[11] 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 240.15Fh-5 should apply to government plans at all, strengthening the case for an alternative approach.[12]

Additionally and by way of background, the CFTC 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.[13]

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[11] Exchange Act Section 15F(h)(2)(C)(iii) and (iv), which are tracked in proposed Regulation 240.15Fh-2 as paragraphs (e)(3) and (e)(4) under the proposed regulatory definition of the term "Special Entity."

[12] 76 Fed. Reg. 42395, 42422 & n.182. 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 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.

[13] 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 require-

We envision our recommendation for a process to certify independent representatives through testing and training, bringing greater legal certainty to the interaction of SBS Entities and entities like us without giving any party undue influence over the other. As noted previously, the same alternative approach was outlined in the comment letter to the CFTC. In the case the alternative approach garners further consideration, we urge the SEC and CFTC to work jointly to facilitate the alternative in order to ensure a consistent approach.

IV. OTHER MATTERS

The SEC specifically requested comments on numerous questions, several of which are of particular interest to the Funds. The SEC specifically requested comment on whether there should be an opt out provision for certain counterparties and, if so, whether there should be an objective standard, such as meeting the "qualified institutional buyer" criteria of Rule 144A under the Securities Act of 1933.[14] We believe that there should be an opt out provision for institutional parties, particularly if the alternative approach discussed herein is not adopted or if there needs to be a transitional period to establish the infrastructure necessary to implement the alternative approach.

The SEC also specifically requested comment on how to interpret the phrase "employee benefit plan, as defined in section 3 of ERISA."[15] We believe that the phrase should not be limited to plans subject to ERISA, but should include government plans.

Finally, the SEC specifically requested comment on whether an in-house independent representative should be deemed to act in the best interests of the Special Entity by virtue of employment with the Special Entity, and we believe that should be the case.[16]

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ments 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.

[14] 76 Fed. Reg. 42395, at 42402.

[15] *Id*. at 42422.

[16] *Id*. at 42430.

V. 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.

Sincerely,

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