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Charles W. Grant, CFA
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February 22, 2011

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

VIA ELECTRONIC MAIL

Re: *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, RIN 3038-AD25*

Dear Secretary Stawick:

Virginia Retirement System ("VRS") respectfully submits this letter in response to the Commodity Futures Trading Commission's (the "Commission") request for comment concerning the Commission's Notice of Proposed Rulemaking on *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties* (the "Proposed Rules").[1] The Commission has set out in the Proposed Rules certain external business conduct standards pursuant Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). These external business conduct standards will apply to all swap transactions between swap dealers[2] and VRS.

The Proposed Rules have the potential to result in material harm to government pension plans like VRS. Harm to government pension plans is ultimately borne by current and former government employees or, eventually, state tax payers. We recommend that the Commission (a) provide an exemption from the external business conduct standards for swap dealers when transacting with certain sophisticated investors, which might include certain government plans, or (b) narrowly tailor the external business conduct standards to make them elective for the counterparty.

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1 75 Fed Reg. 80,638 (Dec. 22, 2010).

2 VRS acknowledges that the external business conduct standards also apply to transactions between major swap participants and firms that are not registered as swap dealers or major swap participants. VRS believes its current derivatives counterparties will be swap dealers and, thus, not major swap participants. VRS also believes it will be considered a "Special Entity" under the Proposed Rules.

I. VRS is an experienced user of swaps.

VRS is an independent agency of the Commonwealth of Virginia charged with overseeing the retirement savings of current and former state and local employees. We oversee retirement benefits for about 600,000 active and retired participants and manage approximately $54.0 billion in investments.

VRS received the 2009 Achievement Award from the Public Pension Coordinating Council ("PPCC") in recognition of the agency's excellence in meeting the Public Pension Standards (developed by PPCC). These standards are the benchmark for measuring excellence in defined benefit plan administration. This is the VRS's seventh award from PPCC.

VRS has an experienced team of investment professionals.[3] They are veterans of equity, fixed income, foreign currency, and other markets. Supporting these investment professionals are a full complement of compliance and risk professionals, knowledgeable management and very proficient middle and back office teams. VRS has made tremendous investments in systems and technology to support its trading activities. These platforms, in addition to supporting equity and fixed income trading, enable VRS to efficiently manage collateral, evaluate and monitor counterparty credit risk and conduct reconciliation exercises.

Derivatives are important investment tools for VRS and the agency is an active participant in the swaps market. VRS trades a variety of underlying exposures, including equity, credit, interest rates and foreign currencies. Currently, VRS trades with several Wall Street firms.

Prior to the Act, VRS negotiated master agreements, custodial agreements[4] and swap transactions on equal footing with Wall Street firms. These dealings are done on a "principal-to-principal" basis. Dealers are our counterparties, not our advisors. In this trading environment, VRS is confident that it receives competitive transaction pricing and enjoys the trading benefits of having several dealers with which to trade. The lower transaction costs from this derivatives trading posture inures to the benefit of the participants whose retirement funds VRS oversees.

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[3] VRS also engages external investment managers to whom it allocates portions of its investment portfolio for investment oversight.

[4] VRS, for example, has entered into several tri-party custodial agreements with Wall Street firms. These agreements provide for the segregation of collateral, including all forms of margin.

II. The external business conduct standards in the Proposed Rules are more harmful than helpful.

The Proposed Rules will remove the ability of VRS to trade swaps on a "principal-to-principal" basis and force swap dealers to trade with VRS on an "advisor-to-client" basis. In this way, the external business conduct standards are potentially more harmful to VRS then helpful.

The external business conduct standards in the Proposed Rules force each swap dealer, when entering into swaps with non-regulated counterparties (*i.e.*, those that are not swap dealers or major swap participants), to take additional measures and accept additional legal liability. This is true regardless of whether such counterparties are Special Entities. For example, the external business conduct standards require the delivery of comprehensive disclosure. Moreover, swap dealers must make certain suitability determinations with respect to their counterparties. In each instance, the swap dealer must determine what is of material interest to its counterparty. Moreover, it may be forced to provide information without its counterparty having a reciprocal obligation to provide information.

Swap dealers likely will pass along costs associated with the additional trading measures to their clients. This is an unfortunate outcome. These measures are designed to bestow benefits on counterparties. However, many counterparties, such as VRS, do not need these "customer protection" measures. They have the requisite sophistication to understand and appreciate the economic and legal terms of a swap transaction. Equally important, they have the financial ability to bear losses associated with the swap. Thus, the external business conduct standards will result in additional costs without any material benefits to such a firm. VRS believes these costs may be substantial and will negatively affect its investment portfolio.

VRS is also concerned about the increased standards of care incurred by swap dealers (particularly those associated with Special Entities). Requirements, such as the suitability determination and the disclosure requirements, present risks to swap dealers that go beyond those inherent in the swap transactions. For example, a suitability determination can be challenged in litigation as a possible defense against enforcement of a swap by a swap dealer. In respect of Special Entities, there are explicit standards of care when a swap dealer acts in an advisory capacity, but also duties when transacting swaps with Special Entities. For example, the swap dealer must assure itself that the Special Entity is advised by a qualified independent representative. It is foreseeable that an aggrieved counterparty that is a Special Entity might seek to invalidate a swap on the basis that the swap dealer's evaluation of the independent representative was insufficient. Swap dealers, understandably, are expected to adjust pricing to reflect such potential risks. This pricing will be detrimental to counterparties like VRS. Again, many counterparties will not receive material benefits in proportion to the related costs.

The increased liability standards may cause certain dealers to limit their trading to certain counterparties. This is a significant concern for firms that are Special Entities. The decrease in competition among dealers could result in higher prices to firms when executing swaps. If VRS is unable to hedge risks efficiently, it will be forced to consider being unhedged with respect to

an exposure. This may introduce risk into the investment portfolio managed by VRS that otherwise could have been placed into the market cheaply and efficiently through a swap transaction.[5]

III. The Proposed Rules should not apply to sophisticated end users.

The Commission should modify the Proposed Rules to return swap trading between swap dealers and sophisticated end users, like VRS, to a "principal-to-principal" basis.

To preserve the level playing field that exists in much of the swap markets, the Commission should exempt swap dealers from the external business conduct standards when entering into swaps with end users that possess a certain level of size and sophistication. The Commission, for example, exempts transactions between swap dealers and parties that qualify as qualified institutional buyers as defined in Rule 144A under the Securities Act of 1933, as amended. The U.S. Securities and Exchange Commission has recognized that such investors generally do not need the protection of regulators. These firms, to the extent they believe any of the external business conduct standards would be desirable, should have the requisite negotiating power to bargain for such benefits. Importantly, they would not be obligated to pay for protections they might deem unnecessary.

IV. Alternatively, the Proposed Rules should be narrowly tailored.

Should the Commission not exempt swap dealers from the external business conduct standards when trading with sophisticated investors, then the Commission should tailor the external business conduct standards to level the playing field between swap dealers and counterparties. As discussed above many of the measures and increased standards of care will result in increased transaction pricing for the swap dealer's counterparty. However, the intended benefit may not be material given the parties' ability to evaluate the terms and risks of a swap transaction and its ability to bear any associated losses. Accordingly, much like the Commission's proposal with respect to collateral segregation in connection with uncleared swaps, the external business conduct standards might apply at the election of the non-regulated entity. That is, the swap dealer will be obligated to notify the end user that it may receive certain information and other services, such as suitability determinations, from the swap dealers upon request. If the counterparty requests that the dealer perform the measures, then the swap dealer would be obligated to perform the measure. In this paradigm, the costs and benefits are made known to the counterparty. It is, importantly, the decision of the investor whether any particular benefit under the external business conduct standards is worth the associated costs.

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[5] If the Proposed Rules result in government plans having more exposure to market risks because efficient hedging is no longer meaningfully available, the underlying policies of the Act of removing risk from important financial institutions, protecting investors and relieving tax payers from shouldering investment losses will have been partially undermined.

V. The requirements when dealing with Special Entities should be amended.

VRS acknowledges that Section 731 of the Act obligates the Commission to issue rules requiring a swap dealer that is acting as an advisor to a Special Entity to act in the best interest of that Special Entity. VRS believes that this is a sound codification of the duties imposed in a principal-agent relationship.

However, the Proposed Rules go beyond what Congress intended. By deeming a swap dealer that recommends a swap to a Special Entity an advisor, the Commission is imposing duties on a relationship that is potentially principal-to-principal and, consequently, imposes additional costs and duties where they might not be desired.[6] Such a requirement will likely curtail a swap dealer's desire to propose specific transactions to sophisticated Special Entities such as VRS, as this will likely lead to them being considered an advisor of such Special Entities.

The Proposed Rule, as currently drafted, poses a number of difficult interpretive questions. For example, will VRS have to go directly to swap dealers with its proposed hedging or investment strategy to avoid the swap dealer being considered an advisor and, thus, charging VRS a higher price to take on the accompanying liability? If a swap dealer makes suggestions on a proposal made by VRS would that swap dealer then become an advisor for the purposes of the Proposed Rule?

Deeming a swap dealer an advisor, and thus triggering the "best interests" obligations when it recommends a swap to a Special Entity, is unworkable. VRS suggests that the determination of whether a swap dealer is acting as an advisor to a Special Entity be left to the counterparties. This would be consistent with the Proposed Rule's requirement for a swap dealer to disclose the capacity in which it is acting and would allow Special Entities that are sophisticated market participants to elect whether they would like to incur the costs associated with asking a swap dealer to take on an increased duty of care.[7]

In addition, the Proposed Rule and Section 731 of the Act require a swap dealer to verify that a Special Entity has a qualified independent advisor.[8] As contemplated by the Proposed Rule, VRS and many other Special Entities have employees that are more than qualified to serve as an independent advisor on swaps.[9] Consistent with the proposed rules, swap dealers should be permitted to rely on a simple representation as to an employee's qualifications to satisfy the

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6 *Proposed Rule* at 80,647.

7 Proposed CFTC Rule 23.450(f)(1).

8 Proposed CFTC Rule 23.450(b).

9 *Proposed Rule* at 80,651.

obligations with regards to the determination of whether a Special Entity has a qualified independent advisor.[10]

VRS supports constructive reform of the over-the-counter swap markets. We appreciate the opportunity to participate in this rulemaking process. The agency would welcome the opportunity to discuss any and all issues about the reform of swap markets as it relates to VRS and government plans in general.

Respectfully submitted,

Charles W. Grant, CFA
Chief Investment Officer
Virginia Retirement System

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10 *Id.*