Gerald W. McEntee
President

Lee A. Saunders
Secretary-Treasurer

Vice Presidents

Ken Allen
Portland, OR

Henry L. Bayer
Chicago, IL

George Boncoraglio
New York, NY

Anthony Caso
Boston, MA

Greg Devereux
Olympia, WA

Danny Donohue
Albany, NY

David R. Fillman
Harrisburg, PA

Michael Fox
Harrisburg, PA

Albert Garrett
Detroit, MI

Raglan George Jr.
New York, NY

Sherryl Gordon
Trenton, NJ

Lakesha Harrison
Oakland, CA

Danny J. Homan
Des Moines, IA

Salvatore Luciano
New Britain, CT

John A. Lyall
Worthington, OH

Roberta Lynch
Chicago, IL

Glenard S. Middleton Sr.
Baltimore, MD

Gary Mitchell
Madison, WI

Veronica Montgomery-Costa
New York, NY

Doug Moore
San Diego, CA

Henry Nicholas
Philadelphia, PA

Eddie L. Parks
Westerville, OH

Randy Perreira
Honolulu, HI

George E. Popyack
Oakland, CA

Greg Powell
Austin, TX

Laura Reyes
San Diego, CA

Eddie Rodriguez
New York, NY

Lawrence A. Roehrig
Lansing, MI

Joseph P. Rugola
Columbus, OH

Kathy J. Sackman
Pomona, CA

Eliot Seide
South St. Paul, MN

Mary E. Sullivan
Albany, NY

Braulio Torres
San Juan, PR

David Warrick
Indianapolis, IN

Jeanette D. Wynn
Tallahassee, FL

21 435-10
7/10

February 22, 2011

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Definitions of “Swap Dealer”, “Security-Based Swap-Dealer”, “Major Swap Participant”, “Major Security-Based Swap Participant” and “Eligible Contract Participant” (File Number S7–39–10)

Dear Mr. Stawick and Ms. Murphy:

The American Federation of State, County and Municipal Employees (“AFSCME”) appreciates the opportunity to comment on several of the definitions that are fundamental to implementing the reforms promised by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). AFSCME is the largest union in the AFL-CIO representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan is a long-term shareholder that manages $850 million in assets for its participants, who are staff members of AFSCME and its affiliates.

During consideration of Dodd-Frank, AFSCME strongly supported the inclusion of provisions establishing the strongest possible market reforms, oversight and transparency for the “shadow markets” – principally the over-the-counter market that has grown to a size that dwarfs other more transparent derivatives markets.

American Federation of State, County and Municipal Employees, AFL-CIO
TEL (202) 429-1000 FAX (202) 429-1293 TDD (202) 659-0446 WEB www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

The Importance of Strong Derivatives Regulation is Well Established

Before passage of Dodd-Frank, OTC derivatives – including interest rate swaps, foreign exchange contracts, equity swaps, commodity swaps, credit default swaps, and others - were described as bilateral agreements between sophisticated parties. As such, OTC derivatives were not subject to obligations to trade on regulated exchanges and clear through regulated clearing operations – obligations that apply to other segments of the derivatives markets. However, the need to bring OTC derivatives into these regulated markets is clear. The public record of analyses gathered in the months following the crisis confirmed the same conclusion: "It is widely acknowledged that OTC derivatives contracts, and particularly credit default swaps, played a significant role in the current financial crisis. Although OTC derivatives have been justified as vehicles for managing financial risk, they have also spread and multiplied risk throughout the economy in the current crisis, causing great financial harm."[1]

Hedging or Mitigating Commercial Risk

AFSCME strongly urges that there be strict and limited interpretations of this component of the definition of major swap participant and this element of the end user exemption from mandatory clearing. We have submitted more extensive comments on this definition as part of the end user exemption comments, but AFSCME notes here that some suggestions that the Commissions describe as "commercial" or define as "managing risk" in an overly broad construction ignore the intent of Congress and exceed the scope of the authority given to the Commissions.

Swap Dealers and Security-Based Swap Dealers

AFSCME urges the Commissions to reject suggestions to outline "dealer versus trader" roles, reject proposals to distinguish between "continuous" activity as a market-maker and "non-continuous" dealing activities, reject suggestions to create an extra layer of exempt activity beyond the *de minimis* exception provided by defining a "less than sole or predominant" level of activity, and reject other suggestions that do not further the goals of improving transparent markets and minimizing the invisible buildup of risk that can be catastrophic not only to individual counterparties but to the financial system as a whole. These definitional suggestions would send the Commission on the pointless and permanent search for the wrong tests rather than moving forward with new market safeguards. They are bright-line efforts to achieve carve-outs through regulation that were not provided in the statute. The Commissions' proposal already states an intention to follow a "facts-and-circumstances" approach to identifying dealing activity. The Commissions already acknowledge in this proposal their anticipation of the development of new business models that will require flexibility on the part of regulators in applying

---

[1] "U.S. Financial Regulatory Reform: The Investors' Perspective", Investors Working Group, an Independent Taskforce Sponsored by CFA Institute Centre for Financial Market Integrity and Council of Institutional Investors, published in July 2009, submitted to the Federal Reserve Board September 22, 2010.

the dealer definitions as the swap markets evolve. Further bright line exemptions at this stage are not justified.

De Minimis Exemption for Special Entities

AFSCME has noted the Commissions' request regarding a *de minimis* exemption for "small" amounts of activity – proposed at $ 100 million annual notional value – that arguably would not warrant the application of dealer obligations. AFSCME supports the lower proposed threshold - $25 million – for dealer transactions with "special entities" (governmental plans, endowments, and others). We do not believe that "the proposed threshold for transactions with `special entities' would provide a disincentive to dealers entering into transactions with such entities." AFSCME looks forward to studying the responses of those who assert that dealer status – and the capital, margin and disclosure safeguards it involves – would preclude these firms from entering into transactions with special entities. Special entities have sizeable assets to invest and significant obligations to satisfy in doing so. Surely, somewhere in a market with a notional value of $600 trillion, sellers will engage these counterparties.

Eligible Contract Participants

Governmental entities would benefit from additional clarity regarding the way in which the Commissions interpret the revised definition of "eligible contract participants." In many of the proposed rules, actual proposed text is minimal though fortunately more explanatory information is usually provided to fill in what is not restated from current law. In this case, though, it would be very helpful to reiterate the Commission's interpretation of the amended statutory language more clearly. Is it the case that the Eligible Contract Participant definition in the Commodity Exchange Act that currently includes governmental entities that invest at least $25 million is revised by Dodd-Frank to include only those entities that invest at least $5 million? Is it correct that the $50 million does not exclude investments of bonds proceeds, though that had been proposed in the House bill? Finally, is it correct that Dodd-Frank leaves in place the existing Eligible Contract Participant alternative to the investment of a specified dollar amount for governmental entities entering into a Swap with specified types of financial institutions? Additional clarity that would allow others to weigh in here would be most appreciated.

Major Swap Participant

AFSCME urges the Commissions to look cautiously at proposals to broadly define the element of the definition of major swap participant (MSP) that excludes positions held by any employee benefit plan as defined in Section 3(3) and 3(32) of the Employee Retirement Income Security Act (ERISA) "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Discussions during the Hill deliberations regarding Dodd-Frank and comments filed to date have made it abundantly clear that derivatives are a big part of retirement plan savings and investments of all kinds – in defined benefit plans, 401k and other defined contribution plans, and in individual savings in mutual funds, insurance policies and other familiar household investments. There should be an extra element of caution triggered when

recommendations are made to consider these investments – largely funded with employee contributions and often tax-deferred – off-limits for determining whether an entity is a "major swap participant" and subject to the capital and margin obligations that follow from that significant role.

Some commenters seem to suggest that any positions held by ERISA plans would of course be "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." We disagree. Swaps that mitigate currency risk of cash market investments made by the plan may fit the definition. However, swaps used for broader investment purposes – for example, certain portfolio restructurings or modifications to gain exposure to an asset class or to avoid transaction costs associated with investing in an underlying asset directly – would not. This issue merits a much deeper look, and a much clearer opportunity for pension trustees and fiduciaries and participants to engage in a discussion with dealers of swaps and other financial products and strategies about the appropriate regulatory structure for the funds for which the fiduciaries are primarily responsible and on which the participants depend.

Similarly, it is important to limit the exemption to plans themselves, not to entities holding "plan assets".

During testimony on February 15, 2011, to the House Financial Services Committee, Chairman Schapiro assured Members of the Committee that she would consult carefully with the Department of Labor ("DoL") regarding the interplay that may exist between her pending regulatory proposals and work underway at Labor. This is an important area in which both Commissions should consult DoL and share with the commenting public some additional clarification about the effects that different options present for tens of millions of working Americans and retirees counting on these plans and individual investments for retirement security.

In fact, it is particularly important that the ERISA agency be brought in at this time.

In written testimony to the Senate Banking Committee in 2009, Madoff whistleblower Harry Markopolos outlined the way in which scoundrels looking to dodge federal oversight play different banking or brokerage regulators off against each other – and when all else fails, assert "Oh but these are ERISA accounts and they fall under the Department of Labor so you don't have jurisdiction." Retirement security would be better assured if it were more clear where ERISA ends and what picks up in its place.

That clarity is also important since it is often unclear to workers just how far ERISA reaches and what rules apply when its reach ends. In fact, consultation on how to understand the appropriate treatment for different kinds of ERISA assets is a practical necessity at the moment: the Labor Department has proposed to update the activities that would result in entities becoming ERISA fiduciaries. Mutual funds, insurance

companies, banks, broker-dealers, and many more have energetically weighed in at DoL, urging that the Department coordinate with the SEC on its interpretation of a fiduciary duty toward retail investors in securities. Many commenters urge a more holistic coordination of investor protection efforts and disclosure improvements. Certainly many important issues are triggered both by Dodd-Frank's efforts to update market safeguards and the Department's efforts to make sure ERISA keeps pace with the sophisticated, high-speed trading environment that is going on while most workers buy and hold – and trust. Both the ERISA and SEC-CFTC efforts must proceed in concert and must proceed through a very inclusive process.

In fact, soon-to-be registered swap dealers that likely serve as Qualified Plan Asset Managers (or QPAMs) under ERISA - or utilize other Prohibited Transaction Exemptions for insurance company pooled separate accounts or general accounts or certain bank collective funds - will want clarification of how these rules fit together. It may be necessary to revise the safeguards that allow financial entities to wear multiple hats and provide multiple products and services to ERISA plans without running afoul of its prohibitions on self-dealing and conflicts of interest.

A close look at the statutory definition of MSP raises an important question about whether the issue here really involves the "plan" as MSP or whether instead it involves the bank, insurance company, savings and loan association, or investment adviser managing assets for the plan. Asset managers for plans may seek to avoid holding a substantial position in swaps for any of the major swap categories, after excluding positions held for hedging or mitigating commercial risk and positions maintained by benefit plans for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. If this is the case, then arguments that look like they are all about benefit plans are really much larger. They are really arguments that have everything to do with how many transactions are likely to take place outside of registered entities with a duty to, for example:

- know their counterparties;
- communicate in good faith;
- disclose material information regarding market, credit, liquidity, foreign currency, legal, operational, and other risks;
- notify the counterparty of its right to receive, upon request, the daily mark regarding the value of the cleared or uncleared swap;
- notify their counterparties of the counterparties' right to require clearing of a swap not subject to mandatory clearing and the sole right to select the DCO at which the swap will be cleared;
- comply with duties regarding institutional suitability; and
- meet obligations triggered when the swap dealer or MSP offers to or enters into a swap with a Special Entity.

It seems logical that banks, insurers, and investment managers are financial entities who will become MSPs. They do not seem to think so, given the comments submitted by individual companies and trade associations. The proposed rule defines as a second category of MSP a financial entity that "(1) is highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency". . . "and (2) maintains a substantial position in outstanding swaps in any major swap category." Financial entities of all kinds offer ERISA as a justification for reducing the volume of swaps that would be measured against this MSP definition, even though ERISA is excluded from its terms.

We do not question whether Congressional proponents of special language involving ERISA pensions and state and local government pension plan assets intended to protect plans and the people who count on them. We do question, however, whether it could have been clear exactly how this would work. After working through the proposals pending to date, it is difficult to see how plans and their participants benefit from the broad carve-outs posed which seem to stretch the sponsors' stated intent and the statutory language. However, it seems readily apparent that the financial entities will benefit if carving out benefit plan clients from the calculating of "substantial positions" serves to lessen the market obligations they would owe any clients.

Federal law provides that exemptions from ERISA's rules against conflicts of interest be granted only after public notice and comment. Clearly the most meaningful time for that comment to begin is now.

It would also be valuable to discuss how the industry's repeated references to ISDA master agreements could accommodate plan fiduciaries' needs to segregate and safeguard margin. Standard documentation "protocols" that attempt to dictate non-negotiable terms to plan fiduciaries through the fine print should be void as against public policy. Clearly, this intersection of regulatory requirements is worth exploring.

Consultation that the plan fiduciaries can engage in – perhaps through joint roundtables or other opportunities – would benefit entities beyond the ERISA plan population. Many other kinds of plans and foundations and endowments follow ERISA's lead on fiduciary guidance and would similarly benefit from greater connection among the rulemaking agencies and greater involvement in the discussion alongside the financial industry. While the financial industry continues to wrestle with the duties it might accept toward buyers and investors, it is very clear that pension plans' fiduciaries already bear a strict and undeniable duty that far exceeds that owed by most of the market participants they utilize.

It has also been asserted by a number of trade associations providing products and services to pension plans that plans will be hurt if Major Swap Participant status is triggered because plans will be presented with fewer opportunities to use uncleared swaps and may bear more costs which will inevitably be passed on to participants. This issue,

too, would benefit from more coordination with the Department of Labor. It is usually said by vendors to pension plans that "cheapest isn't best". And it is vigorously asserted to the Labor Department that regulatory guidance should make that clear, i.e., that fees are not the only factor or the most important factor to consider when weighing alternatives, that other attributes – e.g., "safest" – must be considered. So it seems odd to hear an argument that sounds suspiciously like "cheapest is best" – especially when it relates to investments that plan fiduciaries should consider very carefully. Compelling arguments have been presented that market mechanisms such as clearing transactions, posting collateral, and pre- and post-trade price transparency will improve safety for the investor. Indeed, it appears that pension plan representatives have urged that collateral they post be segregated and remain available to protect the plans. All of these factors seem valuable to the plan fiduciaries and the participants they protect.

Furthermore, the CFTC has estimated in its proposal regarding reporting, recordkeeping and daily trading records for swap dealers and major swap participants that there may be fifty Major Swap Participants (MSPs) who must register with the Commission. Fifty. There are thousands of state and local government pension plans and more than half a million ERISA retirement plans (setting aside health and welfare and other plans). Let's assume all fifty of these MSPs come from the retirement plan population and not the other elements of the financial sector that are submitting comments urging that they be ruled out as MSPs. It seems far from clear that posting collateral is anything but a source of safety to the plan and its sponsor and participants, particularly at the size likely to trigger inclusion in the MSP "top 50" designation.

However, as discussed above, it seems important to look at commenters' references to "plans" not solely as a rescue for "plans" from MSP status but also to examine what happens when pension funds are subtracted from the assets that count toward "substantial positions" and, as a result, reduce the number of entities becoming MSPs and subject to the duties created as a result.

There is a third and final category of MSP to which ERISA again is offered as a reason to narrow its scope. A variety of trade associations and firms who provide products and services to ERISA plans endorse the comment that "[T]he unique attributes of plans . . . should be sufficient, by themselves, for the Commissions to conclude that the swap positions of plans, whether cleared or uncleared, do not `create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"[2] and should be excluded for purposes of this prong of the MSP definition as well.

So, although a limited set of plans' swap positions are included in only one of the three MSP definitions, it is being widely suggested by Wall Street firms that all plan

---

[2] September 20, 2010, Submission Re: S7-16-10 by the American Benefits Council and the Committee on the Investment of Employee Benefit Assets.

swaps be used to reduce all the tests for MSPs. That result would be even more troubling when read in concert with other exclusions that commenters recommend. The proposed rule invites comment on whether there are justifications to exclude from the MSP definition entities such as investment companies, registered broker-dealers or registered futures commission merchants, sovereign wealth funds, entities subject to bank capital rules, and state-regulated insurers as perhaps not presenting the risks that underpin MSP definitions or to avoid duplication with existing regulation. Although each industry answered in the affirmative long before the proposal went out for comment, it is clear that a much deeper understanding of the consequences of these kinds of overbroad carve-outs be developed.

Since the failure of the Reserve Primary fund in September 2008, it is clear that the failure of a money market fund – not the most exotic financial product - can limit withdrawals, require billions in immediate assistance, result in fund sponsors rescuing some funds and Treasury putting up $50 billion to assist others, and necessitate regulatory efforts that continue today at the CFTC, SEC and Treasury. This alone should demonstrate that vague assurances and general recitations of current – but inadequate – regulatory requirements are hardly responsible substitutes for the tools authorized by Dodd-Frank. Each industry's submission confirms the extent to which they use derivatives. And certainly none of their individually tailored regulatory regimes was equipped to track and deter the disaster of less than two years ago. Nothing submitted to date is an adequate basis for gutting more appropriate measures of substantial exposure to risk, nor is it a basis for challenging a rule that refuses such a loophole.

Swap

Finally, it seems important to acknowledge the definition we have not seen yet – a "swap". We are aware that the statutory language of Dodd-Frank was lengthy on this definition but "lengthy" and "clear" are very separate concepts. Members of the House Financial Services Committee pressed for answers during a hearing on February 15, 2011, regarding a date certain when proposed definitions for swaps and other terms might be forthcoming. Though reference was made to this comment proposal, nothing specific was said about a definition for "swaps". However, other rulemakings have noted the statutory language which "provides that the [SEC] and the CFTC, in consultation with the Board of Governors of the Federal Reserve System (Federal Reserve"), shall jointly further define the terms 'swap,' 'security-based swap,'" and more.[3] In fact, this joint proposal putting forth several definitions notes that "[T]he definitions of the terms 'swap,', 'security-based swap,' and 'security-based swap agreement,' and regulations regarding mixed swaps are the subject of a separate rulemaking by the Commissions."[4]

---

[3] See, e.g., FN 5 of S7-34-10, Regulation SBRS – Reporting and Dissemination of Security-Based Swap Information

[4] See FN 4 of S7-39-10, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant"

Chairman Schapiro's testimony of February 15 made clear that 95% of this market falls within the category of swaps. There are several issues we are awaiting – how are common "participation" interests in loans or leases, or guarantees, to be treated? Will "carried interest" or "performance fee" arrangements be exempt from regulation as part of an issuer's agreement designed to raise capital?

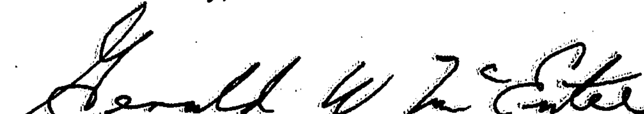
We also believe a pension discussion as urged above could help enlighten the decision to come regarding stable value contracts that are not uncommon in retirement plans. The Dodd-Frank Act requires the SEC and the CFTC, in consultation with the Department of Labor (DoL), Treasury and state insurance and banking regulators to conduct a joint study regarding whether stable value contracts fall within the definition of a swap and, if so, whether exemption would be appropriate and in the public interest. Existing contracts appear protected. But it would be helpful to have an opportunity for input into this issue, and to see that any swap modification would be limited to stable value products or contracts, not to wrap providers. DoL's recent extension of the date by which new fee disclosure tools will be put into practice means it is a particularly important time in which to convene these discussions and explore whether plans are being paid sufficiently for the risk they take on in accepting liquidity restrictions.

Swaps present not only challenges for plan sponsors and fiduciaries but effect the participants' benefits; moreover, it is clear that other "retail" retirement income opportunities will present similar challenges, and that the SEC and CFTC will be faced with decisions about whether and how to apply swap requirements to "novel products," with DoL and Treasury then faced with how they fit into ERISA and tax rules for pension plans. In a world where defined benefit promises are threatened, it is vital that institutional and individual savers have a chance to join this discussion.

* * *

We appreciate the opportunity to express our views on this matter. Should you have questions regarding these comments, please contact Lisa Lindsley at (202) 429-1275.

Sincerely,



GERALD W. McENTEE
International President