California State Teachers' Retirement System
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February 28, 2011

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

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

Re: Further Definition of "Swap Dealer," Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant" (RIN 3038–AD06; SEC Release No. 34-63452 (Dec. 7, 2010) , 75 Fed. Reg. 80,174 (Dec. 21, 2010))

Dear Mr. Stawick and Ms. Murphy:

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.

Like public pension plans that are subject to the fiduciary and other standards imposed by the Employee Retirement Income Security Act ("*ERISA*"), CalSTRS operates under a stringent and carefully considered legal framework. As discussed in greater detail below, both the California Constitution and the California Education Code mandate that investments made on behalf of CalSTRS members and beneficiaries be administered under the prudent person standard. Additionally, oversight of CalSTRS is the exclusive fiduciary responsibility of the CalSTRS Board, comprised of twelve members, including elected beneficiary representatives, state-wide elected officials, and appointed representatives. Further, applicable California law imposes stringent fiduciary duties on investment advisers (both internal and third-party) that advise CalSTRS. In summary, CalSTRS is a sophisticated and legally accountable governmental pension fund.

As a large public pension fund, CalSTRS must have access to a variety of investment options on equal access as other large institutional participants. CalSTRS' Investment Policy, which under California law was adopted by the CalSTRS Board after a public notice and comment process, requires comparison with other large pension funds investments and costs to ensure that CalSTRS is operating in a reasonable manner within our legal framework.[1] Access to cost-effective investments is critical to CalSTRS investment success.

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 its members and beneficiaries (which we discuss in greater detail below), makes efficacy and efficiency of the global financial markets of significant importance to CalSTRS. We thus support the efforts of Commissions 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 U.S. financial market from systemic risk. This is consistent with CalSTRS' mandate 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 proposed definitions of "Major Swap Participant" and "Major Security-Based Swap Participant" (collectively, "*Major Participant*") in the above-cited release (the "*Proposing Release*"). Our primary goal in submitting these comments is to ensure that the proposed definitions do not inadvertently limit or preclude our ability, as a public pension fund governed by the law of the State of California rather than by ERISA, to continue to participate in swaps without being subjected to increased costs and regulation that will disadvantage CalSTRS (and its beneficiaries) when compared to other ERISA plans and also to other sophisticated and legally prudent institutional market participants. We thus support the Commissions' proposal to exclude all employee benefit plans as defined in Paragraphs (3) and (32) of Section 3 of ERISA from the Major Participant definitions.[2]

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[1] We note that any amendments to CalSTRS' Investment Policy must also be approved by the CalSTRS Board after a statutorily-mandated public notice and comment period.

[2] 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 State Constitution, is a governmental plan as defined in Section 3 of ERISA. We adopt herein the Commissions' reference to employee benefit plans as so defined under ERISA as "*ERISA Plans*."

Fiduciary and Prudence Standards Imposed Upon CalSTRS by California Law

To provide context to the Commissions regarding CalSTRS' regulatory posture under California law, we briefly describe below the extensive fiduciary duties under both the California Constitution and the California Education Code to which CalSTRS is subject.

- CalSTRS has plenary authority and fiduciary responsibility for investment of moneys and administration of the system.[3]

- CalSTRS' duty to its participants and their beneficiaries takes precedence over any other duty.[4]

- Members of the Board of CalSTRS are required to discharge their duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[5]

- Any board member who breaches his fiduciary duties requiring assets to be held for the benefit of members and their beneficiaries (Cal. Educ. Code §22251), who engages in any prohibited transaction (Cal. Educ. Code §22252) or who violates a statutory prohibition on conflicts of interest (Cal. Educ. Code §22253), or who participates in or conceals such a violation by another Board member (Cal. Educ. Code §22256) shall be personally liable to make restitution to the fund for any losses resulting therefrom.[6]

- Investment professionals employed by CalSTRS as well as third-party investment advisers retained by CalSTRS are subject to fiduciary duties in the performance of their duties.[7]

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 Commissions treat such Governmental Plans differently from other ERISA Plans for purposes of the Major Participant definitions. If, however, the Commissions were to consider limiting the exclusion from the Major Participant definitions to employee benefit plans that are subject to the fiduciary standards of Title I of ERISA (which we to herein as "*ERISA Title I Plans*"), then, as noted below, CalSTRS does propose that the Commissions include within any such exclusion Governmental Plans, such as CalSTRS, that are not capable of being ERISA Title I Plans.

[3] Cal. Const., Art. XVI, §17 (2nd paragraph), §17(a); *see also* Cal. Educ. Code §22250.

[4] Cal. Const., Art. XVI, §17(b).

[5] Cal. Const. Art. XVI, §17(c), *see also* Cal. Educ. Code §22250(b).

[6] Cal. Educ. Code §§22254, 22256.

[7] Cal Educ. Code §22254 (with respect to investment professionals employed by CalSTRS); Cal Educ. Code §22257 (with respect to third-party investment advisers retained by CalSTRS).

Summary

1. The Major Participant definitions should exclude Governmental Plans, such as CalSTRS, that are subject to statutorily-imposed fiduciary and prudential duties similar to those imposed upon public pension plans subject to the fiduciary standards imposed by Title I of ERISA.[8]

2. If the Commissions do not see fit to exclude Governmental Plans from the Major Participant definitions, in order to avoid the creation of uncertainty as to the status of Governmental Plans that engage in swaps as part of a long-term asset management program, CalSTRS respectfully suggests that the Commissions clarify the Major Participant definitions as follows:

   a. In the first Major Participant test, the exclusion for swap positions used to hedge or mitigate risk "directly associated with the operation of the plan" should apply to swap positions used by Governmental Plans for a broad range of purposes.

   b. The second Major Participant test should never apply to Governmental Plans, because their outstanding swaps do not create substantial counterparty exposure.

   c. The third Major Participant test should never apply to Governmental Plans, because these plans will never be "highly leveraged."

   e. Alternatively, if the Commissions apply the third Major Participant test to Governmental Plans, a plan's leveraged status should be determined based on the ratio of assets to liabilities determined on an annual basis.

CalSTRS supports the proposed definitions of swap dealer and security-based swap dealer, as we believe that these definitions would not result in a Governmental Plan being deemed to be a swap dealer.

1. The Definitions Of "Major Participant" Should Exclude ERISA Plans, Including Governmental Plans

The Dodd-Frank Act requires Major Participants to register with either or both of the Commissions. Under the Act, Major Participants will be subject to extensive new capital and margin requirements, reporting and recordkeeping rules and business conduct requirements. This comprehensive regulatory framework reflects the fact that Major Participants engage in swap activities that "could pose a high degree of risk to the U.S. financial system."[9]

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[8] As noted above, fiduciary and prudential duties are imposed upon CalSTRS by statute as well as by the terms of the California State Constitution. References herein to fiduciary and prudential standards that are statutorily imposed upon Governmental Plans includes such standards that are also imposed by any State Constitution.

[9] Proposing Release, 75 Fed. Reg. at 80,185 & n.69.

In the preamble of the proposed rule, the Commissions raise the question whether certain types of entities should be excluded from the Major Participant definitions. CalSTRS respectfully submits that the requirements imposed upon Major Participants would be inapposite as applied to any ERISA Plan, including any Governmental Plan, in that these plans do not pose the potential systemic risk to the financial system in the United States to merit imposition of these registration and other requirements. The cost of compliance (which would reduce benefits available to plan participants and their beneficiaries on a dollar-for-dollar basis) would vastly outweigh any benefits that might accrue from the imposition of such obligations on such plans.

CalSTRS supports the Commissions' proposal that the swap activities of ERISA Plans, including Government Plans, merit different treatment for purposes of determining Major Participant status than the swap activities of other end-users. We believe that this conclusion is supported by the absence of any evidence that Governmental Plans' use of swaps contributed to the recent financial distress or otherwise pose a high degree of risk to the U.S. financial system. While we do not purport to speak for other Governmental Plans, CalSTRS, as a Governmental Plan subject to fiduciary and prudential standards similar to those imposed upon ERISA Title I Plans by ERISA, believes that it is important that the Commissions recognize that not all prudent public pension plans are subject to the fiduciary standards imposed by ERISA.

CalSTRS recognizes that the statutory definitions of "major swap participant" and "major security-based swap participant" include specific exclusions for certain swap positions maintained by ERISA Plans. The statutory exclusion applies to employee benefit plans as defined in Sections 3(3) and 3(32) of ERISA, without regard to whether those plans are subject to the fiduciary requirements in Title I of ERISA. CalSTRS respectfully submits that this approach is the correct one for the Commissions to take. It is neither necessary nor appropriate to distinguish between ERISA Plans that are subject to the fiduciary standards of ERISA and other ERISA Plans, such as Governmental Plans. As noted above, while Governmental Plans such as CalSTRS are not subject to the fiduciary standard imposed by Title I of ERISA, CALSTRS is subject to similar standards under the California Constitution and the California Education Code. We also note that Governmental Plans created pursuant to state law, such as CalSTRS, are not capable of being ERISA Title I Plans, so to afford preferential treatment to ERISA Title I Plans as compared with such Governmental Plans would effectively penalize these Governmental Plans due to their status as such, a distinction over which they have no control. We note that the Commissions have not demonstrated any empirical basis for concluding that the use of swaps by Governmental Plans that are not ERISA Title I Plans pose any greater risk to the U.S. financial system, nor are we aware of any evidence supporting this proposition.[10]

For the foregoing reasons, CalSTRS respectfully submits that a blanket exclusion from the Major Participant definitions for ERISA Plans, including Governmental Plans, is consistent with the intent of Congress as well as the spirit of these provisions of the

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[10] We note that in the discussion of the Dodd-Frank Act in the Senate, Senator Lincoln observed that a principal objective of the Dodd-Frank Act was "to protect Main Street," and that Congress "should try to avoid doing any harm to pension plan beneficiaries" when it regulated swaps. 156 Cong. Rec. S5906-07 (daily ed. July 15, 2010) (statement of Sen. Lincoln).

Dodd-Frank Act. If the Commissions were to limit such an exemption to ERISA Title I Plans, then CalSTRS respectfully submits that such an exemption should also include Governmental Plans such as CalSTRS that cannot be ERISA Title I Plans.

2.a. In The Absence Of A Blanket Exemption From Major Participant Status For ERISA Plans, The Commissions Should Clarify The Exclusion For Positions Maintained By ERISA Plans, Including Governmental Plans

The Dodd-Frank Act expressly excludes from the first prong of the Major Participant definition "positions maintained by any employee benefit plan (or any contract held by such a plan) . . . for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."[11] As explained in the preceding comment, CalSTRS urges the Commissions to exclude ERISA Plans, including Governmental Plans, from all aspects of the Major Participant definitions.[12] If the Commissions do not adopt this recommendation, however, the Commissions should clarify the exclusion for positions maintained by such plans.

The Commissions should clarify that a variety of different risks are "directly associated with the operation of the plan." The preamble to the proposed rule recognizes that the employee benefit plan exclusion is separate from, and broader than, the exclusion for positions held by other end users for hedging or mitigating commercial risk.[13] CalSTRS agrees with the statement in the preamble that hedging by ERISA Plans, including Governmental Plans, should be broadly excluded from the Major Participant test, but respectfully suggests that the Commissions' position on this issue should be clearly stated in the regulations themselves, and not merely mentioned in the preamble.

Unlike commercial entities, Governmental Plans and other ERISA Plans exist for the purpose of paying benefits, and such plans must match their available assets with their liabilities in order to discharge their benefit obligations. Such plans use swaps to hedge a wide variety of risks that affect the value of the plans' assets, the magnitude of their liabilities, or both. For example, a plan might use credit default swaps to hedge the risk of defaults affecting the value of its bond portfolio, or it might use currency swaps to mitigate the risk that changes in the foreign exchange rate will affect the value of its securities. A plan might also use interest rate swaps to hedge the risk that changes in interest rates will increase the present value of its liabilities; if this risk were not hedged, it could make it impossible for the plan to pay promised benefits.[14] The regulations should state that any swap position used to hedge or mitigate risks

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[11] Dodd-Frank Act § 721(a)(16) (Commodity Exchange Act § 1a(33)); *accord id.* § 761(a)(6) (Securities Exchange Act § 3(a)(67)).

[12] Or, in the alternative, Governmental Plans such as CalSTRS that cannot be ERISA Title I Plans should be excluded from the Major Participant definitions.

[13] See Proposing Release, 75 Fed. Reg. at 80,201 ("We preliminarily do not believe that it is necessary to propose a rule to further define the scope of this exclusion. In this regard, we note that this ERISA Plan exclusion, unlike the other exclusion in the first Major Participant test, is not limited to 'commercial' risk, which may be construed to mean that hedging by ERISA Plans should be broadly excluded.").

[14] The present value of a plan's liabilities, which is used to measure adequacy for future funding obligations, is materially affected by changes in interest rates.

associated with the value of the plan's assets or with the value of its liabilities is a risk "directly associated with the operation of the plan."

The CFTC's proposed rule states that a swap position held for a purpose that is "in the nature of investing" is not eligible for the commercial-risk exclusion.[15] No similar investment-related exception is appropriate in the case of swap positions of ERISA Plans, including Governmental Plans, since a principal purpose of such plans is to accumulate assets through investment. Plans often use swaps for purposes of portfolio rebalancing, diversification, or gaining exposure to alternative asset classes. Although these investment-related activities might be viewed as falling outside a narrow definition of "hedging or mitigating" risk, they are essential to the plan's operations.[16] Employee benefit plans invest over long time horizons and must avoid the risks inherent in maintaining positions that are inappropriately concentrated in particular asset classes or economic sectors. Plans are generally subject to a duty to diversify their investments, whether by statute or by investment policy. Accordingly, the Major Participant definitions should make clear that swap positions maintained by ERISA Plans (including Governmental Plans) for any of these investment-related purposes fall within the exclusion.

2.b. In The Absence Of A Blanket Exemption From Major Participant Status for ERISA Plans, ERISA Plans, Including Governmental Plans, Should Be Excluded From The Second Major Participant Test

The second test used to identify Major Participants treats an entity (other than a swap dealer) as a Major Participant if its outstanding swaps "create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[17] The regulations should make clear that Governmental Plans (as well as other ERISA Plans) are always excluded from this test because their outstanding swaps do not create this type of systemic risk.

As CalSTRS explained above, it is held to strict standards of conduct that prohibits it from taking high-risk or speculative positions in swaps. The assets of Governmental Plans (including assets of CalSTRS) generally are held in trust for the benefit of our members and their beneficiaries. There is no mechanism by which an employee benefit trust can declare bankruptcy and thus avoid its obligations to its creditors.[18] Accordingly, an ERISA Plan (including a Governmental Plan) would create counterparty exposure only if its obligations under outstanding swaps exceeded its assets; and CalSTRS' statutory and constitutional requirements for the prudent investment and diversification of plan assets ensure that it will not take on swap obligations approaching this magnitude.

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[15] Proposed 17 C.F.R. § 1.3(ttt)(2)(i).

[16] We note that CalSTRS is required to diversify its investments both by the California Constitution (Cal. Const., Art. XVI, §17(d)) and by statute (Cal. Educ. Code §22250(d)).

[17] Dodd-Frank Act § 721(a)(16) (Commodity Exchange Act § 1a(33)(A)(ii)); *accord id.* § 761(a)(6) (Securities Exchange Act § 3(a)(67)(A)(ii)(II)).

[18] In addition, the State of California cannot declare bankruptcy.

2.c. In The Absence Of A Blanket Exemption from Major Participant Status for ERISA Plans, ERISA Plans, Including Governmental Plans, Should Be Excluded From The Third Major Participant Test

The third Major Participant test applies to "highly leveraged" financial entities that maintain a substantial position in any major swap category.[19] These entities pose a threat to the U.S. financial system because their high leverage might render them unable to meet their obligations under swaps.

Governmental Plans rarely incur any substantial amount of debt. The strict fiduciary standards to which CalSTRS is subject preclude it from engaging in highly-leveraged or other speculative transactions.

Because ERISA Plans, including Governmental Plans, do not maintain significant amounts of debt, the regulations should provide that they are never "highly leveraged" under the third Major Participant test. Entities that are subject to capital requirements established by a federal banking agency are exempt from this test. ERISA Plans, including Governmental Plans, are subject to similarly strict financial and prudential constraints and should similarly be exempt.

2.d. In The Absence Of A Blanket Exemption From Major Participant Status For ERISA Plans Under The Third Major Participant Test, The Definition Of "Highly Leveraged," As Applied To Employee Benefit Plans, Should Be Clarified

If, contrary to CalSTRS' recommendation, the third Major Participant test applies to Governmental Plans and other ERISA Plans, CalSTRS believes that it is necessary for the Commissions to modify the definition of "highly leveraged" so that it applies to these plans in a workable and understandable manner. The proposed rule would define "highly leveraged" as a ratio of an entity's total liabilities to equity (as determined in accordance with U.S. generally accepted accounting principles) in excess of a predetermined amount—the proposal suggests either 8 to 1 or 15 to 1. The entity's leverage ratio must be determined as of the close of each fiscal quarter.

Unlike other financial entities, employee benefit plans have no shareholders and therefore have no "equity" as defined by U.S. GAAP. If one were to look beyond U.S. GAAP for a workable definition of the concept of "equity" as applied to employee benefit plans, no usable concept would be found, because the concept is entirely inapposite when applied to an employee benefit plan. Thus, for purposes of determining a Governmental Plan's (or other ERISA Plan's) leveraged status, the regulations should state that the ratio is determined using the value of the plan's assets in lieu of using the non-applicable term "equity" as the denominator of the highly leveraged ratio.

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[19] Dodd-Frank Act § 721(a)(16) (Commodity Exchange Act § 1a(33)(A)(iii)); *accord id.* § 761(a)(6) (Securities Exchange Act § 3(a)(67)(A)(ii)(III)).

The regulations also should make clear that the value of the plan's assets may be determined as of its most recent annual valuation date. The value of a Governmental Plan's (or other ERISA Plan's) assets generally is determined once each year for purposes such as determining the plan's funding level and providing an annual financial report to relevant regulators and constituents. Because such plans hold many assets that do not have a readily ascertainable market value, determining the value of the plan's assets is an expensive and time-consuming process. The Commissions should not require plans to perform a special quarterly valuation for purposes of determining a leverage ratio, especially when, as CalSTRS has explained, it is extremely unlikely that ERISA Plans, including Governmental Plans, would ever be "highly leveraged."

For purposes of determining a plan's leveraged status, only its borrowings and other contractual obligations to third parties should be treated as liabilities, and not its obligation to pay benefits to plan participants and beneficiaries. All employee benefit plans have obligations to pay the retirement benefits, medical benefits or other benefits provided under the plan. These benefit obligations often become due over very long time periods, as participants retire or reach other milestones that entitle them to benefits. Employee benefit plans that are financially sound often do not have immediately on hand assets sufficient to pay 100% of their benefit obligations, since these obligations will not become due until many years in the future. Thus, the fact that a plan's benefit obligations exceed its assets does not mean that the plan should be considered "highly leveraged." Accordingly, the regulations should make clear that the plan's benefit obligations will not be taken into account in determining its total liabilities.

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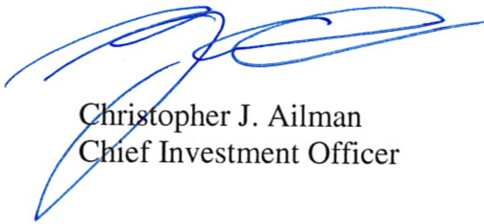
CalSTRS appreciates the opportunity to submit these comments. If we can be of further assistance to the Commissions as they consider these important issues, please let us know.

Sincerely,



Christopher J. Ailman
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