MEMORANDUM

TO: File
FROM: Aaron Foxman
RE: Meeting with the representatives of various ERISA Regulated Pension Funds
DATE: November 12, 2010

On November 10, 2010, Darren Vieira, Brian Bussey, Kim Allen, Peter Curley, Haimera Workie, Richard Grant, Yue Ding, Ignacio Sandoval, Aaron Foxman, Diana Dietrich, Joshua Kans, John Ramsay, and Leah Drennan of the Securities and Exchange Commission ("SEC") met with representatives from various ERISA regulated pension funds (collectively, the "Pension Fund representatives") at the SEC's headquarters in Washington, DC.

The Pension Fund representatives included James Harshaw (General Motors), Kent Mason (Davis & Harman), Bella Sanevich (NISA Investment Advisors), Judy Schub (Association of Financial Professionals), Diann Howland (American Benefits Council), Maureen Donley (Skadden), and Eric Silva (Winston & Strawn).

The Pension Fund representatives discussed various matters pertaining to the Dodd-Frank Wall Street Reform and Consumer Protection Act, including anti-avoidance requirements, business conduct standards, the definition of "Major Security-Based Swap Participant", and swap data repositories. The Pension Fund representatives meeting agenda and materials are attached to this memorandum.

ERISA REGULATED PENSION FUNDS – DODD-FRANK ISSUES

November 10, 2010; 2:00 p.m. – 3:00 p.m.
SEC Headquarters (100 F Street, N.E., Washington, DC)

AGENDA

1. Anti-avoidance for clearing requirements
2. Business conduct standards, valuation and electronic confirmations
3. MSP Definition as it relates to pension funds
4. SDR and Middleware interconnectivity

November 3, 2010

MSP STATUS WOULD HARM PLANS AND PLAN PARTICIPANTS

The American Benefits Council and the Committee on Investment of Employee Benefit Assets represent directly or indirectly most of the private retirement community in this country. In that capacity, we urge you to follow Congress' clear intent with respect to the application of the major swap participant ("MSP") rules to ERISA plans.

During the consideration of the Dodd-Frank Act, countless individuals within Congress and the Administration told us that they never intended ERISA plans to be MSPs. This intent was then reflected in the only MSP exemption added after House consideration—an exemption for plan positions maintained to hedge or mitigate risk.

It is critical that the CFTC and the SEC implement Congressional intent with respect to the application of the MSP rules to ERISA plans. A full discussion of this issue is set forth in our September 20 comment letter, which is attached. Set forth below is a brief summary of certain key points.

Prong One of the MSP definition (Substantial Position Test). Under this test, by statute, positions maintained by ERISA plans to hedge or mitigate risk are excluded. This exclusion covers positions maintained to:

- Hedge interest rate, currency, equity, and other risks;
- Avoid volatility in funding obligations;
- Match cash flow with expected payments; or
- Mitigate portfolio risks by rebalancing or gaining exposure to additional asset classes.

The reason plans are mentioned only in Prong One is that Congress understood that plans could conceivably only meet Prong One, especially when plan swaps lead to no counterparty credit risk because they will likely be either cleared or fully collateralized. As a result, it would be consistent with Congressional intent for the Commissions to confirm that swaps that are either cleared or fully collateralized entered into by plans can not trigger MSP status under either Prongs Two or Three. Nevertheless, we make the following additional observations below.

Prong Two (Financial Stability of the United States Banking System or Financial Markets). ERISA plans are unleveraged (as discussed below), highly regulated, subject to the highest fiduciary standard in U.S. law, and are not operating entities subject to business-line risks and competitive challenges. These factors by themselves are sufficient for regulators to determine that ERISA plans would not have a level of uncollateralized swap risk that could threaten the financial stability of the United States banking system or financial markets and the history of ERISA plans in the swap markets would also serve to support such a conclusion. We are not aware (after consultation by members with many swap dealers) of a single instance since ERISA plans were created in 1974 in which an ERISA plan has ever failed to pay a counterparty on a swap, even when an ERISA plan sponsor went into bankruptcy. Rather the existence of pension plans in the swap markets has served to enhance the stability of banks and the financial markets because pension plans (i) are reliable, creditworthy counterparties which provide consistent profits to banks, (ii) provide non-volatile liquidity to the markets and (iii) because of ERISA, utilize swaps only for prudent reasons. If pension plans are deemed to be MSPs, we are confident that many pension plans will exit, or limit their activities in, the swap markets due to the burdensome nature of being an MSP and the related costs. This could have the unintended, but real, consequence of creating more systemic risk to the United States banking system and the financial markets. Thus, there is no reason to subject plans to Prong Two's potentially vague standard which is of uncertain application. Plans should be deemed not to be MSPs under Prong Two.

Prong Three (Highly Leveraged). Aside from a specialized type of plan called an ESOP (a defined contribution plan that is specifically permitted to use borrowed funds to buy employer stock), plans generally do not borrow funds in excess of available liquid assets. In such instances, Plans should be deemed not to be MSPs under Prong Three.

MSP Tests Designed for Companies Should Not Apply to Plans. We know you have received recommendations regarding specific MSP criteria from others outside the plan world. We are expressing no view regarding the advisability of these criteria outside the context of ERISA plans, but many possible criteria are simply unworkable for plans. For example, Basel 1 risk capital, capital generally, and shareholders equity, among others, are not terms that would apply to ERISA plans. Congress recognized the unique nature of pension plans and treated plans separately; the regulations should follow Congress' lead.

Example of How MSP Status would Harm Plans and Plan Participants. The application of MSP capital requirements to plans would harm plans by requiring plan assets to be underinvested or uninvested. This could have one of two effects. First, if a plan is an MSP, the plan may bear the cost of lower earnings. It is clear, however, that plan costs are eventually passed on to participants in the form of smaller benefits or other compensation. Thus, it is plan participants who will suffer. Alternatively, if a plan stops using swaps to avoid becoming an MSP, the plan will become exposed to greater funding volatility. Funding volatility has been for many years the primary cause of employers ceasing to provide pension benefits. And in our current economic climate, greater funding volatility can require companies to set aside far greater cash reserves—reserves that could be better used to retain or create jobs.

The example below illustrates the harm to plans.

Pension Plan Asset & Liabilities (assume 100% funded)	$ 5,000,000,000
Plan wishes to hedge 50% of the interest risk of its liabilities (using physical bonds and swaps)	$ 2,500,000,000
Physical bonds hedge 20% of liabilities	$ 1,000,000,000
Therefore swap hedge must hedge other 30% of liabilities to reach target of 50%	$ 1,500,000,000
Assuming an 8% capital charge (of notional value of swaps) for MSPs, a Plan	$

that is an MSP must set aside Plan Assets otherwise used to generate returns	120,000,000
Plan Assets assumed to return 7.5% annually, so Plan Assets forego following $ return	$ 9,000,000
Sponsor must therefore add $9,000,000 ***ANNUALLY*** to compensate for lost return due to capital charge	
Total Plan Asset return is now diminished by 18bps ***ANNUALLY***, thus reducing the expected return on Plan Assets from 7.50% to 7.32%	**18 loss**

Developing Standardization, Clearing and Anti-Evasion Models for ERISA Pension Plans to Protect Custom Portfolio and Risk Management Swap Terms

Main Objectives

- **CFTC/SEC rules should be**:
  - Specific and provide guidance as to when a given swap “is required to be cleared;”and
  - Not be so narrow that plans regulated by the Employee Retirement Income Security Act of 1974 (“ERISA”) lose the ability to use customized swaps without the fear of potential (and in many cases unintended) repercussions.

ERISA Plans – Unique Issues

- **Plans regulated by ERISA are unique users of OTC derivatives because**:
  - ERISA plans' many fiduciaries utilize *customized swaps* solely for the benefit of the participants.
  - ERISA plans and their fiduciaries *are already subject to the oversight* of multiple regulators, including the Department of Labor and the Internal Revenue Service.
  - Each ERISA fiduciary is required to *act solely in the best interests* of plan participants.
  - Each transaction executed by an ERISA fiduciary with a dealer is required to be done *at "arms length."*
  - Each ERISA fiduciary is subject to the *highest fiduciary standard* under any US regulatory scheme – that of a prudent expert.
  - Clear rules need to be established in order for plans to be able to continue utilizing customized swaps without fear of potential (and in many cases unintended) repercussions.

Benefits of Clearing

- **The benefits of clearing include**:
  - Matching the “buy” and “sell” sides of the transaction prior to accepting the trade for clearing;
  - Collecting margin, including daily mark-to-market posting; and
  - Guaranteeing trades by substituting the credit and risk of the clearinghouse for the credit and risk exposure of each party.

Current Market Practices with ERISA Pension Plans

- **Valuation**
  - ERISA plans generally have processes in place to price their uncleared swap positions independently of the dealer. Although ERISA plans may receive daily values for swap positions from dealers in their role as calculation agents, typically ERISA plans will have a plan fiduciary or a service provider conduct an independent valuation of their swaps.
- **Collateralization**
  - ERISA fiduciaries have in many cases negotiated ISDA terms that include zero, or close to zero, collateral thresholds for their uncleared swaps. Zero collateral thresholds mean that the mark-to-market exposure of a counterparty is required to be collateralized, subject typically to *de minimis*amounts.
- **Retaining ERISA Plan Protections**
  - Accordingly, many ERISA plans already have many of the benefits of clearing built into their OTC documents and processes for their uncleared swaps, without sacrificing the customization that ERISA plans' need to protect the best interests of their participants.

Concerns of ERISA-Regulated Pension Plans

- **Loss of Custom Terms**
  - An expansive view of "Standardization" combined with vague or overbroad "anti-evasion regulation" could result in ERISA pension plans losing, as a result of clearing of swaps deemed "Standardized", important "custom" terms which provide portfolio and risk management protections and benefits to pension plans and their beneficiaries.
  - *See <u>Annex A</u> for an example of what the loss of custom terms could mean for a plan.*

Why Do ERISA Plans Use Custom Terms?

- ERISA plans use customized swaps predominantly for hedging purposes
- For example, an ERISA-regulated plan may use:
    - Interest rate swaps to hedge the interest rate risk associated with benefit obligations owed to participants in the future and use specifically tailored terms in order to more precisely hedge the ERISA plan's interest rate exposure than is provided through a "cleared" swap.
        - In other words, customized swap terms allow an ERISA pension plan to line up its payments with the obligations owed to beneficiaries.
    - Equity or commodity swaps to hedge the risk of adverse price changes in assets held by the ERISA plan, and may seek to use swaps with specifically tailored terms in order to more precisely hedge the plan's risks.

- *See <u>Annex B</u> for a comparison of select terms of potential standardized, clearable interest rate, equity and commodity swaps and customized interest rate, equity and commodity swaps.*

Standardization and Clearing

- **Proposition**
  - *Whether an ERISA pension plan loses or keeps important custom terms will depend on (i) the model that the CFTC/SEC utilizes to determine when a swap is "standardized" and required to be cleared, and (ii) the breadth of any CFTC/SEC anti-evasion regulation*.

- The relevance of the standardization model is illustrated in the following example:

  - (1) ERISA Pension Plan A enters into a swap which contains Terms X, Y, Z. Term Z is an important custom term in the view of the pension plan fiduciary.

  - (2) A Clearing Organization is willing to clear swaps with Terms X and Y.

Standardization and Clearing (continued)

- Depending on the standardization model chosen, results will be different:
  - <u>Standardization Model 1</u>:
    - All Swaps with only Terms X and Y.
    - Result: Trade is not cleared
  - <u>Standardization Model 2</u>:
    - All Swaps which have X and Y as terms and, once cleared, all other swap terms are deemed cancelled
    - Result: Trade is cleared and ERISA Pension Plan A loses important portfolio and/or risk management term protections and benefits

- We would advocate that the CFTC/SEC adopt Standardization Model 1, otherwise pension plans and their beneficiaries stand to lose important portfolio and risk management terms and benefits as a result of mandatory clearing.

Anti-Evasion

- **Proposition**
  - *Even if the CFTC/SEC adopts Standardization Model 1, a regulation prohibiting the "evasion" of clearing could still inadvertently cause ERISA pension plans to lose important portfolio and risk management terms*

- For example, an anti-evasion CFTC/SEC regulation which is vaguely written and/or overbroad could result in:
  - (1) ERISA pension plan fiduciaries not insisting on legitimate "custom" terms "in the best interests" of participants to avoid being deemed in violation of the "anti-evasion" regulation; and
  - 2) Dealers refusing to accommodate ERISA pension plans' "custom" terms for fear of being deemed to have violated or have enabled the violation of the "anti-evasion" regulation

Anti-Evasion (continued)

- **Unintended Results**
  - The end result is that the implementation of Dodd-Frank Act (DFA) which was intended to reduce systemic risk could result in pension plans and their beneficiaries being exposed to more risk.

- **Right-Sizing Anti-Evasion Rules**
  - We recognize the challenge that the CFTC/SEC has in formulating an "anti-evasion" regulation which does not encourage the avoidance of clearing but which also does not limit swap terms for portfolio management, risk management or other legitimate purposes.

Legislative Focus – Margin

- We suggest that the principal reason why a party would seek to evade clearing under the DFA, other than specific contract terms, is MARGIN.

- We would advocate that anti-avoidance should be viewed in terms of AVOIDING POSTING MARGIN, as compared to focusing on particular trade terms.

- MARGIN is the equivalent to POSTED COLLATERAL for UNCLEARED SWAPS. The posting of MARGIN is one of the key reasons why clearing platforms can reduce systemic risk.

Proposal for Regulation

- **A PARTY SHOULD NOT BE DEEMED TO BE “EVADING” THE CLEARING REQUIREMENT FOR A PARTICULAR SWAP IF**:
  - (i) The swap’s terms are not identical to a “swap that is required to be cleared” or the swap is not “clearable”;
  - (ii) The swap is for the benefit of a plan that is subject to ERISA regulation;
  - (iii) The swap is essentially fully collateralized (taking into account minimum transfer amounts, rounding, timing differences between collateral notification and delivery and other de minimis amounts contained in a plan’s swap documentation negotiated with the dealer); and
  - (iv) the transaction is reported to the CFTC/SEC and/or a swap data repository.

Annex A

Example of the potential value of customized swaps for ERISA pension plans

To provide some context of the importance of this issue, CIEBA members manage $867 billion in defined benefit pension plan assets on behalf of 11.6 million participants. This represents 40% of all *private sector* defined benefit plan assets according to data from the Federal Reserve.

The below example is just one of many countless potential ways that custom swaps can uniquely protect the benefits promised to retirees.

Background

In a defined benefit pension plan, a retiree is promised payments in the future. The payment obligations of a pension plan span payments occurring presently to payments promised more than 50 years from now. The present value of payments to be made in the future varies considerably with interest rates. As such, plans often use interest rate derivatives to hedge their risk of interest rate fluctuations (i.e., to align asset fluctuations more closely with the fluctuations in the economic value of the promised payments). Interest rates for calculating funding levels are set by law.

Illustrative Interest Rate Example

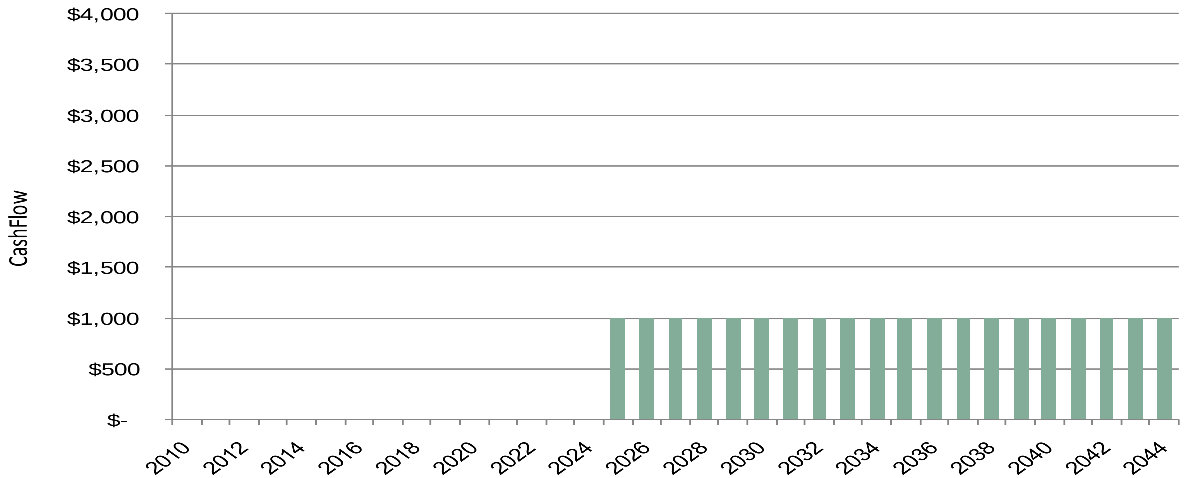
A simplified example will illustrate plans' critical need to manage interest rate risk effectively. Assume that a plan has $15 billion of assets and $15 billion of liabilities so that the plan is 100% funded and there is thus no shortfall to fund. Assume that interest rates fall by 100 basis points. That alone would increase liabilities substantially; based on a real-life example, we assume a 13% increase in plan liabilities to $16.95 billion solely by reason of the interest rate decline. We assume a plan portfolio invested 25% in bonds, which increases in value to $15.49 billion. Thus, the decline in interest rates has created a $1.46 billion shortfall. Under the current pension funding rules, shortfalls must be amortized over seven years, so that the plan sponsor in this example would owe annual contributions to the plan of approximately $248 million, starting with the current year, solely attributable to the interest rate decline.

Hedging interest rate risk effectively could avoid this result by creating an asset that would cause the value of the plan assets to rise to the same $16.95 billion if interest rates fall by 100 basis points. Thus, plan sponsors are able to avoid the spectre of sudden increases in cash obligations of hundreds of millions of dollars. If, on the other hand, plans' ability to hedge effectively is curtailed by the clearing rules, funding obligations will become very volatile, as illustrated above. This will, in turn, force employers to reserve large amounts of cash to cover possible funding obligations; this will divert cash from critical job retention and business growth projects.

An example explaining interest rate hedging is set forth below.

Interest Rate Hedging

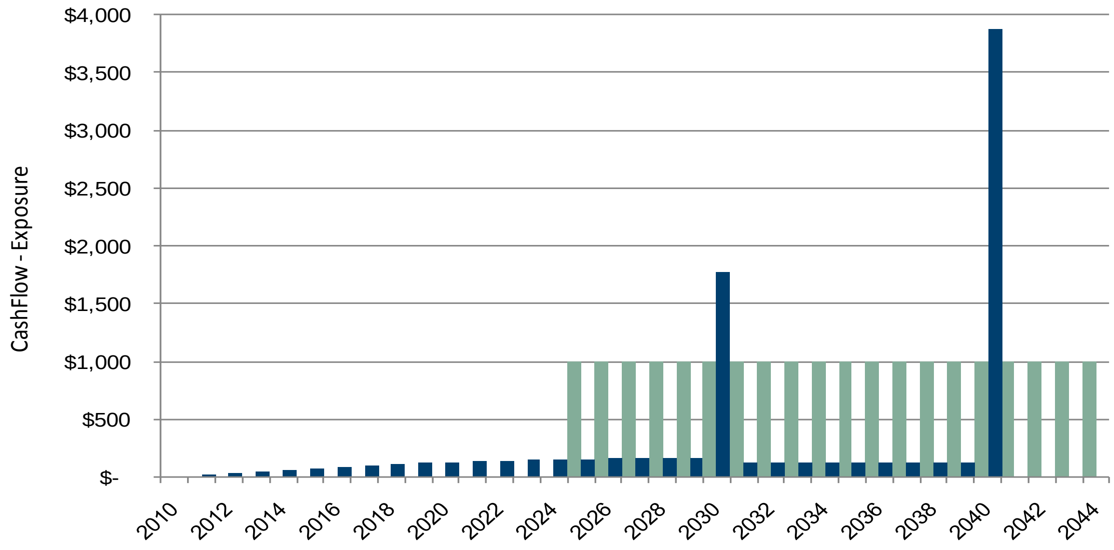
Below is as a simplified promised benefit to an employee who will retire in 15 years, and receive $1,000 per year over the term of the following 20 years. This is the cashflow profile of the liability.



Company needs to reserve $8,915 today in order to pay the benefit described above. If interest rates fall 1%, the Company will need to reserve approximately $1,960 (or 22%) more in order to pay the same benefit. If assets of the pension plan do not increase commensurately, the solvency of the plan is at risk to the Company’s ability to contribute the additional assets. In the event the Company is unable to do so by reason of bankruptcy, the burden would be placed on the Pension Benefit Guaranty Corporation (PBGC) – a federal corporation – to provide the additional assets and/or benefits would be reduced as part of the PBGC settlement of the liabilities.

The Company can mitigate this risk by hedging against interest rate fluctuations using interest rate swaps.

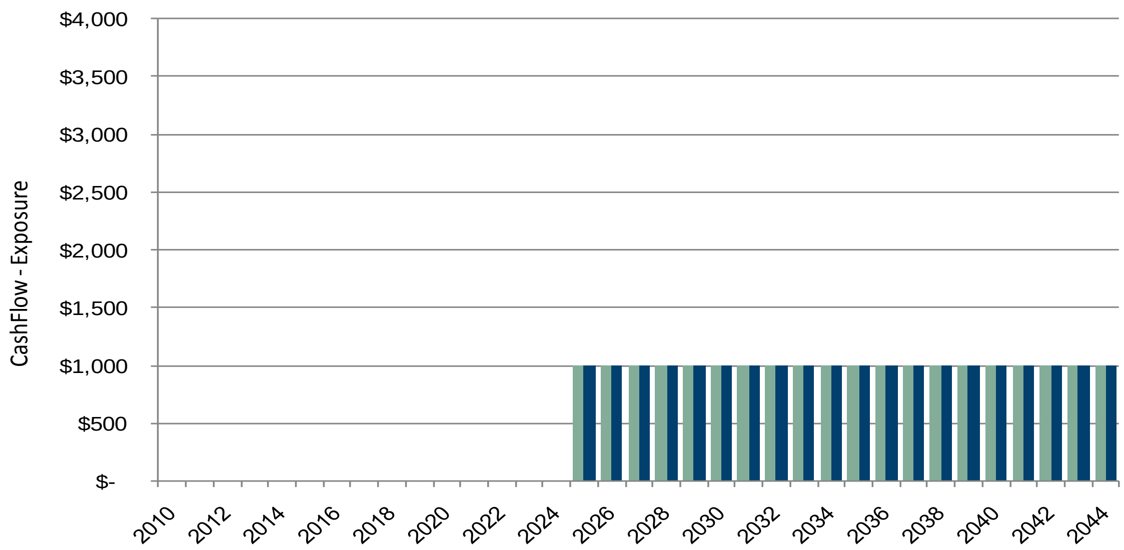
Assume that the Company can only use 10, 20 and 30 year interest rates swaps (whether due to clearing requirements or other regulatory action). The following portfolio could be designed in an effort to match the effective cashflow profile of the liability (the “standardized swap portfolio”).



In the above example, cashflows do not precisely match the expected benefit payments. Therefore, the Company is still exposed to interest rate fluctuations (although to a smaller extent than if it was not hedged at all). As a recent example, if interest rates moved in a manner similar to that experienced between April and September 2010, the standardized swap portfolio would have a mismatch of 3% vs. the customized swap portfolio (illustrated below). Thus, the Company would still need to reserve an additional $267—3% of the full $8,915—in order to pay the retirement benefit.

If this need to reserve an additional 3% arises in, for example, a $15 billion plan, as discussed above, the extra reserve would total $450 million, a very material amount for any company.

If, however, the Company is not limited as to which swaps it may use (in other words, customized, zero coupon swaps are available and permitted), the Company can design a portfolio with the following cashflow portfolio – ostensibly an identical profile to that of the liability.



The above example is over-simplified for expository ease and “standardized”/”clearable” positions may be available to more completely mitigate the specific risk than described above.

While it is impossible to say at this time what instruments will be “clearable,” and this particular example may not be applicable, regulators need to be cognizant of the critical importance of customization to pension plan fiduciaries seeking to protect the retirement benefits of their participants.

Annex B

- Comparison of select terms of potential standardized, clearable interest rate, equity and commodity swaps and customized interest rate, equity and commodity swaps:

Interest Rate Swaps

Provision	Standardized Term	Customized Term
Float-side Index	3 month LIBOR	1 month LIBOR or another Index (e.g., Fed Funds)
Coupon Rates	Par rate (on market)	Step-up or Step-down coupon rates or zero coupon swaps
Starting Date	Spot starting date	Forward starting date
Coupon Payment Dates	Semi-annual based on maturity date of spot starting swap	Custom payment dates (longer or shorter than standard intervals)
Notional Value	Remains Constant	Notional amount adjusts on an amortization schedule or based on inflation

Equity Swaps

Provision	Standardized Term	Customized Term
Equity Reference Index	Well known Indices and widely traded names	Customized basket of issuers tailored to Plan Portfolio and specific market segments
Reset/Payment Dates	Quarterly reset and payment dates	Monthly reset and payment dates or annual reset and payment dates
Rights of Counterparty (e.g. voting, disclosure, hedging rights)	No voting No disclosure No restrictions on hedging	Voting rights Disclosure requirements (13D, 13G filings) Limitations on hedging
Adjustments to Notional Amounts or Reference Shares	No Adjustments to Notional Amounts or Reference Shares	Adjustments to Notional Amounts or Reference Shares to Rebalance Portfolio

Commodity Swaps

Provision	Standardized Term	Customized Term
Exposure Adjustment	No ability to unwind or add exposure prior to expiration	Only the Plan has the right to unilaterally terminate a transaction at no cost or can negotiate increase features
Reset/Payment Dates	Quarterly reset and payment dates	Monthly reset and payment dates or annual reset and payment dates
Maturity	Quarterly	Any negotiated date
Commodity Reference Index	Well known Indices	Customized basket of commodities

ABOUT CIEBA

The Committee on the Investment of Employee Benefit Assets, better known as CIEBA, is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA represents more than 100 of the country's largest private sector retirement funds. Its members manage $1.4 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries.

CIEBA was formed in 1985 to provide a nationally recognized forum and voice in Washington for ERISA-governed corporate pension plan sponsors on fiduciary and investment issues. Members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate pension plan assets.

CIEBA's mission is to improve retirement security and increase investment management effectiveness by:

- Informing pension plan sponsors of legislative, regulatory and investment issues affecting defined benefit and defined contribution plans
- Providing a forum for discussion of these issues and development of effective solutions
- Helping its members address these issues and effectively discharge their fiduciary responsibilities
- Serving as an information resource for legislative and regulatory bodies
- Supporting constructive policy and legislative initiatives
- Building understanding and support for the private sector pension system

CIEBA is committed to strengthening the private sector pension system so that it continues as a major source of retirement income for millions of Americans. Its members also recognize that the private pension system's assets provide a significant source of long-term capital essential for growth.

Robert Hunkeler, Vice President of Investments at International Paper, is the current chairman of CIEBA.

About the American Benefits Council

- The American Benefits Council (the Council) is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.
- We are professionals in the benefits field with expertise in investments, retirement, health insurance, accounting, actuarial science, banking, law, and benefits consulting who provide service and support to corporate benefit plan sponsors.
- We serve as a technical resource on benefits issues for lawmakers, the media and other industry trade associations. We also lead other public policy organizations in developing and communicating a collective business community position and forge alliances on benefits issues.
- Our mission is to be the most effective advocate for voluntary private employee benefits.

American Benefits Council

Segregation of Customer Margin for Cleared Swaps

Objectives

- To ensure that by moving from the bilaterally-settled OTC model to the centrally-cleared model, swap participants:
    - *do not become exposed to additional risks that are not typical for the bilateral OTC model*
        - (*e.g.*, possibility of credit exposure to other customers of a clearing member in the event of other customer's or clearing member's default); and
    - *do not lose additional protections available in the bilateral model*

ERISA Plans – Unique Concerns

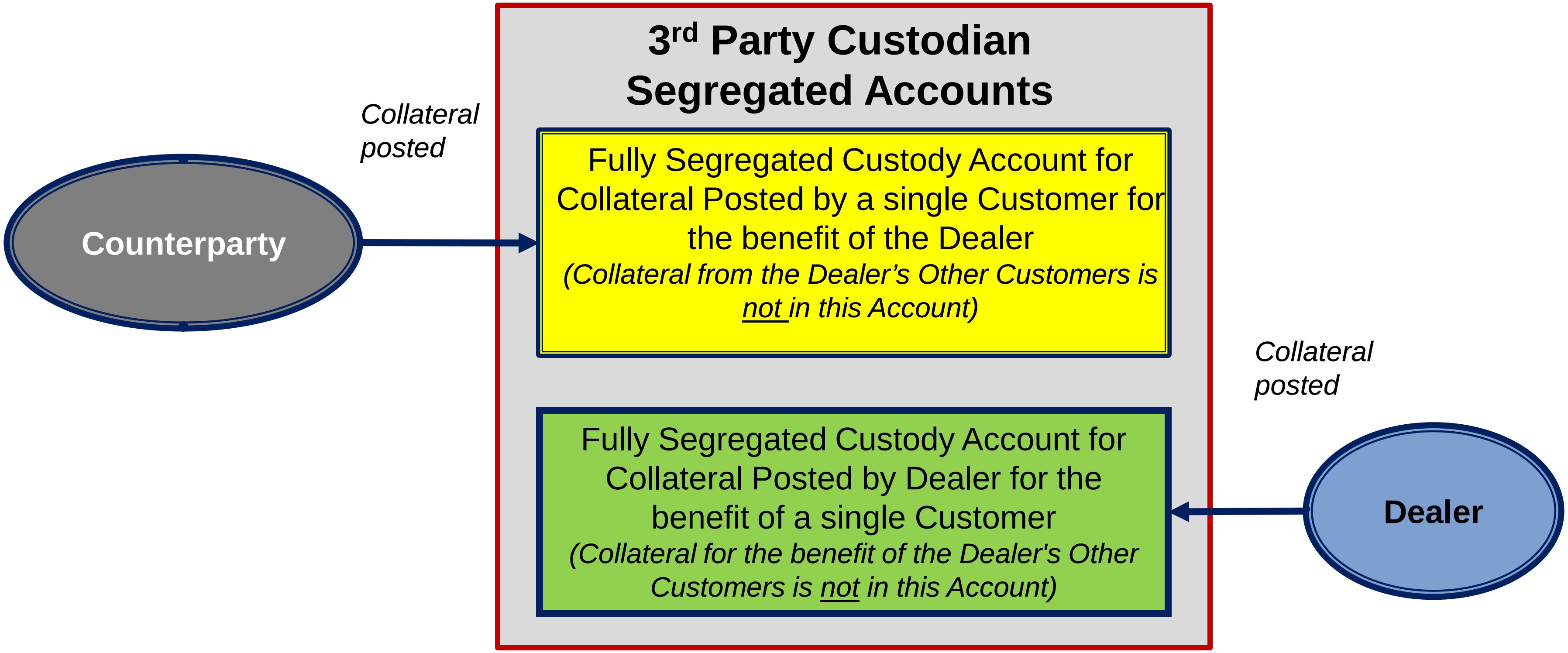
- **Plans regulated by ERISA* are unique users of OTC derivatives because**:
  - ERISA plans use swaps to manage risk and to reduce the volatility of the plan funding obligations, e.g. minimize interest rate swings.
  - ERISA plans' many fiduciaries utilize *customized swaps* solely for the benefit of the participants.
  - ERISA plans and their fiduciaries *are already subject to the oversight* of multiple regulators, including the Department of Labor and the Internal Revenue Service.
  - Each ERISA fiduciary is required to *act solely in the best interests* of plan participants.
  - Each transaction executed by an ERISA fiduciary with a dealer is required to be done *at "arms length."*
  - Each ERISA fiduciary is subject to the *highest fiduciary standard* under any US regulatory scheme – that of a prudent expert.

** The Employee Retirement Income Security Act of 1974*

Pension Plans Risks In Clearing

- Current clearing systems (*e.g.*, futures clearing systems) expose plans to some risks not incurred for many uncleared swaps.
- Currently, the clearing member typically holds funds it receives from customers to margin their customer swaps in a <u>single aggregate</u> customer account. Likewise, the clearinghouse holds margin it receives from the clearing member for swaps held by the clearing member for its customers in a <u>single aggregate</u> customer account.
- This could place the customer's margin at risk if one of the other customers who has margin held in that same account defaults and the clearing member cannot make up the shortfall.

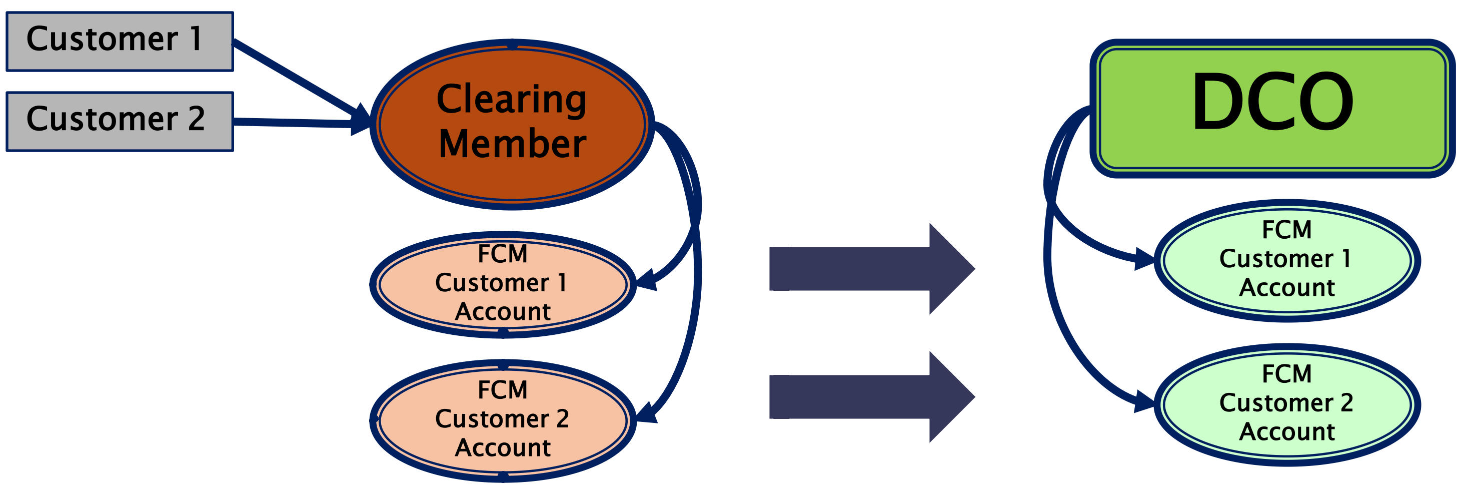
Segregated Collateral OTC Model



The above model served to protect a significant amount of pension plan assets when Lehman, as a swap dealer, went into bankruptcy. Collateral posted by a pension plan customer for the benefit of Lehman was utilized <u>only</u> to satisfy the obligation of such pension plan to Lehman (not the obligations to Lehman of other Lehman customers). Lehman's obligations to such pension plan customer were also collateralized.

Proposed Segregation Model

Proposed **Full Legal Segregation** Clearing Model for Pension Fund Swaps



Segregated Accounts

Segregated Accounts

No *recourse to* ***other*** *customer funds upon one customer's default shortfall.*

Pension Plan Risks in OTC

- In OTC swaps, while another customer's default to an OTC swap dealer could impact the financial health of that dealer, the risk of a pension plan customer of that same dealer losing its collateral as a result is not a risk that many pension plans have with their OTC trades.
  - Plans generally do not post initial margin in the OTC context;
  - Plans monitor the exchange of collateral very carefully, so that the dealer does not hold "extra" plan collateral;
  - A significant amount of pension plan assets enjoy negotiated protections for collateral in fully segregated third-party custodian accounts in the OTC context;
  - These protections include prohibitions on rehypothecation, lending or borrowing of plan collateral.

- Although plans have participated in the futures markets with similar pooled customer margin account risks, such participation could be weighed against the risks/benefits of OTC swap trading.

Margin Account Risks

- Pension plans are some of the lowest leveraged, least risky customers. By combining their margin with highly leveraged entities that are engaged in risky strategies (*e.g.*, hedge funds) and that are more likely to default than pension plans, pension plans are essentially being forced to take on the risk created by these customers' aggressive strategies and leverage.

- As indicated by the level of trading on futures exchanges globally (some estimate only 16% of the total derivatives market*), many plans' derivatives trading has been primarily done on an OTC basis. Thus, plans have not been exposed to these margin risks for most of their derivatives positions.

** "The Global Derivatives Market: An Introduction," Deutsche, Boise/Eurex White Paper, April 2008.*

Margin Account Risks

- The risk of losing margin due to another customer's default can be expected to increase significantly as the volume of cleared trades increases.
- The amount of customers in combined customer margin accounts also is likely to increase.

Replicating Pension Plan Protections for Cleared Swaps

- If a pension plan is required to clear its swap trades, it should be able to elect that a ***<u>separate fully and legally</u>*** segregated account (<u>not</u> an aggregate account) be maintained by the clearing member at the clearinghouse solely on its behalf.

Replicating Pension Plan Protections for Cleared Swaps

- **Segregated margin accounts should**:
  - Not allow the margin of one customer to be used for any reason other than that customer's account and trading activity;
  - Be held at a third-party custodian;
  - Be held in the United States; and
  - Be protected from rehypothecation, borrowing or lending by the dealer.

Costs Issues

- **Possible Argument #1**:
  - "*Full legal segregation is too costly*"

- **Response #1**:
  - In the OTC market, full segregation is commonly provided without dealers charging plans additional fees.
  - Plans simply pay 3rd-party custody costs for segregation, which they deem reasonable and worth the expense.
  - One pension plan has informed ABC/CIEBA that its per account segregation costs for custody, reconciliation services (to the dealer and to its investment manager), margin services, transaction charges, and custody statements are only $20,000 - $25,000 per year.
    - These costs are paid to a 3rd-party custodian.
  - Pension plans have the ability to require their margin (collateral) to be segregated for their OTC swaps.
  - **Accordingly, clearing members and dealers already have the ability to separately account for and segregate pension funds moneys on commercially reasonable terms.**

Current Practice Issues

- **Possible Argument #2:**
  - "*Full legal segregation is not current practice*"

- **Response #2**:
  - Full legal segregation is not current practice for futures, but it is common practice for swaps dealers in OTC.
  - It is universal practice in the OTC world that no clients cross-collateralize other clients.
  - It is the practice to segregate and use 3rd-party custodians in the OTC world with respect to all U.S.-registered investment companies and with respect to a significant number of ERISA-regulated pension funds.

Proposal for Regulation

- CFTC rules on segregation, customer protection and clearing should require that:

  - ERISA-regulated funds should have an option to require that their funds deposited with the clearing member or a DCO be held in a separately and legally segregated account that under no circumstances may become a source of funds to cover other customers' or clearing member's positions.

  - Clearing members should be required to accommodate ERISA-regulated plan requests to hold collateral in such segregated accounts on commercially reasonable terms and conditions that prohibit rehypothecation, borrowing, or lending.

About CIEBA

CIEBA
The Committee on Investment of Employee Benefit Assets

The Committee on the Investment of Employee Benefit Assets, better known as CIEBA, is the voice of the Association for Financial Professionals (AFP) on employee benefit plan asset management and investment issues. CIEBA represents more than 100 of the country's largest private sector retirement funds. Its members manage $1.4 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries.

CIEBA was formed in 1985 to provide a nationally recognized forum and voice in Washington for ERISA-governed corporate pension plan sponsors on fiduciary and investment issues. Members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate pension plan assets.

CIEBA's mission is to improve retirement security and increase investment management effectiveness by:

- Informing pension plan sponsors of legislative, regulatory and investment issues affecting defined benefit and defined contribution plans
- Providing a forum for discussion of these issues and development of effective solutions
- Helping its members address these issues and effectively discharge their fiduciary responsibilities
- Serving as an information resource for legislative and regulatory bodies
- Supporting constructive policy and legislative initiatives
- Building understanding and support for the private sector pension system

CIEBA is committed to strengthening the private sector pension system so that it continues as a major source of retirement income for millions of Americans. Its members also recognize that the private pension system's assets provide a significant source of long-term capital essential for growth.

Robert Hunkeler, Vice President of Investments at International Paper, is the current chairman of CIEBA.

About the American Benefits Council

- The American Benefits Council (the Council) is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.
- We are professionals in the benefits field with expertise in investments, retirement, health insurance, accounting, actuarial science, banking, law, and benefits consulting who provide service and support to corporate benefit plan sponsors.
- We serve as a technical resource on benefits issues for lawmakers, the media and other industry trade associations. We also lead other public policy organizations in developing and communicating a collective business community position and forge alliances on benefits issues.
- Our mission is to be the most effective advocate for voluntary private employee benefits.

American Benefits Council

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ERISA Pension Plans' Perspective – No Unilateral Change of Swap Terms by Data Collectors and the Use of Required Electronic Technology

Main Objectives

- **Preserving Plan Protections**
  - Pension plans' fiduciaries negotiate carefully with their swap dealer counterparties terms that are in the best interest of the participants (as required by the Employee Retirement Income Security Act of 1974 (ERISA)) for their uncleared, non-exchange traded swaps.
  - These swaps must be reported under the Dodd-Frank Act (DFA).
- **Reporting**
  - **The terms of an uncleared, non-exchange traded swap <u>should not</u> be unilaterally modified, directly or indirectly, through the affirmation, confirmation, processing or reporting (collectively, "Reporting") of that swap.**
  - Entities that might engage in Reporting include:
    - swap data repositories (SDRs)
    - swap execution facilities (to the extent non-exchange traded swaps are Reported (SEFs)),
    - designated clearing organizations (to the extent non-exchange traded swaps are Reported (DCOs*)) and
    - middleware providers to these entities.
  - Collectively, we refer to these entities as "Data Collectors".

<u>Note</u>: None of the comments herein address a DCO's clearing and margin functions or emergency powers.

Main Objectives

- **Unilateral Modification of Terms & Contracts of Adhesion**
  - Data Collectors may require uniform swap terms that are inconsistent with the terms carefully negotiated by the plan fiduciary for uncleared, non-exchange traded swaps.
  - CFTC rules should <u>not</u> permit Data Collectors to force pension plan fiduciaries to agree to these terms or sign agreements of any kind which unilaterally change the terms of the plan's uncleared, non-exchange traded swaps.
- **ERISA Mandate**
  - ERISA plan fiduciaries <u>must be able to</u> fulfill their fiduciary mandate under ERISA without conflicting with CFTC rules.

ERISA Plans

- **Plans regulated by the ERISA* are unique users of OTC derivatives because**:
  - ERISA plans use swaps to manage risk and to reduce the volatility of the plan funding obligations, *e.g.,*minimize the effect of interest rate swings.
  - ERISA plans' many fiduciaries utilize *customized swaps* solely for the benefit of the participants.
  - ERISA plans and their fiduciaries *are already subject to the oversight* of multiple regulators, including the Department of Labor and the Internal Revenue Service.
  - Each ERISA fiduciary is required to *act solely in the best interests* of plan participants.
  - Each transaction executed by an ERISA fiduciary with a dealer is required to be done *at "arms length."*
  - Each ERISA fiduciary is subject to the *highest fiduciary standard* under any US regulatory scheme – that of a prudent expert.

  * The Employee Retirement Income Security Act of 1974

Reaching Legislative Intent

- **Legislative Intent**
  - DFA was intended to promote transparency and security in OTC derivatives.
  - DFA was not intended to eliminate plans' ability to negotiate protective terms.
  - DFA was not intended to abrogate or dilute protective requirements of ERISA.
  - DFA was not intended to give Data Collectors the power to mandate terms of uncleared, non-exchange traded swaps.

Pension Plans Objectives

- **Customized Protective Terms**
  - Pension plan fiduciaries need to continue to be able to negotiate custom protective terms for pension plans for uncleared, non-exchange traded swaps. Otherwise, the law would have the effect of decreasing, rather than increasing, the security of plans, contrary to the policies behind ERISA.
- **Unintended Consequences**
  - Only material economic terms (*e.g.*, price, strike, notional amount, rate and counterparty information) should be required to be reported to an SDR. Otherwise, the Reporting effort could be economically prohibitive to participants and/or inadvertently mandate terms for uncleared, non-exchange traded swaps.
- **Accommodate Reporting of Customized Data**
  - Any Reporting system should be required to accommodate "custom" terms (perhaps just noting that a term is a "custom" term could suffice).
- **Neutrality of Market Utilities**
  - Data Collectors who facilitate Reporting should be:
    - "neutral" trade information collection/processing resources, and
    - restricted from unilaterally revising terms agreed upon by the counterparties to an uncleared, non-exchange traded swap.

Examples

- If pension plans are required to sign a non-negotiable User Agreement of one of the few Data Collectors, pension plans would have to:
  - Consent to new, perhaps unfavorable terms and conditions for uncleared, non-exchange traded swaps (which can be further changed without meaningful consent by or meaningful notice to the pension plan's fiduciary).
  - Agree that terms to an uncleared, non-exchange traded swap as agreed upon between the pension plan fiduciary and its dealer counterparty would only govern the trade if not "expressly modified" by the Data Collectors' User Agreement.

These examples are based upon real-life experiences that illustrate how pensions funds' ability to negotiate terms in OTC swaps can be impaired by Data Collectors' User Agreements.

Examples (cont.)

- If plans' terms can be overridden by Data Collectors and the use of Data Collectors is effectively required by law, then the user agreements of Data Collectors would be given the force of law.
  - Neither Congress nor the Administration intended to give Data Collectors the power to mandate terms for uncleared, non-exchange traded swaps.
  - Ways to avoid the result of "private law writing" would be:
    - (1) to prohibit Data Collectors from overriding terms of uncleared, non-exchange traded swaps; or
    - (2) to permit market users that reject Data Collectors agreements to report the trades to the government (CFTC/SEC), rather than to the SDRs; AND
    - (3) to prohibit market participants and market utilities from requiring that certain Data Collectors be used.

Proposals for Regulation

- **To protect pension plans, plan participants, and to remain compliant with the mandates of ERISA, the CFTC/SEC should adopt regulations which**:
  - Prohibit Data Collectors from directly or indirectly (including through the use of middleware) unilaterally modifying in any fashion the terms of uncleared, non-exchange traded swaps.
  - Allow the use of "Main Street technology" (*e.g.*, Excel spreadsheets, e-mail, pdfs of confirmations) for reporting of swaps.
  - Require SDRs to import “custom” swap trade terms or to have data field options to designate that a swap trade term is a “custom” term.
  - Prohibit Data Collectors from requiring that clients use specified Data Collectors (such as middleware) as a condition to reporting swaps.

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AMERICAN BENEFITS COUNCIL

October 19, 2010

**APPLICABILITY OF BUSINESS
CONDUCT STANDARDS TO
ERISA PLANS**

This document is being submitted on behalf of the American Benefits Council (the "Council") and the Committee on Investment of Employee Benefit Assets ("CIEBA").

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

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This document addresses the certain business conduct standards that the CFTC and SEC may impose on swap dealers, security-based swap dealers, major swap participants ("MSPs"), and major security-based swap participants when they offer to enter into or enter into a swap with a "Special Entity" that is an ERISA plan. (For convenience of presentation, all references below are simply to swap dealers and MSPs.) Specifically, this document addresses the application of new section 4s(h)(5)(A) of the Commodity Exchange Act and the parallel new section 15F(h)(5)(A) of the Securities Exchange Act of 1934 to ERISA plans. The former provides:

> **(5) SPECIAL REQUIREMENTS FOR SWAP DEALERS AS COUNTERPARTIES TO SPECIAL ENTITIES.—**
>
> **(A) Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity shall—**
>
> **(i) comply with any duty established by the Commission for a swap dealer or major swap participant, with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of this Act, that requires the swap dealer or major swap participant to have a reasonable basis to believe that the**

counterparty that is a Special Entity has an independent representative that—

(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 transaction; and

(VII) in the case of employee benefit plans subject to the Employee Retirement Income Security act [sic] of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002); and

(ii) before the initiation of the transaction, disclose to the Special Entity in writing the capacity in which the swap dealer is acting; and

<u>Inapplicability of Business Conduct Standards to Plans.</u>

Without a statutory change, the Special Entity business conducts standards applicable under CEA section 4s(h)(5) and Securities Exchange Act section 15F(h)(5) to swap dealers and MSPs do not apply with respect to ERISA plans. The cross-reference in the flush language of clause (i) to "an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of this Act" does not include ERISA plans. This is the right result because Special Entities that are ERISA plans already have similar or greater protections under ERISA with respect to each of the requirements of such sections. The "eligible contract participants" referenced in the statute have no similar protections under current law and therefore it would be perfectly sensible for Congress to extend the business conduct standards only to protect those entities.

Given the specific language of the provision as a whole and the disconnect in its language as it relates to ERISA plans, it would at best be a "stretch" for the Commissions to conclude that the Special Entity business conduct standards fully apply when a swap dealer or MSP offers to enter into or enters into a swap with an ERISA plan. In fact, as pointed out in the Council's September 8 letter to the Commissions, the most conceptually sound interpretation of the statute is that the dealer or MSP would satisfy the Special Entity business conduct standard in the case of an ERISA plans if the dealer or MSP receives a representation from a plan fiduciary that the fiduciary is subject to and complies with ERISA. The other areas covered by the business conduct statutory requirements are addressed very well under ERISA, so that their application would be at best duplicative and at worst inconsistent (as discussed below).

Perhaps the application of business conduct standards to ERISA plans will be addressed in a technical corrections bill to the Dodd-Frank Act. In the meantime, to interpret the business conduct standards to fully apply to ERISA plans would be inconsistent with the language of the statute.

Issues that Apply if the Business Conduct Standards Apply at all to ERISA Plans.

Above, we set forth two alternative positions: (1) the referenced business conduct standards do not apply to ERISA plans at all, and (2) such standards should be satisfied by a representation from a plan fiduciary that the plan's representative is an ERISA fiduciary and will comply with ERISA. If the second position is accepted, two additional issues must be confronted: (1) what it means for a representative to be independent, and (2) how a swap dealer or MSP can obtain a reasonable basis for believing that the plan representative is an ERISA fiduciary and will comply with ERISA.

Independence. As discussed more fully in the Council's September 8 letter, it is critical that the reference to the representative being "independent" means independent of the swap dealer or MSP, not independent of the plan. To conclude otherwise would have severe adverse effects on the very large number of ERISA plans, which, consistent with clear guidance from the Department of Labor, have established sophisticated in-house investment advisory teams. To effectively require such teams to be dismantled and their functions outsourced would harm plans and disrupt the plan system. Moreover, there is no hint in the statute or legislative history that Congress intended to take such a radical step; rather, as discussed in the Council's September 8 letter, there is clear evidence that Congress did not so intend.

Representations. Also as discussed in the Council's September 8 letter, it is critical that there be an effective and administrable means for swap dealers and MSPs to achieve the required "reasonable basis". If swap dealers and MSPs were required or permitted to do independent investigations into a representative's satisfaction of the enumerated requirements, such a process would effectively give swap dealers and MSPs undue control over their counterparty's choice of representative and allow swap dealers and MSPs to potentially inappropriately influence an ERISA plan's entire swap program. Moreover, the time and cost involved would effectively preclude plans from using swaps in many cases.

It should be expressly permitted for swap dealers and MSPs to rely on plan fiduciary representations for purposes of satisfying the reasonable basis requirement, without any obligation on the part of the swap dealer or MSP to do their own investigation. Such representations should be framed in the same manner as the statute, i.e., that a plan fiduciary has a reasonable basis to believe that the applicable business conduct standards will be or are satisfied. As discussed more fully below under "No Cause of Action," it should be made clear that the representations needed to satisfy the business conduct standards do not give rise to any additional contractual rights.

Issues that Apply if the Business Conduct Standards Fully Apply to ERISA Plans.

If, contrary to our statutory interpretation set forth above, the decision is made to fully apply the Special Entity business conduct standards to ERISA plans, such application should be structured within the framework discussed below to harmonize the law and regulation under ERISA with these business conduct standards in order to avoid harming the interests of the beneficiaries and employees served by ERISA plans. The discussion below builds on the "Representations" discussion above. If all the business conduct standards apply to ERISA plans, a swap dealer or MSP should be treated as having the required reasonable basis if the representations described below are made (without any requirement that the swap dealer or MSP do its own investigation). Also, under this interpretation of the law, the definition of "independence" described above remains critical.

Fair pricing and appropriateness of swap. The statute requires a swap dealer or MSP to have a reasonable basis to believe that the Special Entity has a representative that will provide "written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction." It is completely consistent with this language to allow a swap dealer or MSP to satisfy this standard by receiving a copy of a written representation from an ERISA plan's fiduciary to the plan that such plan fiduciary will review the price and appropriateness of each swap the plan considers entering into, as required under ERISA.

For purposes of the pricing representation, instead of a plan fiduciary representing that a fiduciary will review the price, as noted above, the representation could be that a plan fiduciary will seek to achieve "best execution" of the swap, as such concept applies to an SEC-registered investment adviser. This would ensure that the plan's representative seeks to execute a swap on what it reasonably believes are the most favorable qualitative and quantitative terms under the circumstances and consistent with ERISA, taking into account such factors as the fiduciary deems appropriate, which may include price, the counterparty's financial stability and responsiveness, and all other factors an SEC-registered investment adviser considers when fulfilling its duty to seek to achieve best execution. Since the "seeking to achieve best execution" standard does not apply to many plan representatives, this type of representation would be an alternative to the more general representation described above. Either representation would be sufficient for a swap dealer or MSP to have the required reasonable basis regarding pricing.

With respect to the "appropriateness" representation, if the independent representative represents to the Special Entity that a swap is consistent with the investment guidelines established by the plan, and this representation is provided to the swap dealer or MSP, the "appropriateness" requirement should be deemed satisfied. In such a case, the applicable review by the representative with respect to a particular swap would be whether such swap is consistent with such specific guidelines (which guidelines need not be disclosed to the swap dealer or MSP).

The above structure is workable and consistent with the Dodd-Frank statutory structure. Concerns have been raised, however, that the statute may be interpreted to require a separate written representation regarding the fairness and appropriateness of each swap. This type of application of this prong of the business conduct standards would be very disruptive with respect to the use of swaps by ERISA plans and would be contrary to the fiduciary framework established by ERISA.

- **Timing.** Swaps often need to be negotiated and executed in "real time". The price available to hedge a risk at 1:00 p.m. may not be available at 3:00 p.m., and certainly not the next day or the next week. If a separate representation was needed with respect to every swap, hedging programs would be extremely disrupted.
- **Losses.** Requiring a plan's representative to provide the "lead" plan fiduciary with a separate written representation prior to every swap may cause delays in implementing a plan's hedging programs. Such delays may result in lost opportunities to hedge, thus creating losses and volatility. Accordingly, the cost of requiring a written representation for every swap could be material and would come directly from the assets of the plan that are intended to provide benefits to participants.
- **ERISA.** ERISA has a very appropriate framework for dealing with the timing and cost issues. The relevant plan fiduciary must evaluate any action to determine if the benefits of the action outweigh the costs. Under ERISA, it could be a breach of the "lead" fiduciary's duty to ask for a written representation for each or even many swaps entered into for the ERISA plan if the adverse timing effects of obtaining the written representation, including lost hedging opportunities, could outweigh the potential benefits of such representation.[1]

Disclosures. The statutes provide that a swap dealer or MSP must have a reasonable basis to believe that the Special Entity has a representative that will make "appropriate disclosures." It would appear that this prong of the business conduct standard contemplates that the swap dealer or MSP receives a representation that the representative will make appropriate disclosures to the Special Entity. Given the breadth of the term "appropriate disclosures," the Commissions could surely interpret this standard, in the case of ERISA plan fiduciaries, to be

[1] DOL Interpretive Bulletin 08-2, 29 C.F.R. § 2509.08-2 (stating that, in connection with the exercise of shareholder rights, "[i]f the responsible fiduciary reasonably determines that the cost of voting . . . is likely to exceed the expected economic benefits of voting . . . the fiduciary has an obligation to refrain from voting"); DOL Interpretive Bulletin 94-2, 29 C.F.R. § 2509.94-2 (stating that "the Department interprets ERISA [section] 404(a)(1) to require the responsible plan fiduciary to weigh the costs and benefits of voting on proxy proposals relating to foreign securities and make an informed decision with respect to whether voting a given proxy proposal is prudent and solely in the interest of the plan's participants and beneficiaries"); DOL Field Assistance Bulletin 2006-01 (Apr. 19, 2006) (stating, in connection with the distribution to plans of settlement proceeds relating to late trading and market timing, "a plan fiduciary must be prudent in the selection of a method of allocating settlement proceeds among plan participants" and that prudence would "require a process by which the fiduciary weighs the costs to the plan or the participant accounts and ultimate benefit to the plan or the participants associated with achieving that goal"); DOL Field Assistance Bulletin 2002-01 (Sept. 26, 2002) (stating that, in connection with refinancing an exempt ESOP loan, "at a minimum . . . a fiduciary must make a careful assessment of the costs and benefits conferred upon the ESOP," among other things) ; ERISA Op. Ltr. 2007-07A (Dec. 17, 2007) (stating that, with regard to proxy voting, "fiduciaries need to take into account the costs involved when deciding whether to exercise their shareholder rights"); Testimony of Louis Campagna (Department of Labor) to The ERISA Advisory Committee Working Group on Fiduciary Responsibilities and Revenue Sharing Practices (July 11, 2007) (addressing a need to consider the cost and benefit to the plan and participants in implementing any revenue sharing allocation method); DOL Reg. § 2550.404a-4 (stating that the safe harbor in connection with the selection of an annuity provider for an individual account plan is satisfied if the fiduciary, among other things, "appropriately considers the cost . . . of the annuity contract in relation to the benefits . . . to be provided").

met by a representation that the fiduciary will provide all disclosures that are appropriate under ERISA.

If the above approach is not adopted, the concern is that this business conduct standard could require more or different and contradictory disclosures compared to those the law already requires to be made by ERISA plan fiduciaries. If the standard were interpreted to require significantly more disclosure than is currently required under ERISA, that disclosure itself could be contrary to the framework established by ERISA. The cost of disclosure can in many cases be passed on to the plan and thus the participants.[2] Accordingly, it may be counterproductive in some cases to require too much disclosure. Today, if a "lead" fiduciary required excessive disclosure at an unjustified cost to the plan, that would be a breach of its fiduciary duty. [3]

Other requirements. It is critical that none of the other requirements in the subclauses be interpreted in a manner to conflict with ERISA. For example, there is no reason to interpret the "best interests" requirement differently than the "solely in the interest" requirement in ERISA section 404(a)(1). That being said, the other business conduct standards could be satisfied by a written representation from an ERISA plan fiduciary (which may be the plan representative) that the relevant plan representative (1) has sufficient knowledge to evaluate the transaction and risks, (2) is not subject to a statutory disqualification under ERISA, the Commodity Exchange Act, or the Securities Exchange Act of 1934, to the extent applicable, (3) is independent of the swap dealer or MSP, (4) has undertaken to act in the best interests of the plan, and (5) is a fiduciary under ERISA.

For purposes of the first requirement—regarding sufficient knowledge—a representative that is fit to act as a fiduciary under ERISA should be deemed to have the sufficient knowledge. For purposes of the third requirement, a representative would be independent of a swap dealer or MSP unless (1) one of the entities controls, directly or indirectly, the other entity, or (2) the entities are under common control. For this purpose, "control" of any entity means ownership of a majority of the voting power of the entity. For purposes of the fourth requirement, an ERISA fiduciary that acts "solely in the interest of the participant and beneficiaries" in compliance with

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[2] DOL Field Assistance Bulletin 2006-03 (Dec. 20, 2006) (stating that distribution costs associated with certain disclosures "in many instances, will be passed on to the plan's participants and beneficiaries"); Preamble to Proposed Rules on Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43,014, 43,031 (July 23, 2008) (stating that "small and large plans will incur administrative costs due to the proposed regulation" regarding fiduciary requirements for disclosure in participant-directed individual account plans); DOL Field Assistance Bulletin 2006-03 (Dec. 20, 2006) ("With regard to individual account plans that, prior to January 1, 2007, provide participants and beneficiaries diversification rights at least equal to those conferred under section 204(j), the Department is persuaded that the furnishing of the 101(m) notice as a stand-alone disclosure may result both in confusion to participants and beneficiaries and distribution costs that, in many instances, will be passed on to the plan's participants and beneficiaries."); see generally Preamble to Final Regulations on Small Pension Plan Security Amendments, 65 Fed Reg. 62,958, 62,970 (Oct. 19, 2000) (stating that, in revising the regulation for individual account plan disclosure, "it was unnecessary to require small plans to furnish duplicative information" and the revision "has the effect of eliminating . . . start up and annual modification costs for individual account plans . . . without compromising SAR disclosure"); Preamble to Final Regulations for Reporting and Disclosure, 34,526, 34,530 (Aug. 15, 1975) ("The imposition of the reporting and disclosure requirements of Part 1 of Title I of the Act on unfunded pension plans maintained by employers primarily for the purpose of providing deferred compensation for select groups of management or highly compensated employees would entail wasteful expenses associated with the preparation, printing and distribution of unnecessary materials.").
[3] See authorities cited in note 1.

ERISA section 404(a)(1) should be treated as acting in the best interests of an ERISA plan counterparty.

No Cause of Action.

It is critical that the business conduct standards not be usable by swap dealers or MSPs to harm plans. For this reason, it should be made clear that the representations needed to satisfy the business conduct standards do not give rise to any additional contractual rights. For example, assume that due to changing economic conditions, a swap between a swap dealer and a plan has become very disadvantageous for the swap dealer. The swap dealer should not be able, for example, to void the swap—or make any other type of claim against any party—by asserting that one or more of the above-mentioned representations made by the plan or its representative were incorrect. In other words, these business conduct standards—which were meant to protect plans—should not be permitted to be a weapon that can be used against plans or their representatives. Correspondingly, the swap dealer or MSP should be permitted to rely on such representations and should not have any liability or be exposed to the possibility of having the swap voided by reason of a plan fiduciary representation, relied upon by the dealer in good faith, turning out to have been incorrect.

In fact, it is very important that the regulations prohibit the use of the representations required by the business conduct standards to void a trade or otherwise give rise to contractual rights. As noted, it would be turning Congressional intent on its head to permit pro-plan rules to be used to harm plans in contractual disputes.

In analogous situations, regulators have permitted reliance on certifications. For example, under Rule 144A, under the Securities Act, a seller of securities is entitled to rely on a certification by an executive officer of the purchaser that the purchaser meets the conditions necessary to establish that the purchaser is a qualified institutional buyer ("QIB"). Rule 144A (d)(1)(iv). The Adopting Release for Rule 144A states that: "[u]nless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification." Another example is Regulation EE issued by the Federal Reserve, which provides that a person will qualify as a "financial institution" (for netting purposes) if it represents orally or in writing that it meets the appropriate test. 12 CFR 231.3.

Under the language of these regulations, if the certification is reasonably obtained, the recipient of the certification may treat its counterparty as a QIB/financial institution. A subsequent determination that the certification was wrong will not retroactively void the QIB/financial institution status of the counterparty.

Summary.

In brief, we strongly believe that under the statutory language, the referenced business conduct standards have no, or very limited, application to ERISA plans. If, however, the decision is made to apply such standards more fully to ERISA plans, it is critical that the regulations permit compliance with such standards in clear administrable ways that are consistent with the principles of ERISA and that do not place unwarranted burdens on ERISA plans' use of swaps.

We would be pleased to have further discussions with respect to these issues. In that regard, if you have questions, please contact Lynn Dudley (Council, 202-289-6700, ldudley@abcstaff.org) or Judy Schub (CIEBA, 301-961-8682, jschub@afponline.org).

AMERICAN BENEFITS COUNCIL

September 8, 2010

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

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

Dear Mr. Stawick and Ms. Murphy:

I am writing on behalf of the American Benefits Council (the "Council") to express the views of major employee benefit plans across the country with respect to a critical set of issues arising under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). More specifically, pursuant to requests for public comments from both the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC"),[1] this letter addresses certain business conduct standards that may be applied with respect to swaps involving employee benefit plans.

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

Swaps play a critical role with respect to our members' pension plans. Pension plans use swaps to manage risk, such as interest rate, currency, and equity risk, and to thereby reduce the volatility of the plan funding obligations imposed on the companies maintaining the plans. If swaps were to become materially less available to pension plans, funding volatility would increase substantially, forcing companies in the aggregate to reserve billions of additional dollars to satisfy possible funding obligations. Those greater reserves would have an enormous effect on the capital that would be available to businesses to create and retain jobs and for other activities that promote economic growth. In addition, increasing asset volatility can jeopardize the security of plan benefits and undermine employers' commitment to provide new benefits, both of which adversely affect participants.

[1] See, e.g., CFTC Release: PR 5856-10 (July 21, 2010) (topic III); Speech by Chairwoman Mary Schapiro (July 27, 2010).

Accordingly, the issues addressed in this letter are of great importance to our members, to the pension plan system more generally, and to the economy. We look forward to working with you to ensure that the new rules strengthen plans, as intended, so that workers' retirement security is enhanced. It is critical that the new rules not be interpreted in such a way as to undermine such security.

Specifically, I am writing today with respect to new section 4s(h)(5) of the Commodity Exchange Act ("CEA") (as added by section 731 of the Dodd-Frank Act), which sets forth certain business conduct standards that the CFTC may impose on swap dealers and major swap participants ("MSPs") that offer to enter into or enter into a swap with a "special entity". That section provides:

> **(5) SPECIAL REQUIREMENTS FOR SWAP DEALERS AS COUNTERPARTIES TO SPECIAL ENTITIES.—**
>
> **(A) Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity shall—**
>
> **(i) comply with any duty established by the Commission for a swap dealer or major swap participant, with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of this Act, that requires the swap dealer or major swap participant to have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that—**
>
> **(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 transaction; and**
>
> **(VII) in the case of employee benefit plans subject to the Employee Retirement Income Security act [sic] of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002); and**
>
> **(ii) before the initiation of the transaction, disclose to the Special Entity in writing the capacity in which the swap dealer is acting; and**
>
> **(B) the Commission may establish such other standards and requirements as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in the furtherance of the purposes of this Act.**

A parallel provision with respect to security-based swaps is contained in section 15F(h)(5) of the Securities Exchange Act of 1934 (as added by section 764 of the Dodd-Frank Act)[2]. Our comments below apply equally to the CEA and the Securities Exchange Act.

Generally, a "special entity" is defined to mean a Federal agency, a State or local governmental entity, an employee benefit plan, a governmental plan, or an endowment. We are writing today with respect to employee benefit plans, including governmental plans. However, the statutory analysis is very different for plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and plans not explicitly subject to ERISA, such as governmental plans. Accordingly, we divide our discussion into two parts: ERISA plans and non-ERISA plans.

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[2] Section 15F(h)(5) provides as follows:

> (5) SPECIAL REQUIREMENTS FOR SECURITY-BASED SWAP DEALERS AS COUNTERPARTIES TO SPECIAL ENTITIES.—
>
> (A) IN GENERAL.—Any security-based swap dealer or major security-based swap participant that offers to or enters into a security-based swap with a special entity shall—
>
> (i) comply with any duty established by the Commission for a security-based swap dealer or major security-based swap participant, with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of the Commodity Exchange Act, that requires the security-based swap dealer or major security-based swap participant to have a reasonable basis to believe that the counterparty that is a special entity has an independent representative that—
>
> (I) has sufficient knowledge to evaluate the transaction and risks;
>
> (II) is not subject to a statutory disqualification;
>
> (III) is independent of the security-based swap dealer or major security-based 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 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); and
>
> (ii) before the initiation of the transaction, disclose to the special entity in writing the capacity in which the security-based swap dealer is acting.
>
> (B) COMMISSION AUTHORITY.—The Commission may establish such other standards and requirements under this paragraph as the Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act.

ERISA PLANS

I. How does clause (i) of new section 4s(h)(5)(A) apply with respect to ERISA plans?

By its terms, clause (i) of section 4s(h)(5)(A) quoted above only applies where the swap dealer or MSP's counterparty is "an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18)". Thus, clause (i) only applies where such counterparty is:

> (vii) (I) A governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity; [or]
>
> (II) A multinational or supranational government entity.

As written, clause (i) is initially limited to the above types of entities (referred to here as "governmental entities"). However, subclause (VII) refers to "employee benefit plans subject to the Employee Retirement Income Security act [sic] of 1974", and viewed in isolation imposes a rule on such plans. This sets up a potential inconsistency in the statute. Clause (i) only applies to governmental entities (which are not subject to ERISA), but subclause (VII) of clause (i) refers to plans subject to ERISA. The only way to reconcile this inconsistency is as follows. Clause (i) is generally limited to situations where the counterparty is a governmental entity. However, by reason of subclause (VII), ERISA plans are made subject to clause (i), but only with respect to the requirements of subclause (VII). Thus, where the counterparty is an ERISA plan, clause (i) requires that the swap dealer or MSP must have a reasonable basis to believe that the ERISA plan has a fiduciary as defined in ERISA.

This interpretation makes sense both from a technical perspective and from a congressional intent perspective. From a technical perspective, there is no statutory basis to apply any part of clause (i) to ERISA plans other than subclause (VII).

From a congressional intent perspective, this also makes sense. In order to function as a fiduciary under ERISA, a representative must satisfy, among other things, requirements that are similar to those set forth in subclauses (I)-(VI). There was accordingly no reason for Congress to apply overlapping rules to a fiduciary that is already highly regulated under ERISA.

Specifically, consider each of the requirements in section 4s(h)(5)(A)(i)(I)-(VI):

> **"(I) has sufficient knowledge to evaluate the transaction and risks".** See ERISA section 404(a)(1)(B), which requires ERISA fiduciaries to discharge their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims".

"(II) is not subject to statutory disqualification". Unless a representative satisfies ERISA's standards, such representative cannot legally be an ERISA fiduciary.

"(III) is independent of the swap dealer or major swap participant". See ERISA section 406(b), which prohibits a fiduciary from acting on behalf of a plan if it has conflicted loyalties, which would be the case if the plan's fiduciary were not independent of the opposing party to a swap.

"(IV) undertakes a duty to act in the best interests of the counterparty it represents". See ERISA section 404(a)(1) which provides in relevant part that a fiduciary must "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries [of the plan]".

"(V) makes appropriate disclosures". It is clear under ERISA that fiduciary duties include the duty to make all appropriate disclosures to the plan. *See, e.g.*, *Eddy v. Colonial Life Ins. Co. of Am.*, 919 F.2d 747 (D.C. Cir. 1990) (stating that "[t]he duty to disclose material information is the core of a fiduciary's responsibility").

"(VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction". Again, it is clear under ERISA that a fiduciary advising regarding a transaction must evaluate both the price and appropriateness of the transaction. *See, e.g.*, *California Ironworkers Field Pension Trust v. Loomis Sayles & Co.*, 259 F.3d 1036 (9th Cir. 2001) ("When applying the prudence rule, the primary question is whether the fiduciaries, 'at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.'") (quoting Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983)).

This analysis leads to a very logical result. Where a governmental entity is the counterparty, the swap dealer or MSP must have a reasonable basis to believe that the representative meets subclauses (I)-(VI). Since those subclauses relate to issues already addressed by ERISA with respect to ERISA fiduciaries, only subclause (VII) applies where an ERISA plan is the counterparty.

Thus, in the case of ERISA plans, compliance with clause (i) of section 4s(h)(5)(A) is very straightforward and logical. The swap dealer or MSP need only have a reasonable basis to believe that the plan's representative is "independent" (a requirement included in the language prior to subclause (I)) and is an ERISA fiduciary.

II. What is meant by the reference to a special entity having an "independent" representative?

The "independence" issue is clear. The representative advising the plan with respect to the swap must be independent of the swap dealer or MSP; there is no requirement that the representative be independent of the plan. This was squarely confirmed by a colloquy between Senators Blanche Lincoln (D-AR) and Tom Harkin (D-IA) on July 15, 2010 (Fed. Reg. S5903):

> Mrs. LINCOLN….Our intention in imposing the independent representative requirement was to ensure that there was always someone independent of the swap dealer or the security-based swap dealer reviewing and approving swap or security-based swap transactions. However, we did not intend to require that the special entity hire an investment manager independent of the special entity. Is that your understanding, Senator HARKIN?
>
> Mr. HARKIN. Yes, that is correct. We certainly understand that many special entities have internal managers that may meet the independent representative requirement….

Any other conclusion here would be inconsistent with Congressional intent—Congress certainly did not intend to cause plans across the country to dismantle efficient internal investment teams. Moreover, there is no policy reason to require representatives to be independent of the special entity. On the contrary, the objective is to ensure that the special entity is not relying on the swap dealer or MSP with respect to the swap.

In order for the swap dealer or MSP to have a reasonable belief that a plan's representative is independent of the swap dealer or MSP, the swap dealer or MSP must have a reasonable basis to believe that the representative is not controlled by, or under common control with, the dealer or MSP that is the plan's counterparty.

III. What does a swap dealer or MSP need to do in order to have a "reasonable basis" to believe that the specified requirements are satisfied?

It is critical that swap dealers and MSPs have a clear, simple, and administrable means of demonstrating the requisite "reasonable basis" required under clause (i) of section 4s(h)(5)(A). In many cases, a plan will enter into multiple swaps during a year with the same swap dealer or MSP. Swap dealers and MSPs need to have an efficient means of satisfying the reasonable belief requirement that does not entail costly and subjective due diligence with respect to every swap. Otherwise, plans' ability to use swaps would be materially affected, plans' costs would rise, and funding volatility could reach dangerous levels.

We would suggest the following safe harbor. If a swap dealer or MSP receives a written representation from the plan or its representative that (1) states that the plan's representative is independent of the swap dealer or MSP and is an ERISA fiduciary, and (2) states that the plan or its representative shall notify the swap dealer or MSP if at any time the representation becomes inaccurate, then the swap dealer or MSP can rely on such written representation for purposes of satisfying the reasonable belief standard until the swap dealer or MSP receives a contrary representation from either party. If the swap dealer or MSP receives the written representation from the representative, reliance would only be permitted with respect to swaps involving that representative.

One other point is very important. It should be made clear that the safe harbor representations do not give rise to any additional contractual rights. For example, assume that due to changing economic conditions, a swap between a swap dealer and a plan has become very disadvantageous for the swap dealer. The swap dealer should not be able, for example, to void the swap—or make any other type of claim against any party —by asserting that one or more of the representations made by the plan or its representative under clause (i) were incorrect. In other words, these business conduct standards—which were meant to protect plans—should not be permitted to be a weapon that can be used against plans or their representatives. Correspondingly, the swap dealer or MSP should be permitted to rely on such representations and should not have any liability or be exposed to the possibility of having the swap voided by reason of the representation turning out to have been incorrect.

In analogous situations, regulators have permitted reliance on certifications. For example, under Rule 144A, under the Securities Act, a seller of securities is entitled to rely on a certification by an executive officer of the purchaser that the purchaser meets the conditions necessary to establish that the purchaser is a qualified institutional buyer ("QIB"). Rule 144A (d)(1)(iv). The Adopting Release for Rule 144A states that: "[u]nless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification." Another example is Regulation EE issued by the Federal Reserve, which provides that a person will qualify as a "financial institution" (for netting purposes) if it represents orally or in writing that it meets the appropriate test. 12 CFR 231.3.

Under the language of these regulations, if the certification is reasonably obtained, the recipient of the certification may treat its counterparty as a QIB/financial institution. A subsequent determination that the certification was wrong will not retroactively void the QIB/financial institution status of the counterparty.

IV. What is needed for the swap dealer or MSP to satisfy the requirement in clause (ii) of section 4s(h)(5)(A) that it disclose to the plan the capacity in which it is acting?

The swap dealer or MSP should be permitted to make a one-time disclosure to the plan or its representative regarding the capacity in which it is acting with respect to swaps with the plan. Of course, if in a future swap a swap dealer or MSP functions in a different capacity—i.e., not as a counterparty—the swap dealer or MSP would be obligated to make a separate representation regarding the capacity in which it is acting with respect to that future swap.

NON-ERISA PLANS

There are questions as to whether clause (i) of section 4s(h)(5)(A) applies to non-ERISA plans, such as governmental plans, and if so, which provisions of such clause apply and which may be satisfied by ERISA-like requirements in relevant state statutes/ordinances. We defer on that issue to the governmental plan community. However, as advisors and representatives of governmental plans, we are keenly interested in ensuring that, to the extent clause (i) applies to governmental plans, it applies in an administrable and appropriate fashion.

Some of the analysis provided above with respect to ERISA plans applies equally to non-ERISA plans, i.e.:

- The definition of "independent";
- The means of satisfying the reasonable basis requirement; and
- The means of satisfying the requirement that the swap dealer or MSP disclose the capacity in which it is acting.

However, additional issues may apply to non-ERISA plans by reason of the application of subclauses (I)-(VI). Those issues are addressed below.

I. What is needed for a swap dealer or MSP to have a reasonable basis to believe that a special entity's independent representative (a) has "sufficient knowledge to evaluate the transaction and risks", (b) "undertakes a duty to act in the best interests of the counterparty it represents", and (c) "makes appropriate disclosures"?

As discussed above, it is critical that swap dealers and MSPs not be required to do burdensome and unnecessary due diligence, such as, in this case, detailed investigations regarding whether a representative makes "appropriate" disclosures. A written representation described above from the plan or its representative should be sufficient if it states that the requirements in section 4s(h)(5)(A)(i) regarding the representative's knowledge, duties, and disclosure practices are satisfied[3]. A different rule would not only be extremely burdensome, but would also give swaps dealers and MSPs a potential tool to exercise inappropriate control over the opposing party in a swap. Swap dealers and MSPs could decide which representatives were knowledgeable, act in the best interests of their counterparty, and make appropriate disclosures. This would give swap dealers or MSPs inappropriate power over their counterparty's selection of a representative. It is critical that plans retain the ability to protect themselves.

II. What is needed for a swap dealer or MSP to have a reasonable basis to believe that the independent representative "will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction"?

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[3] Where the representative makes a representation, it should be permitted for the representative to do so in a way applicable to all of its plan clients—such as on its website—as opposed to on a plan by plan basis.

A written representation described above from the plan or its representative should be sufficient if the representation states that the representative is obligated, by law and/or contract, to review pricing and appropriateness with respect to any swap transaction in which the representative serves as such with respect to the plan. In this regard, it is critical to clarify one point. While it is very important that every swap be reviewed with respect to pricing and appropriateness (and that existing swaps be monitored appropriately), the CFTC and the SEC should not impose any requirement that the representative provide a separate opinion on pricing and appropriateness for each and every swap entered into by plans. That would be very costly and very disruptive. Where swaps are used to hedge risk, swap transactions can be entered into with some regularity. To require separate formal opinions regarding pricing and appropriateness would make it extremely difficult to execute swaps as needed to fit plans' investment objectives. In fact, such a requirement would drive up plan costs materially and cause plans to have to reduce their use of swaps, thereby hurting participants and exposing the company sponsoring the plan to far greater risks and funding volatility. Moreover, there is no reason for separate opinions for each swap. If the representative is contractually or legally obligated to review pricing and appropriateness, the law would only be adding time and expense by requiring a separate opinion letter regarding every swap.

We very much appreciate your consideration of our views.

Sincerely,

Lynn D. Dudley
Senior Vice President, Policy

cc:

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September 20, 2010

Mr. David A. Stawick
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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
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Re: File Number S7--16-10 / Definitions of major swap participant and major security-based swap participant

Dear Mr. Stawick and Ms. Murphy:

The American Benefits Council (the "Council") and the Committee on the Investment of Employee Benefit Assets ("CIEBA") appreciate this opportunity to provide comments to the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC," and collectively, the "Commissions") regarding the definitions of the terms "major swap participant" and "major security-based swap participant" in the Wall Street Transparency and Accountability Act of 2010 (the "Act" or "WSTAA").

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. CIEBA represents more than 100 of the country's largest pension funds. Its members manage more than $1 trillion of defined benefit and defined contribution plan assets, on behalf of 15 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

Swaps and security-based swaps play a critical role for our members' plans. If plans were considered to be major swap participants or major security-based swap participants ("major participants"), plans would have to set aside capital that could otherwise be paid out to retirees and beneficiaries or that could be invested in higher expected return assets such as stocks or bonds. Plan fiduciaries might then opt to avoid using otherwise prudent swaps.

Pension plans use swaps to manage risk and to reduce the volatility of the plan funding obligations imposed on the companies maintaining the plans. If swaps and security-based swaps were to become materially less available or become significantly more costly to pension plans, funding volatility could increase substantially, forcing companies in the aggregate to reserve billions of additional dollars to satisfy possible funding obligations, most of which may never need to be contributed to the plan because the risks being reserved against may not materialize. Those greater reserves would have an enormous effect on the working capital that would be available to companies to create new jobs and for other business activities that promote economic growth.

The issues we raise regarding the major participant definitions are of great importance to our members, to the plan system generally, and to the economy. We look forward to working with you to ensure that the new rules strengthen financial regulations in a manner that enhances workers' retirement security. It is critical that the new rules not be interpreted in a way that undermines such security.

Summary of MSP Issues

Many plans regulated by the Employee Retirement Income Security Act of 1974 ("ERISA") use swaps to hedge or mitigate the risks endemic to plan liabilities and investments, and such plans conduct these swap transactions through fiduciaries regulated under ERISA. Congress intended to permit plans (including investment vehicles held by plans) to continue to use swaps in this manner and, for this reason, expressly carved out swaps maintained for plans from the "substantial position" statutory threshold that subjects major participants to comprehensive and costly regulation. The Commissions should give full effect to these statutory provisions by:

- For all swaps:
  - Prong one of the major participant definitions (see pages 5-10):
    - Confirming that all swaps relating to asset/liability hedging fall within the plan swap exclusion;
    - Clarifying that swaps entered into primarily to mitigate any plan risks are eligible for the plan swap exclusion;
    - Clarifying that swaps maintained in trust accounts and other vehicles are subject to the statutory exclusion for plans' swaps; and
    - Applying the plan swap exclusion to appropriate foreign-based plans.
  - Prong two (see page 11):
    - Confirm that plans will not become major participants under prong two because they will never create systemic risk; and
  - Prong three (see page 10):
    - Confirm that plans will not become major participants under prong three because they are not "highly leveraged" relative to the amount of capital they hold.
- For uncleared swaps (see pages 9-10):
    - Excluding uncleared plan swaps with four specified protections from the "substantial position" calculation.
- For cleared swaps (see page 10):

- Excluding cleared swaps from the "substantial position" calculation.

Summary of Critical Issues Separate from MSP Status

- For cleared swaps (see pages 11-13):
  - Strengthening clearing systems to allow plans to maintain, separate from other customers, fully collateralized accounts with clearing members, thereby further enhancing the case for excluding cleared swaps from the substantial position analysis.
- For uncleared swaps (see pages 13-16):
  - Clarifying the ability of plans to continue to use third-party custodians to segregate all uncleared swap collateral;
  - Confirming that plans are permitted to enter into swaps that prohibit dealers and major participants from investing or using uncleared swap collateral.

The Unique Nature of ERISA Plans

It is hard to contemplate a counterparty that is less of a risk to the financial stability of the United States or any dealer than ERISA plans. ERISA plans have met their swap obligations to dealers despite the bankruptcy of Fortune 500 plan sponsors, the market crash of 2008, and every other significant financial event since the adoption of ERISA in 1974. There are a number of reasons for the uniqueness of ERISA plans.

- ERISA plans are required to be prudently diversified. In entering into swaps for plans, ERISA requires that plan fiduciaries act solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence that a prudent person familiar with such matters would use.[1]
- “Investment managers” for ERISA plans are required to be regulated entities (registered investment advisers, banks, or insurance companies) that are (1) subject to the highest standard of care under U.S. law, (2) liable for significant financial penalties for failure to comply with relevant provisions of ERISA, and (3) liable in many instances for the acts of other fiduciaries.[2]
- ERISA plan assets are required to be held in trust for future payment, subject to the oversight of a trustee which is typically a U.S. regulated bank.[3]
- Because of the regulatory structure that applies to ERISA plans, subject to one narrow exception, it would be rare—if it occurs at all—for plans to be highly leveraged.[4] It is for

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1 ERISA section 404(a)(1)(B).

2 ERISA sections 3(38) (investment manager requirements), 404(a) (fiduciary standards), 405 (co-fiduciary liability), 409 (fiduciary liability), 502 (ERISA enforcement).

3 ERISA section 403(a).

4 Although not flatly prohibited, plans generally do not borrow (outside of special very narrow circumstances regarding loans used to acquire employer securities in certain types of defined contribution plans called

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this reason that whenever adverse market conditions result in a demand that a plan post collateral (typically high-quality collateral) on its swap or security-based swap, the assets in the plan's portfolio are available to meet that demand.

- ERISA plans are financially transparent; they typically have third-party custodians report their net asset value to dealers on a monthly basis and are required by law to report their holdings annually to the Department of Labor.[5]
- ERISA plans are not operating entities subject to business-line risks and competitive challenges.
- There is no provision under any law for ERISA plans to file for bankruptcy or reorganization to avoid their financial obligations to counterparties. Even the filing of bankruptcy by an ERISA plan sponsor or the involuntary termination of the plan does not relieve a plan of its financial obligations to counterparties. In fact, in an involuntary termination, the counterparty has a priority claim with respect to the plan's obligation to it.

Because of the foregoing factors, many dealers treat ERISA plans as if they were AAA-rated entities for credit analysis purposes. The low-risk nature of ERISA plans has been reflected in prior CFTC regulations.[6] To date, the CFTC has relied on ERISA's "pervasive" regulation of plans and plan fiduciaries as the reason it does not need to regulate these plans.[7] Regulating ERISA plans as major participants could, at best, result in duplicative regulation, and more likely, result in conflicting regulation that could cause confusion and harm to plans.[8]

Definitions of Major Swap Participant and Major Security-based Swap Participant

As Treasury Secretary Geithner has testified, the intent of the WSTAA is to "subject all dealers in OTC derivatives markets and any other firms whose activities in those markets pose a ***systemic threat*** to a strong regulatory and supervisory regime as ***systemically important*** firms."[9] Consistent with Secretary Geithner's testimony, the Act will impose robust regulation on any entity, whether or not that entity is a dealer, whose swaps and security-based swaps could pose a systemic threat to the stability of our country's financial system.

Secretary Geithner also testified that a key element of addressing systemic risk is to "establish and enforce substantially more conservative capital requirements for institutions that

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"ESOPs"). Using borrowed funds for investment purposes may trigger unrelated business taxable income. See Internal Revenue Code section 514; IRS Rev. Rul. 74-197. Borrowing must also satisfy ERISA's requirements, including the requirement that the decision to borrow be made prudently. The end result is that plans generally do not borrow.

5 See Form 5500.

6 See, for example, CFTC Rule 4.5.

7 *See* 50 Fed. Reg.15868, 15869 and 15873 (1985); 58 Fed. Reg. 6371, 6373 (1993).

8 Our comments are limited to ERISA-regulated plans, unless specifically noted otherwise. We are not speaking for governmental plans.

9 Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <http://www.treas.gov/press/releases/tg71.htm> (last accessed September 3, 2010) (emphasis added).

pose potential risk to the stability of the financial system."[10] In establishing the capital and margin requirements that shall apply to dealers and major participants, WSTAA itself states that the intent is "[t]o offset the greater risk to the swap dealer or major swap participant and the financial system."[11] The Act also imposes business conduct and sales practice rules upon dealers and major participants.[12]

There is significant cost associated with these regulations as considerable resources must be invested in order to comply with such comprehensive requirements. Congress acknowledged this cost and the unintended consequences of overextending this regulation by limiting its application to those entities whose swaps and security-based swaps could threaten the stability of our country's financial system—dealers and major participants.

This cost is particularly burdensome in the case of plans that could otherwise use reserved capital to pay benefits and/or invest more appropriately. Applying the capital requirements to plans would thus have a very adverse effect on workers, retirees, and their benefits.

We ask that the Commissions interpret the terms related to the major participant definitions in accordance with Congressional intent to prevent systemic risk in a manner that recognizes the limited risk posed by plans.

Exclusions For Hedging Or Mitigating Risk

The first prong of the three-part major participant definitions[13] provides two exclusions for hedging or mitigating risk. The first exclusion from substantial position covers "*positions*

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10 Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <http://www.treas.gov/press/releases/tg71.htm> (last accessed September 3, 2010).

11 New CEA Section 4s(e)(3)(A), as established by WSTAA Section 731; equivalent security-based swap version at new SEA 15F(e)(3)(A), as established by WSTAA Section 764(a). For capital and margin requirements generally, see new CEA Section 4s(e), as established by WSTAA Section 731, and new SEA 15F(e), as established by WSTAA Section 764(a).

12 New CEA Sections 4s(f), 4s(g), 4s(h), 4s(i), 4s(j), and 4s(k), as established by WSTAA Section 731; New SEA Sections 15F(f), 15F(g), 15F(h), 15F(i), 15F(j), and 15F(k), as established by WSTAA Section 764(a).

13 MSP is defined in full (under new CEA Section 1a(33), as established by WSTAA 721(a)(16)) as follows:
"*MAJOR SWAP PARTICIPANT.—*
(A) IN GENERAL.—The term 'major swap participant means any person who is not a swap dealer, and—
(i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding—
(I) positions held for hedging or mitigating commercial risk; and
(II) positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan;
(ii) whose 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; or
(iii)(I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and
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held for hedging or mitigating commercial risk."[14] Chairman Peterson, Chairman of the House Agriculture Committee, intended a broad interpretation of commercial risk as evidenced by his comment in the legislative record that "few, if any, end users will be major swap participants, *as we have excluded* "*positions held for hedging or mitigating commercial risk*" from being considered a "substantial position" under that definition."[15] We ask that the Commissions adopt a rule defining the term "commercial risk" in a manner consistent with this Congressional intent.[16]

To ensure that plans would not become major participants, the second exclusion from substantial position covers "*positions maintained by any employee benefit plan (or any contract held by such plan) as defined in paragraphs (3) and (32) of section 3 of [ERISA] for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.*"[17] By providing this plan-specific exclusion, Congress clearly stated its intent "to avoid doing any harm to plan beneficiaries."[18] As noted by Senator Lincoln, Chairwoman of the Senate Agriculture Committee and a key author of the Act,

> "it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or major security-based swap participant. . . . [E]mployee benefit

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> *(II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission."*
>
> *"(B) DEFINITION OF SUBSTANTIAL POSITION.—For purposes of subparagraph (A), the Commission shall define by rule or regulation the term 'substantial position' at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States. In setting the definition under this subparagraph, the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps and may take into consideration the value and quality of collateral held against counterparty exposures.*
>
> *"(C) SCOPE OF DESIGNATION.—For purposes of subparagraph (A), a person may be designated as a major swap participant for 1 or more categories of swaps without being classified as a major swap participant for all classes of swaps.*
>
> *"(D) EXCLUSIONS.—The definition under this paragraph shall not include an entity whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured by the parent company or another subsidiary of the parent company."*

The MSSP definition under new SEA Section 3(a)(67), as established by WSTAA Section 761(a)(6) is identical to the MSP definition, except that the MSSP definition relates to ***security-based swaps*** maintained by a person who is not a ***security-based swap dealer*** and does not include the exclusion found in (D) of the MSP definition.

14 New CEA 1a(33)(i)(I), as established by WSTAA Section 721(a)(16); New SEA Section 3(a)(67)(A)(ii)(I), as established by WSTAA Section 761(a)(6).

15 Representative Peterson, Congressional Record–House, June 30, 2010, H5248 (emphasis added).

16 WSTAA Sections 721(b) and 761(b)(1).

17 New CEA 1a(33)(i)(II), as established by WSTAA Section 721(a)(16); New SEA Section 3(a)(67)(A)(ii)(I), as established by WSTAA Section 761(a)(6).

18 Senator Lincoln, Congressional Record-Senate, July 15, 2010, S5906.

> plans are already subject to extensive regulation relating to their usage of swaps."[19]

When establishing the criteria for swaps that are excluded from the substantial position analysis, we request that the Commissions clarify three points, consistent with these statements of Congressional intent.

First, ERISA requires that all plan assets be held in trust. In light of this requirement, we request that the Commissions confirm that the Act's plan exclusion will apply to positions held in trust as "plan assets," including by entities such as master trusts and group trusts. To find otherwise would make this plan exclusion meaningless.

Second, the Act's plan exclusion applies to all swaps and security-based swaps maintained by an ERISA plan "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Congress included two separate uses of swaps that would satisfy the exclusion: hedging and mitigating. The term "hedging" in the context of a pension plan would clearly include, for example, hedging the interest rate exposure associated with the asset-liability profile of a pension fund. The mismatch between the interest rate sensitivity of the plan's promised payments to its beneficiaries (i.e., the plan's liabilities) and its investments is one of the single biggest risks facing pension plans. Moreover, there may be other investment-related risks that the plan wishes to hedge, such as currency risk.

By including "or mitigating" in the statutory language, Congress expanded this exclusion beyond the traditional hedges noted above to include other forms of managing risk. Congress recognized that swaps used for risk management also should be covered by the plan exclusion. We ask that the Commissions take into account the many risks directly associated with the operation of the plan that a plan fiduciary traditionally hedges or mitigates through the use of swaps or security-based swaps. These traditional hedges and risk-mitigation activities include:

- hedging the interest rate exposure associated with the asset-liability profile of a plan;
- hedging foreign exchange translation risk of non-U.S. denominated securities;
- matching asset cash flow with expected liabilities;
- hedging the risk of adverse price changes in stocks, bonds or other assets held by the plan;
- mitigating the risk of non-diversification by gaining exposure to traditional or alternative asset classes or financial markets;
- rebalancing investments to a policy target, thus diminishing the risk of varying from the stated investment policy and/or not being prudently diversified as required by ERISA;
- controlling the risk of volatility in plan assets and reducing the funded status volatility of a pension plan.

Each of these risks can directly impact the financial health and viability of a plan. A plan fiduciary's reduction and management of these risks will be viewed as prudent (and in many cases, required) by ERISA. As so many plans today use these kinds of risk hedging and

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[19] Senator Lincoln's Colloquy, July 15, 2010, S5907.

management strategies, it is fair to say that the Congressional intent underlying the plan exclusion could be frustrated unless the Commissions recognize in their rulemakings that the plan exclusion applies to swaps used for these purposes.[20]

In short, if any plan swap is done to hedge or mitigate risk as discussed above, such swap should clearly be excluded in determining whether the plan maintains a "substantial position" under the first prong of the major participant definition.

If any plan swaps are taken into account in determining whether the plan has a substantial position under the first prong, such swaps should be taken into account based on the aggregate amount the plan would owe its counterparties (net of collateral posted and other contractual obligations) if the swaps were terminated early. This figure would be determined over an averaging period, such as a quarter, to avoid permitting quirky volatility from affecting the analysis. All that being said, it is hard for us to imagine that plans could ever have a substantial position under the statutory rule, consistent with Congressional intent.

Third, the Act's plan exclusion covers employee benefit plans as defined in paragraphs (3) and (32) of section 3 of ERISA. This definition of "employee benefit plan" does not include foreign plans (but does include U.S. plans maintained by foreign sponsors). Many of our members have foreign affiliates, and foreign plans are maintained for the benefit of those affiliates' employees. If a foreign plan is subject to regulation in its home country and a swap is entered into in the United States on behalf of the foreign plan for the primary purpose of hedging or mitigating any risk associated with the operation of the plan, we ask that the Commissions clarify that such swaps will not be counted towards the plan's substantial position, to the extent that the WSTAA applies. We understand that the level of regulation may vary by jurisdiction, but we believe that the Commissions should, at the very least, recognize the equivalent regulatory oversight of Canada, the United Kingdom, and EU jurisdictions.

Substantial Position

The first and third prongs of the three-part major participant definitions revolve around the term "***substantial position***." Under both prongs, a non-dealer who "maintains a substantial position in swaps for any of the major swap categories as determined by the Commission" may be a major participant. As stated in the WSTAA, Congress has directed the Commissions to define the term substantial position "*at the threshold that the Commission determines to be prudent for the effective monitoring, management, and oversight of entities that are* ***systemically important*** *or* ***can significantly impact the financial systems of the United States***."[21]

"*Systemically important"* is not defined in the Act, but the plain words of the statute and the legislative history noted above both point directly to systemic risk. That is, a person is

[20] Congressional Record–House, June 30, 2010, H5248.

[21] New CEA Section 1a(33)(C), as established by WSTAA Section 721(a)(16) (emphasis added); New SEA Section 3(a)(67)(B), as established by WSTAA Section 761(a)(6) (emphasis added).

systemically important if that person's failure in a major swap category would "pose[s] potential risk to the stability of the financial system."[22]

When establishing the substantial position threshold, the Act requires the Commissions to consider other factors that affect systemic risk. One such factor is whether the swap is cleared. WSTAA mandates that, "*[i]n setting the definition [substantial position], the Commission shall consider the person's relative position in uncleared as opposed to cleared swaps*."[23] When determining a person's uncleared swap positions, we request that regulators not view all uncleared swaps to represent the same level of risk, but rather analyze the systemic risk of an entity's swap positions by considering: (i) the regulatory oversight of such entity (*e.g.,* plans are regulated under ERISA); (ii) whether such person is leveraged after taking into account that person's available capital; (iii) whether adequate collateral is contractually required to be posted in a timely manner after material market movements; and (iv) the quality of collateral posted.

Substantial position - Uncleared Swaps

The amount of systemic risk varies tremendously within the universe of uncleared swaps. Uncleared swaps for which neither party posts any collateral pose the most systemic risk of all swaps. Here, if one of the two parties to such a swap defaults on its obligations for that swap, the other party's recourse is limited to that of an unsecured creditor in bankruptcy. To reduce risk when entering into an uncleared swap, many market participants (including employee benefit plans and registered investment companies as noted by Senator Lincoln) "typically post collateral."[24]

The terms of collateral arrangements vary widely and impact greatly the amount of risk that collateralization minimizes, which explains the rationale for the provision in the Act that authorizes the Commissions to consider "*the value and quality of collateral held against counterparty exposures*."

When plans enter into an uncleared swap, the amount of collateral usually required will be an agreed-upon portion (often 100%, disregarding de minimis market movements) of the current market value of the amount that a party would owe if the swap became due (which value will change based on daily market movements). The greater the value of collateral posted by a party, the less risk the other party has that the posting party would be unable to pay what it owes on the swap when it becomes due. The less time a party has to post collateral after an adverse market movement, the less risk the other party incurs. When an uncleared swap is 100% or "fully" collateralized (other than with respect to de minimis market movements), risk can be effectively negated.

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22 Secretary of Treasury Timothy Geithner, Written Testimony for the House Financial Services Committee Hearing, March 26, 2009, available at <http://www.treas.gov/press/releases/tg71.htm> (last accessed September 3, 2010)..

23 New CEA 1a(33)(B), as established by WSTAA Section 721(a)(16); Equivalent text applicable to MSSPs is provided as new SEA 3(a)(67)(B), as established by WSTAA Section 761(a)(6).

24 Senator Lincoln, Congressional Record-Senate, July 15, 2010, S5907.

Whenever parties agree to post collateral, the parties also agree upon the types and quality of collateral that may be posted. Parties may further minimize risk of an uncleared swap by limiting acceptable collateral to securities whose value is considered stable. For example, many plans only accept cash (in stable currencies) and U.S. Government obligations.[25]

In this context, for purposes of determining whether a party has a "substantial position" in swaps, we ask that the Commissions acknowledge and promote risk reduction practices, such as the kinds discussed above, by excluding, for purposes of determining whether a party has a "substantial position" in swaps, an uncleared swap that has all the following four characteristics:

- the party is subject to regulatory oversight (*e.g.,* plans regulated under ERISA);
- the party is unleveraged after taking into account its available capital;
- the uncleared swap is adequately collateralized in a timely manner after material market movements; and
- all collateral is cash (in stable currencies) or high-quality investments (such as U.S. Government obligations).

Because an uncleared swap that meets all of these criteria poses little counterparty risk and therefore effectively no systemic risk to our country's financial system, such an uncleared swap should not be counted towards a person's substantial position threshold for purposes of the major participant determination.

Substantial position - Cleared Swaps

As Chairman Gensler has stated, "[c]learinghouses have effectively reduced risk since they were first developed in the futures markets in the late Nineteenth Century."[26] Indeed, clearing a swap can dissipate counterparty exposure by mutualizing counterparty risk among the clearinghouse's clearing members. Regulated clearinghouses have a laudable record for financial integrity subject to the oversight of the Commissions. Congress therefore was on solid ground in the Act when it encouraged the Commissions, in effect, not to count cleared swaps towards the substantial position threshold for major participant purposes. We strongly support that result for cleared swaps.

<u>Leverage</u>

The third prong of the major participant definitions only applies to persons that are highly leveraged. Plans will rarely, if ever, be "highly leveraged" under any definition developed by the Commissions. In fact, outside of the specialized context of "ESOPs" (a type of defined contribution plan that is specifically permitted to use borrowed funds to buy employer securities), the signatories to this letter are unaware of any plan that could possibly be considered highly leveraged.

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[25] Similarly, many mutual funds insist that collateral be posted only in the form of cash (in stable currencies) and U.S. Treasury obligations.

[26] Remarks of Chairman Gary Gensler, Over-the-Counter Derivatives Reform, Institute of International Bankers Washington Conference, March 1, 2010.

<u>Substantial Counterparty Exposure</u>

The second prong of the major participant definitions captures non-dealers "*whose 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.*" Any fear that a plan could default on its derivative obligations and have a meaningful effect on the financial stability of the U.S. banking system, financial markets, or any counterparty is misplaced and is not supported by the history of plans regulated under ERISA or the experience of any dealer counterparty. The unique attributes of plans (outlined at the beginning of this letter) 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*." We respectfully request that the Commissions' regulations regarding "substantial counterparty exposure" for purposes of the second prong of the major swap participant definitions exclude positions of plans regulated under ERISA.

In any event, in determining whether plans can give rise to substantial counterparty exposure that could threaten the financial markets, all cleared swaps should be disregarded, as should all uncleared swaps with respect to which, as discussed above:

- the party is subject to regulatory oversight (*e.g.*, plans regulated under ERISA);
- the party is unleveraged after taking into account its available capital;
- the uncleared swap is adequately collateralized in a timely manner after material market movements; and
- all collateral is cash (in stable currencies) or high-quality investments (such as U.S. Government obligations).

<u>Other Issues Critical to the Protection of Plans.</u>

We have discussed above why plans’ swap positions pose very little risk. In fact, many plans would like to go further and ensure that they have even less risk. That is certainly consistent with the intent of the legislation. In that context, we offer the following recommendations.

<u>Allow Plans to Elect the Same Protections with Respect to Cleared Swaps That They Now Have with Respect to Uncleared Swaps.</u> While cleared swaps will generally pose less of a systemic risk threat than many uncleared swaps, current clearing systems do expose plans to some risks that many uncleared swaps currently do not experience. These are risks the Commissions and the clearinghouses could remove by adopting changes in current clearing practices. If these reforms were to be implemented, it would greatly strengthen the case for excluding cleared swaps from the "substantial position" threshold determination. A description of these risks and proposed solutions follows.

First, with respect to unclear swaps, plans generally do not post initial margin. Thus, the initial margin requirements associated with clearing create new risks to plans, risks that are exacerbated by the way margin is held in the clearing context, as discussed below.

With a cleared swap, margin posted by a customer to its clearing member is posted by the clearing member to the clearinghouse, where it is held in a single aggregate customer account at the clearinghouse for all of the clearing member's customers' swaps. This potentially places the customer's margin at risk if one of the other customers who has margin held in that same account defaults and neither the clearing member nor the clearinghouse system can make up the shortfall.[27] For example, if ten customers have swap positions cleared by the same clearing member at a particular clearinghouse and one of those ten customers defaults on its swaps, the margin that the clearing member posted to the clearinghouse on behalf of the remaining nine customers could be used to satisfy the shortfall of the clearing member's defaulting customer after certain other resources are used.

This is especially troubling to plans as the level of this risk will not be transparent to the plan fiduciary. A plan fiduciary will never know who the clearing member's other customers are nor the amount of margin involved. As the plan fiduciary will not be able to assess the creditworthiness of its clearing member's other customers, it will therefore have less information upon which to determine the plan's own credit risk.[28]

Moreover, because of the WSTAA clearing mandates, dealers will have more customers and more assets in their pooled customer margin accounts, which, by virtue of statistical probability, increases the likelihood that there will be a defaulting customer in the pooled margin account. In this regard it is important to remember that the volume of trading on futures exchanges has recently only been a fraction of the total size of the derivatives market. It has been estimated that only 16% of the outstanding derivatives market is now traded on exchanges.[29] It is contemplated that a significant portion of the remaining 84% of the global derivatives market will move to clearing platforms in response to the WSTAA clearing requirement. Even if only 50% of the over $600 trillion swap market moves to clearing platforms, this will represent a nearly 300% increase in the amount of trading on clearing platforms and a corresponding increase in the risk of a default by a customer in a margin account. Importantly, this volume will:

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[27] In contrast, where a triparty custodian is used for uncleared swaps, segregated collateral is posted by each party to an account created specifically for, and only used by, the party posting the collateral.

[28] Before entering into a swap (or security-based swap) on behalf of a pension plan, Department of Labor directives require a plan fiduciary to evaluate the plan's credit risk, market risk, operational risk and legal risk by:

- Considering how the swap fits within the plan's portfolio and investment policy and its potential exposure to loss;
- Securing sufficient information to analyze the plan's credit risk, and the effects of market risk on the plan's portfolio and its overall risk using an appropriate methodology;
- Determining whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan's derivatives activity; and
- Ensuring the plan has proper written documentation.

U.S. Department of Labor letter to Comptroller of the Currency, March 2, 1996.

[29] "The Global Derivatives Market: An Introduction," Deutsche, Boise/Eurex White Paper, April 2008.

(i) increase to unprecedented levels the ratio of the amount traded on the exchanges to the capital of clearing members, and thus the likelihood that a default could occur that would exceed the available capital of all the clearinghouse's members;

(ii) increase the number of clearing members that could default and impact the clearinghouse and any default guarantee fund;

(iii) increase the number of new types of contracts traded on exchanges, which contracts contain risks to which the clearinghouse had not been previously exposed, thus reducing the historical confidence in the clearinghouse margin and default fund arrangements; and

(iv) increase the number of customers that could default in a combined customer margin account and potentially impact other customers' margin.

It is not unrealistic to contemplate a scenario where a single clearing member or small number of clearing members represent a significant portion of a contract's market, e.g., credit default contracts. If the volume of trading expands exponentially and only a few members' capital is relied upon to pay a significant portion of the clearinghouse margin and the clearinghouse default guarantee fund, the risks discussed above are materially heightened.

Given (1) the fact that plans do not generally post initial margin in the OTC context, (2) the ability of plans to negotiate protections today for margin in segregated and fully collateralized third-party custodian accounts in the OTC context, and (3) as discussed above, the increased risks to plans' margin in clearing platforms, we ask that the Commissions provide a plan with the ability to elect that a separate account be maintained by the clearing member at the clearinghouse on its behalf and that the margin in such accounts not be available under any circumstances to satisfy the default of any other clearing member customer or of a clearing member. In addition, we request that the margin account requirements applicable with respect to plans making such an election be sufficient to "replicate" the collateral protections that plans can negotiate for in the OTC context where such OTC accounts contain high-quality collateral that is segregated with a third-party custodian for the benefit of the secured party (including interest thereon), held in the United States, and protected from rehypothecation, borrowing or lending by the dealer. The implementation of these protections for plans would ameliorate the risks described above and further solidify the rationale for not counting a plan's cleared swaps when determining whether a plan maintains a substantial position.

Preservation of Plans' Ability to Negotiate for Greater Security in the Case of Uncleared Swaps. While some swap counterparties agree to post collateral directly to each other, others insist that all collateral be segregated and held by a third-party custodian that is not affiliated with either party. This use of a third-party custodian can further protect the collateral posted if one of the two parties files for, or otherwise finds itself in, bankruptcy. Congress recognized the importance of collateral segregation and the use of a third-party custodian by including a provision in the WSTAA that preserves the ability of plans and other end users to insist on segregation and use of a third-party custodian for uncleared swaps. In pertinent part, the Act provides:

"At the request of a counterparty to a swap that provides funds or other property to a swap dealer or major participant to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall—
(i) segregate the funds or other property for the benefit of the counterparty; and
(ii) in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the swap dealer or major swap participant.

. . .

The segregated account described [above] shall be—
(A) carried by an independent third-party custodian; and
(B) designated as a segregated account for and on behalf of the counterparty."[30]

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[30] WSTAA Section 724(c) provides in full:

(c) SEGREGATION REQUIREMENTS FOR UNCLEARED SWAPS.— Section 4s of the Commodity Exchange Act (as added by section 731) is amended by adding at the end the following:

''(l) SEGREGATION REQUIREMENTS.—

''(1) SEGREGATION OF ASSETS HELD AS COLLATERAL IN UNCLEARED SWAP TRANSACTIONS.—

''(A) NOTIFICATION.—A swap dealer or major swap participant shall be required to notify the counterparty of the swap dealer or major swap participant at the beginning of a swap transaction that the counterparty has the right to require segregation of the funds or other property supplied to margin, guarantee, or secure the obligations of the counterparty.

''(B) SEGREGATION AND MAINTENANCE OF FUNDS.—At the request of a counterparty to a swap that provides funds or other property to a swap dealer or major swap participant to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall—

''(i) segregate the funds or other property for the benefit of the counterparty; and

''(ii) in accordance with such rules and regulations as the Commission may promulgate, maintain the funds or other property in a segregated account separate from the assets and other interests of the swap dealer or major swap participant.

''(2) APPLICABILITY.—The requirements described in paragraph (1) shall—

''(A) apply only to a swap between a counterparty and a swap dealer or major swap participant that is not submitted for clearing to a derivatives clearing organization; and
''(B)(i) not apply to variation margin payments; or
''(ii) not preclude any commercial arrangement regarding—
''(I) the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation; and
''(II) the related allocation of gains and losses resulting from any investment of the segregated funds or other property.
''(3) USE OF INDEPENDENT THIRD-PARTY CUSTODIANS.—The segregated account described in paragraph (1) shall be—
''(A) carried by an independent third-party custodian; and
''(B) designated as a segregated account for and on behalf of the counterparty.
''(4) REPORTING REQUIREMENT.—If the counterparty does not choose to require segregation of the funds or
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Although this provision does "not apply to variation margin payments,"[31] for years, some plans have insisted that all of their collateral be segregated and held by an independent, third-party custodian.[32] It would be a perverse result indeed if the limited scope of this provision cost these plans the additional protection of segregated variation margin for uncleared swaps. That would mean that the WSTAA would have the result of reducing the security and stability of the swap system. Rather, consistent with the Act's goal of reducing systemic risk to the financial markets of the United States, we request that the Commissions clarify that the limited application of this provision was not intended to suggest that plans' variation margin or mark-to-market collateral for uncleared swaps could no longer be segregated as a matter of contract. The surest way for the Commissions to help preserve existing variation margin segregation practices is to adopt regulations that permit these plans to retain their ability to insist that variation margin be segregated and held by a third party custodian.

One additional layer of protection insisted upon by some plans is prohibiting borrowing, lending, or rehypothecating collateral.[33] Rehypothecation of collateral posted by a plan for uncleared swaps may diminish the plan's rights to recover this collateral in the event of a dealer bankruptcy. For example, if a dealer is permitted to rehypothecate and, accordingly, transfers such collateral to a secured creditor of the dealer, and the dealer then enters bankruptcy, custodial claimants may well only have a proprietary claim to the extent of any excess remaining after the dealer's obligation to its secured creditor is fully satisfied. Many investors who thought they had "collateralized" swap positions with Lehman suffered serious losses when they realized that their arrangements permitted Lehman to rehypothecate posted collateral.

There is ample authority in the WSTAA for the Commissions to adopt rules allowing parties to prohibit such rehypothecation, borrowing or lending of collateral for uncleared swaps. The Act expressly states that the provisions regarding segregation of uncleared swap collateral or uncleared security-based swap collateral shall "not preclude ***any*** commercial arrangement regarding . . . the investment of segregated funds or other property that may only be invested in such investments as the Commission may permit by rule or regulation[.]"[34] This plainly allows swap parties to prohibit the use of uncleared collateral by contract. Accordingly, we ask that the Commissions preserve and confirm the ability of plans to prohibit dealers and major participants

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other property supplied to margin, guarantee, or secure the obligations of the counterparty, the swap dealer or major swap participant shall report to the counterparty of the swap dealer or major swap participant on a quarterly basis that the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements are in compliance with the agreement of the counterparties.''

Equivalent text applicable to security-based swap dealers and MSSPs is provided as new SEA Section 3E(f), as established by WSTAA Section 763(d).

31 New CEA 4s(l)(2)(B)(i), as established by WSTAA Section 724(c); New SEA Section 3E(f)(2)(B)(i), as established by WSTAA Section 763(d).

32 Similarly, some mutual funds use independent third-party custodians for their swaps' collateral.

33 Similarly, some mutual funds prohibit the borrowing, lending, or rehypothecating of collateral.

34 New CEA Section 4s(2)(B)(ii), as established by WSTAA Section 724(c); New SEA Section 3E(f)(2)(B)(ii), as established by WSTAA Section 763(d).

with whom they enter into uncleared swaps from rehypothecating, borrowing, or lending funds posted as collateral.

. . .

It is critical that our members' plans continue to be able to use swaps to provide retirement security and health benefits to millions of Americans across the country. Plans are unique, heavily regulated entities that are required by law to act prudently in the sole interest of plan participants and that do not need extra layers of unnecessary requirements that would adversely affect participants. Accordingly, Congress made it clear that it did not intend to apply such requirements to plans that use swaps to manage risk rather than to create risk. In addition, it is critical that the new law not be interpreted in such a way as to eliminate important tools that plans now use to obtain greater security with respect to their swaps.

We thank the Commissions for the opportunity to comment in advance of their joint rulemaking on definition of the key terms and the regulation of major participants. If you have any questions, please do not hesitate to call Lynn Dudley (202-289-6700, the Council) or Judy Schub (301-961-8682, CIEBA).

American Benefits Council Committee on the Investment of Employee Benefit Assets