CALSTRS
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California State Teachers'
Retirement System
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Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants (RIN 3235–AL10; 76 Fed. Reg. 42,396 (Jul 18, 2011))

Dear Ms. Murphy:

This letter is submitted on behalf of the members of the California State Teachers' Retirement System ("*CalSTRS*"). CalSTRS is the second-largest public pension system in the United States, with nearly $150 billion in assets that are managed on behalf of over 840,000 members and beneficiaries. We appreciate the opportunity to submit this comment letter to address certain aspects of the above-cited release (the "*Proposing Release*").

As a large public pension fund, CalSTRS must have access to a variety of investment options on equal footing with other large institutional participants. CalSTRS evaluates its performance by benchmarking its investments and costs with other large pension funds. Access to cost-effective investments that help to ensure stable cash flows is critical to CalSTRS' investment success.

Swaps[1] are regularly entered into by CalSTRS investment professionals in order to protect plan assets from economic risks and ensure stable and predictable cash flows necessary for proper plan funding. CalSTRS uses swaps solely as an end-user[2] to hedge against market

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1 The term "swaps" in this letter includes security-based swaps.

2 For CalSTRS to act as a dealer in swaps would be inconsistent with its statutorily-imposed mandate, which is to invest on behalf of its beneficiaries.

fluctuations, interest rate changes and other economic forces that create asset price volatility and cash flow uncertainty. Swaps are also used to rebalance investment portfolios, enhance diversification and to gain exposure to particular asset classes without incurring the risks associated with a direct investment.

CalSTRS supports the efforts of the United States Securities and Exchange Commission (the "*Commission*") to enhance the transparency of the over-the-counter derivatives market and protect the United States financial markets from systemic risk in connection with its implementation of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*"). CalSTRS has constitutional and statutory responsibilities as a fiduciary to its members and beneficiaries to act prudently with respect to investment decisions. Well-functioning, stable and efficient financial markets make it easier to serve the best interests of our members and beneficiaries.

We appreciate the opportunity to submit this comment letter to address certain aspects of the Commission's proposed rules relating to business conduct standards for security-based swap dealers and security-based major swap participants. Our primary goal in submitting these comments is to ensure that the proposed rules do not adversely affect our ability, as a public pension fund governed by the laws of the State of California rather than by the Employee Retirement Income Security Act ("*ERISA*"), to continue to enter into swap transactions on reasonable and affordable commercial terms, and without being subjected to increased costs and regulation that will disadvantage CalSTRS as compared to other ERISA plans and sophisticated market participants or make swap transactions prohibitively expensive. CalSTRS supports Dodd-Frank's agenda of ensuring that swap dealers and major swap participants deal fairly with special entities (as such term is defined in Dodd-Frank), including governmental plans and other ERISA Plans. However, CalSTRS would like to comment on two portions of the Proposing Release:

1. The Definition of Special Entity Should Include Governmental Plans.

When addressing the scope of the definition of special entity, the Commission asks for comments about the definition of ERISA plans and governmental plans.[3]

ERISA plans and governmental plans should be treated similarly under the Commission's business conduct standards. CalSTRS, which was established pursuant to the California State Constitution, is a governmental plan. Section 3(32) of ERISA defines a "governmental plan" as a "plan established or maintained for its employees by . . . the government of any State or political subdivision thereof. . ."[4] Section 3(3) of ERISA includes governmental plans in the definition of employee benefit plans.[5] While governmental plans are not subject to the stringent fiduciary duties imposed on ERISA plans pursuant to Title I of

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3 Proposing Release, at 42421.

4 29 U.S.C. § 1002(32).

5 29 U.S.C. § 1002(3).

ERISA, that does not mean that governmental plans should be treated differently solely due to their status.

CalSTRS is subject to similar fiduciary duties as a matter of California law. Both the California Constitution and the California Education Code mandate that investments made on behalf of CalSTRS members and beneficiaries be administered under the prudent person standard.[6] Additionally, oversight of CalSTRS is the exclusive fiduciary responsibility of the CalSTRS Board, comprised of twelve members, including elected beneficiary representatives, state-wide elected officials and appointed representatives.[7] Further, applicable California law imposes stringent fiduciary duties on investment advisers (both internal and third-party) that advise CalSTRS.[8]

As the second-largest pension fund in the United States, we also respectfully submit that CalSTRS is equally sophisticated as large ERISA plans. Moreover, ERISA plans and governmental plans are similarly administered in accordance with a stringent fiduciary standard and for the benefit of their beneficiaries. We also note that, under ERISA, CalSTRS and other similarly-situated governmental plans cannot be ERISA plans. Thus, any distinction between an ERISA plan and a governmental plan, if the governmental plan is subject to comparable fiduciary standards and if both plans are transacting as end-users and otherwise adhering to their respective legally-mandated fiduciary obligations, would artificially distinguish between otherwise similar entities, due solely to a distinction in status that is imposed as a matter of law.

We do not believe that such a distinction is warranted by the goals of Dodd-Frank.[9] We also do not believe that such a distinction would be justified by the events of the recent credit crisis, as pension funds (whether governed by ERISA or state law) did not create

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6 CalSTRS has plenary authority and fiduciary responsibility for investment of moneys and administration of the system. Cal. Const., Art. XVI, § 17 (2nd paragraph), § 17(a); *see also* Cal. Educ. Code § 22250. CalSTRS' duty to its participants and their beneficiaries takes precedence over any other duty. Cal. Const., Art. XVI, § 17(b).

7 Members of the Board of CalSTRS are required to discharge their duties with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims. Cal. Const. Art. XVI, § 17(c), *see also* Cal. Educ. Code § 22250(b). Any board member who breaches his or her fiduciary duties requiring assets to be held for the benefit of members and their beneficiaries (Cal. Educ. Code § 22251), who engages in any prohibited transaction (Cal. Educ. Code § 22252), who violates a statutory prohibition on conflicts of interest (Cal. Educ. Code § 22253), or who participates in or conceals such a violation by another Board member (Cal. Educ. Code § 22256) shall be personally liable to make restitution to the fund for any losses resulting therefrom. Cal. Educ. Code §§ 22254, 22256.

8 Investment professionals employed by CalSTRS as well as third-party investment advisers retained by CalSTRS are subject to fiduciary duties in the performance of their duties. Cal Educ. Code § 22254 (with respect to investment professionals employed by CalSTRS); Cal Educ. Code § 22257 (with respect to third-party investment advisers retained by CalSTRS).

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

the issues that Dodd-Frank is designed to address. Instead, such a distinction would create inefficiencies and increase risk in the markets, as functionally identical entities would be treated differently solely for regulatory purposes. This would also increase risk to the retirement system in the United States and to beneficiaries of governmental funds, as engaging in swaps designed to hedge risks in these plans would become more expensive, and thus plan administrators may find that the risk of proceeding unhedged may be less than the cost of entering into the hedge, thus resulting in an increase of risk retention by these plans.

For the foregoing reasons, we respectfully submit that the Commission should not distinguish between ERISA plans and governmental plans that are subject to comparable fiduciary duties, so long as both are acting as end-users and are otherwise abiding by their fiduciary obligations.

2. Cost-Benefit Analysis Does Not Support Imposing Special Protections On Large Sophisticated Pension Funds.

In its discussion of the treatment of special entities, the Commission implies that the varying levels of sophistication among pension funds may justify additional protection for such entities.[10] Since pension funds like CalSTRS must already comply with strict fiduciary duties under state law, we believe they do not need extra protection when acting as end-users of swaps and should be allowed to opt-out of any rules that impose heightened fiduciary duties on security-based swap dealers acting as counterparties in swap transactions.

If, when entering into transactions with employee benefit plans, security-based swap dealers acting as counterparties have to comply with heightened fiduciary duties, such dealers will be forced to satisfy new regulatory requirements that will increase their costs. Such costs will ultimately get passed on to end-users like CalSTRS. To the extent employee benefit plans have to pay higher costs to enter into swap transactions, each dollar an employee benefit plan spends to satisfy new regulatory requirements will be a dollar less that is available for plan beneficiaries. To the extent that plan fiduciaries elect to enter into fewer swap transactions because of price sensitivity and overall cost concerns, plan beneficiaries will be harmed because plan assets will have greater exposure to economic shocks and market volatility. There is also the risk that security-based swap counterparties will decide not to do business with employee benefit plans, as the risks imposed on them by such heightened fiduciary duties may outweigh the benefits they perceive from remaining in this portion of the market. Such a result would disadvantage governmental plans such as CalSTRS by limiting their access to a portion of the swap counterparty market.

In addition, extra protection is inappropriate because of how employee benefit plans like CalSTRS use swaps. Unlike other types of sophisticated players that enter into swap transactions in order to benefit from taking on more risk, employee benefit plans adhering to

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10 Proposing Release, at 42401.

their fiduciary duties use swaps in order to hedge against market and economic risks, a purpose intended to reduce rather than magnify their risk exposure.[11]

In the years preceding the financial crisis of 2008, sophisticated investors entered into risky swap transactions in attempt to financially benefit from greater exposure to unreasonable and unmanaged risks. Significant losses were incurred as a result of the underestimation of these risks.[12] However, CalSTRS is not aware of any of these risk-magnifying transactions being entered into or promoted by employee benefit plans that adhered to their fiduciary duties. The assets of employee benefit plans (including assets of CalSTRS) generally are held in trust for the benefit of their members and beneficiaries and plan fiduciaries cannot assume or generate unmanaged risks. Moreover, there is no mechanism by which an employee benefit trust can declare bankruptcy and thus avoid its obligations to its creditors, and therefore plans face different incentives vis-à-vis risk than other sophisticated investors that enter into swap transactions.[13] Thus, because of employee benefit plans', like CalSTRS', level of sophistication, participation in the market only as end-users of swaps, and the fiduciary duties imposed upon them, it is inappropriate to provide them with additional protections and the costs imposed by such protections would not be offset by anticipated benefits therefrom.[14]

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

Sincerely,

Christopher J. Ailman
Chief Investment Officer

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11 To the extent an employee benefit plan uses swaps other than as an end-user, we would suggest that those transactions could very well be treated differently under Dodd-Frank. For example, we note that for purposes of the end-user exemption from clearing swaps, Dodd-Frank provides that employee benefit plans may avail themselves of such exemption only if the transaction is using swaps to hedge or mitigate commercial risk. *See* Dodd-Frank Act § 723.

12 Proposing Release, at 27567. As proposed, the rules would treat pension funds as financial end-users, which we think is inappropriate.

13 In addition, the State of California cannot declare bankruptcy.

14 *Bus. Roundtable and Chamber of Commerce of the U.S. v. SEC*, 10-1305, Ginsburg, C.J. (Fed. Cir. July 22, 2011) (finding that SEC acted "arbitrarily and capriciously" for failing to "adequately to assess the economic effects of a new rule" related to the inclusion of certain information in proxy materials).