CalPERS

SECURITIES AND EXCHANGE COMMISSION ■ COMMODITY FUTURES TRADING COMMISSION
JOINT MEETING ON HARMONIZATION OF REGULATION

Opening Statement of Eric Baggesen Senior Investment Officer for Global Equity California Public Employees' Retirement System

I am pleased to be here today on behalf of the California Public Employees' Retirement System (CalPERS) and our more than 1.6 million public employees and their families. Our mission is to advance the financial and health security for over 1.6 million public employees, retirees, and their families. CalPERS is the largest public pension system in the United States with a total fund market value of approximately $180 billion and annual payout obligations of over $10 billion to California pensioners.

Recent market events have demonstrated our society's unwillingness to allow some market participants to suffer the ultimate price of their poor decisions. By shifting the risk of failure to our government and ultimately to taxpayers, we have interrupted the cycle of accountability. There appears to be little alternative to more universal and effective regulation to mitigate an unfettered risk taking as engendered by this transfer of failure to society in general. As market participants, we look to the CFTC and SEC as the frontline entities charged with this regulatory burden.

Harmonizing regulation between the CFTC and SEC presents a number of opportunities and challenges. Our perspective is one where the CFTC has historically been focused on the operation of the derivative markets supporting trade in the physical commodities that underlie our economy. The SEC in contrast, is perceived as being primarily charged with investor protection in the securities markets. The differences in focus were highly relevant in a simpler time but are now being strained by the non-ending evolution impacting the global marketplace. The current reality has lead to a situation where market participants have created new instruments for risk transfer that have attributes from both the commodity and security markets, while avoiding being subject to regulation from either. We believe that anything short of a complete partnering between the two regulatory entities will fail to adequately address the risks that have become so apparent.

An anecdotal observation of the last 12 month's events point to these age old sources of the dislocations affecting the global markets:

- Leverage
- Timing or duration mismatch
- Creditworthiness

These elements are exactly the same as those which caused the Savings & Loan crisis of the 1980's although originating in a different part of the marketplace. A very significant additional factor in the current circumstances is the presence of a massive amount of leverage originating in non-transparent, over the counter derivatives. These instruments and the market participants active in their trading, appear to be the greatest source of the systemic risk that was often beyond the reach of regulatory authorities.

Objectives

Transparency must be the foremost objective. It is apparent that there were entire pools of exposure and therefore risk that were not well understood by the marketplace. Current levels of disclosure have not been sufficient to provide this information. Steps that may foster transparency include:

- Registration – All market participants engaged in activity executed in the financial and commodity markets must be subject to some form of registration to allow their identification.

- Trade Reporting – An unambiguous benefit stemming from organized market exchanges is the reporting of trading activity and pricing to all participants. This transparency aspect may be lost in OTC or "over the counter" trading environments unless provisions are made to insure reporting. Regulators must have the ability to see all trading activity and other market participants should have access to at least summary level information.

  An alternate concept of "exchange" may need to emerge where the mechanics of trading become less the focus while the recording and reporting of trading activity becomes the central activity. Imagine the real estate market where transactions are happening in untold numbers of offices while the real exchange of ownership is upon the recording of the activity in the records of a city or town.

- Clearinghouse Settlement – Clearinghouses provide a material service to the markets by removing the need to perform counterparty credit analysis and mitigate the risk of a failure to perform. One price for this service is the application of limits on the amount of leverage that can be created without collateral. The clearinghouse model has been an apparent success such that we know of no failures by any market using this mechanism. Attractive attributes of clearinghouses are:

  - Limits on the size of positions and therefore leverage
  - Limits on size of uncollateralized liabilities
  - Limits on the time duration of any liability
  - Real time knowledge of the trading activity and pricing

  These attributes make clearinghouses effective "pseudo" regulators of some of the risk attached to the instruments they are involved with. Through their analytic capabilities or tremendously risk adverse nature, clearinghouses appear to have been better at the job of managing credit exposure than the credit rating agencies.

Effectiveness is the secondary objective. If the regulatory partnership between the CFTC and SEC is only able to accomplish transparency it will be a success. If this partnership is also able to forestall some future dislocation by its intervention then it will be doubly effective. To hope for this impact, both the CFTC and SEC will need to be resourced with talent capable of understanding the complexity and dynamic nature of the markets. Fostering this talent will require the agencies to communicate and share information.

The final objective is efficiency. There are tremendous synergies possible between the CFTC and SEC. An ideal structure would be to have a single registration point for any market participant. Imagine the potential of coordinating examinations of market intermediaries, many of which are currently active in both regulatory regimes.

In closing, we appreciate your consideration of CalPERS' perspective as a large public plan, institutional investor, and fiduciary to the financial interests of hard working pensioners and their families. We would welcome the opportunity to work with your organizations to address these challenges.