



Investment Office

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February 1, 2005

Barbara Z. Sweeney.
Senior Vice President and Corporate Secretary
NASD - National Association of Securities Dealers
1735 K Street, NW
Washington, DC 20006-1500

Subject: NASD Notice 04-83 – Nov. 2004 – Fairness Opinions

Dear Ms. Sweeney:

I am writing to you on behalf of the California Public Employees' Retirement System (CalPERS). CalPERS is the largest public pension system in the U.S., with approximately \$180 billion in assets. We manage the retirement benefits and health insurance on behalf of nearly 1.4 million members.

CalPERS appreciates the opportunity to comment on the NASD's efforts to improve the disclosure and quality of fairness opinions issued by its members. CalPERS is very supportive of the NASD's efforts to address procedures, disclosure requirements and conflicts of interest when its members provide fairness opinions in corporate control transactions. CalPERS strongly believes that the NASD should propose a new rule to regulate the identification and disclosure of conflicts by its members that provide fairness opinions in corporate control transactions and, further, that the NASD should consider taking stronger measures to address certain conflicts of interest inherent in some corporate control transactions.

We agree that any proposed rule should require NASD members to:

1. disclose in any fairness opinion appearing in any proxy statement any significant conflicts of interest, including if applicable, whether the member has served as an advisor on the transaction in question, and the nature of compensation that the member will receive upon the successful completion of the transaction; and
2. follow specific procedures to guard against conflicts of interest in rendering fairness opinions.

CalPERS respectfully requests that the NASD consider the following additional suggestions to address the serious and real conflicts of interest that its members currently have when rendering fairness opinions in corporate control transactions.

- A. The NASD rule should prohibit investment banks from receiving “success” fees for transactions in which they issue fairness opinions. We believe there is inherent bias when a contingent fee structure is used in rendering any opinion. There is a very large incentive for an investment bank to find that a transaction is fair, regardless of the circumstances, when the bank will receive the bulk of its fee only if the transaction is successful. Contingent fee structures for public accountants are already prohibited by the SEC.
- B. We suggest the NASD further define standards of independence that investment banks should follow in rendering fairness opinions. The original concept of “fairness opinions” is to show the price of a deal is independently verified by an “arm’s-length” analysis and this concept should be reflected in the NASD’s independence standards.
- C. The NASD rule should require that fairness opinions disclose not only whether the offered price is fair but also whether, in the bank’s reasonable opinion, a materially better price could have been obtained.
- D. Shareholders should be informed on whether a company’s officers, directors or employees receive an excessively disproportionate benefit from the transaction and whether this benefit materially influenced the price of the transaction or the selection or direction of the investment bank. Fairness opinions may ignore or be silent on compensation agreements that apply to the executives of the client company in its “change-of-control” agreements. Top executives with large negotiated change-of control, severance agreements may be encouraged to influence the direction of a fairness opinion. Shareholders may perceive the opinion as biased if later they determine the opinion did not disclose these agreements.
- E. The NASD should request that the SEC strengthen its proxy rule requirements when board of directors obtains a fairness opinion that is referred to in the proxy statement and prospectuses. For example, the disclosure regarding the fairness opinion should include not only the valuation methods used in the fairness analysis, but also all material assumptions used to generate the opinion. Since a number of valuation methods can be applied which are sensitive to small changes in the assumptions underlying the analysis, the rule should expand on disclosure to reduce the subjectivity that is inherent in fairness opinions. Further, this detailed disclosure should also include whether financial projections were supplied by the client and whether the investment banker also obtained data from an independent source. Additionally, a disclosure rule should require that investment bankers consider and disclose any material changes that are likely to occur in the underlying assumptions and data.

In summary, CalPERS is appreciative of the work of the NASD and the opportunity to comment. These comments are meant to provide some guidance in the drafting of the NASD rule. However, CalPERS reserves the right to comment further at such time when the NASD submits its rule to the SEC and the SEC requests comments from the public. CalPERS believes full disclosure of conflicts of interests is essential for the integrity of the financial markets. If you have any questions regarding our comments on the proposed rule, please contact Ted White, Portfolio Manager, Corporate Governance at (916) 795-2731.

Sincerely,

A handwritten signature in cursive script that reads "Mark Anson".

Mark Anson
Chief Investment Officer