Clients&FriendsMemo

DOL Provides Important ERISA Guidance Regarding Cleared Swaps

February 26, 2013

Introduction

On February 7, 2013, the U.S. Department of Labor (the "DOL") issued an advisory opinion[1] concerning the application of the fiduciary and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")[2] to certain "cleared swap" transactions conducted pursuant to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The DOL clarified, subject to the conditions specified in the advisory opinion, that (i) clearing members are not considered fiduciaries under ERISA solely by reason of exercising contractually determined rights in the event of a plan default or other specified events; (ii) margin held by a clearing member or central counterparty ("CCP") is not considered a "plan asset" under ERISA; (iii) CCPs are not parties in interest under ERISA with respect to plans engaging in swaps, but clearing members are parties in interest; and (iv) the guarantee of customer positions, services performed by clearing members, and the exercise of default or similar rights in connection with cleared swaps could constitute prohibited transactions under Section 406 of ERISA except that an exemption, such as Prohibited Transaction Exemption ("PTE") 84-14 (the "QPAM Exemption"), may apply.

Background

The Dodd-Frank Act established a regulatory framework for swaps by, among other things, imposing clearing and trade execution requirements on swap participants, including ERISA plans. Under the central clearing model established by the statute, in order for an ERISA plan to enter into a swap that must be centrally cleared, a plan fiduciary must first identify an appropriate counterparty (generally a swap dealer). Then, the fiduciary must select a CCP and, if it is not a direct member of that CCP, a futures commission merchant ("FCM") that is a member and is willing to clear the swap as the ERISA plan's clearing agent. Upon the CCP's acceptance of the swap for clearing, the original swap would be extinguished and replaced by equal and opposite swaps between the CCP

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1 Advisory Opinion 2013-01A.

2 References to sections of ERISA in this memorandum are deemed to include references to the corresponding provisions of the United States Internal Revenue Code of 1986, as amended.

and the party on each side of the original trade. To the extent either of the parties is clearing through an FCM, the FCM acts as the party's agent for purposes of the cleared swap contract and guarantees the party's obligations on such swap to the CCP. Under this structure, CCPs are responsible for setting margin requirements with respect to swap transactions, but the FCM provides for the collection, transmission and/or receipt of initial and variation margin to and from the CCP, and may itself demand margin from the ERISA plan above the CCP's minimum requirement.

If an ERISA plan customer were to default under a swap, the FCM, as guarantor, would be contractually obligated to the CCP (and the CCP to the other counterparty). As a result, standard contracts between a clearing member and the customer provide for a specific set of rights in the event of a default. These rights, which typically include the right to liquidate the customer's positions by entering into risk-offsetting transactions, and, in connection with the liquidation, entering into risk-reducing transactions, may also be triggered by a number of other contractually determined events.

Due to perceived uncertainty regarding the interaction of this newly established swaps clearing framework with various provisions of ERISA, the Securities Industry and Financial Markets Association ("SIFMA") requested an advisory opinion from the DOL on the matters discussed below.

Fiduciary Status

According to the DOL, a clearing member acting pursuant to an agreement negotiated with an ERISA plan customer would not be a fiduciary under ERISA Section 3(21)(A)(i)[3] solely by reason of the termination and close-out of a customer's swap position, or the sale of any assets posted as margin (whether held by the CCP or the clearing member) to satisfy losses and costs incurred due to the customer's default or other contractually determined events. The DOL stated its view that exercising such contractual liquidation or close-out rights does not necessarily amount to the type of authority or control over plan assets contemplated under ERISA, assuming that such rights result from negotiations between a clearing member and an independent plan fiduciary, and that the parties understand that the clearing member will not be acting in a fiduciary capacity. The DOL cautioned, however, that plan fiduciaries must discharge all of their duties in accordance with ERISA's standards for fiduciary conduct. This would include determining that an investment in a swap is prudent and made solely in the interests of the plan's participants and beneficiaries. In making the determination as to whether to invest in a swap, plan fiduciaries would be required to engage in the same procedures and same type of analysis involved in making any other investment decision, including consideration of:

[3] Under Section 3(21)(A)(i) of ERISA, a person will be a fiduciary with respect to a plan to the extent such person "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."

- How the investment fits within the plan's investment policy;
- The role the particular swap plays in a plan's portfolio;
- The plan's potential exposure to losses through the swap;
- The contractual rights the plan is granting to any of the parties to the arrangement, including the clearing member; and
- The potential economic exposure to the plan as a result of the exercise of those rights.

The DOL noted that the Dodd-Frank Act imposes the same clearing requirements on ERISA plans as on other swap participants. Therefore, Congress did not appear to intend to treat plan customers differently, and did not appear to contemplate that clearing members or CCPs would act as ERISA fiduciaries. Any contrary result would potentially expose a clearing member to an incompatible set of obligations: those that it owes to itself and the CCP, and those that it would owe to the plan customer as an ERISA fiduciary. As a result, the DOL stated that it would defer to Congress' understanding of how clearing members would operate, and interpret ERISA so as to not impair the cleared swaps framework.

Margin

The DOL would not consider collateral that a plan customer may post as margin under a swap transaction to be a "plan asset." The DOL likened such margin to a performance bond - an assurance that a swap counterparty would comply with its agreement. Additionally, the DOL noted that Commodity Futures Trading Commission ("CFTC") rules require clearing members to collect margin from customers, and that a plan customer will generally have no rights to any assets in the margin account. Rather, when a plan enters into a cleared swap transaction, its assets are the "rights embodied in the swap contract as evidenced by the written agreement" between the plan and clearing member.[4]

Whether Clearing Members and CCPs are Parties in Interest to Plans

CCP. The DOL would not consider a CCP a party in interest solely due to its role in the swaps clearing framework. The DOL noted that it is of the view that the CCP does not provide services to the plan customer, and would not be deemed to be a party in interest to the plan customer solely by reason of providing clearing services for the plan's clearing member.[5] The DOL further provided that because the rights and obligations under the plan customer's agreement with the clearing member are subject to the Commodity Exchange Act, CFTC rules and the CCP's rules regarding defaults, actions taken by the CCP pursuant to such rules with regard to customer accounts in

[4] Much of the DOL's analysis with respect to cleared swaps margin is based off of the analysis in Advisory Opinion 82-49A (Sept. 21, 1982), which addresses (among other things) the classification of margin in the context of futures contracts.

[5] Section 3(14)(B) of ERISA provides that "a person providing services" to a plan is a party in interest to such plan.

connection with clearing member defaults would not necessarily amount to the authority and control that would give rise to fiduciary status under Section 3(21)(A)(i) of ERISA.

Clearing Member. In contrast, a clearing member would be a party in interest with respect to a plan entering into a cleared swap transaction. The DOL stated that, due to the direct contractual relationship between a plan customer and a clearing member, such clearing member would be considered to provide services to the plan within the meaning of Section 3(14)(B) of ERISA.

Prohibited Transactions/Exemptions

Clearing members, as parties in interest with respect to a plan, would be subject to the prohibited transaction provisions of Section 406 of ERISA when dealing with plan customers. These prohibitions, unless exempted, would prohibit the provision of services,[6] any extensions of credit (including, in the view of the DOL, the guarantee of any obligations)[7] or any sale or exchange of property between a plan and a party in interest.[8]

The DOL advisory opinion expresses the view that the QPAM Exemption[9] would provide relief from the prohibited transaction provisions of ERISA with respect to the agreement between the clearing member and plan customer for services, as well as the extension of credit provided to the customer by the clearing member.[10] All of the conditions of Part I of the QPAM Exemption must be satisfied, including the condition that the terms of the transaction at issue be negotiated on behalf of the investment fund by, or under the authority and general direction of, a "qualified plan asset manager" (the "QPAM") as that term is defined in the QPAM Exemption, and that the QPAM makes the decision on behalf of the investment fund to enter into the transaction. On this point, the DOL stated that this condition will be met so long as the agreement between the QPAM and clearing member sets forth all the material terms of the provision of services and guarantee by the clearing member.

With respect to a clearing member's exercise of contractually agreed liquidation or close-out rights, the DOL stated that it would consider such transactions to be "subsidiary transactions," as the term is discussed in the preamble to the QPAM Exemption, so long as certain conditions are met. The advisory opinion explains that subsidiary transactions include those transactions that are authorized by default or other contractual provisions "forming an integral part of a primary transaction negotiated by the QPAM, but that are contemplated to occur subsequent to the execution of a

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6 ERISA §406(a)(1)(C).
7 ERISA §406(a)(1)(B).
8 ERISA §406(a)(1)(A).
9 PTE 84-14.
10 The DOL stated that its analysis under the QPAM Exemption would also be applicable with respect to relief provided by PTE 96-23 (the "INHAM Exemption").

primary transaction." The relief provided by the QPAM Exemption to a primary transaction would apply to a subsidiary transaction so long as the agreement governing the primary transaction (in this case, the agreement between the plan customer and clearing member) includes specific provisions relating to the subsidiary transactions "such that the QPAM can reasonably foresee their potential outcomes." This would enable the QPAM to evaluate the subsidiary transactions as part of its decision to enter into the primary transaction. Specifically, the DOL indicated that the QPAM would look to the terms of the agreement regarding the rights of the clearing member on default or other specified events in evaluating the potential outcomes of these transactions, including:

- Provisions addressing how the clearing member may engage the plan in risk-offsetting positions;
- Provisions regarding the price at which the clearing member may liquidate provisions, and the liquidation process;
- Provisions addressing how the plan's positions may be auctioned off; and
- Provisions addressing how the clearing member may purchase the plan's positions directly.

The DOL cautioned that, in certain cases, the QPAM may need to request and evaluate additional information from the clearing member before entering into an agreement.

Unanswered Questions and Material Implications

The advisory opinion does not address whether any prohibited transaction exemptions other than the QPAM or INHAM Exemption might apply in this context. These other exemptions might include PTEs 91-38, 90-1, 95-60, or ERISA Section 408(b)(17). The advisory opinion also does not address any issues with respect to any conditions of the QPAM Exemption other than the condition in Part I(c). For example, a frequent concern with reliance on the QPAM Exemption is the condition in Part I(a), regarding whether the party in interest has the authority to negotiate the terms of the arrangement between the QPAM and the plan, or the authority to retain or dismiss the QPAM. There are a number of other points raised or overlooked by the advisory opinion which will need to be addressed in relevant market practice, if not by the DOL in further guidance.

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