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DOL Issues Guidance for ERISA Plans to Engage in Cleared Swaps

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Why This Is Important

On February 7, 2013, the US Department of Labor (DOL) issued Advisory Opinion 2013-01A (the "Advisory Opinion"), which provides guidance under the Employee Retirement Income Security Act of 1974 (ERISA) for employee benefit plans that are subject to ERISA ("ERISA Plans") to engage in "cleared swaps." ERISA Plans often use swaps in the investment of their assets, and, beginning September 9, 2013, many swap transactions by ERISA will be subject to mandatory clearing. Entering into a swap that is required to be cleared, but not clearing it, would be a violation of the Commodity Exchange Act ("CEA"). Concern about potential liability under ERISA by parties that enter into or clear swaps with ERISA Plans has created uncertainty as to whether ERISA Plans would be able to access the swaps market once the cleared swap requirements went into effect.

The Advisory Opinion indicates that there are not ERISA issues, for either an ERISA Plan or its Clearing Member, that would generally prevent ERISA Plans from engaging in covered swaps. However, the DOL also advised that the Account Agreement (as defined below) between an ERISA Plan and its Clearing Member must spell out the potential consequences to the ERISA Plan (including the Clearing Member's remedies upon default) in more detail than may now be the case, and that the Account Agreement must be approved on behalf of the ERISA Plan by a "QPAM" or "INHAM."

The Advisory Opinion identifies issues that could arise under ERISA and provides guidance on how those issues may be resolved. The Advisory Opinion is based on the DOL's view of the relationship between ERISA and the legislation providing for cleared swaps,[1] as well as prior guidance from the DOL on futures transactions by ERISA Plans[2] and Prohibited Transaction Class Exemption 84-14, as amended (the "QPAM Exemption"). The Advisory Opinion addresses only swaps that are regulated by the Commodity Futures Trading Commission (CFTC) and not "security-based swaps", which are regulated by the Securities and Exchange Commission.

[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which, among numerous significant changes to the US financial regulatory framework, amended the CEA.

[2] DOL Advisory Opinion 82-49A (the "Pianko Letter"). The Pianko Letter provides guidance when an ERISA Plan engages in futures transactions on a contract market through a futures commission merchant (FCM), including that (1) initial and maintenance margin is not a "plan asset" of the ERISA Plan, (2) the ERISA Plan's asset in a futures transaction is its rights contained in its customer agreement with its FCM and the futures contract as evidenced by a written confirmation, and (3) an ERISA Plan's FCM is not acting as a fiduciary under ERISA solely by reason of liquidating the contracts in the ERISA Plan's account or selling any margin in the account to cover losses in the account, if such rights are set out in its customer agreement with the ERISA Plan.

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Background—ERISA

ERISA regulates the structure and operation of most US private sector employee benefit plans, such as pension and 401(k) plans. Among the aspects of plans that are regulated by ERISA is the investment of plan assets. ERISA defines "fiduciary" to include any person to the extent that it exercises authority or control over the management or disposition of plan assets or provides (or has authority to provide) investment advice for a fee concerning plan assets. Persons acting as fiduciaries are subject to standards of fiduciary duty as well as a duty to avoid "prohibited transactions." In general, a prohibited transaction is any of a broadly defined set of transactions between a plan and a "party in interest," which is a person with one of a number of defined relationships to a plan, including a service provider (i.e., a "person providing services to the plan").[3]

While the decision to use swaps in the management of plan assets is a fiduciary act, the mechanics of swap transactions can raise prohibited transaction issues. The primary focus of the Advisory Opinion is these prohibited transaction issues.

Background—Swaps and Cleared Swaps

As a result of the Dodd-Frank Act, the term "swap" is now broadly defined in the CEA as any agreement, contract or transaction between two parties that involves

> payments based on the value or level of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, . . . without also conveying a current or future direct or indirect ownership interest in an asset.[4]

Swaps before Dodd-Frank. ERISA Plans frequently use swaps in their investment strategies and for hedging interest rate, currency and other exposures. Historically, swaps have been customized over-the-counter contracts in which each party is at risk for the other's default on its obligations under the swap. The potential for over-the-counter swaps to cause "prohibited transactions" (as defined in ERISA) is well understood and ERISA Plans entering into such transactions have routinely structured them to fall within one of the exceptions to the prohibited transaction rules, such as the QPAM Exemption.[5]

Cleared swaps under Dodd-Frank. Together, the Dodd-Frank Act and CFTC regulations require the clearing of certain swaps. It is a violation of the CEA for any person to engage in a swap that is required to be cleared without submitting the swap for clearing through a designated clearing organization (DCO), absent an available exemption.[6] "Clearing" is the process by which each party to a bilateral swap submits the swap they have negotiated to a DCO for clearing. (The Advisory Opinion uses the term "central counterparty" (CCP), instead of DCO, so we will use CCP in this Alert.) The swap is submitted to the CCP on behalf of each party through the party's FCM, which is a "Clearing Member" of that CCP (or has a relationship with a second FCM that is a Clearing Member[7]). Each party's Clearing Member acts as agent for that party pursuant to an account agreement between the party and the Clearing Member.

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3 Section 4975 of the Internal Revenue Code of 1986 (the "Code") provides for an excise tax on prohibited transactions, which are defined similarly, but not identically, as under ERISA. ERISA Plans are generally subject to Code Section 4975 along with other employee benefit arrangements that are not subject to ERISA, such as Individual Retirement Accounts. The guidance in the Advisory Opinion is also applicable to Code Section 4975, and references to ERISA Plans in this Alert should be read to include arrangements subject to Code Section 4975.

4 CEA, 7 U.S.C. Section 1a(47).

5 In brief, the QPAM Exemption permits a plan to engage in certain transactions with a party in interest that would otherwise be prohibited transactions if the transaction is negotiated by, or under the direction of, a qualified professional asset manager (QPAM) and the QPAM makes the decision for the plan to enter into the transaction. A QPAM must be a bank with equity capital in excess of $1 million, savings and loan with equity capital or net worth in excess of $1 million, insurance company with net worth in excess of $1 million, or an investment adviser that is registered under the Investment Advisers Act of 1940 with assets under management of $85,000,000 (determined as of the last day of its most recent fiscal year) and shareholder or partner equity in excess of $1 million (as shown on its most recent balance sheet prepared in accordance with generally accepted accounting principles). In addition, the QPAM must be independent from the party in interest involved in the transaction, have a "diverse clientele" and cannot rely on the QPAM Exemption for prohibited transactions that would involve self-dealing by the QPAM or a person related to the QPAM.

As an alternative to the QPAM Exemption, some large ERISA Plans rely on Prohibited Transaction Class Exemption 96-23 (the "INHAM Exemption"), which provides similar relief for transactions negotiated by and entered into on behalf of an in-house investment manager (INHAM). An INHAM is a subsidiary or affiliate of the plan sponsor which is an investment adviser registered under the Investment Advisers Act of 1940.

6 The clearing mandate currently applies to four classes of interest rate swaps and two classes of credit default index swaps. See 77 Fed.Reg. 24284 (December 13, 2012).

7 Where there is a second FCM acting as Clearing Member, its customer relationship will be with the first FCM, and the Clearing Member will not know the identity of the first FCM's customer. In this Alert, we have assumed that the ERISA Plan's FCM is a Clearing Member and is acting as such for the ERISA Plan.

Once the swap is accepted for clearing by the CCP, it is transformed into two new swaps, one between the first party and the CCP and the other between the second party and the CCP. Each of the original parties has the same economic position in its swap with the CCP that it had in the original swap. As a result of clearing, the original swap ceases to exist and the parties to the original swap no longer have obligations to each other. Each original party, however, is required to post initial margin with the CCP and daily variation margin as required. That margin is delivered to the CCP by the Clearing Member, acting as agent for its customer. It is important to understand that in a cleared swap, each original party's Clearing Member is liable to the CCP, as a Clearing Member of that CCP. Each original party, in turn, is liable to its respective Clearing Member through its account agreement with the Clearing Member. To reduce its risk to the CCP, the Clearing Member may require its customer to post margin with the Clearing Member that is in excess of the margin required by the CCP.

An ERISA Plan that enters into a cleared swap thus becomes a party to two contracts—the swap contract with the CCP entered into by the ERISA Plan's Clearing Member, acting as agent for the ERISA Plan, and its customer agreement with its Clearing Member ("Account Agreement"). If the ERISA Plan fails to deliver margin as required under its swap contract, its Clearing Member will ordinarily post the margin itself to avoid a default under the ERISA Plan's swap contract, but the failure of the ERISA Plan to deliver margin will also cause a default under the Account Agreement. Upon such a default, or other specified events affecting the ERISA Plan which may put the Clearing Member at risk (collectively, "Events of Default"), the Account Agreement gives the Clearing Member the right to terminate and close out the ERISA Plan's position and sell any margin posted by the ERISA Plan. In addition, the Account Agreement typically will authorize other measures ("Close-Out and Hedging Transactions") to protect the Clearing Member's interests upon an Event of Default. These include entering into transactions that offset, replace or reduce the risk of the ERISA Plan's position; hedging against the ERISA Plan's liability by entering into additional swaps in the ERISA Plan's account; and transferring positions and margin from the ERISA Plan's account to the Clearing Member's account.

ERISA Issues

When an ERISA Plan engages in a cleared swap, the following parties are involved: the ERISA Plan, the investment manager or other fiduciary that makes the decision for the ERISA Plan to enter into the swap (the "Investment Fiduciary"[8]), the ERISA Plan's Clearing Member and the CCP. The Advisory Opinion addresses the following questions arising in cleared swaps:

- Is initial and variation margin deposited on behalf of an ERISA Plan with the Clearing Member or CCP a plan asset of the ERISA Plan?
- Does an ERISA Plan's Clearing Member act as a fiduciary if, pursuant to its Account Agreement, it liquidates the swap contracts in the ERISA Plan's account or sells any margin posted by the ERISA Plan in order to cover losses in the account?
- Is a CCP, by virtue of the services it provides in connection with a cleared swap, a "service provider" and therefore a "party in interest" to an ERISA Plan that engages in a cleared swap?
- Is the ERISA Plan's Clearing Member, by virtue of the services it provides under its Account Agreement, a "service provider" and therefore a "party in interest" to an ERISA Plan with which it enters into an Account Agreement?
- Does an ERISA Plan's Clearing Member, by engaging in Close-Out and Hedging Transactions pursuant to its Account Agreement, engage in transactions that would be prohibited transactions under ERISA, absent an applicable exemption?

Analysis of ERISA Issues in the Advisory Opinion. In the Advisory Opinion, the DOL stated that it took the purposes of the Dodd-Frank Act—and the CFTC's regulations under that Act—into account in formulating its guidance, and intended to defer to Congress's intention and interpret ERISA "so as not to impair or impinge upon the swaps framework."[9] In addition, the Advisory Opinion indicates that the DOL conferred with officials of the CFTC while it prepared the Advisory Opinion and that "they do not believe the conclusions reached in this letter are inconsistent with the CEA or the CFTC's regulation of cleared swap transactions under the CEA."

From that starting point, the DOL answered the above questions as follows:

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8 In addition to entering into a cleared swap directly through an Investment Fiduciary, an ERISA Plan may indirectly enter into a cleared swap when it invests in a collective investment vehicle (such as a hedge fund or group trust) whose assets are deemed to be "plan assets" under Section 3(42) of ERISA and the DOL "plan asset" regulations (29 C.F.R. § 2510.3-101). In that situation, the investment manager of the collective investment vehicle would be acting as an Investment Fiduciary for each ERISA Plan that was an investor in the collective investment vehicle.

9 While the DOL did not refer to it in the Advisory Opinion, Congress provided, in Section 514(d) of ERISA, a general rule that ERISA shall not be construed "to alter, amend, modify, invalidate, impair, or supersede any law of the United States . . . or any rule or regulation issued under any such law."

Margin deposited by an ERISA Plan on a cleared swap is not a "plan asset." In the Pianko Letter, the DOL provided guidance on the application of ERISA to futures transactions on a contract market. In that guidance, the DOL determined that margin paid by an ERISA Plan in connection with futures transactions was similar to a performance bond or good faith deposit on the plan's obligation under a futures contract and, so long as the ERISA Plan had no ownership interest in the margin (other than the right to withdraw amounts as provided in its account agreement), the margin was not a plan asset.

The DOL adopted this reasoning for initial and variation margin paid by an ERISA Plan and held by a Clearing Member in connection with a cleared swap. The Advisory Opinion states that the ERISA requirement that plan assets be held in trust would not apply, and a Clearing Member (or, presumably, a CCP) holding margin would not be a custodian of plan assets. The non-plan asset nature of margin would also indicate that the payment or receipt of margin from an ERISA Plan for a cleared swap will not be a transaction involving plan assets.

Again following the Pianko Letter, the Advisory Opinion states that the ERISA Plan's assets in a cleared swap transaction are "the rights embodied in the swap contract as evidenced by the written agreement . . . between the plan and Clearing Member."

Liquidation of swap contracts or sale of margin from ERISA Plan's account. The DOL concluded in the Pianko Letter that the liquidation of contracts or margin in the futures account of an ERISA Plan that was in default was not a fiduciary act by the ERISA Plan's FCM, and came to a parallel conclusion with respect to cleared swaps.

This conclusion is based on the DOL's statement, noted above, that when an ERISA Plan engages in a cleared swap, its asset is the bundle of rights as set out in the ERISA Plan's Account Agreement, under which both the ERISA Plan and the Clearing Member will have rights and obligations. The Advisory Opinion states that a default by an ERISA Plan on a margin call "changes the essential character of the plan's relationship with the Clearing Member from one where the Clearing Member is facilitating the swap transaction to one where the Clearing Member is acting on its own behalf under the terms of the [Account] Agreement to protect itself, the CCP and the clearing process from risk of loss." Therefore, the DOL concluded that:

> a Clearing Member acting pursuant to the Agreement negotiated with the plan fiduciary would not be exercising any authority or control with regard to plan assets and would not be a plan fiduciary within the meaning of section 3(21)(A)(i) [of ERISA] solely by reason of liquidating the swap contracts in a plan's account and selling any collateral posted as margin in order to pay off losses suffered by such account.

The DOL specifically noted that it assumed any such rights of the Clearing Member upon default would be the result of negotiations between the Clearing Member and an Investment Fiduciary (which is independent of the Clearing Member) on behalf of the Plan.

The CCP will not ordinarily be a party in interest or fiduciary to an ERISA Plan that enters into a cleared swap. In the Advisory Opinion, the DOL discusses the role of the CCP in facilitating the clearing of swaps as required by law, and managing a default of an ERISA Plan in a cleared swap. The CCP's functions in clearing swaps for ERISA plans and other swap market participants and addressing defaults were characterized as "an integral part of a comprehensive, regulatory regime designed by Congress." The DOL stated that a CCP is acting pursuant to the CEA, CFTC regulations and the CCP's own default rule. Recognizing the CCP's function within the new required clearing process, the DOL concluded that (1) "the CCP does not provide services to the plan, and will not be deemed to be a party in interest with respect to the plan solely by reason of providing clearing services for the plan's Clearing Member;" and (2) "actions taken by the CCP pursuant to those rules with respect to plan customer accounts upon Clearing Member default would not necessarily amount to the type of authority or control over plan assets contemplated under section 3(21)(A)(i) of ERISA" (i.e., such actions would not be fiduciary actions for purposes of ERISA).

The Clearing Member is a party in interest to an ERISA Plan in connection with a cleared swap. In contrast to its conclusion that the CCP would generally not be a party in interest or fiduciary to an ERISA Plan in connection with a cleared swap, the Advisory Opinion sets out the DOL's view that,

> by virtue of a direct contractual agreement with the plan in the procurement of the clearance of swap transactions and other services, such as the collection and transmission, and/or receipt, of margin payments from the plan, the Clearing Member is providing services to the plan and as a result would be a party in interest with respect to the plan within the meaning of Section 3(14)(B) of ERISA.

Potential prohibited transactions involving Clearing Member; application of the QPAM Exemption. The DOL's opinion that a Clearing Member would be a party in interest because it provides services to an ERISA Plan means that, absent an applicable exemption, transactions between a Clearing Member and an ERISA Plan could be prohibited transactions under ERISA. The Advisory Opinion identifies three types of potential prohibited transactions in which a Clearing Member might engage with an ERISA Plan: (1) providing services to the ERISA Plan in connection with a cleared swap, (2) providing a guarantee of the ERISA Plan's obligations under a cleared swap, and (3) sale or exchange of property with the ERISA Plan.

The practical result of the DOL stating that the Clearing Member may engage in an ERISA-prohibited transaction in certain aspects of acting for an ERISA Plan in a cleared swap is that, without an applicable exemption, a potential Clearing Member would not act in that capacity for an ERISA Plan. Similarly, an Investment Fiduciary acting for an ERISA Plan would not enter into a cleared swap transaction if it believed that it might result in non-exempt prohibited transactions. The DOL indicated, however, that the potential prohibited transactions could be addressed through the QPAM Exemption.

The Advisory Opinion states that the provision of services and extension of credit by the Clearing Member in connection with a cleared swap will be covered by the QPAM Exemption, provided that all conditions of the QPAM Exemption are satisfied, including that the Account Agreement between the ERISA Plan and the Clearing Member sets forth all the material terms of the provision of services and guarantee by the Clearing Member. In order to satisfy the requirements of the QPAM Exemption, the Account Agreement would have to be negotiated on behalf of the ERISA Plan by, or under the authority and general direction of, a QPAM, and it must be the QPAM that makes the decision for the ERISA Plan to enter into the Account Agreement.[10]

This discussion of the use of the QPAM Exemption to address provision of services and extension of credit by the Clearing Member contemplates that the parties, in entering into the Account Agreement, understand that the Clearing Member has the authority to perform these actions in connection with a cleared swap. The next part of the Advisory Opinion discusses the application of the QPAM Exemption to actions by the Clearing Member in connection with its rights to effect Close-Out and Hedging Transactions. Although these rights are provided for in the Account Agreement, the parties would contemplate that, so long as things go along as intended, the Clearing Member would not be taking such actions, unlike providing services and extending credit, which are necessary elements of clearing the swap.

The Advisory Opinion characterizes transactions between the ERISA Plan and Clearing Member where the latter is exercising its rights to effect Close-Out and Hedging Transactions as "subsidiary transactions" contemplated by the Account Agreement negotiated and approved by the QPAM, and which are covered by the QPAM Exemption if all other conditions of the exemption are satisfied.

According to the Advisory Opinion, in order for the QPAM Exemption to apply, the Account Agreement must describe the terms of the Clearing Member's ability to effect Close-Out and Hedging Transactions sufficiently so that the potential outcomes of those transactions are reasonably foreseeable to the QPAM. The Advisory Opinion states that where a QPAM, acting for an ERISA Plan, enters into a customer agreement that provides for Close-Out and Hedging Transactions,

> including, but not limited to: (1) provisions addressing how the Clearing Member may engage the plan in risk-offsetting positions; (2) provisions regarding the price at which the Clearing Member may liquidate positions, as well as the liquidation process; (3) provisions addressing how the plan's positions may be auctioned off; and (4) provisions addressing how the Clearing Member may purchase the plan's positions directly,

transactions entered into pursuant to that agreement would be considered to have been negotiated and approved by the QPAM for purposes of the QPAM Exemption.[11]

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[10] In a follow-up to the Pianko Letter, the DOL, in a letter dated August 16, 1985, to the Futures Industry Association ("Shapiro Letter"), declined to provide specific relief for an FCM to provide "non-fiduciary services," including "receipt, payment and holding of margin," on the basis that such services were exempted by the statutory exemption of Section 408(b)(2) of ERISA for "necessary services" provided by a party in interest. The Advisory Opinion does not discuss the applicability of Section 408(b)(2) of ERISA or any other statutory or class exemption, other than the QPAM and INHAM Exemptions, to cleared swaps.

[11] Footnote 23 of the Advisory Opinion states that the same analysis would apply under the INHAM Exemption, so references to a QPAM in this Alert may be read to include an INHAM, assuming that all conditions of the INHAM Exemption are satisfied.

The effect of this guidance in the Advisory Opinion should be that when an ERISA Plan is a party to any cleared swap, the ERISA Plan's Clearing Member will require that its Account Agreement be negotiated and approved for the ERISA Plan by a QPAM. ERISA Plans should assume that CCPs, Clearing Members and other parties will not participate in cleared swaps for ERISA Plans unless the Account Agreement transaction is negotiated and entered into on behalf of the ERISA Plan by an Investment Fiduciary that is a QPAM.

Action Steps

As a result of the Advisory Opinion, fiduciaries of ERISA Plans that participate in the swaps market should undertake reviews of their plan documents and procedures, including investment policy statements, investment management agreements with managers who use swaps in their strategies, and account agreements with broker-dealers and FCMs, to determine whether changes may be necessary to permit the ERISA Plan to engage in cleared swaps in accordance with the Advisory Opinion. In addition, parties that deal with ERISA Plans in the swaps market, including FCMs that may serve as Clearing Members for ERISA Plans and managers of vehicles whose assets are deemed to include plan assets and who use swaps, should review their customer agreements, subscription agreements and other documents and procedures, including, but not limited to, those dealing with defaults and Close-Out and Hedging Transactions, to determine whether changes may be necessary in order to be able to rely upon the Advisory Opinion.