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BENEFITS BRIEF

February 21, 2013 www.groom.com

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DOL Issues Guidance on Swap Clearing Process

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requires that swap transactions go through a clearing process. Market participants, including retirement plans, traditionally involved in swap transactions were reluctant to begin working on compliance with these requirements due to the lack of any guidance from the Department of Labor ("DOL") on the fiduciary status of certain parties involved in the clearing process as well as the "plan asset" status of amounts held in margin accounts as a part of this process.

On February 7, 2013, the DOL issued Advisory Opinion 2013-01A ("Opinion") which provides clarification as to the following issues involving swap transactions:

i. whether certain parties involved in the clearing of swaps, as required by the Dodd-Frank, are fiduciaries for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") if the counterparty to the swap is an ERISA-governed plan or an entity the assets of which are treated as "plan assets" for purposes of ERISA ("Plan"),

ii. whether certain amounts are "plan assets" for purposes of ERISA when such amounts are posted by Plans as margin in order to meet the swap clearing requirements mandated by Dodd-Frank, and

iii. whether certain parties involved in the clearing of swaps are "parties in interest" for purposes of ERISA's prohibited transaction provisions.

In the Opinion, the DOL recognized that Congress did not intend that parties involved in the clearing process would act as fiduciaries for purposes of ERISA and, indeed, that the swaps clearing process established by Dodd-Frank and the Commodity Futures Trading Commission ("CFTC") regulations could not function if parties involved in the clearing process were acting as fiduciaries. Thus, the DOL concluded a clearing member and a clearing counterparty are not fiduciaries for purposes of ERISA in performing typical clearing functions. Along those same lines, margin deposited by swap counterparties that are Plans are not "plan assets" for purposes of ERISA. While this is consistent with prior DOL positions, this is still welcome news to parties involved in the swaps marketplace as the concept may extend to other aspects of swaps transactions.

However, while the Opinion was favorable with respect to fiduciary status, the Opinion raises issues regarding the following:

i. the "party in interest" status of clearing members; and

ii. the availability (or lack thereof) of certain statutory and class exemptions needed to avoid non-exempt prohibited transactions.

Below is a brief summary of the DOL's conclusions found in the Opinion. We encourage you to contact your Groom attorney to discuss how the Opinion impacts you as this may be the most definitive guidance we receive before the CFTC's swap clearing regulations become effective later this year.

Clearing Member and Central Counterparty not Fiduciaries

The DOL concluded that neither a clearing member ("CM") nor a central counterparty ("CCP") is a fiduciary for purposes of ERISA merely by performing certain clearing functions required of them under Dodd-Frank and the CFTC's regulations.

When the Plan and a swap dealer determine that they wish to be counterparties in a swap, they agree to submit the swap to a CCP, which is a clearing organization registered with the CFTC. The CM, which is a member of the CCP, acts as a guarantor to the swap. In the event one of the swap counterparties fails to meet its obligations under the swap contract, the CM is contractually obligated to the CCP to provide remedies to the CCP and the CCP in turn is contractually obligated to provide remedies to the non-defaulting counterparty. In order to protect the interests of the counterparties and to protect its own interests, the CM will engage in close-out and/or risk reducing transactions to liquidate a counterparty's position in a swap or a series of swaps.

Prior to the Opinion, there was a concern that the CM, in performing its role, may be viewed as a fiduciary under section 3(21) of ERISA because it exercises discretionary authority or discretionary control respecting management of the Plan. For example, the CM has a great deal of discretion in determining the timing and amount involved in performing close-out transactions and can even enter into hedging transactions in anticipation of a default. In addition, there was concern that the CM could be viewed as a fiduciary if it exercised any authority or control over plan assets in executing a close out or other clearing-related transaction that required transfer of margin to the CCP. The CCP is mandated by Dodd-Frank and CFTC regulations to perform a series of functions to, among other things, assure that the CM can appropriately perform its role in the clearing process and to otherwise assure the functionality of such process. The CCP engages in many of the same types of activities as the CM.

In reaching its conclusion that CMs and CCPs are not fiduciaries, the DOL specifically stated that Congress, in enacting Dodd-Frank, did not intend a CM or CCP to be a fiduciary and that "the CFTC's regulations could not function properly if Clearing Members were exposed to the incompatible obligations of ERISA fiduciary status." The DOL also looked to Congressional intent to reach the same conclusion with respect to CCPs. We believe that the DOL's focus on Congress' intent is well-reasoned and important because it suggests that the DOL may be inclined to use this reasoning in other areas where fiduciary status may be implicated such as application of the CFTC's business conduct standards to swap dealers and major swap participants.

Margin as "Plan Assets"

The DOL concluded that assets deposited on margin with a CM by Plans and other investors are not "plan assets" for purposes of ERISA. More specifically, Dodd Frank and the CFTC regulations require that as part of the clearing process, swap counterparties deposit cash with the CM on margin in the nature of a performance bond. In the event of counterparty default, including default by a Plan, the CM may use margin deposits to offset the defaulting party's obligations under the swap contract. Amounts held in margin accounts are not titled to any specific counterparty and the margin deposits of many different counterparties are commingled. If the margin deposits are "plan assets," the handling of such amounts could be construed as a fiduciary act.

In reaching its conclusion, the DOL expectedly looked to Advisory Opinion 82-49A in which it determined amounts held in margin accounts on behalf of Plans engaged in futures transactions were not "plan assets" because no plan had an ownership interest in any of the margin deposits. The DOL stated that margin used in the context of clearing swaps is analogous to margin used to effect futures transactions. Furthermore, the DOL noted that the margin requirements were intended to ensure the functionality of the clearing process as a whole rather than to protect the interests of any Plan. Again, this reasoning suggests that the DOL does not intend to interpret or apply ERISA in a manner that frustrates the clearing process.

Clearing Member, but not Clearing Counterparty, is a "Party in Interest"

While a CM and CCP are not fiduciaries for purposes of ERISA, the DOL concluded that a CM, but not a CCP, is a "party in interest" as defined under ERISA because it acts as a provider of services to a Plan in its capacity as a CM. The DOL noted that there is no direct contractual relationship between a CCP and an ERISA-governed plan. Furthermore, the CCP performs its functions within the clearing process on behalf of the CM. As such, the CCP is not a service provider to the Plan. The CM, on the other hand, has a contractual relationship with the Plan pursuant to which the CM agrees to provide what the DOL viewed as services to the Plan including clearance of swap transactions and the collection, transmission and receipt of margin payments. This direct contractual relationship to provide what the DOL believes are "services" to a Plan appears to be the basis for the DOL's determination of "party in interest" status.

The DOL's conclusion is significant in light of the lack of guidance regarding what exemptions may be available (discussed below). Arguably, the DOL should have determined that the CM is not a provider of services, but rather is simply counterparty to the swap transaction. The basis for this position is that for all practical purposes, once the Plan selects a CM, the CCP stands between the swap counterparties and the CM and merely acts as a conduit between the Plan and the CCP to allow for the clearing process to function.

The DOL's contrary conclusion is significant because it means that a CM must rely upon a statutory or class exemption in order to prevent non-exempt prohibited transactions from occurring in the clearing of the swap transactions it enters. However, as discussed below, the Opinion gave no guidance on what exemptions may be used except for DOL Class Prohibited Transaction Exemption 84-14 applicable to a qualified professional asset manager or "QPAM."

Use of QPAM Exemption

After concluding that a CM is a service provider to a Plan and thus a "party in interest," the DOL focused on how a Plan can use the class exemption for QPAMs to avoid non-exempt prohibited transactions. Primarily, the DOL focused on what provisions should be included in the agreement between the CM and the fiduciary (including information regarding "secondary transactions") in order for the Plan to rely upon the QPAM exemption.

Most notably, the Opinion did not reference the use of any class or statutory exemption other than the QPAM exemption. The absence of any guidance on the applicability of other exemptions begs the question of whether the DOL believes any other exemption may be available. For example, the Opinion does not consider whether the service provider exemption under section 408(b)(17) of ERISA could apply if the party entering into the swap transaction on behalf of the Plan is not a QPAM. Both Plan fiduciaries and CMs should consider how this will impact their respective decisions to enter into swaps and to agree to be a CM on behalf of Plans.

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Summary

In summary, while the Opinion is helpful guidance in respect of the fiduciary status of the parties involved in swap transactions, it raises some important questions regarding "party in interest" status and the ability to use certain statutory and class exemptions under ERISA in the swap context. The Opinion also provides guidance on what information should be included in certain agreements governing the swap transaction. All parties involved in swaps should immediately consider what steps are necessary in the coming weeks to assure compliance with Dodd-Frank, the CFTC regulations and ERISA. An ERISA-governed plan must comply with the clearing requirements by September 9, 2013. Furthermore, entities such as private investment funds that use swaps must comply by June 10, 2013.