

# Swap Meet

What plans should consider if they use swaps

The Department of Labor (DOL) recently issued Advisory Opinion 2013-01A, in which it provided some clarification as to the fiduciary status of parties involved in the swap-clearing process. Employers that sponsor retirement plans subject to the fiduciary provisions of the Employee Retirement Income Security Act (ERISA) and that invest in swaps should consider this opinion, as well as regulations issued by the Commodity Futures Trading Commission (CFTC). All plans must comply with the clearing requirements by September 9. Furthermore, those plans that invest in private investment funds and similar funds that use swaps must comply by June 10.

A swap, a tool often used by a pension plan to manage financial risk, is a contract between the retirement plan and another party, usually a swap dealer. When transacting a swap in its most basic form, the plan and the dealer agree to exchange certain cash flows or other rights to which each party is entitled before they enter into the swap. For example, the plan may own bonds that periodically pay cash based on a fixed rate of interest while the dealer owns bonds that periodically pay cash based on a floating rate of interest. Through the swap contract, the parties “swap” those payment streams without having to buy the underlying bonds.

In order to protect counterparties to these transactions, Congress included in the Dodd-Frank Wall Street Reform and Consumer Protection Act a requirement that swaps be subject to a clearing process. When a plan and a dealer determine that they wish to enter into a swap, such counterparties agree to submit the swap to a central counterparty (CCP), which is a clearing organization, and a clearing member (CM), which is a member of the CCP that acts as a guarantor to the swap. In the event that 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 it. In turn, the CCP is contractually obligated to provide remedies to the nondefaulting counterparty. Swap counterparties, including retirement plans, will be required to make cash payments to be held by the CM on margin. In order to protect the interests of a nondefaulting counterparty 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 (including margin held by the CM).

Through Advisory Opinion 2013-01A, the DOL also recognized that Congress did not intend a CM or a CCP to act as a fiduciary for purposes of ERISA and, indeed, that the swaps clearing process would simply not function if they were fiduciaries. Thus, the DOL concluded that they are not fiduciaries for purposes of ERISA in performing clearing functions.

While the opinion is favorable with respect to fiduciary status, the DOL also concluded that a clearing member, but not a central counterparty, is a “party in interest” to a plan because, in the DOL's view, the CM acts as a service provider to the plan. This finding is potentially significant because retirement plan fiduciaries who wish to engage in swaps must make sure a statutory or class exemption is available to prevent a nonexempt prohibited transaction. Unfortunately, the opinion spoke only to the availability of the DOL class exemption applicable to a qualified professional asset manager (QPAM). Thus, while the opinion is helpful in that it provides an outline as to what should be included in an agreement between the plan and the CM in order to rely upon 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 is available. For example, the opinion does not consider whether the service provider exemption under Section 408(b)(17) of ERISA would apply if the party entering into the swap transaction on behalf of the plan is not a QPAM.

With this rules guidance, plan sponsors should review their plans' portfolios to determine whether the plan invests in swaps and, if so, identify what steps need to be taken to assure compliance with ERISA. Sponsors should also expect clearing members, investment managers and other parties involved in swap transactions to ask for additional representations to assure compliance, or to protect themselves from liability, with respect to ERISA, Dodd-Frank and CFTC regulations. Areas of compliance include not only the clearing process but also CFTC registration and business conduct requirements.

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