Essential Guarantees

Proposed PTE 80-26 amendment could dampen investing

When the Employee Retirement Income Security Act (ERISA) became law, several class exemptions were granted to enable a number of transactions beneficial to plans to continue taking place. Prohibited Transaction Exemption (PTE) 80-26 is one of these. It permits loans to be made on an interest-free basis to a plan for the payment of ordinary operating expenses.

On May 24, the Department of Labor (DOL) issued a Notice of Proposed Amendment to provide retrospective and temporary prospective relief under PTE 80-26. The proposed amendment was requested by the Securities Industry and Financial Markets Association (SIFMA), which sought relief to cover potential extensions of credit to individual retirement accounts (IRAs) in the wake of two advisory opinions issued in the last several years.

Two Advisory Opinions

The DOL-issued Advisory Opinions 2009-03A (Oct. 27, 2009) and 2011-09A (Oct. 20, 2011) called into question the use of certain guarantee, indemnity, security interest and/or lien clauses in brokerage agreements and other investment contracts. Specifically, the DOL has taken the position that these arrangements may be prohibited "extensions of credit" between an IRA account holder and an IRA—for example, between a plan sponsor and a plan. The 2011 opinion further concluded that, where the obligation being guaranteed involves an investment loss, the loss is not an ordinary operating expense of the plan, and, accordingly, the guarantee itself is not exempted by PTE 80-26.

Regrettably, these two advisory opinions have created a great deal of confusion and concern, particularly in the brokerage industry where these types of guarantees are essential to ordinary trading activities. Importantly, the advisory opinions are based on the faulty premise that these kinds of risk-sharing agreements constitute a prohibited loan by the plan sponsor.

SIFMA's request to expand PTE 80-26 was based on the widespread use of these types of indemnity and cross-collateralization clauses in many brokerage agreements. Specifically, SIFMA sought the expansion of PTE 80-26 to provide retroactive relief, effective January 1, 1975, and temporary prospective relief for the 12 months after the DOL issued final relief. Most noteworthy, SIFMA requested permanent prospective relief, which would allow plan sponsors, the self-employed and IRA owners to indemnify their IRAs and other plans so that they may continue to engage in short sales, margin transactions, and options and futures trading—all of which require the types of indemnification and cross-collateralization clauses at issue.

The DOL's proposed amendment would grant the request for retrospective relief and a six-month window of temporary prospective relief following the date of a decision being published in the Federal Register. The proposed amendment denied the request for permanent exemptive relief for the agreements at issue.

Negative Consequences

Should the DOL's proposed amendment become final, significant negative consequences may result. In virtually every type of plan service, service providers can incur losses, liabilities and out-of-pocket expenses. Indemnities by plan sponsors, account holders and others have been a feature of the vast majority of all service contracts entered by plans since ERISA was enacted. In fact, they are expressly recognized in Interpretive Bulletin 75-4 as permitted under ERISA Section 410.

By casting uncertainty over these commonly used risk-sharing measures, and effectively disallowing the indemnification for these standard risks, the DOL's action in amending PTE 80-26 will likely result in the restructuring of a significant number of contracts between IRA account holders and plan sponsors and the service providers of those accounts and plans. During the course of restructuring these contracts, service providers may be forced to reassess the fees charged in order to compensate for the additional risk they must now shoulder.

To the extent that a service provider cannot obtain appropriate indemnities or guarantees that its losses will be covered, it is likely that the plan will suffer by being prevented from engaging in activities that might generate those losses, such as futures and options trading and investing in real estate or other less-liquid assets.

The DOL's comment period on the proposed amendment ended on July 23. Should the amendment be finalized in its current form, plan sponsors may want to contact their providers, to help ensure as smooth a transition as possible.

Stephen M. Saxon is a partner with the Washington, D.C.-based Groom Law Group. Groom is one of the pre-eminent employee benefits firms in the country. Steve and his colleagues have worked on every major legislative and regulatory initiative affecting employee benefits since the enactment of ERISA.