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Department of Labor Paves the Way to Clearing Swaps for ERISA Plans

The Department of Labor (DOL) recently issued a long-awaited advisory opinion (the Advisory Opinion) clarifying and confirming the ability of central counterparties (CCPs) and their clearing members (Clearing Members) to clear swaps for pension plans without violating various requirements in the Employee Retirement Income Security Act of 1974 (ERISA).[1] The Advisory Opinion was prompted by the clearing mandate for swaps that is a cornerstone of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[2] Recent Commodity Futures Trading Commission (CFTC) rules implemented the mandatory clearing requirement.[3] Under those rules, certain interest-rate swaps and certain credit default swaps will be required to be cleared by September 9, 2013, for pension plans subject to ERISA and by March 11, 2013, for "active funds," including those that are deemed to hold "plan assets" of pension plans subject to ERISA.[4]

These looming compliance dates brought into focus certain interpretive issues regarding the application of fiduciary and prohibited transaction rules under ERISA to CCPs and Clearing Members when they clear swaps for ERISA plans.[5] The primary concern arose when CCPs and Clearing Members exercise rights upon a customer default and certain other events. Even though mandatory swap clearing will not apply to many pension plans for many months, by issuing the Advisory Opinion now the DOL in effect opened the door to allow CCPs and Clearing Members to clear swaps for ERISA plans in advance of the clearing mandate in order to promote the cited benefits of cleared swaps — removing counterparty credit risk, reducing systemic risk and creating transparency in the markets.

The Advisory Opinion clarifies that Clearing Members and CCPs do not become ERISA fiduciaries of an ERISA plan merely by holding cleared swaps margin or exercising rights with respect to ERISA plan accounts upon default or other specified events for the plan. The Advisory Opinion also concludes that CCPs do not become service providers to ERISA plans by clearing swaps. In addition, although the DOL in the Advisory Opinion recognizes Clearing Members to be parties in interest with respect to ERISA plans as a result of providing swaps clearing and related services, the Advisory Opinion provides guidance regarding the application of the prohibited transaction exemption for transactions negotiated on behalf of an ERISA plan by a "qualified professional asset manager" (QPAM, with the exemption referenced herein as the QPAM Exemption)[6] to transactions between Clearing Members and ERISA plan customers.

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1 *See* Advisory Opinion 2013-01A (Feb. 7, 2013).

2 *See* Public Law 111-203, 124 Stat. 1376 (2010) (amending the Commodity Exchange Act (CEA) to include the Section 2(h)(1) clearing mandate).

3 *See* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74284 (Dec. 13, 2012).

4 *See* 77 Fed. Reg. at 74336-37. The compliance deadlines for other market participants vary.

5 As a general matter, a counterparty to a cleared swap must (a) be a Clearing Member or (b) clear the swap through a CCP via a clearing broker that is a Clearing Member and a registered Futures Commission Merchant (FCM). Therefore, to clear a swap, an ERISA plan generally must use the services of a Clearing Member and a CCP.

6 Prohibited Transaction Class Exemption 84-14, 75 Fed. Reg. 38837 (July 6, 2010)(as amended).

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Congressional Intent and the Cleared Swaps Framework

In considering the application of ERISA to cleared swaps transactions, the DOL took note of Congress' intent when it enacted Dodd-Frank and imposed the clearing requirement. The DOL observed that:

> By imposing the same clearing requirements on employee benefit plans as other swap participants, it appears Congress did not intend for Clearing Members or CCPs to treat plan customers differently. It does not appear, for example, that Congress contemplated that Clearing Members or CCPs would act as ERISA fiduciaries with respect to plan customers. The swaps regulations developed by the [CFTC] similarly do not envision Clearing Members or CCPs having ERISA responsibilities that would subject them to potentially inconsistent obligations.[7]

The DOL noted that standard contracts between Clearing Members and their customers typically permit Clearing Members to take certain actions in the event of a customer default in performing obligations under the agreement, a customer's bankruptcy, insolvency or a similar proceeding or for any other reason the Clearing Member deems advisable for its protection because circumstances may arise where a customer's default is reasonably foreseeable. The DOL recognized that such agreements likely would authorize the Clearing Member to:

- enter into transactions that offset one or more of the customer's (ERISA plan's) transactions;
- enter into transactions that do not fully offset but that replace, provide the economic equivalent of, or reduce the economic risk of, one or more of the customer's transactions;
- hedge the risk of the customer's transactions, as a short-term interim measure, until the Clearing Member can liquidate and terminate the customer's positions, including adding new swap positions for the customer's account in order to mitigate the liability of the Clearing Member in the event it is not reasonably possible to enter into close-out transactions; and
- take steps to transfer any transactions and associated margin in the customer's account to the Clearing Member's house account and enter into close-out or risk-reducing transactions in respect to the transferred transactions.

The DOL said that it intended "to defer to Congress' understanding of how Clearing Members would operate" and noted that CFTC officials did not believe the DOL's conclusions were inconsistent with the CEA or the CFTC's regulation of cleared swap transactions.[8]

In that context, the DOL provided the following opinions:

Status of Margin Posted by a Plan in a Cleared Swap Transaction

Echoing the DOL's 1981 characterization of margin for futures trades, the DOL opined that margin (both initial and variation margin) posted by an ERISA plan and held by a Clearing Member or a CCP in connection with a cleared swap transaction does not constitute plan assets for the purposes of Title I of ERISA, and that as a result, the Clearing Member would not be a custodian with respect to an

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7 Advisory Opinion 2013-01A.

8 *Id.*

ERISA plan customer by virtue of holding margin.[9] Instead, the DOL advised that when an ERISA plan engages in a cleared swap transaction, "its assets are the rights embodied in the cleared swap contract as evidenced by the written agreement … between the plan and Clearing Member, including rights the plan may have to gains payable to the plan that may be realized by the Clearing Member in entering into close-out and risk-reducing transactions."[10]

Status of Clearing Member When Exercising Rights Upon Default or Other Specified Events

The DOL opined that a Clearing Member's exercise of typical default and similar remedies provided under a swap agreement would not result in the Clearing Member being considered a fiduciary with respect to an ERISA plan customer. The DOL took the view that where the Clearing Member's liquidation and closeout rights result from negotiations with an independent plan fiduciary, the Clearing Member "would not be a plan fiduciary 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."[11]

Party in Interest Status of CCPs and Clearing Members

The DOL opined that a CCP would not, as a result of performing clearing functions or as a result of exercising default remedies, be considered a service provider, and therefore a party in interest, with respect to an ERISA plan entering into a cleared swap transaction.[12] In contrast, the DOL opined that a Clearing Member that clears swaps for an ERISA plan would be a party in interest by virtue of the direct contractual agreement with the plan to clear the swap and provide other services that facilitate the swap transaction, such as collecting and transmitting margin payments.[13]

Application of QPAM Exemption to Transactions Between a Plan and a Clearing Member

The DOL stated that because a Clearing Member would be considered a party in interest with respect to an ERISA plan entering into a cleared swap transaction, certain transactions between the plan and Clearing Member that occur in connection with the swap transaction, including the Clearing Member's provision of services and the Clearing Member's guarantee of the plan's obligations to the CCP, would be prohibited transactions under Section 406 of ERISA.[14]

However, the DOL indicated that relief generally would be available under the QPAM Exemption for the Clearing Member's provision of services to the ERISA plan and the extension of credit that is deemed to result from the Clearing Member's guarantee, provided that the plan entering into the cleared swaps transaction was represented by a QPAM and the agreement negotiated by the QPAM on behalf of the plan "sets forth all the material terms of the provision of services and guarantee by the Clearing Member."[15]

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9 *See id.*; *see also* Advisory Opinion 82-49A (determining that initial and maintenance margin deposited by an ERISA plan with an FCM in connection with futures transactions did not constitute plan assets for purposes of Title I of ERISA). The DOL also noted that because the margin would not be considered plan assets, ERISA's requirement that the assets of a plan be held in trust would not apply to margin deposits. *See* ERISA §403(a).

10 Advisory Opinion 2013-01A.

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.*

15 *Id.*

The DOL also addressed how relief under the QPAM Exemption could be available for transactions between an ERISA plan and a Clearing Member that occur in connection with the Clearing Member's exercise of rights upon default or other specified events. The DOL noted that such relief would generally be available for such transactions if the agreement negotiated by the QPAM contained sufficient terms of the default, liquidation and close-out transactions "such that the potential outcomes of the [liquidation and close-out] transactions are reasonably foreseeable to the QPAM when entering into the [a]greement."[16] The DOL indicated that the foregoing analysis would also apply in addressing whether relief would be available under the prohibited transaction exemption for transactions negotiated on behalf of an ERISA plan by an "in-house asset manager."[17]

16 *Id.* The DOL made clear that in carrying out its fiduciary responsibilities, "a QPAM may need to request and evaluate additional information beyond what is set forth in the [a]greement regarding liquidation and close-out transactions and pricing methodologies covered by the [a]greement …" *Id.*

17 Prohibited Transaction Class Exemption 96-23, 76 Fed. Reg. 18,255 (Apr. 1, 2011).