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LEGAL ALERT

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DOL Resolves Important ERISA Issues About Cleared Swap Transactions

In Advisory Opinion 2013-01A (February 7, 2013), the Department of Labor (DOL) issued an important advisory opinion addressing the treatment under the Employee Retirement Income Security Act of 1974, as amended (ERISA), of cleared swap transactions conducted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) or otherwise, to which an ERISA plan is a party.

In brief, pursuant to the Dodd-Frank Act, ERISA plans, as financial entities, will be required to clear certain over-the-counter swaps (*i.e.*, not executed on an exchange) at a “derivatives clearing organization” (DCO), as required by Commodity Futures Trading Commission (CFTC) regulations, via futures commission merchants that are members of the relevant DCO (Clearing Members).[1] (ERISA plans could also voluntarily elect to clear certain swaps.) Upon acceptance of the swap by the DCO for clearing, the original swap between the parties is extinguished and replaced by two equivalent swaps between the DCO and each of the original counterparties. In the event of default by one of the parties to its Clearing Member, the defaulting party’s cleared swap contract with the DCO may be liquidated, and collateral posted by it as margin may be sold to pay off losses suffered in the account. In certain circumstances, the Clearing Member or DCO is also authorized to engage in offsetting or other risk-reducing transactions with respect to a party’s account.

Retirement plans are regular and sophisticated users of swap contracts in their investment portfolios. These plans are also regularly subject to the fiduciary responsibility and prohibited transaction rules of ERISA or the Internal Revenue Code. A concern had arisen about the potential ERISA consequences of the participation by retirement plans in mandatory clearing, including whether a Clearing Member could be deemed an ERISA “fiduciary,” subject to ERISA statutory obligations to act exclusively for a retirement plan in a manner fundamentally inconsistent with its obligations as a clearing member.

With respect to the ERISA consequences of participation by retirement plans in the central clearing system, DOL concluded that:

- In the event of the plan’s default, a Clearing Member would not itself be acting as an ERISA fiduciary by reason of liquidating the swap contract in the plan’s account and selling any collateral posted by the plan as margin to pay off losses suffered by the account. In reaching this conclusion, DOL was “informed by our understanding that, when Congress enacted the Dodd-Frank Act, it did not intend for Clearing Members to perform these activities in a fiduciary capacity – and, indeed, that the swaps framework enacted by Congress and implemented in the CFTC’s regulations could not function properly if Clearing Members were exposed to the incompatible obligations of ERISA fiduciary status.” In this regard, and consistent with its 1982 position with respect to futures contracts executed through a designated contract market, DOL opined that (i)

[1] The Dodd-Frank Act requires the CFTC to issue determinations with respect to which swaps will be subject to mandatory clearing. To date, the CFTC has issued one mandatory clearing determination that applies with respect to certain interest rate swaps and credit default swaps. The CFTC is expected to issue additional mandatory clearing determinations in the future. For purposes of mandatory clearing, the CFTC has adopted rules that permit it to utilize a phased implementation timeline whenever it issues a mandatory clearing determination. For purposes of the timeline, ERISA plans are considered “Category 3” entities, which are afforded the longest amount of time to comply with a mandatory clearing determination. For more information, please see Sutherland’s November 30, 2012 Legal Alert.

the swap contract between the plan and the Clearing Member, including any contractual right of the plan to gains realized by the Clearing Member in entering into close-out and risk-reducing transactions, is an ERISA "plan asset," but (ii) the margin held by the Clearing Member or DCO in connection with the swap transaction is not an ERISA "plan asset."

- The Clearing Member representing the ERISA plan, by reason of its direct contractual relationship with the plan to procure clearance and provide other services, is a "service provider" and thus a "party in interest" to the plan for purposes of the ERISA prohibited transaction rules, but the DCO is not.

- Close-out and liquidation transactions between the Clearing Member and the plan that occur in connection with the swap transaction would be prohibited transactions. However, those transactions would be "subsidiary transactions" for which exemptive relief is provided by the "qualified professional asset manager" or QPAM exemption under ERISA (PTE 84-14), provided that (i) the "primary transaction" – the contract for swap clearing services – negotiated for the plan by the QPAM contains sufficient terms so that the potential outcomes are reasonably foreseeable to the QPAM when entering into the contract, and (ii) the other terms of the QPAM exemption are satisfied.

The Advisory Opinion thus removes significant legal uncertainties with respect to the use of the central clearing system by ERISA plans.

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If you have any questions about this development, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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