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DOL Clarifies Application of ERISA Rules to Cleared Swaps

New guidance defers to the Dodd-Frank/CFTC framework for regulating the swaps clearing process.

On February 7, the U.S. Department of Labor (DOL) issued an advisory opinion[1] on the application of the ERISA fiduciary rules to the categories of swaps subject to mandatory clearing under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). In Advisory Opinion 2013-01A, the DOL responded to questions on how the various parties to a cleared swap with an ERISA plan—specifically, the clearing member who deals directly with the plan (Clearing Member) and the central counterparty that acts as the clearing organization and ultimate swap counterparty to the plan (Clearing Organization)—would be treated under ERISA's fiduciary responsibility and prohibited transaction rules.

Intending to defer to Congress's understanding of how swaps are to be traded and cleared under Dodd-Frank and to avoid subjecting market participants to potentially inconsistent obligations, the DOL crafted responses, based on interpretations of ERISA, to industry questions that it believes would not "impair or impinge upon the swaps framework" required under Dodd-Frank. In adopting positions similar to those it previously adopted for futures transactions (which are also subject to mandatory clearing), the DOL has found certain limits in the application of ERISA where other regulatory and contractual frameworks govern. The DOL indicated that it conferred with U.S. Commodity Futures Trading Commission (CFTC) officials in crafting this guidance and that the CFTC staff does not believe the conclusions the DOL reached are inconsistent with CFTC's regulation of cleared swaps.

Responses to Key Questions

The advisory opinion addresses the following five main questions:

1. **Margin "Plan Asset" Status:** Is margin held by a Clearing Member or a Clearing Organization in connection with a cleared swap considered to be a "plan asset" under ERISA?

   DOL Response: No, because the margin is in the nature of a performance bond to assure performance under the swap, and the plan, as a swap counterparty, will have no right to any assets held in the margin account. Rather, the plan's assets in a cleared swap are limited to the contractual rights embodied in the swap contract and under applicable law.
2. **Clearing Member Fiduciary Status:** Is a Clearing Member an ERISA fiduciary to a plan when it exercises contractual rights against the plan in the event of a plan default or other specified event, including offsetting the plan's posted margin?

   DOL Response: No, because the margin held by the Clearing Member is not considered a "plan asset." However, were the Clearing Member to provide "investment advice" or "recommendations" (within the meaning of ERISA) to the plan in conjunction with a swap, the Clearing Member would be a fiduciary to the plan.
3. **Clearing Member Party in Interest Status:** Is a Clearing Member a party in interest to a plan under ERISA when it is representing the plan in a cleared swap?

1. View the advisory opinion at http://www.dol.gov/ebsa/regs/AOs/ao2013-01a.html.

DOL Response: Yes, the Clearing Member is a party in interest because it is providing services to the plan under a direct contractual agreement with the plan.

4. **Clearing Organization Party in Interest Status:** Is a Clearing Organization a party in interest to a plan under ERISA when it acts as a counterparty to the plan?

   DOL Response: No, the Clearing Organization does not become a party in interest to the plan solely by acting as a counterparty and providing related clearing services with respect to the cleared swap because it is providing services to the Clearing Member, not to the plan.

5. **Exemptions for "Subsidiary" Transactions with the Clearing Member:** Are Prohibited Transaction Exemption (PTE) 84-14 and PTE 96-23—the Qualified Professional Asset Manager (QPAM) and In-House Asset Manager (INHAM) Exemptions—available to cover dealings between a Clearing Member and a plan, including the provision of services and guarantees by the Clearing Member for the benefit of the plan and the Clearing Member's implementation of liquidation and close-out transactions?

   DOL Response: Yes, because each of these exemptions covers "subsidiary" transactions to a "primary" transaction. Thus, so long as the plan fiduciary reviews the terms and conditions of the subsidiary transactions in conjunction with its review of the primary transaction—the swap in this case—these exemptions will cover the actions of the Clearing Member when it exercises contractual rights under the primary transaction.

Observations and Implications

General Implications

In seeking guidance from the government on applying the ERISA fiduciary rules to cleared swaps, the financial services industry argued that the DOL should follow the same positions it applied in its 1982 letter on futures transactions. The DOL has largely done so. If the DOL had done otherwise, it would likely have required detailed exemptive relief, raising additional questions and creating complicated issues on how participants in the clearing process could comply with the different regulatory regimes—CFTC rules and ERISA regulation—as each has a very different focus. By determining, based on deference to the applicable regulatory framework, that parties engaged in the various steps of cleared swaps do not become ERISA fiduciaries, the DOL has largely harmonized its interpretation of ERISA with Congress's intent to require mandatory clearing of certain swaps.

On a more general level, the language of the advisory opinion is interesting in light of the DOL's current initiative to revise the definition of an "investment advice" fiduciary under ERISA. One of the issues raised regarding the DOL's proposed redefinition of "fiduciary" is that the DOL staff did not sufficiently take into account the realities of how the markets operate, potentially creating conflicts of interest that would prevent plans from engaging in certain types of arrangements and transactions. Thus, it will be interesting to see if the DOL's willingness to defer to congressional intent and avoid market disruptions will extend to its re-proposal, which is expected to be released later this year.

Fiduciary Responsibilities

It is important to note that, in the course of the advisory opinion, the DOL emphasized the responsibilities of plan fiduciaries entering into swaps on behalf of a plan, including that they must act prudently, and spelled out specific factors that fiduciaries should take into account. While this reflects prior guidance applying the ERISA prudence rule to derivatives transactions, such as swaps, the current guidance directly considers cleared swaps and adds to the list of factors in the prior guidance (i) the contractual rights a plan grants to a Clearing Member in the event of default and (ii) whether the plan has received adequate consideration for its potential economic exposure. Consideration of these contractual rights is also described as necessary for a Clearing Member's exercise of those rights to be covered by the QPAM exemption. Fiduciaries should be sure to take these factors into account in their investment process.

In describing how swaps are cleared, the DOL indicated that, when entering into a contract with a Clearing Member, a plan "is not relying on any communication of a Clearing Member as investment advice or as a recommendation under ERISA to enter into swaps." If that were not the case, despite the guidance in the advisory

opinion, the Clearing Member would become an ERISA fiduciary to the plan with regard to particular swaps, potentially triggering conflicts of interest in the trading and clearing process. Thus, care must be given to the communications between a plan and a Clearing Member in order to avoid the Clearing Member becoming a fiduciary to the plan.

Prohibited Transaction Exemptions

The prohibited transactions portion of the opinion focuses only on two class exemptions as being available to cover the guarantee, liquidation, and close-out transactions, under the view that these are "subsidiary" parts of the "primary" swap transaction. What is not discussed is whether additional exemptions may also be available, including PTE 90-1 (for insurance company pooled separate accounts) and PTE 91-38 (for bank collective investment funds), in addition to section 408(b)(2) of ERISA covering the basic service relationship with a Clearing Member. However, there is no guidance as to whether the same "subsidiary transactions" concept would apply under these exemptions to cover the close-out and risk-reduction transactions in the same manner as under PTE 84-14. Nevertheless, as the application of this concept is based on an explanation of the exemptive relief available under PTE 84-14, rather than the terms of the exemption itself, there would not appear to be any reason why the same concept should not apply to the scope of relief under the other exemptions. In any event, it would be necessary to determine in each instance that the conditions of a particular exemption can be satisfied.

Security-Based Swaps

The request to DOL for an advisory opinion focused solely on CFTC-regulated swaps, given the imminent deadlines for mandatory clearing under the CFTC rules. As a result, the DOL advisory opinion does not deal with "security-based swaps," a separate category that is subject to regulation by the Securities and Exchange Commission (SEC) rather than the CFTC. Considering Congress's intent to require mandatory clearing of certain SEC-regulated security-based swaps and assuming the clearing mechanism for security-based swaps operates in a similar manner, in the absence of further guidance, it is difficult to see why the same interpretations would not apply to cleared security-based swaps. Nevertheless, the advisory opinion, by its terms, is limited to issues relating to CFTC-regulated swaps.

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