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Impact of Financial Reform Legislation on Employee Benefit Plans

Despite the presence of several exclusions for plans and plan-related services, employee benefit plans will feel the effects of the new regulatory requirements.

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On June 25, the conferees on the pending financial reform legislation approved, by a party-line vote, what is now titled the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173). The next step is for the agreed-upon language to be approved by the House and Senate. The House approved the language on June 30; no vote has yet been scheduled in the Senate.

The bill covers a number of issues for banks, broker-dealers and other financial institutions that provide financial products and services. This update focuses on the effects on financial products and services provided to employee benefit plans, including plans subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). Plans will feel the impact in three areas: (1) swaps and other derivatives, (2) stable value funds, and (3) the new consumer protection agency.

Swaps and Other Derivatives

Over the past 20 years, employee benefit plans have become increasingly greater users of swaps and other derivatives, either as part of professionally managed separate accounts or pursuant to a "liability-driven investment" or other planwide overlay strategy. For this reason, the bill's provisions on swaps would have direct implications for employee benefit plans, and several of these provisions were drafted specifically with benefit plans in mind.

Title VII of the bill would regulate the derivatives market by doing the following:

(1) Defining the terms "swap" and "security-based swap" broadly, to include almost any agreement or transaction where the value is determined by reference to an underlying asset or level

(2) Imposing clearing, exchange trading, capital, margin, registration, reporting, recordkeeping, and business conduct requirements on such agreements or transactions and certain parties thereto

The definitions contain few exclusions. Under the proposed regulatory structure, swaps other than security-based swaps would generally be regulated by the Commodity Futures Trading Commission

(CFTC), and security-based swaps would generally be regulated by the U.S. Securities and Exchange Commission (SEC). The relevant provisions for the two categories are generally parallel.

The new rules would impose various responsibilities on "swap dealers," "security-based swap dealers," "major swap participants" and "major security-based swap participants." Plans should not be considered "swap dealers" or "security-based swap dealers." However, but for an exclusion for employee benefit plans, plans might be covered by the definitions of "major swap participant" and/or "major security-based swap participant." The exclusion covers "positions maintained by any employee benefit plan (or any contract held by such a plan) . . . for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan." Nevertheless, there could still be circumstances in which a plan is considered a "major swap participant" and/or "major security-based swap participant," thereby subject to various rules with regard to its participation in the swaps markets.

The bill drops troublesome fiduciary language contained in the Senate version of the bill, which would have provided that a swap dealer or security-based swap dealer who advises on, enters into, or offers to enter into a swap transaction with a pension plan would have a fiduciary duty to the plan. However, the bill contains a series of other standards and requirements for parties to swap transactions. Both the CFTC and SEC would be given the general authority to establish anti-fraud rules and adopt "business conduct requirements" for swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants (collectively, Covered Participants).

In carrying out their authority to adopt business conduct requirements, the agencies are to formulate rules that do the following:

(1) Establish a duty for a Covered Participant to verify that any counterparty meets the eligibility standards for an eligible contract participant.

(2) Require disclosure by a Covered Participant to any counterparty to the transaction (other than another Covered Participant) of:

   (a) Information about the material risks and characteristics of the swap.

   (b) Any material incentives or conflicts of interest that the Covered Participant may have in connection with the swap.

   (c) (i) For cleared swaps, upon the request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization.

       (ii) For uncleared swaps, receipt of the daily mark of the transaction from the Covered Participant.

(3) Establish a duty for the Covered Participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

(4) Establish such other standards and requirements as the agency may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the applicable statute.

The bill would impose a series of additional responsibilities on Covered Participants that deal with "special entities," a term that includes employee benefit plans and governmental plans (in addition to federal and state agencies, states, municipalities, and endowments). If a Covered Participant acts as an "advisor" to such a special entity, then it may not defraud the entity and has a "duty to act in the best interests of the special entity," and "shall make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the Covered Participant is in the best interests of the special entity," including information on the special entity's financial status, tax status, and investment or financing objectives. The concept of what it means to serve as an "advisor" is not defined in the bill.

Even if the Covered Participant is not an advisor, it would still be subject to special requirements in dealing with "special entities." In such cases, the Covered Participant must disclose in writing the capacity in which it is acting, and have a "reasonable basis" to believe that the special entity has an independent representative that fulfills the following criteria:

(1) Has sufficient knowledge to evaluate the transaction and risks
(2) Is not subject to a statutory disqualification
(3) Is independent of the Covered Participant
(4) Undertakes a duty to act in the best interests of the counterparty it represents
(5) Makes appropriate disclosures
(6) Will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction
(7) In the case of employee benefit plans subject to ERISA, is a fiduciary as defined under ERISA

These rules do not apply to transactions initiated by the special entity on an exchange or swap execution facility, where the swap dealer/participant does not know the identity of its counterparty.

These provisions can be expected to affect the structure of swap transactions between Covered Participants and employee benefit plans. At a minimum, financial institutions can be expected to request additional representations from plans and plan fiduciaries to assure that the various "special requirements" applicable to dealings with plans have been met, and to confirm that they are not serving as an "advisor" to the plan.

Stable Value Funds

Previous versions of the bill did not contain any exclusion for stable value funds, a commonly used form of investment for participant-directed individual account plans such as 401(k) plans, from its broadly defined categories of swaps and security-based swaps. This led to the concern that, under those broad definitions, certain types of stable value investments, particularly "wrap" contracts, would become subject to the clearing, trading, margin, and other requirements for swaps. If wrap contracts and similar stable value investments could not be structured to meet those requirements, they might have to be terminated, creating uncertainty for stable value funds and their plan investors.

The conference report (Section 719(d)) contains a special provision to deal with stable value fund issues. It requires the SEC and CFTC, in consultation with the U.S. Departments of Labor and the Treasury and state regulators of stable value contract issuers (i.e., state insurance and banking departments), to conduct a joint study to determine whether stable value contracts fall within the definition of a swap. If they determine that stable value contracts are swaps, they are to determine whether an exemption from the swap rules would be appropriate and in the public interest.

If the agencies decide not to exempt stable value contracts from regulation as swaps, existing contracts would be grandfathered. Until the effective date of implementing regulations, stable value contracts would not be subject to the swap rules, and stable value contracts in effect prior to the effective date of such regulations would not be considered swaps.

For this purpose, a "stable value contract" is defined as follows:

> [A]ny contract, agreement, or transaction that provides a crediting interest rate and guaranty or financial assurance of liquidity at contract or book value prior to maturity offered by a bank, insurance company, or other State or federally regulated financial institution for the benefit of any individual or commingled fund available as an investment in an employee benefit plan (as defined in section 3(3) of the Employee Retirement Income Security Act of 1974, including plans described in section 3(32) of such Act) subject to participant direction, an eligible deferred compensation plan (as defined in section 457(b) of the Internal Revenue Code of 1986) that is maintained by an eligible employer described in section 457(e)(1)(A) of such Code, an arrangement described in section 403(b) of such Code, or a qualified tuition program (as defined in section 529 of such Code).

This definition excludes defined benefit retirement plans and non-participant-directed plans, which constitute a small proportion of stable value investors.

The result is to provide a safe harbor for stable value contracts from the effects of the new rules, at least until the SEC-CFTC study is concluded. This will avoid the need to unwind stable value arrangements in light of the new regulatory requirements.

Bureau of Consumer Financial Protection

Title X of the bill would create a new Bureau of Consumer Financial Protection (the Bureau), which would have the authority to regulate financial products and services. Many in the retirement services area were concerned that this agency would have overlapping authority over employee benefit plans with the Department of Labor and the Internal Revenue Service, creating the potential for multiple and possibly conflicting layers of regulation.

Section 1027 establishes certain limitations on the new Bureau's authority. Section 1027(g) creates an exclusion for "specified plans or arrangements," which are defined to include qualified plans, 403(a) plans, 403(b) arrangements, individual retirement accounts (traditional and Roth), Archer MSAs, health savings accounts, qualified tuition programs described in section 529 of the Internal Revenue Code (the Code), Coverdell education savings accounts described in section 530 of the Code, and "employee benefit or compensation plans or arrangements," including ERISA plans.

The new law is not to be construed as altering, amending, or affecting the authority of the Secretary of the Treasury, the Secretary of Labor, or the Commissioner of Internal Revenue to regulate any such plan. Furthermore, Section 1027(g) excludes an entity that is a specified plan or arrangement, as well as the activity of establishing or maintaining such a specified plan or arrangement for one's own employees or members (or establishing or maintaining a qualified tuition program or other pre-paid tuition program offered by a state), from the scope of the offering or providing of consumer financial products and services that is subject to the oversight of the Bureau. The issue for regulators and regulated entities will be how broadly or narrowly to interpret what comes within this exclusion.

The statute would permit the Labor and Treasury Departments to submit a written request to the Bureau on implementing appropriate consumer protection standards for the provision of services to plans, and they may grant or deny a request from the Bureau to the same effect. If the Labor and Treasury Departments, in making or granting such a request, provide a basis for the Bureau to implement appropriate consumer protection standards and the scope for applying those standards, the Bureau may exercise rulemaking and enforcement authority over the plan-related matters covered by the request. Consequently, despite the general exclusion, there is still the potential for the Bureau to exercise regulatory authority over matters relating to employee benefit plans.

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Donald J. Myers** (202.739.5666; dmyers@morganlewis.com), **Michael B. Richman** (202.739.5036; mrichman@morganlewis.com), and **Thomas V. D'Ambrosio** (212.309.6964; tdambrosio@morganlewis.com), or any of the following Morgan Lewis attorneys:

New York		
Thomas V. D'Ambrosio	212.309.6964	tdambrosio@morganlewis.com
Craig A. Bitman	212.309.7190	cbitman@morganlewis.com
Philadelphia		
I. Lee Falk	215.963.5616	ilfalk@morganlewis.com
Washington, D.C.		
Donald J. Myers	202.739.5666	dmyers@morganlewis.com
Michael B. Richman	202.739.5036	mrichman@morganlewis.com
Steven W. Stone	202.739.5453	sstone@morganlewis.com

In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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