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Swapping Safely: DOL's Take On Swaps And ERISA Plans

Law360, New York (February 20, 2013, 12:31 PM ET) -- Much of the investment capital in the U.S. market is in retirement plans subject to the Employee Retirement Income Security Act of 1974. Over the years, an important element of a number of plans' investment portfolios has been investment in derivatives instruments, including swaps. On Feb. 7, 2013, the U.S. Department of Labor issued Advisory Opinion 2013-01A (the "swaps opinion"), which may have the effect of ameliorating growing concerns among financial institutions regarding swap transactions with ERISA plans.

Swaps could theoretically raise issues regarding the possible characterization of collateral as a "plan asset" under ERISA, as well as under ERISA's "prohibited transaction" rules relating to transactions with "parties in interest" and fiduciary self-dealing. Authority issued in 1982 by the DOL in the context of futures trading has been viewed as helpful regarding a number of the issues that could potentially arise in the swaps context, including the position that assets in a margin account are not plan assets. However, over the past several months, there has been evidence that financial institutions have become increasingly reticent about continuing to engage in clearing and other transactions with ERISA plans involving swaps.

The recent concerns relating to swaps have not specifically come about as a result of a change in law or official interpretation. Rather, the disruption in the market regarding swaps and ERISA plans seems to have been brought about by various factors, including a reaction to the subprime crisis, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act and some concerns in the marketplace that, notwithstanding the absence of an official statement on the subject, the DOL's position on certain relevant issues might be changing.

The issues have become magnified in light of the upcoming implementation of requirements under Dodd-Frank that swaps generally be cleared through clearinghouses. The new requirements may be viewed as having put additional pressure on existing issues, as well as raising new issues specifically relating to clearing.

Against this backdrop, the DOL issued the swaps opinion, in which the DOL expressly recognizes that (i) Congress did not intend for clearing members to perform activities under Dodd-Frank in a fiduciary capacity and (ii) the swaps framework "could not function properly if Clearing Members were exposed to the incompatible obligations of ERISA fiduciary status."

The swaps opinion indicates, among other things, that:

- swap-related margin held by a central counterparty or clearing member is not a “plan asset” under ERISA;
- a clearing member would not ordinarily be expected to be an ERISA fiduciary solely by reason of liquidating a plan’s swaps and selling collateral posted to pay off the plan's losses;
- the central counterparty is not deemed to provide services to the plan (and will not be a party in interest with respect to the plan) solely by reason of providing clearing services for the plan’s clearing member; and
- actions taken by the central counterparty pursuant to its default rules, upon a default by a clearing member, “would not necessarily amount” to fiduciary activity under ERISA.

The swaps opinion does provide, however, that the activities of a clearing member that represents a plan, and has a direct contractual agreement with the plan, constitute services to a plan, and that the clearing member would therefore be a party in interest to the plan. Thus, the ERISA "prohibited transaction" rules might apply.

The swaps opinion goes on to suggest, however, that where the plan is represented by an independent manager that qualifies as a so-called “qualified professional asset manager” (QPAM) or by a manager that is an “in-house asset manager” (INHAM), the QPAM exemption and the INHAM exemption, respectively, might provide relief. It is possible that there are other approaches that might also be workable where no QPAM or INHAM is being used.

It is noted that a number of the favorable determinations by the DOL in the swaps opinion seem to be premised on particular factual settings and, in some cases, appear to rely on certain provisions that could be included in the documentation governing the swap. Thus, it is possible that swap-related practices and documentation may evolve somewhat in light of the discussion in the swaps opinion.

The helpful clarifications offered by the swaps opinion are expected to be welcomed by financial institutions wishing to offer and service swaps, and by ERISA plans wishing to have access to the swaps market. The DOL appears to have gone a long way toward administering ERISA in a rational and practical manner so as to avoid needless complexity and disruption in this important area.

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