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CLIENT PUBLICATION

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DOL Provides ERISA Relief for Cleared Swap Transactions with Plans

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

John J. Cannon III
New York
+1 212 848 8159
jcannon@shearman.com

Kenneth J. Laverriere
New York
+1 212 848 8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1 212 848 7171
dlilienfeld@shearman.com

Linda E. Rappaport
New York
+1 212 848 7004
lrappaport@shearman.com

Donna M. Parisi
New York
+1 212 848 7367
dparisi@shearman.com

Azam H. Aziz
New York
+1 212 848 8154
aaziz@shearman.com

Geoffrey B. Goldman
Office Location
+1 212 848 4867
geoffrey.goldman@shearman.com

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DOL Advisory Opinion 2013-01A:

On February 7, 2013, the US Department of Labor ("DOL") issued Advisory Opinion 2013-01A addressing the application of certain aspects of ERISA[1] to swap contracts subject to mandatory clearing.[2] The Advisory Opinion covers swaps regulated by the Commodities Futures Trading Commission but does not appear to cover security-based swaps regulated by the Securities and Exchange Commission.

The Advisory Opinion provides a path forward for ERISA plans that utilize swaps subject to the Dodd-Frank Act's mandatory clearing requirements as part of their investment strategy and eliminates most of the ERISA uncertainty for market participants in entering into swap agreements with plans. It also offers useful guidance to those who negotiate the ERISA representations and other terms in swap agreements.

[1] The Employee Retirement Income Security Act of 1974, as amended.

[2] The discussion in this memo regarding the application of Title of ERISA is intended, except where context requires otherwise, also to address the application of the parallel provisions of Section 4975 of the US Internal Revenue Code of 1986, as amended.

In the Advisory Opinion, the DOL States That:

- A clearing member does not act as a fiduciary of an ERISA plan when, upon a default by the plan, the clearing member exercises certain contractually predetermined default rights contained in the clearing agreement negotiated with an independent fiduciary of the plan. This conclusion appears to be predicated on two conditions: that the swap documentation is negotiated for the plan by a fiduciary that is "independent" (presumably from the clearing member); and that the default remedy exercised by the clearing member is one of the remedies negotiated and set forth in the swap documentation.
- In the context of a swap transaction, the plan's assets consist of its rights under the swap agreement and, therefore, margin posted with the clearing member or the central clearing party is not a plan asset for purposes of ERISA. This conclusion relies, in part, on similar advice given by the DOL in the 1980s regarding collateral posted in futures transactions.
- A clearing member is a party in interest to a plan by virtue of the provision of clearing services to the plan, but a central clearing party is not a party in interest solely by reason of providing clearing services. The Advisory Opinion does not directly address the ERISA status of an executing broker in situations where an ERISA plan places a trade with one broker that then "gives up" the trade to the plan's clearing member. Presumably, certain ERISA representations will be necessary in the executing broker agreement, and the parties will need to determine that the transaction with the executing broker is not a non-exempt prohibited transaction for purposes of ERISA.
- As a result of the clearing member's status as a party in interest, most transactions between the ERISA plan and the clearing member would be prohibited under ERISA unless a prohibited transaction exemption applies. In the Advisory Opinion, the DOL indicates that the so-called "QPAM exemption" (Prohibited Transaction Exemption 84-14, as amended) would be available to exempt a clearing member's transactions with the ERISA plan. The DOL indicated that the "subsidiary transaction" provisions set forth in the preamble of the original QPAM exemption would also be available to exempt the clearing member's exercise of its contractual default rights, provided that the QPAM exemption is satisfied at the time of the plan's entry into its swap agreement and these subsidiary transactions are negotiated by the QPAM and set forth in the agreement. Although not covered directly in the Advisory Option, we continue to believe that other ERISA exemptions could also be relied upon to exempt the services provided by the clearing member to the plan or the transactions between the clearing member and the plan associated with the swap transaction.

In formulating its views in the Advisory Opinion, the DOL observed that Congress did not appear to intend for clearing members or central clearing organizations to treat ERISA plans differently from other customers with respect to access to mandatory clearing. The DOL also noted that Congress did not appear to intend that clearing members or central clearing parties act as ERISA fiduciaries to plan customers. Finally, the DOL indicated that it intended "to defer to Congress' understanding of how [clearing members] would operate and interprets ERISA so as not to impair or impinge upon the swaps framework."

The Advisory Opinion has implications for swap documentation. Swap agreements and clearing documentation with ERISA plans typically include a number of representations covering ERISA matters. Key among these are representations from the plan party: (i) that posted margin is not a plan asset; (ii) that the party negotiating for the plan is a QPAM; (iii) that the clearing member is not an ERISA fiduciary; and (iv) that the transactions between the plan and the clearing member are not prohibited by, or are exempt under, ERISA. The Advisory Opinion resolves some of the uncertainty with

respect to these representations by clarifying that margin will not typically be treated as a plan asset and that a clearing member is not a plan fiduciary solely as a result of exercising close out rights upon a default by a plan member. The Advisory Opinion also underscores the importance of perfecting one or more ERISA prohibited transaction exemptions for services and transactions between the ERISA plan and the clearing member.

The Advisory Opinion also emphasizes the importance of remedies upon default being set forth in the swap documentation and of parties being able to demonstrate that those remedies have been negotiated on behalf of the plan by a fiduciary acting for the plan who is independent from the clearing member. According to the Advisory Opinion, rights and remedies requiring precise documentation in the swap documentation include the following:

- how the clearing member may engage the plan in risk-offsetting positions;
- the price at which the clearing member may liquidate positions;
- how the plan's positions may be auctioned off; and
- how the clearing member may purchase the plan's positions directly.

Finally, the Advisory Opinion underscores the importance of having swap documentation for ERISA plans negotiated by knowledgeable and informed fiduciaries. In the Advisory Opinion, the DOL states that a fiduciary acting for the plan "must act prudently with respect to the decision to enter into [a clearing agreement] as well as in negotiating the specific terms of the [clearing agreement]." The DOL further admonishes that "in order to satisfy its responsibilities under ERISA, [a fiduciary] may need to request and evaluate additional information beyond that set forth in the [swap agreement] regarding liquidation and close-out transactions and pricing methodologies covered by the [clearing agreement], before making a determination to enter into [the clearing agreement]."

In sum, the Advisory Opinion should make it possible for ERISA plans to take advantage in a commercially reasonable manner of the swaps clearing framework mandated by the Dodd-Frank Act while continuing to afford plans the legal protections of ERISA. The Advisory Opinion also re-emphasizes the important role that independent fiduciaries representing plans must play in negotiating swap documentation and in causing plans to engage in swap transactions. We suspect that, over time, best practices for plan fiduciaries will involve greater diligence and careful documentation related to the negotiation of these agreements and the decision to enter into these transactions.

599 LEXINGTON AVENUE | NEW YORK | NY | 10022-6069