CLIENT UPDATE

DOL CLARIFIES ROLE OF CLEARING MEMBERS IN CLEARED SWAPS

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INTRODUCTION

On February, 7, 2013, the U.S. Department of Labor (the "DOL") confirmed in Advisory Opinion 2013-01A that a clearing member of a derivatives clearing organization is not a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA") when it acts as a clearing agent pursuant to a standard agreement providing clearing services for an employee benefit plan in connection with a cleared swap. This is a welcome determination that prevents clearing members from being subject to potentially inconsistent obligations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and ERISA with respect to cleared swaps. In its analysis, the DOL stated that margin deposited for a cleared swap is not a plan asset, shedding light on a long-standing debate on the ERISA status of margin generally in swap transactions, which predates the Dodd-Frank Act. However, the DOL found that a clearing member is a "party in interest" under ERISA by virtue of the services it provides to a plan with respect to a swap transaction and, therefore, an applicable exemption is necessary from ERISA's prohibited transaction rules to facilitate the transactions between the plan and a clearing member. According to the DOL, Prohibited Transaction Class Exemption 84-14 (the "QPAM Exemption") can be used to provide exemptive relief not only for primary transactions covering swap clearing services but also secondary transactions such as liquidation and close-out transactions.

BACKGROUND

The Dodd-Frank Act established a comprehensive regulatory framework for swap transactions that requires certain swaps to be submitted to a derivatives clearing organization for clearing. In a traditional bilateral over-the-counter swap transaction, counterparties deal directly with each other and are subject to the counterparty credit risk. In contrast, in a cleared swap transaction, each counterparty submits the swap to a derivatives clearing organization for clearing. If the derivatives clearing organization accepts the swap for clearing, the original swap will be extinguished and the derivatives clearing organization will act as a central counterparty ("CCP") to the two mirror swap transactions with each original counterparty. Each counterparty deals with the CCP either directly or through a clearing member that acts as an agent and guarantor for its counterparty customer. The agreements between the customer and the clearing member require that the customer post margin as collateral, and typically permit the clearing member to enter into offsetting and other risk-reducing transactions in case the customer defaults.

CLEARING MEMBER NOT A PLAN FIDUCIARY

In anticipation of the implementation of the CCP framework, swap participants have been concerned that actions taken by the clearing member under the discretionary provisions of a standard agreement between an employee benefit plan and a clearing member could cause a clearing member to be considered a plan fiduciary with respect to the plan. Under ERISA, if a person exercises discretionary authority or control respecting the management or disposition of plan assets, then that person is a plan fiduciary. Under the standard agreement, a clearing member has some degree of flexibility with regard to the mechanism for terminating and closing out cleared swap positions. For example, under a typical agreement, a clearing member can enter into transactions that are opposite, or offsetting, one or more of the plan's transactions or that replace one or more of the plan's transactions. These rights are typically activated not only by the plan's default in a margin payment, but also by other agreed-upon events, such as bankruptcy. In addition, the clearing member can set the margin level higher than the level set by the CCP. This discretionary authority is critical to enable a clearing member to manage credit risk, since the clearing member is liable to the CCP for the exposure, and in certain circumstances, a plan default may cause the clearing member to become insolvent, which could have significant consequences on the swap market.

The DOL opinion confirms that a clearing member does not become a plan fiduciary solely by exercising pre-negotiated account liquidation rights upon a plan's default or the occurrence of other contractually specified events. This conclusion is based largely on the understanding that Congress did not intend clearing members to act in a fiduciary capacity, and that to impose fiduciary obligations would impede the proper functioning of the swap framework enacted by Congress and implemented by the Commodity Futures Trading Commission ("CFTC"), which was intended to allow flexibility for clearing members in liquidating and closing out a defaulting cleared swap account to prevent a catastrophic impact on the financial markets.

MARGIN NOT A PLAN ASSET

The DOL opinion also confirmed that margin paid by an employee benefit plan that is held by a clearing member or CCP in a swap transaction is not a plan asset for ERISA purposes. The DOL recognized that margin acts like a performance bond or good faith deposit, and that the clearing member and CCP hold the margin for their own benefit to assure performance by the customer; they do not hold the margin on behalf of the plan, nor does the plan have any rights to any assets held in the margin account. In addition, CFTC rules require clearing members to collect margin. According to the DOL, the rights embodied in the swap contract and granted pursuant to applicable law and the agreement with the clearing member, not the margin, are the plan's asset in a cleared swap transaction. This issue has been debated for many years in the context of traditional swap transactions with the only guidance contained in DOL Advisory Opinion 82-49A (September 21, 1982) where the DOL held that collateral posted in a futures transaction pursuant to regulatory requirements is not a plan asset. Given the broad scope of the DOL's analysis, this confirmation should also be helpful to clarify the plan asset status of margin requirements in other situations.

CLEARING MEMBER IS A PARTY IN INTEREST; CCP IS NOT

The DOL found that a clearing member is a "party in interest" as a service provider for purposes of ERISA's prohibited transaction rules because it has a direct, contractual agreement with the plan in obtaining the clearance of swap transactions and providing other services, such as handling margin payments from the plan. A CCP, however, would not be a "party in interest" because the CCP provides services to the clearing member rather than the plan, and its discretion to act is strictly limited by regulation and its own risk management rules, procedures and agreements.

QPAM EXEMPTION AVAILABLE FOR PROHIBITED TRANSACTIONS

Because a clearing member is a "party in interest", certain transactions between the clearing member and the plan (including the sale or exchange of property, the provision of services, and the direct or indirect lending of money or other extension of credit such as the guarantee by the clearing member) could be "prohibited transactions" under section 406(a) of ERISA. In addition, a prohibited transaction could also result if there is a liquidation or close-out transaction with other "parties in interest" to the plan. According to the DOL, however, relief is available under the QPAM or INHAM Exemption (Prohibited Transaction Class Exemption 96-23) if the agreement sets forth all the material terms of the provision of services and guarantee by the clearing member. Most importantly, the DOL clarified that these exemptions would cover the liquidation and close-out transactions — the so-called "subsidiary transactions" as termed in the preamble to the QPAM exemption — if the QPAM reviews the terms of subsidiary transactions as part of its determination that the transaction as a whole is prudent and otherwise in the best interests of plan participants, and the agreement governing the primary transaction includes specific provisions relating to the subsidiary transactions such that the QPAM can reasonably foresee their potential outcomes.

OBLIGATIONS OF PLAN FIDUCIARIES

The DOL cautioned that plan fiduciaries must consider their fiduciary duties under ERISA when making an investment, including that the plan's QPAM may need to request and evaluate additional information beyond what is set out in the agreement regarding liquidation and close-out transactions and pricing methodologies. Under the customary standards, plan fiduciaries must determine that an investment in a swap contract is prudent and made solely in the interests of the plan's participants and beneficiaries and consider how the investment fits within the plan's investment policy and portfolio and the risks of the investment, including the economic exposure associated with the contractual rights granted to the clearing member.

CONCLUSION

Overall, this DOL opinion is good news for CCPs and clearing members, as it provides greater clarity on the framework regarding ERISA's application to swap transaction participants. The opinion also provides important insights as to the DOL's position on "subsidiary transactions" for purposes of the QPAM exemption and on "margin", and these insights are helpful outside the facts of the advisory opinion. Based on this opinion, the parties would be best served when entering into the clearing services agreement if the

plan relies on either the QPAM or INHAM Exemption, with such agreement containing details of the primary transactions, subsidiary transactions and a representation by the appropriate plan fiduciary that it has considered the investment in a swap under ERISA's fiduciary standards and the consequences of the subsidiary transactions. We note that this DOL opinion is limited to cleared swaps and clearing members that are regulated by the CFTC. While we believe that the same conclusion should apply by extension to cleared security-based swaps and clearing members of clearing agencies for security-based swaps that are all regulated by the Securities and Exchange Commission, we caution that this DOL opinion does not expressly cover non-CFTC swaps.

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This memorandum was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

Please do not hesitate to contact us with any questions.

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