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2013-01A
ERISA SEC.
3(21), 3(14), 406
PTE 84-14, PTE 96-23

Dear Ms. Nussdorf:

This is in response to your request for an advisory opinion on behalf of the Securities Industry and Financial Markets Association (SIFMA) regarding the application of the Employee Retirement Income Security Act of 1974 (ERISA) to certain “cleared swap” transactions conducted pursuant to provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).¹ Specifically, you asked whether a clearing member (Clearing Member) is a fiduciary under section 3(21)(A)(i) of ERISA when, upon default by a pension plan of its obligations under a cleared swap, the Clearing Member exercises various account liquidation rights that were negotiated between the Clearing Member and a plan fiduciary at the outset of a swap transaction. You also asked whether the Clearing Member or central counterparty (CCP) is a party in interest under section 3(14)(B) of ERISA with respect to the plan engaging in a swap. Finally, you asked whether the exercise of these default rights or status as a party in interest may result in certain “prohibited transactions” under section 406 of ERISA.²

You and other parties interested in the request have provided the Department with extensive information on cleared swap transactions under the Dodd-Frank Act, which is summarized below. The Dodd-Frank Act amended the Commodity Exchange Act (CEA), 7 U.S.C. 1 et seq., to establish a comprehensive regulatory framework for swaps in order to, among other things, reduce risk, increase transparency, and promote market integrity within the overall financial system. To accomplish such goals, the Dodd-Frank Act imposes clearing and trade execution requirements on standardized derivative products that affect swap dealers and major swap participants in their dealings with counterparties, including “special entities” – a term that includes employee benefit plans defined under ERISA. By imposing the same clearing requirements on employee benefit plans as other swap participants, it appears Congress did not intend for Clearing Members or CCPs to treat plan customers differently. It does not appear, for example, that Congress contemplated that Clearing Members or CCPs would act as ERISA fiduciaries with respect to plan customers. The swaps regulations developed by the Commodity Futures Trading Commission (CFTC) similarly do not envision Clearing Members or CCPs having ERISA responsibilities that would subject them to potentially inconsistent obligations.

¹ Public Law 111-203, 124 Stat. 1376 (2010).

² Section 4975 of the Internal Revenue Code of 1986, as amended (Code), contains parallel provisions to ERISA section 406. Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), 5 U.S.C. App. 1, 92 Stat. 3790, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. The references herein to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.

On the one hand, under the Dodd-Frank Act, the Clearing Member has a prescribed role within the swaps clearing framework that requires it to enter into agreements with customers that give it broad discretion to make margin calls, to call defaults and to close-out a customer's position as needed to protect the Clearing Member's own interests, the interests of the CCP and the interests of its other customers. On the other hand, making a Clearing Member an ERISA fiduciary by virtue of carrying out its prescribed role would likely force it to take actions that benefit the plan customer but put itself, other customers or the CCP at risk. The Department thus intends 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.

A swap is defined in section 1a of the CEA (7 U.S.C. 1a) and includes any bilateral agreement in which counterparties exchange cash flows of one party's financial instrument for those of the other party's financial instrument at specified intervals based on a notional principal amount. Under the Dodd-Frank Act, all swaps required by the CFTC to be centrally cleared must be submitted to a CCP for clearing. A CCP must be a "derivatives clearing organization" (DCO) within the meaning of the CEA. Section 2(h)(1) of the CEA (7 U.S.C. 2(h)(1)), as added by section 723(a)(3) of the Dodd-Frank Act, provides in relevant part that "it shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is registered under the CEA or a derivatives clearing organization that is exempt from registration under the CEA if the swap is required to be cleared." You state that while regulations issued by the CFTC necessary to implement the provisions of the Dodd-Frank Act regarding the mandatory clearing of swaps are not yet in full effect,³ many market participants believe that the purpose of central clearing – the reduction of systemic risk and creation of transparency in the markets – is sufficient reason to begin clearing swaps in advance of the Dodd-Frank Act mandate.

Central clearing, in contrast to bilateral over-the-counter (OTC) swap transactions, changes the risk inherent in a swap transaction to both sides of the transaction. In the central clearing model, a plan's fiduciary contacts swap dealers for quotes on a particular transaction and, once it identifies a dealer as the desired counterparty, selects the clearing organization and a Clearing Member of that organization (which may or may not be affiliated with the plan's counterparty) to clear the swap. The protections offered by the clearing model are that instead of being subject to their counterparty's risk of default, each of the parties to the original swap transaction will face the CCP (either directly or through a Clearing Member as guarantor of the counterparty's obligations). Upon acceptance of a swap by the CCP for clearing, the original swap is extinguished, and is replaced by an equal and opposite swap between the CCP and each Clearing Member acting as principal for a house trade or acting as agent for a customer trade.⁴ Thus, if the original counterparty (e.g., a pension plan) defaults, its Clearing Member, as guarantor, is still contractually obligated to the CCP and the CCP to the other counterparty.

CCPs will have recourse to their own resources, as well as the financial commitments of their members and owners in fulfilling their commitments. You state that because CCPs will take only "paired" transactions, they will be neutral on market events and risk. Because Clearing

³ Subsequent to the submission of your letter, the CFTC issued final regulations requiring clearing of specified classes of interest rate and credit default swaps beginning March 11, 2013. 77 FR 74284 (December 13, 2012).

⁴ See 17 CFR § 39.12(b)(6); 76 FR 69334, 69437 (Nov. 8, 2011).

Members guarantee customers' obligations to the CCPs, the CCPs will be focused mainly on Clearing Member risk. In addition, CCPs will be able to manage their risk by requiring minimum capital and credit requirements from their members, by maintaining a default fund, by enforcing margin requirements on their Clearing Members, even if the Clearing Member's customer fails to post the necessary margin, and by holding most of the initial and variation margin themselves, rather than allowing it to be held by a Clearing Member. Initial and variation margin is in the nature of a performance bond to make up losses and pass on gains experienced by either counterparty through the duration of the swap. In light of the fact that the clearing model involves some transfer of default risk to the Clearing Members, the CCPs, rather than actual counterparties, will be the judge of the level of adequate margin in swap transactions.

All Clearing Members that clear on behalf of customers will be registered as futures commission merchants (FCMs), pursuant to the CEA, and will be required to comply with CFTC rules regarding how margin (which can be cash or securities) is held and invested. The CCP's Clearing Member may be involved in the collection, transmission and/or receipt of initial and variation margin to and from the CCP and the potential custody of excess margin. Margin that is held by Clearing Members may not be commingled with the Clearing Member's proprietary assets, although customer margin may be commingled with other customers' margin in the Clearing Member's omnibus account. The standard contracts (Agreements) between the Clearing Member and the customer do not provide that the customer holds title to assets in the margin account or that the Clearing Member has any authority to manage or invest assets on behalf of the plan. The customer is not relying on any communication of a Clearing Member as investment advice or as a recommendation under ERISA to enter into swaps. We assume that in no way will the Agreement be drafted to undercut the fundamental obligation of the Clearing Member and CCP to hold margin as protection for itself and the CCP and not for the plan.

It appears that if a customer defaults in the performance of any obligation under any transaction or agreement, the CFTC rules and the Agreements between the parties will provide specific rights to the Clearing Member and will typically permit the Clearing Member to liquidate the customer's positions by entering into completely or partially offsetting transactions and, in connection with the liquidation, to enter into certain risk-reducing transactions. In addition to default, these liquidation rights can be triggered by such things as a customer's bankruptcy, insolvency or similar proceedings, or for any other reason the Clearing Member deems advisable for its protection because circumstances may arise (e.g., a customer's bankruptcy filing) where a customer's default is reasonably foreseeable, and Clearing Members must have the ability to take anticipatory steps to protect themselves, the CCP, and other market participants. In each case, the Clearing Member will enter into such offsetting and risk-reducing transactions with other market participants, itself or its affiliates. The purpose of these provisions is to reduce the Clearing Member's market exposure, since, if the margin posted by the customer is inadequate to cover its exposure, the Clearing Member is liable to the CCP for that exposure. Even though the CCP is technically the counterparty to the defaulting customer, because the Clearing Member has guaranteed the customer's obligations, it is the party at risk in the event of a customer's default and thus needs controls over these remedies.

Although there typically exists some degree of flexibility with regard to mechanisms for terminating and closing out cleared swap positions by customers, the terms of any particular

Agreement between a Clearing Member and a customer will include provisions relating to the process by which Clearing Members may terminate and close out a defaulting customer's positions. Where the customer is an ERISA-covered pension plan, an independent, qualified plan fiduciary will approve the Agreements and specific contractual close-out rights negotiated thereunder before the contract is executed. You indicate that the Agreements will likely authorize the Clearing Member to do the following:

- enter into transactions that are opposite, or offsetting, one or more of the customer's (plan's) transactions;
- enter into transactions that do not fully offset but that replace, provide the economic equivalent of, or reduce the economic risk of, one or more of the customer's transactions;
- if the Clearing Member reasonably determines that it is not reasonably possible to enter into close-out transactions, enter into transactions, as a short-term interim measure, that hedge the risk of the customer's transactions until the Clearing Member can liquidate and terminate the customer's positions, including adding new swap positions for the customer's account in order to mitigate the liability of the Clearing Member; and
- take steps to transfer any transactions and associated margin in the customer's account to the Clearing Member's house account and enter into close-out or risk-reducing transactions in respect to the transferred transactions.

The losses payable by the plan or the gains payable to the plan in connection with these termination and close-out activities are the losses or gains incurred or realized by the Clearing Member in entering into close-out or risk-reducing transactions. The extent to which such close-out or risk-reducing transactions do not fully offset the plan's original transactions, losses or gains are calculated by the Clearing Member. The Agreements will likely require that Clearing Members provide defaulting customers, including ERISA-covered plans, a detailed statement following close out so that the customer (or its applicable fiduciary) can verify compliance with relevant contractual provisions. Further, to the extent the Clearing Member has transferred transactions to, or entered into transactions in, its own in-house account, the Clearing Member will be required to provide, upon the customer's request, information regarding such transactions that is reasonably equivalent to the information that would have been available to the customer if the transactions were entered into by the customer's own account.

Whether Clearing Members are Fiduciaries in Exercising Contractually Determined Rights in the Event of a Plan Default or Other Specified Events.

You request that the Department confirm that a Clearing Member acting pursuant to an Agreement negotiated with an ERISA plan customer would not be a plan fiduciary within the meaning of ERISA section 3(21)(A)(i) solely by reason of the termination and close out of the customer's swap position, and the sale of any assets posted as margin (whether held by the Clearing Member or the CCP) in order to satisfy losses and costs incurred on account of the customer's default or other events specified in the Agreement.

The determination of whether a person is a fiduciary is made by reference, in part, to section 3(21)(A)(i) of ERISA. Section 3(21)(A)(i) of ERISA states that a person will be a fiduciary with respect to a plan to the extent such person "exercises any discretionary authority or discretionary

control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets.” The opinion you request requires us to determine whether a Clearing Member would be exercising any authority or control with regard to the management or disposition of “plan assets” subject to ERISA when engaging in close-out and/or risk-reducing transactions, including offsetting transactions, to liquidate a plan customer’s positions in connection with a cleared swap, or series of cleared swaps. As noted above, our analysis is informed by our understanding that, when Congress enacted the Dodd-Frank Act, it did not intend for Clearing Members to perform these activities in a fiduciary capacity – and, indeed, that the swaps framework enacted by Congress and implemented in the CFTC’s regulations could not function properly if Clearing Members were exposed to the incompatible obligations of ERISA fiduciary status.

Margin and Plan Assets. Regulations issued by the Department describe what constitutes plan assets with respect to a plan's investment in other entities and with respect to participant contributions. In other situations, the assets of an employee benefit plan generally are to be identified on the basis of ordinary notions of property rights. It appears that both initial and variation margin paid by a pension plan in a swap transaction, which are used by the plan’s Clearing Member to support payment obligations that may become necessary for the plan under the swap transaction, are in the nature of performance bonds or good faith deposits and indicate a plan counterparty’s commitment to abide by the operative swap agreements. In Advisory Opinion 82-49A, the Department addressed the classification of margin in the context of futures contracts executed through a designated contract market. In the opinion, the Department’s position was based upon the representation that the plan has no ownership interest in any assets deposited to satisfy the margin or deposit requirements, although the plan may be entitled to withdraw funds based on price movements favorable to the plan. On the basis of that representation, we concluded that the assets used to fund the margin or deposit requirements for such transactions, e.g., futures contracts, would not be plan assets for purposes of Title I of ERISA.

In this context, it appears that margin deposited with a Clearing Member or CCP for a swap, or series of swaps, serves essentially the same function as in the futures contract market context, that is, margin is in the nature of a performance bond to assure that a swap counterparty will comply with its agreement. Furthermore, CFTC rules require Clearing Members to collect margin from their clearing customers. Moreover, as in the advisory opinion referenced above, a plan, as a swap counterparty, will have no right to any assets in the margin account (except for those which become available for withdrawal by reason of price movements favorable to the plan) since the Clearing Member and CCP hold margin to ensure the functionality of the clearing process and not on behalf of the plan. Based on the foregoing, it is the opinion of the Department that margin which is held by the Clearing Member or CCP in connection with a swap transaction is not a plan asset for the purposes of Title I of ERISA.⁵ Rather, when a plan engages in a cleared swap transaction, its assets are the rights embodied in the swap contract as evidenced by the written agreement (i.e., Agreement) between the plan and Clearing Member,

⁵ Since margin is not a plan asset, ERISA’s trust requirement would not apply and the Clearing Member would not be a custodian of plan assets by virtue of holding margin.

including rights the plan may have to gains payable to the plan that may be realized by the Clearing Member in entering into close-out and risk-reducing transactions.⁶

Clearing Members Exercising Rights upon Default or Other Specified Events. Pursuant to an Agreement negotiated with a plan customer, a Clearing Member may have a right to engage in certain liquidation or close-out transactions with respect to the plan's account in the event of a plan default or other contractually specified event. It appears that most of the instances where a Clearing Member may liquidate and close out a plan account will occur when a plan has failed to meet a margin call. However, the negotiated Agreement also may permit the Clearing Member to liquidate and close out a plan account as a result of other contractually specified events. While a primary method for closing out the account is to take offsetting positions, the Clearing Member may engage in the above-described risk-reducing transactions as well. You are concerned that the exercise of these rights may result in fiduciary status under ERISA. Section 3(21)(A)(i) of ERISA states that a person will be a fiduciary with respect to a plan to the extent such person "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets."

As noted above, a plan's assets in a cleared swap transaction are the rights embodied in the swap contract and granted pursuant to applicable law and relevant Agreement with the Clearing Member. It appears that under such Agreement, the plan customer and the Clearing Member each will have certain rights and obligations. A Clearing Member also has an essential role as part of the central clearing system in furthering Congress' goal of reducing systemic risk. A Clearing Member is the guarantor of its customer's obligation to the CCP. Furthermore, to address the concentration of risks faced by Clearing Members as a result of clearing, CFTC regulations require them, among other things, to collect margin payments from clearing customers, and to have processes in place to manage the financial risk they incur as a result of clearing trades.⁷ Thus, a Clearing Member is a portal through which market participants gain access to the protections of central clearing, as well as the first line of risk management in the operation of central clearing.⁸ A Clearing Member therefore has complex relationships with clearing customers, the CCP, and other market participants, that may change with surrounding circumstances. For example, under the Agreement, the Clearing Member will be obligated to act on behalf of the plan customer with respect to the cleared swap with the CCP and to handle margin payments, and the plan will be required to make initial and variation margin payments in a timely manner when called upon by the Clearing Member. Margin's role in the regulatory central clearing scheme is to allow the Clearing Member and CCP to assure their own financial integrity, which, in turn, contributes to the financial integrity and efficiency of the entire swaps marketplace.⁹ Thus, in setting the amount of margin, a Clearing Member will be acting on behalf of itself, and the CCP, to protect against the risk posed by customers.¹⁰

⁶ Margin held by Clearing Members may not be commingled with the Clearing Member's proprietary assets. However, subject to contractual restrictions negotiated with the Clearing Member, assets held in a particular customer's margin account may be commingled with assets of other customer margin accounts in the Clearing Member's omnibus account.

⁷ See 17 CFR §§ 39.13 and 1.73.

⁸ See 76 FR 45724 (Aug. 1, 2011).

⁹ See *Capital Options Investments, Inc. v. Goldberg*, 958 F.2d 186, 190 (7th Cir. 1992) (describing similar role margin plays in the futures marketplace). See also *Interpretation No. 10*, Comm. Fut. L. Rep. (CCH) ¶ 7120, at

Further, as your request points out, a Clearing Member also will need to take steps to protect against risk if a clearing customer defaults on an obligation or upon other events. As such, the ability of a Clearing Member to effectively manage the additional risks that result from a customer default also appears to contribute to the integrity and efficiency of the marketplace. Under some circumstances, a customer default may cause a Clearing Member to become insolvent and default to a CCP, which can disrupt the markets and the clearing system and harm customers in general. The importance of both collecting margin and taking steps to mitigate risk upon a customer default has been recognized in the futures context. For example, the CFTC has indicated that the FCM clearing a futures contract may take protective steps deemed necessary by the FCM in the exercise of its good faith business judgment in the event of customer default.¹¹ CFTC precedent also provides that when a customer receives but fails to pay a margin call in a futures contract “an FCM’s duty to protect the financial position of its other customers and its right to protect its own financial position supersedes any duties it owes to the defaulting customer, except the duty to mitigate damages.”¹² In such circumstances, the Commission permits FCMs to make good faith judgments about the steps necessary to protect their financial interests. These steps may include liquidation of the defaulting customer’s open positions. The CFTC has also noted that when the size of the affected position is substantial in relation to the immediately available liquidity, a simple immediate liquidation may expose both the FCM and its customers to unnecessarily high losses.¹³ In such circumstances, according to CFTC precedent, FCMs must be afforded the flexibility to make sound business judgments. The Dodd-Frank Act and the CFTC (which has regulatory authority in both the futures and cleared swaps marketplace) intended to impose the same flexible standard on Clearing Members in liquidating and closing out a defaulting customer’s cleared swaps accounts.

We assume that the provisions described above relating to Clearing Member liquidation and closeout rights will result from negotiations with an independent plan fiduciary, and that the parties understand that the Clearing Member will not be acting in a fiduciary capacity with respect to the actions taken in liquidating and closing out an account. With respect to rights that are activated by a plan customer’s default in a payment obligation, the consequence of such a default changes the essential character of the plan’s relationship with the Clearing Member from one where the Clearing Member is facilitating the swap transaction to one where the Clearing Member is acting on its own behalf under the terms of the Agreement to protect itself, the CCP and the clearing process from risk of loss. It appears that a Clearing Member would be acting in a similar manner to protect itself, the CCP and the clearing process, when exercising such rights

7133 (“[t]he free flow of required margin payments and the required deposits is absolutely essential to the proper functioning of the commodity exchanges. No customer, especially one who may maintain relatively large positions, can be permitted to interrupt that flow, or there will be the potential for serious adverse consequences to other market participants and the marketplace itself”).

¹⁰ A Clearing Member will have the discretion to require customer margin higher than the minimum level set by a CCP. See 17 CFR § 22.13(a).

¹¹ See *Baker v. Edward D. Jones & Co.*, Comm. Fut. L. Rep. (CCH) 21,167 (CFTC Jan. 27, 1981).

¹² *Lee v. Lind-Waldock & Co.*, Comm. Fut. L. Rep. (CCH) 28173 (CFTC June 29, 2000). See also *Hussain v. Saul Stone & Co.*, Comm. Fut. L. Rep. (CCH) 29,460 (CFTC Apr. 22, 2003)(a customer whose account has been liquidated by his FCM for failure to meet a margin call may raise as a defense that the FCM failed to mitigate its damages).

¹³ *Hussain v. Saul Stone & Co.*, *supra* note 12.

when they are activated by other events that are agreed upon by the plan customer and may indicate that the plan is at risk of default.

Accordingly, the Department is of the view that such granted contractual rights in the event of a default or other events that are agreed upon and may reasonably indicate that the customer is at risk of defaulting do not necessarily amount to the type of authority or control over plan assets contemplated under section 3(21)(A)(i) of ERISA. As a result, it is the Department's opinion that a Clearing Member acting pursuant to the Agreement negotiated with the plan fiduciary would not be exercising any authority or control with regard to plan assets and would not be a plan fiduciary within the meaning of section 3(21)(A)(i) solely by reason of liquidating the swap contracts in a plan's account and selling any collateral posted as margin in order to pay off losses suffered by such account.

In this regard, the Department notes that ERISA establishes comprehensive standards to govern fiduciary conduct. Among other things, fiduciaries with respect to an employee benefit plan must discharge their duties with respect to a plan solely in the interest of the plan's participants and beneficiaries, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Thus, plan fiduciaries must determine that an investment in a swap contract is, among other things, prudent and made solely in the interests of the plan's participants and beneficiaries. In determining whether to invest in a particular swap, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular swap plays in the plan's portfolio, the plan's potential exposure to losses through the swap, the contractual rights the plan is granting to any of the parties to the arrangement, including the plan's Clearing Member, in the event of a default and whether in the exercise of those rights, there has been adequate consideration of the potential economic exposure the plan may assume.¹⁴ Also, this would include a consideration of the fact that certain transactions between a plan and a counterparty who is a party in interest (including a fiduciary) with respect to such plan will be subject to the prohibitions of section 406 of ERISA.

Whether Clearing Members and CCPs are Parties in Interest to Plans.

As a result of the central clearing of a swap contract as described above, payments are made by each of the original swap counterparties (i.e., a swap dealer and end-user) to a CCP through their respective Clearing Members.

You have asked the Department whether, by performing the functions required by their respective roles in clearing a swap on behalf of a plan, the CCP or Clearing Member would be a party in interest with respect to a plan by reason of being "a person providing services to such plan" within the meaning of section 3(14)(B) of ERISA.

¹⁴ See DOL Letter to the Honorable Eugene A. Ludwig, Comptroller of the Currency, dated March 21, 1996.

The functions and related services provided by a CCP are an integral part of the mechanics of the process by which cleared swap transactions occur under applicable law. The role of the CCPs is an integral part of a comprehensive regulatory regime designed by Congress to reduce counterparty, and possible systemic, risks associated with swap payment defaults while, at the same time, enabling effective risk management for market participants. In this regard, CFTC regulations implementing the Dodd-Frank Act require each CCP to adopt procedures that would permit the CCP to take timely action to contain losses and liquidity pressures and to continue meeting its obligations in the event of a default on the obligations of a Clearing Member to the CCP.¹⁵ These regulations require that a CCP's default rules be made publicly available,¹⁶ and set forth the actions that the CCP may take upon a default, which must include the prompt transfer, liquidation, or hedging of the customer or house positions of the defaulting Clearing Member, and which may include, in the discretion of the CCP, the auctioning or allocation of such positions to other Clearing Members.¹⁷ A CCP's default rules also must set forth the sequence in which the funds and assets of the defaulting Clearing Member and its customers and the financial resources maintained by the CCP would be applied in the event of a default.¹⁸ In managing a plan default, the discretion of a CCP and a Clearing Member would be limited by applicable provisions of the CEA, CFTC regulations, and their own risk management rules, procedures, and agreements. This rule framework is guided by the underlining principle of loss mitigation, as discussed above. Accordingly, it is the view of the Department that the CCP does not provide services to the plan, and will not be deemed to be a party in interest with respect to the plan solely by reason of providing clearing services for the plan's Clearing Member. Furthermore, because the rights and obligations under the Agreement between the Clearing Member and its customer will be subject to the CEA, CFTC regulation, and the CCP's default rules, the Department is of the view that actions taken by the CCP pursuant to those rules with respect to plan customer accounts upon Clearing Member default would not necessarily amount to the type of authority or control over plan assets contemplated under section 3(21)(A)(i) of ERISA. With respect to the Clearing Member representing the plan, however, it is the opinion of the Department that, by virtue of a direct contractual agreement with the plan in the procurement of the clearance of swap transactions and other services, such as the collection and transmission, and/or receipt, of margin payments from the plan, the Clearing Member is providing services to the plan and as a result would be a party in interest with respect to the plan within the meaning of section 3(14)(B) of ERISA.

Whether a Transaction Constitutes a Prohibited Transaction under ERISA section 406.

Thus, in the Department's view, when facilitating a swap transaction involving a plan, a Clearing Member is a service provider, and therefore a party in interest with respect to the plan. As a result, certain transactions between the plan and the Clearing Member that occur in connection with swap transactions are prohibited under section 406(a) of ERISA unless an exemption applies. Section 406(a)(1)(A) of ERISA prohibits the sale or exchange of property between a plan and a party in interest. Section 406(a)(1)(C) of ERISA prohibits the provision of services between a plan and a party in interest. Section 406(a)(1)(B) of ERISA prohibits the direct or

¹⁵ 17 CFR § 39.16. The CFTC's rules apply to CCPs that are DCOs registered with the CFTC.

¹⁶ 17 CFR § 39.16(c)(3).

¹⁷ 17 CFR § 39.16(c)(2)(ii).

¹⁸ 17 CFR § 39.16(c)(2)(v).

indirect lending of money or other extension of credit between a plan and a party in interest. An “extension of credit” includes the guarantee of an obligation.¹⁹ As a result, the Clearing Member’s guarantee of the plan’s obligations to the CCP would be a prohibited transaction under section 406(a)(1)(B) of ERISA.

With respect to the Agreement with the Clearing Member for services and an extension of credit, Prohibited Transaction Exemption (PTE) 84-14 (the QPAM Exemption)²⁰ provides relief from section 406(a)(1)(A) through (D) of ERISA for transactions involving an investment fund in which a plan has an interest that is managed by a “qualified professional asset manager.” Certain conditions apply, including, in section I(c) of the exemption, that the terms of the transaction at issue be “negotiated on behalf of the investment fund by, or under the authority and general direction of, the QPAM” and that such QPAM “makes the decision on behalf of the investment fund to enter into the transaction.” The Department takes the view that section I(c) will be satisfied if the Agreement entered into by the QPAM sets forth all the material terms of the provision of services and guarantee by the Clearing Member.

Additionally, according to your representations, the Agreement may give the Clearing Member the right to engage in various liquidation or close-out transactions with respect to the plan’s swap transactions in the event of a plan default or other specified event. As described above, these may include transactions that are opposite, or offsetting, one or more of the plan’s transactions, or that involve transferring swaps from the plan’s account to that of the Clearing Member. The Clearing Member may also engage in short-term hedging transactions in order to mitigate its risk and liability. These transactions may require the Clearing Member to engage in purchases or exchanges directly with the plan, or to facilitate transactions between the plan and parties that may be parties in interest with respect to the plan.

You have asked whether relief for a liquidation or close-out transaction involving the provision of services or the exchange of property between the plan and the Clearing Member, or the exchange of property between the plan and another party in interest counterparty, could be covered by the QPAM Exemption. In this regard, the preamble to the QPAM exemption included a discussion, in response to comments, of the application of the exemption to transactions that are “subsidiary to a primary transaction.”²¹ We stated that section I(c) of the QPAM Exemption will be deemed satisfied in the case of subsidiary transactions “if the QPAM reviews the terms of the subsidiary transactions as part of its determination that the transaction, as a whole, is prudent and otherwise in the best interests of plan participants.”²² In the preamble discussion, the Department did not define a subsidiary transaction, but provided an example of a building that a QPAM was considering for purchase on behalf of an investment fund where there were pre-existing leases to parties in interest with respect to plans investing in the fund. Under these circumstances, as noted above, the Department concluded that section I(c) of the

¹⁹ Congress stated in the ERISA Conference Report that, “...a prohibited transaction generally will occur if a loan to a plan is guaranteed by a party-in-interest [disqualified person], unless it comes within the special exemption for employee stock ownership plans,” H.R. Rep. No 1280, 93d Cong., 2d Sess., at 308 (1974).

²⁰ Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers, 49 FR 9494 (March 13, 1984) as corrected at 50 FR 41430 (October 10, 1985) as amended at 70 FR 49305 (August 23, 2005) and as amended at 75 FR 38837 (July 6, 2010).

²¹ See 49 FR at 9497.

²² *Id.*

exemption would be deemed satisfied in the case of the subsidiary transaction where the QPAM reviewed the terms of the subsidiary transaction as part of its determination that the transaction, as a whole, is prudent and otherwise in the best interests of plan participants.

In addition to pre-existing transactions, however, it is our view that subsidiary transactions include transactions that are authorized by default or other contractual provisions forming an integral part of a primary transaction negotiated by the QPAM, but that are contemplated to occur subsequent to the execution of a primary transaction. Relief is available under the QPAM Exemption for such subsidiary transactions as long as the agreement governing the primary transaction includes specific provisions relating to the subsidiary transactions such that the QPAM can reasonably foresee their potential outcomes. In that event, the QPAM would have the ability to evaluate the subsidiary transactions as part of its decision to enter into the primary transaction, as was the case in the party in interest lease described above.

As applied in the cleared swaps context, the framework enacted by Congress and implemented through the CFTC's regulations requires that Clearing Members have the ability to close out a customer's position as needed to protect the Clearing Members' own interests, the interests of the CCP and the interests of its other customers. Accordingly, we would view the default and other contractual provisions governing the liquidation and close-out transactions as integral to the Agreement for swap clearing services. The QPAM Exemption would provide relief for such liquidation and close-out transactions as subsidiary transactions if the agreement governing the primary transaction (in this case, the Agreement for swap clearing services) negotiated by a QPAM contains sufficient terms of the subsidiary transactions such that the potential outcomes of the subsidiary transactions are reasonably foreseeable to the QPAM when entering into the Agreement. Specifically, in evaluating the potential outcomes of these transactions, the QPAM would look to the terms of the Agreement regarding the rights of the Clearing Member upon a plan's default or other contractually specified event, including, but not limited to: (1) provisions addressing how the Clearing Member may engage the plan in risk-offsetting positions; (2) provisions regarding the price at which the Clearing Member may liquidate positions, as well as the liquidation process; (3) provisions addressing how the plan's positions may be auctioned off; and (4) provisions addressing how the Clearing Member may purchase the plan's positions directly. If the QPAM executes an Agreement including these terms, liquidation and close-out transactions entered into pursuant to the Agreement would not fail to satisfy the requirements of the QPAM Exemption solely by reason of section I(c) of the QPAM Exemption.²³

Under section 404 of ERISA, a QPAM must act prudently with respect to the decision to enter into an Agreement as well as in negotiating the specific terms of the Agreement. We note that in order to satisfy its responsibilities under section 404, a QPAM may need to request and evaluate additional information beyond what is set forth in the Agreement regarding liquidation and close-out transactions and pricing methodologies covered by the Agreement, before making a determination to enter into such an Agreement.

We have conferred with officials of the CFTC regarding this letter. They have authorized us to state that they concur with our description of "cleared swap" transactions conducted pursuant to

²³ This analysis would also apply to section I(a) of PTE 96-23, Plan Asset Transactions Determined by In-House Asset Managers 61 FR 15975 (April 10, 1996) as amended at 76 FR 18255 (April 1, 2011).

provisions of the CEA, and that they do not believe the conclusions reached in this letter are inconsistent with the CEA or the CFTC's regulation of cleared swap transactions under the CEA.

To the extent issues raised by this interpretation affect current practice in the futures or swaps marketplace or relevant provisions or restrictions of the CEA, as amended by the Dodd-Frank Act, the Department is prepared to examine such issues in the context of providing additional regulatory guidance or future prohibited transaction relief.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). The letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

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Office of Regulations and Interpretations

Lyssa E. Hall
Director
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