Dodd-Frank Presentation Materials

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Dodd-Frank and retirement plans

1. The role of derivatives in retirement plan finance

    - Interest rate swaps used to manage interest rate risk in DB plans
    - Asset allocation and transition management
    - GICs

2. 5 questions for plans

    - Will status as "special entity" limit ability to engage in swap transactions?
    - Will plans' interest rate swaps have to be cleared?
    - Will GICs be affected?
    - Will some plans be treated as Major Swap Participants?
    - Will US derivatives markets become less efficient/less useful?

3. Special entity status

    - Pension plans, governmental entities and endowments are "special entities."
    - Swap dealers and MSPs that are mere counterparties must have a reasonable basis to believe that the special entity has a competent independent representative.
    - Concern that this requirement will result in an approved list/counterparty veto-power over the plan's choice of advisor.
    - Some concern that Dodd-Frank obligations (e.g., reporting) may make a "mere" counterparty a fiduciary.

4. Where the special entity is an advisor

- Must act in best interests of plan.
- Advisor status is triggered by merely making a recommendation to the special entity.
- Consequences of "special entity" rule.
    - Likely result: all swap transactions will involve three parties: plan, swap dealer and advisor.

    - Concern that rule will limit R&D on swaps targeted at plans.
    - At the margin derivative transactions will be harder to do for plans.
    - Worst case: it may be impossible, for some plans and some transactions at least, to find a counterparty willing to deal.

5. Must all swaps be cleared?

- A swap must be cleared if it is clearable -- that is, is being cleared by an exchange.
- Cleared swaps lose many efficiencies -- that is, for many plans, they will be more expensive. Margin requirements, cost (for counterparties that do not perform) and design limitations are likely to be problems.
- Key guidance is still missing -- Dodd-Frank "evade" standard.
- Example: if 3-month swaps are clearable, is a 1-month swap legitimately non-clearable or an evasion?

6. GICs

- Dodd-Frank mandated a study.
- Hope is that this issue will just go away.

7. Plans as MSPs

- Dodd-Frank imposes swap dealer rules on certain major market participants -- "major swap participants."
- Tests are quantitative -- e.g., a "current uncollateralized exposure" of $1 billion.
- Rules are technical and it is unclear how plans with multiple exposures will do calculations.
- Nevertheless, everyone, including regulators, believes that in the ordinary course plans should not have a problem.

8. Continuing viability of US derivatives markets

- Obviously, all are committed to making Dodd-Frank work.
- Power-users of the derivatives markets, including DB plans, have some concern that more regulations will reduce efficiency and, ultimately, utility of these markets.

9. Regulatory process

- We are (still) in the middle of the development of regulations.
- Some plans are active in lobbying, others are unaware of possible consequences.

Dodd-Frank compliance process

September 10, 2010

One of the regulatory challenges for defined benefit and defined contribution plan sponsors over the next several years will be compliance with new rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act, AKA financial services reform. In this article we simply want to identify the issues the Act presents for plan sponsors. We'll do our best to discuss what we understand to be the major ones, but it is likely that, in the process of articulating in concrete terms what the new rules mean, new issues will emerge.

Timeline

Let's begin with a basic timeline. For plans, the critical section of the Act is Title VII -- Wall Street Transparency And Accountability -- which generally articulates rules for the swaps/derivatives markets and for participants in those markets. Title VII includes, for instance, provisions with respect to the fiduciary obligations of swaps dealers who deal with pension plans, the treatment of stable value contracts and the treatment of plans that are "major swaps participants."

Generally, Title VII is effective on "the later of 360 days after the date of the enactment of this subtitle or, to the extent a provision of this subtitle requires a rulemaking, not less than 60 days after publication of the final rule or regulation implementing such provision of this subtitle." So the first critical question is, will the new provisions affecting plans apply in July 2011 or will their effect be delayed as specific rules under regulations are worked out? As of today there is no certain answer to this question, but we think it is likely that transactions will not have to comply until guidance is issued. Getting certainty on this point -- when activity in the derivatives markets will be subject to new rules -- is a top priority, and we would expect some guidance on it relatively soon.

Fiduciary provisions

The Act identifies ERISA plans, along with government entities, government plans and endowments, as "Special Entities," with respect to which swap dealers and major swap participants (MSPs) owe certain special duties.

Duties of swap dealers and MSPs that are advisors

While the language of the Act is not entirely clear, it appears that a swap dealer or MSP acting as an advisor to a special entity is, in effect, subject to a fiduciary standard of conduct, including a duty to make reasonable efforts to obtain the information necessary to determine that any recommended swap is in the best interests of the Special Entity. The critical question is: to what extent does this standard impose duties on fiduciary-advisors to ERISA plans that are different from those already applicable under ERISA? It is likely that whatever approach the key agencies -- the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) -- take on this issue, they will want to coordinate with the Department of Labor.

Duties of swap dealers and MSPs that are only counterparties

Where the swap dealer or MSP is acting only as a counterparty, it must, before the transaction is initiated, disclose to the Special Entity in writing the capacity in which it is acting. There is some controversy about whether provisions of the Act -- requiring that a counter-party swap dealer or MSP make a determination that a plan is being adequately advised by an independent expert/fiduciary and imposing certain other requirements -- apply to plans. We would expect relatively early on in the development of regulations in this area to get some guidance on this issue. To the extent that the rules do apply to transactions with plans, there is again the question of how they interact with requirements under ERISA.

Significance for plans

Each of these new standards will affect, e.g., the manner in which swap dealers and MSPs will deal with plans participating in the swap markets. Both dealers and plans will want confidence that the rules, whatever they are, have been complied with. There will also be issues about, e.g, who bears the burden of loss with respect to a transaction that is non-compliant.

Application to stable value contracts

During debate over the Act, concerns were raised about whether stable value contracts, including synthetic GICs, were swaps and therefore subject to the Act's new rules and, if they were subject to the new rules, how they should be treated. As a solution, the Act passed this problem to the agencies.

Under the Act, the SEC and CFTC, in consultation with the Department of the Treasury and the Department of Labor, must, within 15 months, conduct a study "to determine whether stable value contracts fall within the definition of a swap." If stable value contracts are determined to be swaps, then the SEC and CFTC must determine whether an exemption for them is appropriate and in the public interest. Then the SEC and CFTC must publish regulations implementing their determinations. Until all of that happens, the requirements of the Act do not apply to stable value contracts.

Parsing all of this, no news is, in effect, good news. Most agree that there is, generally, not a significant policy issue at stake with respect to stable value contracts -- that is, that there is not a serious potential abuse like that Congress believed existed with respect to some derivatives (e.g., credit default swaps). So we would expect a positive outcome -- benign neglect or an affirmative finding either that stable value contracts are not swaps or that they should be exempt from the Act's swap requirements.

Plans as major swap participants

New rules under the Act with respect to, e.g., capital, margin and the obligation to clear trades apply to swap dealers and "major swap participants." Oversimplifying, a major swap participant is someone who maintains a "substantial position" in swaps. For purposes of this definition, positions held by ERISA plans "for the primary purpose of

hedging or mitigating any risk directly associated with the operation of the plan" are excluded.

Plans that use swaps as a significant investment tool, e.g., in fixed income funds, will want to understand the exact scope of this exclusion. Plans will need to know where the line is: What is a substantial position? Which positions hedge or mitigate risk and which do not? And they will need to know how, if they cross the line, they are to comply with, e.g., the Act's capital requirements -- a plan's "capital" is not a concept that is intuitively meaningful in the pension world.

Interest rate swaps -- clearing requirement

Interest rate swaps play a key role in many plans' investment strategies. Almost all of this activity currently takes place *off* of exchanges. It's clear that, under the Act, almost all of this activity will have to take place *on* exchanges. This change -- from privately arranged transactions to exchange-clearing -- is certainly one of the biggest innovations of the Act. Every interest rate market participant -- emphatically including plan sponsors -- is concerned about how it will be implemented, and it is likely to be a major focus of the SEC's and CFTC's regulatory efforts.

* * *

These are, in our view, the major issues immediately confronting plan sponsors under the Act. It is our sense that efforts to develop regulations on these issues are in the very early stages. We will update this discussion as new issues emerge, and as the agencies come forward with concrete answers to the questions we have discussed.

* * *

This is a publication of the Plan Advisory Services Group. If you have any comments, or have questions about regulatory developments, or would like to be added to our email mailing list, please contact Mike Barry at michaelpbarry@rcn.com.

CFTC proposes business conduct rules

January 28, 2011

Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) raises a number of issues for retirement plans. The major issues we would identify are: (1) the higher standard of conduct applicable to swap dealers/major swap participants (MSPs) dealing with ERISA plans; (2) the treatment of guaranteed investment contracts (GICs); (3) the status of plans as MSPs; and (4) the consequences for plans of major changes to the regulation of US derivatives markets.

In December 2010 the Commodity Futures Trading Commission and the Securities and Exchange Commission released several proposed regulations under Dodd-Frank. In this article we review what most consider the most significant proposal -- new business conduct standards for swap dealers and major swap participants dealing with "special entities" including ERISA plans. In following articles we will review proposals with respect to the definition of "major swap participant" and clearing requirements.

Summary

The discussion that follows is very detailed. So here is our best shot at a summary/bottom line: For DB plans, the CFTC special entity proposal does two things that are problematic. First, it imposes stiff "independent representative" standards on *all* swap transactions involving ERISA plans. One of the consequences of this rule is likely to be that, in effect, swap dealers will have veto power over who advises a plan about swap transactions. And there is concern that in exercising that veto swap dealers may, in the best case, be biased towards advisors that they know and are comfortable with, as opposed to advisors that the plan and plan sponsor know and are comfortable with. Second, it sets the threshold for triggering the new Dodd-Frank "best interests" standard too low. Simply by making a swap recommendation to an ERISA plan, a swap dealer will trigger an obligation to act in the best interests of the plan.

We note, finally, that these rules generally are only applicable to "bespoke" -- that is, non-cleared -- swaps. Cleared swaps, at least where the counterparty-swap dealer/MSP does not know that it is dealing with a special entity or who the special entity is, are generally not subject to these rules.

The critical issue: interest rate swaps

By way of background, we begin with a discussion of why the ability to do certain swap transactions is important for, particularly, defined benefit plans. DB plan funding and accounting costs are subject to two major "external" variables: the performance of the securities markets and changes in interest rates. Interest rates are important because they are used to value liabilities and thus have a significant effect on the calculation of minimum funding and charges to income. When interest rates go down, liability values go up and (typically) funding and pension expense go up.

In recent years sponsors and swap market participants have used derivatives -- interest rate swaps -- to hedge interest rate volatility and thus hedge the interest rate component of pension contribution and expense volatility. This strategy goes by different names -- LDI ("liability driven investment" -- although that term is usually used more broadly), "overlay," etc. Radically oversimplifying, it typically involves a variable rate/fixed rate swap in the LIBOR (London Interbank Offered Rate) market. The derivative "overlay" increases the duration of the plan's portfolio. In practical terms, with such a swap-based hedging strategy in place, when interest rates go down, the value of the swap transaction goes up, offsetting the cost of the increase in liabilities.

The special entity rule "problem"

The ongoing ability of plans to efficiently engage in these sorts of transactions is regarded by many as a critical element of DB plan finance. Many are concerned that Dodd-Frank rules imposing a higher, "fiduciary-type" conduct standard on swap dealers and MSPs dealing with pension plans will compromise plans' ability to engage in these transactions. Stated simply: if a swap dealer must conform to a higher standard of care when dealing with a DB plan than when dealing with a "regular" swap customer, the dealer will prefer dealing with the regular customer and may, in effect, close the market to, or impose additional costs on, DB plans.

So while the special entity rule may look good -- it does indeed require swap dealers to "be nicer" to DB plans -- it actually makes it harder for plans to participate in the swap market.

CFTC proposal

That's the issue. In negotiations during the legislative process, Dodd-Frank conferees addressed these concerns by taking a two-pronged approach. The higher standard of conduct would apply to swap dealers and MSPs *advising* plans. For "mere" counterparties generally the only additional requirement would be that the swap dealer/MSP make a determination that a plan is being adequately advised by an independent expert/fiduciary. The hope -- at the time these provisions of Dodd-Frank were being hammered out -- was that this approach would not significantly affect current practice.

The CFTC proposal implements these rules. It is problematic in a number of ways.

General standard

The focus of this article will be the application of the new Dodd-Frank fiduciary standard to DB plans, but we're going to begin with the general standard applicable to swap dealers in *any* swap transaction -- that is, in effect, the baseline to which the additional fiduciary standards are added.

Generally, with respect to any swap transaction, the proposal imposes on swap dealers and MSPs an anti-fraud standard, an obligation to disclose material information about the risks, characteristics, incentives and conflicts of interest regarding a swap, and a general

obligation to communicate in a fair and balanced manner based on principles of fair dealing and good faith. In addition, where the swap dealer/MSP *recommends* a swap to a counterparty in connection with a swap or swap trading strategy, the swap dealer/MSP must have reasonable grounds to believe that the recommendation is suitable for its counterparty.

Reliance on representations

With regard to this "know your counterparty" suitability standard, the swap dealer/MSP may rely on representations made by the counterparty if:

> It has a reasonable basis to believe that the counterparty was capable of independently evaluating relevant risks with regard to the particular swap or trading strategy.
>
> The counterparty has affirmatively indicated that it is exercising independent judgment in evaluating any recommendations. And,
>
> The swap dealer/MSP has a reasonable basis to believe that the counterparty has the capacity to absorb potential losses related to the recommended swap or swap trading strategy.

What is a "recommendation?"

Whether a swap dealer/MSP has made a recommendation and thus triggered its suitability obligation would depend on the facts and circumstances of the particular case. A recommendation would include any communication by which a swap dealer/MSP provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty, but would not include information that is general transaction, financial, or market information, or swap terms in response to a competitive bid request from the counterparty.

We've included this discussion on the general rule for two reasons. First, to the extent that this new "know your counterparty" standard will make market participation more difficult, it will make it more difficult for everyone, not just ERISA plans. And second, because the "recommendation" standard is also applied in determining who is an "advisor" to special entities, triggering the new "best interests" standard of conduct.

Now let's turn to the proposal directly affecting DB plans.

Transactions between swap dealers/MSPs and special entities

Dodd-Frank applies special rules to swap dealers/MSPs dealing with special entities. While there are some questions about who is a special entity, it is clear that an ERISA DB plan would be a special entity to which the new rules would apply.

There are three key questions about how that new special entity rule would work: First, what standards apply generally to transactions between swap dealers/MSPs and special

entities? Second, how do you tell if you are an "advisor" to a special entity (and thus subject to a higher standard), rather than a "mere" counterparty? And third, what higher standard applies if you are an advisor?

What standards apply generally to transactions between swap dealers/MSPs and special entities?

Generally, any swap dealer/MSP that offers or enters into a swap with a special entity must have a reasonable basis to believe that the special entity has a representative that:

(1) Has sufficient knowledge to evaluate the transaction and risks.

(2) Is not subject to a statutory disqualification.

(3) Is independent of the swap dealer/MSP.

(4) Undertakes a duty to act in the best interests of the special entity.

(5) Makes appropriate and timely disclosures to the special entity.

(6) Evaluates, consistent with any guidelines provided by the special entity, fair pricing and the appropriateness of the swap.

(7) In the case of employee benefit plans subject to ERISA, is an ERISA fiduciary.

As we have discussed (see our article on the Dodd-Frank compliance process), there is a question about whether all of these rules, or just the last one (item (7)), would apply to ERISA plans. The CFTC has asked for comments on that issue. The proposal is to make all of them applicable.

The most problematic element of this rule is probably item (1) -- in effect a requirement that a plan's swap dealer-counterparty be satisfied with the expertise of the *plan's* advisor. The CFTC, in the preamble to the proposal, acknowledged that "[s]ome stakeholders have expressed concern that the independent representative requirement places undue influence in the hands of the swap dealer or major swap participant by allowing it to use [the applicable criteria] to control who qualifies as an independent representative." Even without "undue" influence, it's entirely conceivable that swap dealers/MSPs concerned about exposure here will limit the acceptable universe of "qualified" independent representatives in a way that will disqualify some plans' advisor-representatives. As the universe of advisor-representatives is restricted, advisor-related costs will go up and/or some plans will lose access to the swaps market.

We expect this element of the CFTC proposal to be controversial.

How do you tell if you are an "advisor" to a special entity?

Under the proposal, a swap dealer that makes a "recommendation" to a special entity will be an "advisor." Again, a swap dealer that merely provides to a special entity general transaction, financial, or market information or that provides swap terms as part of a response to a competitive bid request from the special entity does not fall within the definition. The most obvious point to make about this definition is that it sets a much lower threshold than ERISA's fiduciary definition. That is, for a swap dealer, it is a lot easier to become an advisor and thus be subject to Dodd-Frank fiduciary rules than it is to become an ERISA fiduciary.

What standard applies if you are an advisor?

Under Dodd-Frank, a swap dealer that is an advisor to a special entity has a duty to act in the "best interests" of the special entity. The proposal does not define "best interests." It's probably most useful to quote the preamble to the proposal on this point:

> The proposed rule would not define the term "best interests." There are established principles in case law under the [Commodity Exchange Act], with respect to the duties of advisors which will inform the meaning of the term on a case-by-case basis. The Commission believes that those best interest principles, in the context of a recommended swap or swap trading strategy, would impose affirmative duties to act in good faith and make full and fair disclosure of all material facts and conflicts of interest, and to employ reasonable care that any recommendation given to a Special Entity is designed to further the purposes of the Special Entity. … The proposed rules are intended to allow existing business relationships to continue, albeit subject to the new, higher statutory standards of care.

We note that the proposal does not explicitly apply a fiduciary standard to swap dealers "advising" special entities. How close the "best interests" standard comes to a full-blown fiduciary standard the proposal, in effect, leaves to litigation. The CFTC asks for comments on whether they should be subject to an *explicit* "fiduciary" duty.

Information due diligence

In any case, a swap dealer that acts as an advisor to a special entity must make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by the swap dealer is in the best interests of the special entity. The relevant information, according to the proposal, includes:

> The authority of the special entity to enter into a swap.
>
> The financial status of the special entity, as well as future funding needs.
>
> The tax status of the special entity.
>
> The investment or financing objectives of the special entity.

The experience of the special entity with respect to entering into swaps, generally, and swaps of the type and complexity being recommended.

Whether the special entity has an independent representative that meets the criteria discussed above.

Whether the special entity has the financial capability to withstand potential market-related changes in the value of the swap during the term of the swap.

Such other information as is relevant to the particular facts and circumstances of the special entity, market conditions and the type of swap recommended.

Reliance on representations

With respect to these information requirements, the swap dealer may rely on written representations of the special entity, provided that:

The swap dealer has a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of a particular swap dealer-special entity relationship, assessed in the context of a particular transaction.

The representations include information sufficiently detailed for the swap dealer to reasonably conclude that the special entity is: capable of evaluating independently the material risks inherent in the recommendation; exercising independent judgment in evaluating the recommendation; and capable of absorbing potential losses related to the recommended swap.

The swap dealer has a reasonable basis to believe that the special entity has a representative that meets the criteria non-advisor swap transactions.

* * *

As we said, the problematic elements of the new rule are: (1) a regulatory scheme that seems to require that a swap dealer in effect approve the plan's advisor; and (2) the imposition of a higher, "best interests" standard of conduct on swap dealers who recommend a swap strategy/transaction.

While these rules have a superficial appeal -- they look like they are "pro-ERISA plan" -- the economic reality is that, in imposing additional burdens on market makers dealing with plans, they, in the best case, impose additional costs on plan transactions. Worst case, they make those transactions impossible. It's certainly conceivable that, all other things being equal, a swap dealer will be less likely to deal with a special entity, including a pension plan, than a "non-special" entity with respect to which it will not be held to a higher standard of conduct.

Much of the discussion of these rules is related to new rules for clearing swaps because, generally, cleared swaps get a pass on them. In a subsequent article we will discuss,

among other things, new clearing requirement rules.

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CFTC/SEC propose rule defining major swap participants

February 2, 2011

Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) raises a number of issues for retirement plans. The major issues we would identify are: (1) the higher standard of conduct applicable to swap dealers/major swap participants (MSPs) dealing with ERISA plans; (2) the treatment of guaranteed investment contracts (GICs); (3) the status of plans as MSPs; and (4) the consequences for plans of major changes to the regulation of US derivatives markets.

Our last article covered the Commodity Futures Trading Commission proposed rule on business conduct standards for swap dealers and major swap participants dealing with "special entities" including ERISA plans. In this article we discuss the CFTC/Securities and Exchange Commission proposed rule defining "major swap participant." Our next article will discuss the proposal for the review of swaps by the CFTC to determine whether they must be cleared.

The issue: plans as major swap participants

Dodd-Frank imposes new capital, liquidity and business conduct standards on swap dealers and on major swap participants (hereafter, MSPs). While plans will not be swap dealers, they could conceivably be MSPs -- hence the importance of the agencies' rulemaking on this issue.

In the relevant part (relevant to ERISA plans, that is) Dodd-Frank defines an MSP as any person who is not a swap dealer:

> Who maintains a substantial position in swaps for any of the major swap categories, excluding positions maintained by any ERISA employee benefit plan for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan. Or
>
> Whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets.

Note that these tests are in the alternative.

Issues directly affecting plans

For ERISA plans, the key questions are: First, will articulation of the "substantial position" and "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets" tests be so broad (e.g., will the dollar thresholds be so low) that they will sweep in any ERISA plans? And, second, how broadly will the exclusion (from the "substantial position" test) for "hedging or mitigating any risk directly associated with the operation of the plan" be?

Triggers

The first question is, basically, will the tests -- the MSP "triggers" -- for what is a "substantial position," "substantial counterparty exposure" and "serious adverse effects on the financial stability, etc." be set at a level low enough to pick up ERISA plan activity? Summarizing: given the conservative nature of most plan swap activity, it looks like the answer is "no" -- that is, plans generally won't be MSPs under the proposal.

What follows is a more detailed discussion of the proposed MSP status triggers.

Substantial position

As a preliminary matter, since the statute speaks of a substantial position "for any of the major swap categories," the CFTC and SEC had to specify what categories would apply. The CFTC identified four categories of commodity swaps: rate swaps; credit swaps; equity swaps; and other commodity swaps. The SEC identified two categories of security-based swaps: any security-based swap that is based, in whole or in part, on one or more instruments of indebtedness; and any other security-based swaps not included in the first category, including, for example, equity swaps.

Now, the "substantial position" rule: Generally (and oversimplifying somewhat) a person has a substantial position for MSP purposes if:

> It has a "current uncollateralized exposure" of a daily average of $1 billion in any applicable major category of swaps, except that the threshold for the rate swap category would be a daily average of $3 billion. Or
>
> It has a "current uncollateralized exposure plus aggregate potential outward exposure" of $2 billion, except that the threshold for the rate swap category would be a daily average of $6 billion.

The proposal provides elaborate rules for calculating potential future exposure. Quoting the preamble:

> The potential future exposure portion of this proposed test would be based on an entity's "aggregate potential outward exposure," which would reflect the potential exposure of the entity's swap or security-based swap positions in the applicable "major" category of swap or security-based swaps, subject to certain adjustments. … The exposure measures in general would be based on the total notional principal amount of those positions, adjusted by certain risk factors that reflect the type of swap or security-based swap at issue and the duration of the position. … [T]he proposed measures would contain adjustments for certain types of positions that pose relatively lower potential risks. In addition, the general risk-adjusted notional measures of potential future exposure would be reduced to reflect the risk mitigation effects of master netting agreements, in a manner consistent with bank capital standards.

Many believe that, e.g., the typical interest rate swap would not present significant potential future exposure, although with the vagueness of these rules and the complexities of these instruments and markets, it's not entirely clear that that is the case.

Relevance to plans

Note that, for purposes of the "substantial position test," positions maintained by any ERISA employee benefit plan "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan" are ignored. The scope of that exception is discussed below. That exclusion may let many plans "off the hook."

Moreover, as we understand it, most plan swap positions (e.g., DB interest rate swaps) are fully collateralized, which again makes it unlikely that they would "pass" this MSP test.

It is, nevertheless, at least conceivable that some plan's ("purely speculative," uncollateralized or non-hedging) position could exceed these limits; and plans engaging in such activity (if there are any) will want to monitor the level of that activity relative to this test.

Substantial counterparty exposure; serious adverse effects on the financial stability of the United States banking system or financial markets

The agencies are proposing that the focus of this second, "risk to the system" test use the same measures of "current uncollateralized exposure" and "potential future exposure" that are used in the "substantial position" test, but that this test focus on the entirety of an entity's positions, rather than on positions by category. And, this test is applied without regard to the ERISA plan exclusion; that is, plan hedging activity is counted in this test.

Here's the "risk to the system" test: For commodity swaps, the test is passed (and MSP status triggered) if current uncollateralized exposure is at least $5 billion or combined current uncollateralized exposure and potential future exposure is at least $8 billion. For security-based swaps the test is passed if current uncollateralized exposure is at least $2 billion, or combined current uncollateralized exposure and potential future exposure is at least $4 billion.

Scope of the ERISA plan exclusion

The ERISA plan exclusion allows plans to ignore certain positions -- those "hedging or mitigating any risk directly associated with the operation of the plan" -- for purposes of the substantial position test. Most observers believe the ERISA plan exclusion clearly covers, e.g., interest rate hedging by defined benefit plans. Less clear is whether swap transactions, e.g., in connection with a portfolio re-alignment, would also be covered. In this regard, the CFTC/SEC said, in the preamble to the proposed rule, that:

> Some commenters suggested that the exclusion should encompass activities such as portfolio rebalancing and diversification, and gaining exposure to alternative asset classes, and that this type of exclusion also should apply to

certain other types of entities.

The CFTC, apparently, believes this is a non-issue. Again quoting the preamble:

> We preliminarily do not believe that it is necessary to propose a rule to further define the scope of this exclusion. In this regard, we note that this ERISA plan exclusion, unlike the other exclusion in the first major participant test, is not limited to "commercial" risk, which may be construed to mean that hedging by ERISA plans should be broadly excluded.

Translation: the agencies don't appear to see most plan activity as presenting a problem under this test.

* * *

In this discussion we have focused on the issues under the proposal that directly affect ERISA plans. The Dodd-Frank MSP provisions present a number of other issues -- for instance how to calculate uncollateralized exposure -- generally applicable to any potential MSP, that we do not discuss.

Many believe that plan swap activity is generally conservative, collateralized and unlikely to trigger -- even for large plans -- MSP status under the proposal. This would appear to be the attitude of the agencies as well. There is, in the proposal, no attempt to explain how capital and business conduct requirements would apply to an entity such as an ERISA plan.

Nevertheless, plans for which swaps are a significant tool should review the proposal to determine if it presents any issues for them. And, in this regard, we note that for plans, managing a variety of investment strategies and risks with multiple managers, the process of calculating aggregate exposure under these rules may be problematic.

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CFTC proposes rule on swaps clearing

February 15, 2011

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Our two previous articles covered the Commodity Futures Trading Commission proposed rule on business conduct standards for swap dealers and major swap participants dealing with "special entities" including ERISA plans and the CFTC/Securities and Exchange Commission proposed rule defining "major swap participant."

In this article we discuss the CFTC's proposed rule regarding the Process for Review of Swaps for Mandatory Clearing. At this point, as discussed below, we have, effectively, no guidance on this issue. So this article simply (and very briefly) describes the "problem."

The issue

Generally, the new Dodd-Frank mandatory clearing requirement will affect all market participants (although there are certain exceptions for certain transactions and certain market participants). There are, however, a set of issues with which retirement plans have a heightened level of concern. These include:

> The possible compromise of the ability to segregate collateral.
>
> Undertaking (with other clearing facility participants) to guarantee the trades of (possibly) less financially solvent counterparties.
>
> Increased transaction costs (in some cases, significantly increased) resulting from the inability to directly exploit scale; as we understand it, the key issue here is that exchange traded "swaps" will be subject to standardized margin requirements that may not apply in over-the-counter arrangements (because of the high quality of the pension plan's credit). There are also concerns about issues with respect to the netting of collateral.

While there is no question that these features of an exchange system will reduce efficiency for plans and for certain other market participants, the gains in transparency and general market efficiency from having an exchange will offset those "losses." Nevertheless, plans that use swaps as a significant investment and risk management tool will, in many cases, want to be able to continue to do over-the-counter swaps and retain the efficiencies of the current (i.e., pre-Dodd-Frank) system.

Not all swaps are subject to mandatory clearing. Oversimplifying, after the Dodd-Frank exchange system is up and running, if a particular swap is not currently being cleared on an exchange, it's not subject to mandatory clearing.

Guidance to come

So the big question is, how do you determine if the swap you are currently trading will have to be cleared. And the answer at this point is: we're not really sure. The rule proposed in December 2010 by the CFTC describes how you can tell if a swap *may* be cleared. It does not address the converse issue -- how do you tell if your swap is not "clearing eligible?"

The rule that, in all likelihood, will defined the terms of this inquiry will be the CFTC's interpretation of Dodd-Frank's "evasion" provision. Dodd-Frank provides that:

> To include transactions and entities that have been structured to evade this subtitle (or an amendment made by this subtitle), the Commodity Futures Trading Commission shall adopt a rule to further define the terms "swap", "swap dealer", "major swap participant", and "eligible contract participant".

Whether a particular "current" swap is subject to mandatory clearing will depend in large part on how this rule is interpreted and applied. For example, if an exchange is clearing 3-month interest rate swaps and your plan is using a 1-month swap, will the preference for a 1-month swap be considered a "mere" evasion or will it be considered justified based on the unique character of the risks you are trying to hedge?

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We will provide a more detailed treatment of this issue when the CFTC provides guidance.

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This is a publication of the Plan Advisory Services Group. If you have any comments, or have questions about regulatory developments, or would like to be added to our email mailing list, please contact Mike Barry at michaelpbarry@rcn.com.