



APPLICABILITY OF BUSINESS CONDUCT STANDARDS TO ERISA PLANS

This document is being submitted on behalf of the American Benefits Council (the “Council”) and the Committee on Investment of Employee Benefit Assets (“CIEBA”).

The Council is a public policy organization principally representing Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

CIEBA represents more than 100 of the country’s largest pension funds. Its members manage more than \$1.4 trillion of defined benefit and defined contribution plan assets, on behalf of 17 million plan participants and beneficiaries. CIEBA members are the senior corporate financial officers who individually manage and administer ERISA-governed corporate retirement plan assets.

This document addresses the certain business conduct standards that the CFTC and SEC may impose on swap dealers, security-based swap dealers, major swap participants (“MSPs”), and major security-based swap participants when they offer to enter into or enter into a swap with a “Special Entity” that is an ERISA plan. (For convenience of presentation, all references below are simply to swap dealers and MSPs.) Specifically, this document addresses the application of new section 4s(h)(5)(A) of the Commodity Exchange Act and the parallel new section 15F(h)(5)(A) of the Securities Exchange Act of 1934 to ERISA plans. The former provides:

(5) SPECIAL REQUIREMENTS FOR SWAP DEALERS AS COUNTERPARTIES TO SPECIAL ENTITIES.—

(A) Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity shall—

(i) comply with any duty established by the Commission for a swap dealer or major swap participant, with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of this Act, that requires the swap dealer or major swap participant to have a reasonable basis to believe that the

counterparty that is a Special Entity has an independent representative that—

(I) has sufficient knowledge to evaluate the transaction and risks;

(II) is not subject to a statutory disqualification;

(III) is independent of the swap dealer or major swap participant;

(IV) undertakes a duty to act in the best interests of the counterparty it represents;

(V) makes appropriate disclosures;

(VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction; and

(VII) in the case of employee benefit plans subject to the Employee Retirement Income Security act [sic] of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002); and

(ii) before the initiation of the transaction, disclose to the Special Entity in writing the capacity in which the swap dealer is acting; and

Inapplicability of Business Conduct Standards to Plans.

Without a statutory change, the Special Entity business conducts standards applicable under CEA section 4s(h)(5) and Securities Exchange Act section 15F(h)(5) to swap dealers and MSPs do not apply with respect to ERISA plans. The cross-reference in the flush language of clause (i) to “an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of this Act” does not include ERISA plans. This is the right result because Special Entities that are ERISA plans already have similar or greater protections under ERISA with respect to each of the requirements of such sections. The “eligible contract participants” referenced in the statute have no similar protections under current law and therefore it would be perfectly sensible for Congress to extend the business conduct standards only to protect those entities.

Given the specific language of the provision as a whole and the disconnect in its language as it relates to ERISA plans, it would at best be a "stretch" for the Commissions to conclude that the Special Entity business conduct standards fully apply when a swap dealer or MSP offers to enter into or enters into a swap with an ERISA plan. In fact, as pointed out in the Council's September 8 letter to the Commissions, the most conceptually sound interpretation of the statute is that the dealer or MSP would satisfy the Special Entity business conduct standard in the case of an ERISA plans if the dealer or MSP receives a representation from a plan fiduciary that the fiduciary is subject to and complies with ERISA. The other areas covered by the business conduct statutory requirements are addressed very well under ERISA, so that their application would be at best duplicative and at worst inconsistent (as discussed below).

Perhaps the application of business conduct standards to ERISA plans will be addressed in a technical corrections bill to the Dodd-Frank Act. In the meantime, to interpret the business conduct standards to fully apply to ERISA plans would be inconsistent with the language of the statute.

Issues that Apply if the Business Conduct Standards Apply at all to ERISA Plans.

Above, we set forth two alternative positions: (1) the referenced business conduct standards do not apply to ERISA plans at all, and (2) such standards should be satisfied by a representation from a plan fiduciary that the plan's representative is an ERISA fiduciary and will comply with ERISA. If the second position is accepted, two additional issues must be confronted: (1) what it means for a representative to be independent, and (2) how a swap dealer or MSP can obtain a reasonable basis for believing that the plan representative is an ERISA fiduciary and will comply with ERISA.

Independence. As discussed more fully in the Council's September 8 letter, it is critical that the reference to the representative being "independent" means independent of the swap dealer or MSP, not independent of the plan. To conclude otherwise would have severe adverse effects on the very large number of ERISA plans, which, consistent with clear guidance from the Department of Labor, have established sophisticated in-house investment advisory teams. To effectively require such teams to be dismantled and their functions outsourced would harm plans and disrupt the plan system. Moreover, there is no hint in the statute or legislative history that Congress intended to take such a radical step; rather, as discussed in the Council's September 8 letter, there is clear evidence that Congress did not so intend.

Representations. Also as discussed in the Council's September 8 letter, it is critical that there be an effective and administrable means for swap dealers and MSPs to achieve the required "reasonable basis". If swap dealers and MSPs were required or permitted to do independent investigations into a representative's satisfaction of the enumerated requirements, such a process would effectively give swap dealers and MSPs undue control over their counterparty's choice of representative and allow swap dealers and MSPs to potentially inappropriately influence an ERISA plan's entire swap program. Moreover, the time and cost involved would effectively preclude plans from using swaps in many cases.

It should be expressly permitted for swap dealers and MSPs to rely on plan fiduciary representations for purposes of satisfying the reasonable basis requirement, without any obligation on the part of the swap dealer or MSP to do their own investigation. Such representations should be framed in the same manner as the statute, i.e., that a plan fiduciary has a reasonable basis to believe that the applicable business conduct standards will be or are satisfied. As discussed more fully below under "No Cause of Action," it should be made clear that the representations needed to satisfy the business conduct standards do not give rise to any additional contractual rights.

Issues that Apply if the Business Conduct Standards Fully Apply to ERISA Plans.

If, contrary to our statutory interpretation set forth above, the decision is made to fully apply the Special Entity business conduct standards to ERISA plans, such application should be structured within the framework discussed below to harmonize the law and regulation under ERISA with these business conduct standards in order to avoid harming the interests of the beneficiaries and employees served by ERISA plans. The discussion below builds on the “Representations” discussion above. If all the business conduct standards apply to ERISA plans, a swap dealer or MSP should be treated as having the required reasonable basis if the representations described below are made (without any requirement that the swap dealer or MSP do its own investigation). Also, under this interpretation of the law, the definition of “independence” described above remains critical.

Fair pricing and appropriateness of swap. The statute requires a swap dealer or MSP to have a reasonable basis to believe that the Special Entity has a representative that will provide "written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction." It is completely consistent with this language to allow a swap dealer or MSP to satisfy this standard by receiving a copy of a written representation from an ERISA plan's fiduciary to the plan that such plan fiduciary will review the price and appropriateness of each swap the plan considers entering into, as required under ERISA.

For purposes of the pricing representation, instead of a plan fiduciary representing that a fiduciary will review the price, as noted above, the representation could be that a plan fiduciary will seek to achieve “best execution” of the swap, as such concept applies to an SEC-registered investment adviser. This would ensure that the plan’s representative seeks to execute a swap on what it reasonably believes are the most favorable qualitative and quantitative terms under the circumstances and consistent with ERISA, taking into account such factors as the fiduciary deems appropriate, which may include price, the counterparty’s financial stability and responsiveness, and all other factors an SEC-registered investment adviser considers when fulfilling its duty to seek to achieve best execution. Since the “seeking to achieve best execution” standard does not apply to many plan representatives, this type of representation would be an alternative to the more general representation described above. Either representation would be sufficient for a swap dealer or MSP to have the required reasonable basis regarding pricing.

With respect to the “appropriateness” representation, if the independent representative represents to the Special Entity that a swap is consistent with the investment guidelines established by the plan, and this representation is provided to the swap dealer or MSP, the “appropriateness” requirement should be deemed satisfied. In such a case, the applicable review by the representative with respect to a particular swap would be whether such swap is consistent with such specific guidelines (which guidelines need not be disclosed to the swap dealer or MSP).

The above structure is workable and consistent with the Dodd-Frank statutory structure. Concerns have been raised, however, that the statute may be interpreted to require a separate written representation regarding the fairness and appropriateness of each swap. This type of application of this prong of the business conduct standards would be very disruptive with respect

to the use of swaps by ERISA plans and would be contrary to the fiduciary framework established by ERISA.

- **Timing.** Swaps often need to be negotiated and executed in “real time”. The price available to hedge a risk at 1:00 p.m. may not be available at 3:00 p.m., and certainly not the next day or the next week. If a separate representation was needed with respect to every swap, hedging programs would be extremely disrupted.
- **Losses.** Requiring a plan’s representative to provide the “lead” plan fiduciary with a separate written representation prior to every swap may cause delays in implementing a plan’s hedging programs. Such delays may result in lost opportunities to hedge, thus creating losses and volatility. Accordingly, the cost of requiring a written representation for every swap could be material and would come directly from the assets of the plan that are intended to provide benefits to participants.
- **ERISA.** ERISA has a very appropriate framework for dealing with the timing and cost issues. The relevant plan fiduciary must evaluate any action to determine if the benefits of the action outweigh the costs. Under ERISA, it could be a breach of the “lead” fiduciary’s duty to ask for a written representation for each or even many swaps entered into for the ERISA plan if the adverse timing effects of obtaining the written representation, including lost hedging opportunities, could outweigh the potential benefits of such representation.¹

Disclosures. The statutes provide that a swap dealer or MSP must have a reasonable basis to believe that the Special Entity has a representative that will make "appropriate disclosures." It would appear that this prong of the business conduct standard contemplates that the swap dealer or MSP receives a representation that the representative will make appropriate disclosures to the Special Entity. Given the breadth of the term "appropriate disclosures," the Commissions could surely interpret this standard, in the case of ERISA plan fiduciaries, to be

¹ DOL Interpretive Bulletin 08-2, 29 C.F.R. § 2509.08-2 (stating that, in connection with the exercise of shareholder rights, “[i]f the responsible fiduciary reasonably determines that the cost of voting . . . is likely to exceed the expected economic benefits of voting . . . the fiduciary has an obligation to refrain from voting”); DOL Interpretive Bulletin 94-2, 29 C.F.R. § 2509.94-2 (stating that “the Department interprets ERISA [section] 404(a)(1) to require the responsible plan fiduciary to weigh the costs and benefits of voting on proxy proposals relating to foreign securities and make an informed decision with respect to whether voting a given proxy proposal is prudent and solely in the interest of the plan’s participants and beneficiaries”); DOL Field Assistance Bulletin 2006-01 (Apr. 19, 2006) (stating, in connection with the distribution to plans of settlement proceeds relating to late trading and market timing, “a plan fiduciary must be prudent in the selection of a method of allocating settlement proceeds among plan participants” and that prudence would “require a process by which the fiduciary weighs the costs to the plan or the participant accounts and ultimate benefit to the plan or the participants associated with achieving that goal”); DOL Field Assistance Bulletin 2002-01 (Sept. 26, 2002) (stating that, in connection with refinancing an exempt ESOP loan, “at a minimum . . . a fiduciary must make a careful assessment of the costs and benefits conferred upon the ESOP,” among other things); ERISA Op. Ltr. 2007-07A (Dec. 17, 2007) (stating that, with regard to proxy voting, “fiduciaries need to take into account the costs involved when deciding whether to exercise their shareholder rights”); Testimony of Louis Campagna (Department of Labor) to The ERISA Advisory Committee Working Group on Fiduciary Responsibilities and Revenue Sharing Practices (July 11, 2007) (addressing a need to consider the cost and benefit to the plan and participants in implementing any revenue sharing allocation method); DOL Reg. § 2550.404a-4 (stating that the safe harbor in connection with the selection of an annuity provider for an individual account plan is satisfied if the fiduciary, among other things, “appropriately considers the cost . . . of the annuity contract in relation to the benefits . . . to be provided”).

met by a representation that the fiduciary will provide all disclosures that are appropriate under ERISA.

If the above approach is not adopted, the concern is that this business conduct standard could require more or different and contradictory disclosures compared to those the law already requires to be made by ERISA plan fiduciaries. If the standard were interpreted to require significantly more disclosure than is currently required under ERISA, that disclosure itself could be contrary to the framework established by ERISA. The cost of disclosure can in many cases be passed on to the plan and thus the participants.² Accordingly, it may be counterproductive in some cases to require too much disclosure. Today, if a “lead” fiduciary required excessive disclosure at an unjustified cost to the plan, that would be a breach of its fiduciary duty.³

Other requirements. It is critical that none of the other requirements in the subclauses be interpreted in a manner to conflict with ERISA. For example, there is no reason to interpret the “best interests” requirement differently than the “solely in the interest” requirement in ERISA section 404(a)(1). That being said, the other business conduct standards could be satisfied by a written representation from an ERISA plan fiduciary (which may be the plan representative) that the relevant plan representative (1) has sufficient knowledge to evaluate the transaction and risks, (2) is not subject to a statutory disqualification under ERISA, the Commodity Exchange Act, or the Securities Exchange Act of 1934, to the extent applicable, (3) is independent of the swap dealer or MSP, (4) has undertaken to act in the best interests of the plan, and (5) is a fiduciary under ERISA.

For purposes of the first requirement—regarding sufficient knowledge—a representative that is fit to act as a fiduciary under ERISA should be deemed to have the sufficient knowledge. For purposes of the third requirement, a representative would be independent of a swap dealer or MSP unless (1) one of the entities controls, directly or indirectly, the other entity, or (2) the entities are under common control. For this purpose, “control” of any entity means ownership of a majority of the voting power of the entity. For purposes of the fourth requirement, an ERISA fiduciary that acts “solely in the interest of the participant and beneficiaries” in compliance with

² DOL Field Assistance Bulletin 2006-03 (Dec. 20, 2006) (stating that distribution costs associated with certain disclosures “in many instances, will be passed on to the plan’s participants and beneficiaries”); Preamble to Proposed Rules on Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43,014, 43,031 (July 23, 2008) (stating that “small and large plans will incur administrative costs due to the proposed regulation” regarding fiduciary requirements for disclosure in participant-directed individual account plans); DOL Field Assistance Bulletin 2006-03 (Dec. 20, 2006) (“With regard to individual account plans that, prior to January 1, 2007, provide participants and beneficiaries diversification rights at least equal to those conferred under section 204(j), the Department is persuaded that the furnishing of the 101(m) notice as a stand-alone disclosure may result both in confusion to participants and beneficiaries and distribution costs that, in many instances, will be passed on to the plan’s participants and beneficiaries.”); see generally Preamble to Final Regulations on Small Pension Plan Security Amendments, 65 Fed. Reg. 62,958, 62,970 (Oct. 19, 2000) (stating that, in revising the regulation for individual account plan disclosure, “it was unnecessary to require small plans to furnish duplicative information” and the revision “has the effect of eliminating . . . start up and annual modification costs for individual account plans . . . without compromising SAR disclosure”); Preamble to Final Regulations for Reporting and Disclosure, 34,526, 34,530 (Aug. 15, 1975) (“The imposition of the reporting and disclosure requirements of Part 1 of Title I of the Act on unfunded pension plans maintained by employers primarily for the purpose of providing deferred compensation for select groups of management or highly compensated employees would entail wasteful expenses associated with the preparation, printing and distribution of unnecessary materials.”).

³ See authorities cited in note 1.

ERISA section 404(a)(1) should be treated as acting in the best interests of an ERISA plan counterparty.

No Cause of Action.

It is critical that the business conduct standards not be usable by swap dealers or MSPs to harm plans. For this reason, it should be made clear that the representations needed to satisfy the business conduct standards do not give rise to any additional contractual rights. For example, assume that due to changing economic conditions, a swap between a swap dealer and a plan has become very disadvantageous for the swap dealer. The swap dealer should not be able, for example, to void the swap—or make any other type of claim against any party—by asserting that one or more of the above-mentioned representations made by the plan or its representative were incorrect. In other words, these business conduct standards—which were meant to protect plans—should not be permitted to be a weapon that can be used against plans or their representatives. Correspondingly, the swap dealer or MSP should be permitted to rely on such representations and should not have any liability or be exposed to the possibility of having the swap voided by reason of a plan fiduciary representation, relied upon by the dealer in good faith, turning out to have been incorrect.

In fact, it is very important that the regulations prohibit the use of the representations required by the business conduct standards to void a trade or otherwise give rise to contractual rights. As noted, it would be turning Congressional intent on its head to permit pro-plan rules to be used to harm plans in contractual disputes.

In analogous situations, regulators have permitted reliance on certifications. For example, under Rule 144A, under the Securities Act, a seller of securities is entitled to rely on a certification by an executive officer of the purchaser that the purchaser meets the conditions necessary to establish that the purchaser is a qualified institutional buyer (“QIB”). Rule 144A (d)(1)(iv). The Adopting Release for Rule 144A states that: “[u]nless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification.” Another example is Regulation EE issued by the Federal Reserve, which provides that a person will qualify as a “financial institution” (for netting purposes) if it represents orally or in writing that it meets the appropriate test. 12 CFR 231.3.

Under the language of these regulations, if the certification is reasonably obtained, the recipient of the certification may treat its counterparty as a QIB/financial institution. A subsequent determination that the certification was wrong will not retroactively void the QIB/financial institution status of the counterparty.

Summary.

In brief, we strongly believe that under the statutory language, the referenced business conduct standards have no, or very limited, application to ERISA plans. If, however, the decision is made to apply such standards more fully to ERISA plans, it is critical that the regulations permit compliance with such standards in clear administrable ways that are consistent

with the principles of ERISA and that do not place unwarranted burdens on ERISA plans' use of swaps.

We would be pleased to have further discussions with respect to these issues. In that regard, if you have questions, please contact Lynn Dudley (Council, 202-289-6700, ldudley@abcstaff.org) or Judy Schub (CIEBA, 301-961-8682, jschub@afponline.org).