

STROOCK

SPECIAL BULLETIN

What Dodd-Frank Means for Plans and Swaps

July 19, 2010

Overview

On July 15, 2010, the U.S. Senate (the “Senate”) voted to approve the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Final Bill”). The U.S. House of Representatives (the “House”) approved the Final Bill last month, by a vote of 237 to 192.

As detailed in our May 27, 2010 [Stroock Special Bulletin](#) “Senate to Plans: No Swaps for You,”¹ the Senate previously passed a version of the comprehensive financial reform bill – the Restoring American Financial Stability Act of 2010 (the “Senate Bill”) – on May 20, 2010. The Senate Bill included a provision relating to retirement plans subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), governmental plans, endowments and certain other entities (collectively, “Special Entities”) and financial transactions known as swaps.

This **Stroock Special Bulletin** highlights key requirements of the Final Bill, which allows Special Entities’ continued access to swaps, subject to two principal requirements: (i) the party bringing the

Special Entity to the transaction (*i.e.*, an investment manager or a sophisticated representative of the Special Entity, such as a financial officer of a plan sponsor) must (a) be independent of the broker-dealer and (b) have a sufficient level of financial sophistication; and (ii) the broker-dealer facing the Special Entity must adhere to certain standards of conduct.

Key Requirements of the Final Bill

Standards for Swap Dealers

Independent Representative. A swap dealer must comply with any requirements promulgated by the Securities and Exchange Commission (“SEC”) and, as applicable, the Commodity Futures Trading Commission (“CFTC”) (collectively, the “Agencies”) that the dealer has a reasonable basis to believe that the Special Entity counterparty has an independent representative that:

- has sufficient knowledge to evaluate the transaction and risks;
- is independent of the dealer and is not subject to statutory disqualification;
- undertakes to act in the best interests of the counterparty and makes appropriate disclosures; and
- will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction.

In addition, if the counterparty is a plan subject to ERISA, the independent party bringing the plan must be acting as a “fiduciary” (within the meaning of Section 3(21) of ERISA).

Disclosure. Before the initiation of the transaction, the swap dealer must disclose to the Special Entity in writing the capacity in which the swap dealer is acting (presumably that it is not serving as a fiduciary to the entity or plan, but merely as a counterparty to the transaction).

Compliance with Agency Rules and Regulations. The dealer must comply with rules and regulations the Agencies adopt that relate to:

- fraud, manipulation, and other abusive practices involving swaps (including swaps that are offered but not entered into);
- diligent supervision of the business of the registered swap dealer;
- adherence to all applicable position limits; and
- such other matters as the Agencies determine to be appropriate.

Business Conduct Requirements. The Agencies will be required to adopt business conduct requirements that:

- establish a duty for a swap dealer to verify that any counterparty meets the eligibility standards for an eligible contract participant;
- require disclosure by the swap dealer to a plan counterparty to the transaction of
 - o information about the material risks and characteristics of the swap;
 - o any material incentives or conflicts of interest that the swap dealer or major swap participant may have in connection with the swap; and
 - o for cleared swaps, upon the request of the counterparty, receipt of the daily mark of the transaction from the appropriate derivatives clearing organization; and for uncleared swaps, receipt of the daily mark of the transaction from the swap dealer or the major swap participant;
- establish a duty for a swap dealer to communicate in a fair and balanced manner based on principles of fair dealing and good faith; and
- establish such other standards and requirements as the SEC may determine are appropriate in the public interest.

Special Rules for Dealers Acting as Advisors

Where a broker-dealer is otherwise permitted to act as an advisor with respect to a Special Entity and

serve as counterparty to a swap transaction, it would be unlawful for the dealer to:

- employ any device, scheme, or artifice to defraud any Special Entity or prospective customer who is a Special Entity;
- engage in any transaction, practice, or course of business that operates as a fraud or deceit on any Special Entity or prospective customer who is a Special Entity; or
- engage in any act, practice, or course of business that is fraudulent, deceptive or manipulative.

The broker-dealer would have a duty to act in the “best interests” of the Special Entity.

The Final Bill also requires any swap dealer that acts as an advisor to a Special Entity to make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap recommended by the swap dealer is in the best interests of the Special Entity, including information relating to:

- the financial status of the Special Entity;
- the tax status of the Special Entity;
- the investment or financing objectives of the Special Entity; and
- any other information that the Agencies may prescribe by rule or regulation.

Exceptions

The Final Bill does not apply to swaps initiated by Special Entities on an exchange or swap execution facility and where the dealer does not know the identity of the counterparty to the transaction.

Special Study for Stable Value Contracts

As described in our prior **Stroock Special Bulletin**, there was concern that the definition of the term swap for purposes of the Senate Bill could be read to include contracts commonly used in stable value investment options offered under many (if not most) participant directed defined contribution plans.

The legislation does not conclude whether any contracts issued under or in connection with certain stable value investment options offered in connection with participant-directed plans could be deemed to be swaps for purposes of the Final Bill. In the meantime, the rules under the Final Bill will not apply to such stable value contracts, and stable value contracts (as broadly defined in the Final Bill) that are in effect prior to the effective date of the regulations to be promulgated pursuant to the Final Bill, will not be considered swaps. It is worth mentioning, however, that the term “stable value contract” is defined as those contracts issued by a “bank, insurance company or other State or federally regulated financial institution,” which could be read to inadvertently exclude contracts issued by foreign institutions. Even understanding that there is uncertainty as to whether the term “swap” includes stable value contracts in the first place, we would hope that additional clarity is soon provided by the applicable regulators to avoid any unintentional confusion in the marketplace and adverse consequences for plans.

The Agencies are to jointly conduct a study within the ensuing fifteen months following enactment and work with the Department of Labor, Department of the Treasury and applicable State entities for purposes of this determination.

Major Swap Participant

The legislation introduces the term “major swap participant,” which generally include large institutions that take significant positions in derivatives markets. Major swaps participants have a number of dealer-like requirements, including capital, registration, margin, disclosure and other standards.

The legislation makes clear that a major swap participant does not include positions held by retirement plans (or any contract held by any such plan) “for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.” Plans (and their investment advisers) contemplating engaging in derivatives transactions likely will need to consider carefully both the major swap participant standard and this exception. Although many plans engage in transactions such as interest rate swaps to mitigate risks associated with changes in a plan’s funding liabilities, many others enter into transactions for potentially broader investment purposes, for example, to obtain access to certain assets, or to avoid transaction costs associated with investing in an underlying asset directly. Ideally, the Agencies will address the interpretive challenges in a way that best suits the interests of plans’ continued access to swaps for all of these legitimate purposes.

ERISA Prohibited Transaction Rules Still Must Be Considered

Of course, in the context of plans and other entities subject to Title I of ERISA or Section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”), financial counterparties to swap transactions must also take into account the prohibited transaction rules of Section 406 of ERISA and Section 4975 of the Code. In most cases, an exemption from these prohibited transaction rules may be required, such as Prohibited Transaction Class Exemption (“PTCE”) 84-14 (transactions entered into by “qualified professional asset managers”), PTCE 90-1 (transactions in respect of insurance company pooled separate accounts), PTCE 91-38 (transactions in respect of certain bank collective funds), PTCE 95-60 (transactions in respect of insurance company general accounts), PTCE 96-23 (transactions entered into by “in-house asset managers”), or Section 408(b)(17) of ERISA and the corresponding provisions of the Code. ERISA and each of these exemptions contain detailed conditions. Governmental plans may have similar requirements, depending on the statute, regulation, code, policies or procedures applicable to them.

Conclusions

The shape and contours of the reforms under the financial package as applicable to swaps and counterparties such as ERISA and governmental plans are already established with the Final Bill. Although some technical interpretative questions still remain, and regulatory guidance awaits, plan sponsors, investment managers and broker-dealers now have the blueprints for these specific reforms. These blueprints would appear to balance access with assurances that Special Entities come to the table with

a sophisticated independent person acting in their interest, and with a counterparty acting in good faith and in accordance with commercially reasonable business requirements as prescribed by their principal regulator.

For now, dealers will want to continue to make it clear in their documentation that they serve solely as a financial counterparty to any given transaction with Special Entities. Moreover, they may consider assuring (through such combination of diligence and/or contractual assurances as they deem appropriate), even in the absence of regulations, that the persons entering into the transaction on behalf of a Special Entity satisfy the conditions outlined above, including independence from the dealer. For their part, investment managers will want to pay close attention to the details outlined above. They may want to consider, for example, taking steps to assure that they have whatever additional information they need to continue to satisfy the burdens placed on them by the statute, as well as what they may be called upon to provide to dealers in order for them to faithfully discharge their reasonable basis knowledge standard, described above.

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