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Dodd-Frank Meets ERISA— The Impact of Wall Street Reform on Plan Investments



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In his remarks upon signing into law the Dodd-Frank Wall Street Reform and Consumer Protection Act¹ (the Act) on July 21, 2010, President Obama said, “Now, for all those Americans who are wondering what Wall Street reform means for you, here’s what you can expect.”²

¹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf>.

² Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, July 21, 2010 (available at: <http://www.whitehouse.gov/the-press-office/>

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Paraphrasing the words of the President—for all those employee benefit plan fiduciaries who are wondering what Wall Street reform means for you, here’s what you can expect.³

1. New requirements will apply to interest rate swaps and other derivatives transactions entered into by and on behalf of employee benefit plans. Stable value contracts will not be regulated as swaps, at least initially.

2. Most advisers to hedge funds and private equity funds will have to register with the Securities and Exchange Commission (SEC) and even those already registered will have to collect and report more information.

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³ While other aspects of the Act could affect plans and plan sponsors, (e.g., the new requirements on public companies enhancing shareholder rights and disclosure of executive compensation, and the establishment of a new Bureau of Consumer Financial Protection) we’ve chosen to address in this article those aspects of the bill most related to plan investments.

3. New limits on bank investment and related activities could affect the activities of banks and their affiliates on behalf of employee benefit plan customers.

4. We won't know the full impact of the 1500-page Act until we start seeing implementing regulations from, among others, the SEC, the Commodities Futures Trading Commission (CFTC), and the Federal Reserve and other banking regulators. Nevertheless, there are a few steps plan fiduciaries should consider taking now, and some things to keep in mind for the future. We note these throughout the article and highlight them at the end.

A. Regulation of Over-the-Counter Swaps

Title VII of the Act, the Wall Street Transparency and Accountability Act, establishes a new regulatory framework for the derivatives market and will impose substantial new regulation on transactions designated as "swaps" and on certain swap market participants. Transactions covered by the new regulatory framework will include a broad range of "derivative" instruments commonly referred to as swaps, puts, caps, and collars relating to commodities, currencies, securities, securities indices and other financial instruments, "synthetic" contracts, and financial or economic interests of any kind based on future performance or notional amounts.

Among other things, the Act extends the jurisdiction and broadens the authority of the SEC, the CFTC and banking regulators over, and imposes significant new rules on, a broad range of privately negotiated (over-the-counter) or (OTC) transactions defined as "swaps" (CFTC jurisdiction) or "securities-based swaps" (SEC jurisdiction).⁴ With limited exceptions, swaps will need to be standardized and settled through a registered clearinghouse.⁵ Swaps not settled through a clearinghouse will still be subject to reporting requirements.⁶ Persons acting as "swap dealers" and "major swap participants" will be required to register with the CFTC and/or SEC and subject to substantial new requirements regarding capital, margin deposits, disclosure (transparency), and conflicts.⁷ The Act will also prohibit future bailouts of swap dealers and major swap participants.⁸

As investors, retirement plans and other employee benefit plans and the pooled investment vehicles in which plans invest use swaps and other derivatives for a range of investment purposes. Therefore, regulation of counterparties to plan transactions could substantially alter the terms and conditions, and costs, for plans engaging in swaps and other covered transactions. Accordingly, plans are likely to see the impact of the new regulation of these transactions as the new rules are implemented.

Importantly, as modified in conference, the Act substantially mitigates the potential effects of certain provisions in early versions of financial services reform that were of particular concern to the benefit plan community. Some provisions of key interest to plan fiduciaries are as follows:

⁴ Act, § 712.

⁵ Act, § 723(a)(3).

⁶ Act, § 729.

⁷ Act, § 731.

⁸ Act, § 716.

■ Treatment of stable value fund "wrap" contracts was a key issue for participant-directed 401(k) and similar plans. Stable value funds are a popular investment option offered to plan participants; there was concern that wrap contracts and other contracts providing a "benefit-responsive guarantee" to support stable value fund accounting could be regulated as "swaps." As modified in conference, the Act temporarily exempts stable value contracts from regulation as swaps and permanently grandfathers stable value contracts existing as of the date of enactment.⁹ The SEC and CFTC, in consultation with the Department of Labor, the Treasury Department and state insurance regulators, must determine within 15 months of enactment whether stable value contracts fall within the definition of a "swap."¹⁰ If they determine that they do, they must make a further determination of whether stable value contracts should be exempted from the Act.¹¹

■ Employee benefit plans generally will be exempted from the definition of "major swap participant" when engaging in swaps "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan."¹² The scope of this exception is unclear; for example, plans regularly engage in swaps for purposes that might be viewed as other than hedging or mitigating risk, such as certain portfolio restructurings. Also, it is not clear whether the exception applies only to plans themselves, or also to entities holding "plan assets," including master trusts and group trusts.

■ One of the most controversial provisions of the Senate Bill would have imposed a "fiduciary duty" (over and above new business conduct standards) on swap dealers who provide advice to, offer to enter into swaps with, or actually enter into swaps with private or governmental retirement plans and endowment funds.¹³ There was significant concern that this provision would create insurmountable conflicts of interest for swap dealers so as to prevent them from transacting business with plans. As modified in conference, the Act instead imposes requirements on swap dealers and major swap participants who act as advisers to or counterparties to "Special Entities" (including ERISA plans, governmental plans and endowments).

— Where a swap dealer or major swap participant advises a Special Entity, these requirements make it unlawful to defraud the Special Entity, and impose an affirmative duty on the adviser to make reasonable efforts to obtain information to determine that the recommended swap is in the Special Entity's best interest in light of the Special Entity's financial status, tax status and investment objectives.¹⁴

— Where a swap dealer or major swap participant is a counterparty to (or offers to be a counterparty to) a Special Entity, the Act requires that, prior to entering into the swap, a swap dealer must have a reasonable basis to believe that the Entity is represented by someone who (i) has sufficient knowledge to evaluate the risks of the transaction; (ii) is not "disquali-

⁹ Act § 719(d).

¹⁰ Act § 719(d)(1)(A).

¹¹ Act § 719(d)(1)(A).

¹² Act § 721(a)(33)(i)(II).

¹³ Act § 731, adding Commodity Exchange Act (CEA) § 4s(h)(2).

¹⁴ Act § 731, adding CEA § 4s(h)(2)(A)(4).

fied” from representing the Entity; (iii) is independent of the swap dealer; (iv) has a (fiduciary) duty to act in the best interest of the Entity; (v) makes appropriate disclosures; (vi) makes a written determination regarding fair pricing and appropriateness of the transaction; and (vii) in the case of an ERISA-governed plan, is a fiduciary. Notably, the Act’s legislative history makes clear that while the person representing a Special Entity must be independent of the Special Entity’s counterparty, it is not necessary for the representative to be independent of the Special Entity itself (i.e., an outside manager is not required).¹⁵ These rules do not apply to swaps initiated by a Special Entity of its own accord via an exchange, or which are conducted as “blind” transactions.¹⁶

■ The full scope of transactions that will be covered by the new regulatory framework remains to be seen, and is likely to result in new uncertainty for some plan transactions. Exceptions will be available for instruments subject to regulation as securities, true debt instruments, certain bank products, and certain agreements that anticipate settlement by actual delivery of a commodity or a security, or an agreement with an issuer designed to raise capital. For instance, it is unclear to what extent derivative contracts covered by new regulation may include common “participation” interests in loans or leases, or to guarantees. Arguably, however, the exception for capital raising should allow for typical “carried interest” or “performance fee” arrangements.

B. Regulation of Advisers to Private Investment Funds

The Private Fund Investment Advisers Registration Act of 2010 (Title IV of the Act) amends the Investment Advisers Act of 1940 (the Advisers Act) to eliminate (with some exceptions) the “private fund” exemption from the registration requirements of the Advisers Act.¹⁷ Currently, advisers with fewer than 15 clients are not required to register or be regulated as investment advisers.¹⁸ For this purpose, an “investment fund” such as a hedge fund with multiple investors is typically treated as a single client. Accordingly, advisers to hedge funds, private equity funds, and other “private funds” excepted from registration as investment companies under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) have traditionally relied on this exemption to avoid regulation as investment advisers.

The elimination of the private fund exemption will require most advisers to private funds to register with the SEC and also subject these advisers (whether previously registered or not) to new reporting, disclosure, and examination requirements. For example, many private fund advisers will be required to report to the SEC about assets under management, use of leverage, counterparty credit-risk exposure, trading and investment positions and practices, valuation policies and prac-

tices, types of assets held, side letters, and any other information the SEC deems necessary.¹⁹

Elimination of the “private fund” exemption will not change requirements with respect to bank collective trust funds and other investment vehicles maintained solely for investment by tax-qualified plans, which generally are exempted by Section 3(c)(11) of the Investment Company Act.²⁰ In addition, the Act provides some limited exemptions from Advisers Act registration, including (among others) exemptions for venture capital fund advisers and advisers to so-called “family offices.”²¹ Also exempted from Advisers Act registration are private equity and other private fund advisers who (a) do not advise funds other than private funds and (b) have less than \$150 million in assets under management in the United States. This provision represents a change from earlier versions of the legislation, which would have exempted even large private equity fund managers from Advisers Act registration requirements.²² The exact scope of these exemptions will be addressed in regulations to be issued by the SEC.

Rules governing whether an adviser may register with the SEC or must instead register in each of the states in which it conducts business are also changed.²³ Current law provides that an investment adviser generally may not register with the SEC unless it has more than \$30 million in assets under management or would be required to register in 30 or more states. Under the Act, an adviser with assets between \$30 million and \$100 million may not register with the SEC (and must register in the state(s) in which it conducts business) unless the adviser would be required to register with 15 or more states.²⁴

Finally, Title IV makes some adjustments to requirements for the qualification of investors in private funds.²⁵ For now, these changes primarily affect whether “natural persons” will meet “accredited investor” status, but additional changes may be expected. In this regard, the Act requires the SEC and Comptroller General to conduct reviews or studies of net worth thresholds to be applied to investors in private funds, and requires the SEC to adjust the “qualified client” test for the effects of inflation.²⁶

Elimination of the private fund exemption from Advisers Act registration and other changes made by Title IV of the Act could have several consequences for plans, including:

■ Many hedge fund managers and private equity managers not already registered will need to do so. Notably, even non-U.S. based advisers to foreign funds could be subject to the new registration requirements if they do not qualify as a “foreign private adviser” under the Act.

■ Importantly, newly registered advisers and advisers that are currently registered will be required to maintain and file new types of information with the

¹⁹ Act, § 404.

²⁰ Section 402 of the Act adds a definition of the term “private fund” to the Advisers Act by reference to §§ 3(c)(1) and 3(c)(7) of the Investment Company Act.

²¹ Act, §§ 407, 409.

²² Act, § 408.

²³ Act, § 410.

²⁴ Act, § 410.

²⁵ Act, § 413(a).

²⁶ Act, §§ 413(b), 415, 418.

¹⁵ Act § 731, adding CEA § 4s(h)(2)(A)(5).

¹⁶ Act § 731, adding CEA § 4s(h)(2)(A)(7).

¹⁷ Act, § 403.

¹⁸ 15 U.S.C. § 80b-3(b).

SEC, much of which will be of interest to the adviser's clients, including plans and plan fiduciaries.

■ Plan sponsors who may themselves be in the business of advising others should consider the impact of SEC regulation with respect to the advisers' own plans. As noted above, the SEC will be required to issue rules regarding the exemption of mid-size advisers (e.g., those who "solely" advise private funds and whose assets under management are less than \$150 million). (A similar rulemaking will take place with respect to "family offices" under Section 409 of the Act.) In these rulemakings, the SEC will likely be faced with the question of how to treat an adviser's own plans. For instance, should a mid-size adviser who advises the employee benefit plans it sponsors be required to register? Will a family office fail to meet the requirements of an SEC exemption merely because it sponsors and advises an employee benefit plan for employees of the family office?

■ Plan sponsors that are not currently engaged in an investment advisory business (and not registered as investment advisers) but who may be deemed to "advise" the employee benefit plans they sponsor, or foundations or endowments with which they have a relationship, should consider the possible implications of the elimination of the private fund exemption and future SEC regulation on employers as advisers. The SEC staff has previously issued interpretations that plan sponsors whose employees advise the sponsor's own plans on investments could meet the definition of an "adviser" for purposes of the Advisers Act, while also indicating that plan sponsors generally need not register under the Advisers Act (based in part some cases on the "private fund" exemption). With the private fund exemption no longer available, there is a possibility that the SEC could review whether some plan sponsors no longer qualify for exemption from the Advisers Act registration requirements.

Provisions under Title IV of the Act generally are effective one year after the date of enactment, although advisers may be able to register early during a one-year transition period.²⁷ Fiduciaries of plans investing in hedge funds and other private funds with advisers that may be newly subject to registration requirements may wish to consider contacting these fund managers to learn about the manager's strategy for addressing new registration or recordkeeping requirements applicable to the manager. Plan sponsors and advisers may also want to review and update side letter provisions to reflect new SEC requirements, when finalized.

C. Ban on Certain Bank Entities Investing in, or Sponsoring, Private Funds (the Volcker Rule)

Title VI of the Act creates a new section 13 of the Bank Holding Company Act, which, during the legislative debate, became known as the "Volcker Rule." The provisions impose new requirements on any "banking entity" including the investment and trading activities of an insured depository institution, a company that directly or indirectly controls an insured depository institution, a company treated as a bank holding company, or any subsidiary of such an institution or company

(Banking Entity).²⁸ The Volcker Rule will prohibit any Banking Entity from engaging in "proprietary trading," including transactions in stocks, bonds, options, commodities, derivatives, or other financial instruments for its own trading book.²⁹ However, Banking Entities will be permitted to (among other things) engage in trading on behalf of a customer and market making activities or trading "otherwise in connection with customer relationships, including risk-mitigating hedging activities related to such customer transactions."³⁰

In addition, because an insurance company affiliate of a bank is deemed to be a Banking Entity for purposes of the Act, the Act contains a special carve-out from the proprietary trading prohibition for insurance company general account investments.³¹ There is no specific carve-out for investment activities of insurance company separate accounts (the assets of which are also legally owned by the insurance company), so questions have arisen regarding whether separate account investments might be captured under the "proprietary trading" ban. While this question may be the subject of future rulemaking, it seems likely that, for now, insurance companies might reasonably take the view that separate account investments are undertaken "on behalf of customers" and therefore permitted under the Act.³²

Section 619 will also prohibit a Banking Entity from "sponsoring" or investing in a hedge fund or private equity fund (defined as any entity or fund exempt from registration under Section 3(c)(1) or 3(c)(7) of the Investment Company Act or any similar fund).³³ "Sponsoring" a fund is defined broadly to include serving as general partner, managing member, or *trustee* of a fund; selecting or controlling a majority of the fund's directors, trustees or managers; or sharing its own name for purposes of marketing, promotion, etc. (private labeling).³⁴ The effective date for this provision is the earlier of one year after regulations are issued by the federal bank regulatory agencies (required within nine months after the new Financial Stability Oversight Council completes a study of new rules affecting Banking Entities) or two years after the date of enactment.³⁵ The bank regulatory agencies could approve a maximum of three individual one-year extensions if not detrimental to the public interest.³⁶

There were concerns under the Senate version of the Act that the Volcker Rule prohibition on banks sponsoring private funds could have reached certain types of commingled benefit plan trusts, e.g., VEBAs, group trusts, multiple employer plan trusts, and other investment vehicles for plans that may rely on (in part or entirely) private fund exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. Many of those vehicles, in turn, have bank trustees, which might have been forced to resign under the Senate Bill. (Most "single employer" retirement plan trusts (including master trusts) are either not investment companies at all, or are exempt from registration for *other* reasons,

²⁷ Act, § 419.

²⁸ Act, § 619, adding BHCA § 13(h)(1).

²⁹ Act, § 619, adding BHCA § 13(a)(1)(A).

³⁰ Act, § 619, adding BHCA § 13(d).

³¹ Act, § 619, adding BHCA § 13(d)(1)(F).

³² Act, § 619, adding BHCA § 13(d)(1)(H).

³³ Act, § 619, adding BHCA §§ 13(a)(1)(A), (h)(2).

³⁴ Act, § 619, adding BHCA § 13(h)(5).

³⁵ Act, § 619, adding BHCA § 13(c)(1).

³⁶ Act, § 619, adding BHCA § 13(c)(2).

e.g., based on the exemption under Section 3(c)(11) of the Investment Company Act, and would not have been affected. Collective trust funds and pooled separate accounts also generally rely on the Section 3(c)(11) exemption.)

Fortunately, the final version of the Act contains several changes that should permit banks to continue to serve as trustee and provide other services to most commingled benefit plan trusts. First, the rule now defines a covered “banking entity” to **exclude** any FDIC-insured institution acting only in a fiduciary capacity (i.e., a limited purpose trust company).³⁷ Second, “sponsoring” a hedge or private equity fund does not include any activity engaged in by a banking entity if: the bank is acting **only** in the capacity of a bona fide trustee, fiduciary or investment adviser; it is offering the fund **only** to its bona fide fiduciary customers; it makes no more than a de minimis personal investment in the fund; and it satisfies certain other conditions.³⁸ The full extent of this exception has yet to be determined, though it very much resembles existing law as it relates to the investment of bank fiduciary customers in common trust funds.³⁹

Federal banking agencies and the SEC are directed to adopt regulations to carry out the Volcker Rule; it will be important for financial institutions and plan fiduciaries to monitor the rulemaking process so that plan investment activities will not be disrupted.

What Plan Investment Fiduciaries Should Do

Further paraphrasing the words of the President in signing the Act, now that we’ve discussed what plan fi-

³⁷ Act, § 619, adding BHCA § 13(h)(1).

³⁸ Act, § 619, adding BHCA § 13(d)(1)(G).

³⁹ E.g., arguably the reference to bona fide fiduciary customers requires a fiduciary relationship outside the investment fund.

duciaries need to know about Wall Street reform, what is to be done? Here are some ideas:

1. Swaps and Derivatives provisions:

- Review plan investments in swaps and other derivatives. Does the plan manage its derivatives investments in-house, or use an outside investment manager? In either case, plan fiduciaries need to be educated about the new settlement and clearing requirements.

- Communicate with managers and counterparties regarding new standards applicable to persons advising and dealing with plans in swap transactions.

2. Investment Advisers Act amendments:

- Review plan investments in private equity, hedge funds and other similar funds. Discuss with fund managers how they expect to address the new registration, reporting, and recordkeeping requirements.

- Review side letters with private fund managers and consider whether any “most favored nations” or informational provisions are triggered by the new legal requirements. When making new investments in private funds, consider adding side letter provisions incorporating disclosures based on the new legal requirements on private fund managers.

- Keep tabs on SEC rulemakings addressing Adviser’s Act registration requirements that address whether an employer is an adviser by reason of advising its own employee benefit plans. It may be necessary for the plan sponsor community to make its voice heard to the SEC on this point.

3. “Volcker Rule” provisions:

- Communicate with bank trustees of private funds the plan invests in or is considering investing in. Discuss the application of the Volcker Rule to the bank’s business related to plan investors and its approach to addressing the new requirements.