U.S. DOL PWBA Office of Regulations and Interpretations

March 21, 1996

Honorable Eugene A. Ludwig
Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Dear Mr. Ludwig,

At our last meeting we discussed the Department of Labor's views with respect to the utilization of derivatives[1] in the management of a portfolio of assets of a pension plan which is subject to the Employee Retirement Income Security Act of 1974 (ERISA). This letter is to provide you with an update of our views in a format which may be of use to you and your staff.

ERISA governs private-sector sponsored employee welfare and pension benefit plans and provides a general framework within which plan fiduciaries are expected to conduct their investment activities. Under ERISA, a fiduciary includes anyone who exercises discretion in the administration of an employee benefit plan; has authority or control over the plan's assets; or renders investment advice for a fee with respect to any plan assets.[2] Thus, any entity, including an institution such as a bank, that meets this functional test with respect to an employee benefit plan sponsored by a private-sector employer, employee organization, or both, would be considered a fiduciary under ERISA.

ERISA establishes comprehensive standards to govern fiduciary conduct. Among other things, fiduciaries with respect to an employee benefit plan must discharge their duties with respect to a plan solely in the interest of the plan's participants and beneficiaries, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. [3]

Investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments. Thus, plan fiduciaries must determine that an investment in derivatives is, among other things, prudent and made solely in the interest of the plan's participants and beneficiaries.

In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses. While derivatives may be a useful tool for managing a variety of risks and for broadening investment alternatives in a plan's portfolio, investments in certain derivatives, such as structured notes and collateralized mortgage obligations, may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments. Characteristics of such derivatives may include extreme price volatility, a high degree of leverage, limited testing by markets, and difficulty in determining the market value of the derivative due to illiquid market conditions.

As with any investment made by a plan, plan fiduciaries with the authority for investing in derivatives are responsible for securing sufficient information to understand the investment prior to making the investment. For example, plan fiduciaries should secure from dealers and other sellers of derivatives, among other things, sufficient information to allow an independent analysis of the credit risk and market risk being undertaken by the plan in making the investment in the particular derivative. The market risks presented by the derivatives purchased by the plan should be understood and evaluated in terms of the effects that they will have on the relevant segments of the plan's portfolio as well as the portfolio's overall risk.

Plan fiduciaries have a duty to determine the appropriate methodology used to evaluate market risk and the information which must be collected to do so. Among other things, this would include, where appropriate, stress simulation models showing the projected performance of the derivatives and of the plan's portfolio under various market conditions. Stress simulations are particularly important because assumptions which may be valid for normal markets may not be valid in abnormal markets, resulting in significant losses. To the extent that there may be little pricing information available with respect to some derivatives, reliable price comparisons may be necessary. After entering into an investment, a plan fiduciary should be able to obtain timely information from the derivatives dealer regarding the plan's credit exposure and the current market value of its derivatives positions, and, where appropriate, should obtain such information from third parties to determine the current market value of the plan's derivatives positions, with a frequency that is appropriate to the nature and extent of these positions.

If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.

As part of its evaluation of the investment, a fiduciary must analyze the operational risks being undertaken in making the investment. Among other things, the fiduciary should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment. In particular, the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan's derivatives activity, and whether the plan fiduciary has personnel who are competent to manage these systems. If the investments are made by outside investment managers hired by the plan fiduciary, that fiduciary should consider whether the investment managers have such personnel and controls and whether the plan fiduciary has personnel who are competent to monitor the derivatives activities of the investment managers.

Plan fiduciaries have a duty to evaluate the legal risk related to the investment. This would include assuring proper documentation of the derivative transaction and, where the transaction is pursuant to a contract, assuring written documentation of the contract before entering into the contract.Also, as with any other investment, plan fiduciaries have a duty to properly monitor their investments in derivatives to determine whether they are still appropriately fulfilling their role in the portfolio. The frequency and degree of the monitoring will, of course, depend on the nature of such investments and their role in the plan's portfolio.

We hope these comments have been helpful. However, if you should have any further questions or if we can provide any further assistance, please feel free to contact Morton Klevan at (202) 219-9044 or Louis Campagna at (202) 219-8883.

Sincerely,

Olena Berg

[1] We refer to derivatives in this letter as financial instruments whose performance is derived in whole or in part from the performance of an underlying asset (such as a security or index of securities). Some examples of these financial instruments include futures, options, options on futures, forward contracts, swaps, structured notes and collateralized mortgage obligations.

[2] See ERISA section 3(21)

[3]See ERISA section 404(a).
