Client Alert

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Dodd-Frank Protocol Carries Burdens and Benefits for Pension Plans

By Jeffrey Stern, Dulcie D. Brand and Anthony H. Schouten

The Commodity Futures Trading Commission has issued new "know your customer" and external business conduct rules to give effect to certain provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under these rules, major dealers in swaps and derivatives ("Swap Dealers") will be required to, among other things, conduct diligence on counterparties, verify their status as "eligible contract participants" and ensure that swap recommendations are suitable for them. In addition, these rules impose heightened duties on Swap Dealers that trade with employee benefit plans subject to Title I of the Employee Retirement Income Security Act of 1974, governmental plans as defined in ERISA Section 3, endowments, state and federal agencies, and other protected counterparties ("Special Entities").

While these rules do not apply to Special Entities, in order for Swap Dealers to operate clear of the heightened duties to Special Entities, Swap Dealers will require certain representations and covenants from Special Entities. To address this industry-wide need (as well as other Dodd-Frank rules), the International Swaps and Derivatives Association developed the ISDA 2012 DF Protocol ("DF Protocol"), to which many Special Entities—and their representatives, advisors and investment managers ("Advisors")—are now being asked to "adhere" as a condition to continued trading with Swap Dealers.

The key regulations governing the duties owed by Swap Dealers to Special Entities (found primarily in 17 CFR 23.440 and 17 CFR 23.450 ("Special Entity Regulations")) divide Special Entities into two categories: (1) Any employee benefit plan subject to Title I of ERISA ("ERISA Special Entities"); and (2) any of the following: (a) any governmental plan, as defined in Section 3 of ERISA, (b) a Federal or State agency, a State, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State, (c) any endowments or (d) any employee benefit plan defined in Section 3 of ERISA that elects to be a Special Entity ("Non-ERISA Entities"). To avoid heightened duties when trading with a Non-ERISA Entity, the Special Entity

Regulations require that a Swap Dealer must have a reasonable basis to believe that the Non-ERISA Entity has an Advisor that (in short) (i) can evaluate the swap and risks; (ii) is independent of the Swap Dealer; (iii) acts in the best interests of that Special Entity; (iv) makes appropriate and timely disclosures to the Special Entity; and (v) evaluates fair pricing and the appropriateness of the swap. A Swap Dealer will satisfy this requirement if, among other things, the Non-ERISA Entity represents in writing (the DF Protocol contains such representations) that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected an Advisor that satisfies those requirements, and that such policies and procedures provide for ongoing monitoring of the performance of such Advisor consistent with those requirements. Thus, the Special Entity Regulations effectively require a Non-ERISA Entity to represent that it has policies and procedures in place not only to ensure the knowledge, independence, duties and agreed-upon standard of conduct of its Advisor, but also to monitor its Advisor's ongoing performance of its role as specified in the regulations.

A similar set of requirements apply to swaps between a Swap Dealer and an ERISA Special Entity. Under the Special Entity Regulations, any Swap Dealer that trades with an ERISA Special Entity must have a reasonable basis to believe that the Special Entity has an Advisor that is a "fiduciary" (as defined in Section 3 of ERISA). The regulations include a safe harbor (again, addressed by the DF Protocol) whereby the Swap Dealer will have that reasonable basis if the Special Entity identifies the Advisor and represents in writing that the Advisor is such a fiduciary.

The Dodd-Frank regulations also impose a separate obligation on Swap Dealers that recommend swaps (or trading strategies involving swaps) to Special Entities: the Swap Dealer must have a reasonable basis to believe that those recommendations are suitable for the counterparty. As with the other Special Entity Regulations, a Swap Dealer may meet this obligation by receiving a written representation from the Special Entity (or its Advisor) that it is exercising independent judgment in evaluating such recommendations. A Special Entity will also typically be required, as a threshold matter, to represent whether it is a "major swap participant" under Dodd-Frank.

Any Special Entity that is contemplating making some or all of the applicable representations specified in the DF Protocol will want to consider whether the underlying agreements with its Advisors are sufficiently robust, complete and specific to support those representations. Any Non-ERISA Entity will also need to review its internal policies to confirm that it can make the representations such policies are reasonably designed to ensure that it has selected an Advisor that satisfies the requirements of the Special Entity Regulations, and that such policies and procedures provide for ongoing monitoring of the performance of such Advisor consistent with those requirements. Each Special Entity will also have to assess whether it is a major swap participant under Dodd-Frank. Because of the way in which the Dodd-Frank regulations define a major swap participant, this determination will require a review of the notional amount and exposure of the Special Entity's swap positions; and though this review is unlikely—in the vast majority of cases—to result in a conclusion that the Special Entity is a major swap participant, the analysis is nonetheless complex and will likely require the cooperation of the Special Entity's Advisors.

However, there appears to be an indirect benefit for Special Entities from this process. In making the representations and covenants currently being required by the dealer community, a Special Entity may use its adherence to the DF Protocol as an opportunity to revisit the contractual arrangements with its Advisors to (i) obtain the benefit of representations and covenants those Advisors make to the dealers and (ii) amplify the duties and standards of care set forth in their advisory agreements, so that its Advisors do, in fact, satisfy the criteria for Special Entity Advisors contemplated by Dodd-Frank and its regulations.

It bears mention that as a practical matter, many Special Entities may be unknowingly making the representations or adhering to the DF Protocol. Advisors are requesting compliance in a wide variety of formats. Some Advisors will specifically reference the DF Protocol when addressing these requirements with their clients or will, through the details of the Advisor request, alert the client that further review by legal counsel may be necessary. Other Advisors are sending rather opaque requests for the authority to enter into any necessary agreements. Each ERISA Special Entity and Non-ERISA Entity should consider whether to alert investment staff to forward any such requests to internal or external counsel for review. For large organizations, it may be desirable to develop practices aimed at ensuring a consistent response to all Advisor requests relating to the DF Protocol. It is also important that all of the Advisors to a Special Entity provide consistent information to all Swap Dealers that trade with the Special Entity.

The Special Entity Regulations, ostensibly designed to protect Special Entities, seem to produce a somewhat peculiar result: in order to continue trading with Swap Dealers, Special Entities and their Advisors (through the DF Protocol or otherwise) are being required to make representations that protect Swap Dealers from the heightened duties that the Swap Dealers would otherwise owe these counterparties. However, if Special Entities take steps to update or modify their contractual arrangements to ensure the accuracy of the representations they are making to Swap Dealers, these Special Entities can assure that they are well counseled by their Advisors and accordingly do not command the special statutory protections contemplated by the Special Entity Regulations. Just as the DF Protocol is altering existing swap documentation to address the relationship between Special Entities and Swap Dealers, the Special Entity Regulations may, ultimately, require the relationship between Special Entities and their Advisors to align with the allocation of Advisor roles and duties implicitly mandated by the new Dodd-Frank rules.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Jeffery Stern (bio)
New York
+1.212.858.1110
jeffrey.stern@pillsburylaw.com

Dulcie D. Brand (bio)
Los Angeles
+1.213.488.7244
dulcie.brand@pillsburylaw.com

Anthony H. Schouten (bio)
New York
+1.212.858.1115
anthony.schouten@pillsburylaw.com

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