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LEGAL ALERT

May 29, 2013

DOL Proposes Short-Term Relief for and then Prohibition of Many Cross-Collateralization Agreements for IRAs and ERISA Plans

On May 24, 2013, the U.S. Department of Labor (DOL) proposed to amend ERISA Prohibited Transaction Class Exemption 80-26 (PTE 80-26) to allow an indemnity, security interest or other cross-collateralization agreement with a financial institution involving an individual retirement account (IRA), or an employee benefit plan subject to the prohibited transaction rules of ERISA or the Internal Revenue Code (IRC), but only on a retrospective and temporary basis. Under the proposed amendment, this relief would expire six months after publication of a final amendment in the Federal Register.

Background

It is common practice for the account opening documentation for brokerage, futures, options and similar accounts to provide in effect that, in the event a liability arising in the account (e.g., a trading loss, fee or tax) exceeds its assets, that liability may be satisfied from "related" accounts maintained at that financial institution. In advisory opinions issued in 2009 and 2011, DOL concluded, generally, that such a cross-collateralization agreement committing non-IRA assets of an IRA owner to cover indebtedness of, or arising from, the IRA to a bank or other financial institution:

- Is an ERISA prohibited transaction – specifically, a prohibited extension of credit from the IRA owner as "disqualified person" to the IRA – for which
- PTE 80-26 – the exemption permitting interest-free loans or extensions of credit between a plan and disqualified person/party in interest in certain circumstances – does not provide exemptive relief.

These conclusions were inconsistent with widely held views in the regulated community.

In part for that reason, the Internal Revenue Service (IRS) issued an announcement later in 2011 providing that, pending further action from DOL and issuance of further guidance from the IRS, the tax treatment of an IRA would be determined without taking into account the potential prohibited transaction consequences of such a cross-collateralization agreement so long as there has been no execution or other enforcement of the agreement against the IRA assets (that is, the flip side of the fact pattern considered in the advisory opinions).

The Proposed Amendment

In response to a request from the Securities Industry and Financial Markets Association (SIFMA), DOL proposed to provide under PTE 80-26, until six months after publication of the final amendment, relief from ERISA §§ 406(a)(1)(A) and (D) and 406(b)(1) and (2) (and corresponding provisions of the IRC) for:

- A "Covered Extension of Credit" between an IRA/plan and a disqualified person/party in interest, i.e., an indemnification or cross-collateralization agreement or other extension of credit in a written brokerage, futures or other investment agreement (Account Opening

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Agreement) in favor of a financial institution by which the plan/IRA account (Plan Account) guarantees debits to another account (Related Account) or vice versa;

- A “Covered Loan” pursuant to the Covered Extension of Credit from the Related Account to the Plan Account – but not from the Plan Account to the Related Account; and
- A “Covered Repayment” of that Covered Loan by the Plan Account.

This retrospective and temporary relief would be subject to the following conditions:

- The financial institution is subject to oversight by a regulatory agency or self-regulatory organization;
- The Covered Loan arises from a debit to the Plan Account that is a lawful (apparently under federal law) expense incurred by the Plan Account (which potentially includes a fee, expense, investment loss or tax); and
- The amount of the Covered Loan does not exceed the amount of that expense, no interest or other fee is charged, and the amount of the Covered Repayment does not exceed the amount of the Covered Loan.

DOL was unpersuaded, however, that, absent further conditions and safeguards, permanent prospective relief should be provided at this time. Accordingly, DOL intends that the six months of temporary relief will provide “ample time” for financial institutions to remove cross-collateralization provisions from their existing account agreements with ERISA plans and IRAs and to resolve any outstanding debits. In a footnote, DOL also stated that cross-collateralization between a plan account and the corporate account of the plan sponsor could be a violation of the general fiduciary standards of ERISA § 404.

Observations

DOL’s positions on this issue, including with respect to permanent prospective relief, will result in changes in many but not all affected arrangements.

- If an IRA/plan itself maintains multiple accounts with a financial institution, there is no prohibited transaction issue with cross-collateralization among those accounts.
- In other limited circumstances, a prohibited transaction exemption may be available other than under PTE 80-26. ERISA § 406(b)(17) and IRC § 4975(d)(20), added by the Pension Protection Act of 2006, provide relief for extensions of credit, among other transactions, provided (i) the disqualified person/party in interest dealing with the IRA/plan (or an affiliate) is not a fiduciary with discretionary authority or control over the assets involved in the transaction and (ii) the IRA/plan pays no more than “adequate consideration.” This relief may have limited practical utility, however, for cross-collateralization agreements:
    - For IRAs, the IRA owner (conventionally, also the owner of the related account) generally would be considered a fiduciary; and
    - For ERISA plans, DOL presumably intends its caution on § 404 to chill the use of cross-collateralization agreements even where § 406(b)(17) relief is available.

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- To the extent that financial institutions determine to remove these provisions from their account opening agreements with IRAs and ERISA plans, that change would increase the risk to the financial institution of an unpaid debit in those accounts. It would be rational for financial institutions to consider repricing, other compensating changes in terms, or even termination of those accounts. If so, certain types of investment flexibility currently found useful in IRAs and ERISA plans may be curtailed.

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