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DOL Proposes to Substitute Creditworthiness Determinations for Credit Ratings in ERISA Prohibited Transaction Class Exemptions

On June 21, 2013, the Department of Labor (DOL) published [proposed amendments to certain class exemptions](#) required by Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which directs federal agencies to remove from their regulations any references to, or requirements of reliance on, credit ratings and to replace those requirements with substitute standards of creditworthiness.

DOL has determined that its class exemptions constitute regulations for this purpose and has proposed amendments to applicable exemptions. As described in more detail in the attached overview, the proposal affects six existing class exemptions dealing with financial and investment transactions.¹ DOL proposes to substitute for the credit rating previously specified in the exemption a comparable standard of credit quality to be determined, generally, by a responsible fiduciary for the plan that is engaging in the exempted transaction. For example, an existing requirement that a debt security be rated in the four highest categories by a national credit rating firm would become a determination that the security is subject to no more than moderate credit risk and is reasonably liquid. According to the preamble:

- DOL sees this determination as a fiduciary act subject to the standards of Section 404 of the Employee Retirement Income Security Act of 1974, as amended (ERISA).
- That determination can take into account, but apparently cannot exclusively rely on, credit ratings.
- To the extent a fiduciary lacks the time or expertise to make that determination, as a matter of prudence the fiduciary may need to consult an expert third-party.

DOL outlined in the preamble (but did not incorporate in the exemptions themselves) a number of factors, derived from Securities and Exchange Commission (SEC) regulations for implementing Section 939A, that fiduciaries may consider “helpful” in making the credit determinations required by the proposed amendments. Because these factors came from guidance designed for financial professionals, they are quite sophisticated in certain respects. Depending on the nature of the security at issue, the listed factors include:

- Credit spreads (i.e., the amount of credit risk a position in commercial paper and/or nonconvertible debt is subject to, based on the spread between the security’s yield and the yield of Treasury or other securities, or based on credit default swap spreads that reference the security);

¹ PTE 75-1, 40 Fed. Reg. 50845 (October 31, 1975), as amended by 71 Fed. Reg. 5883 (February 3, 2006); PTE 80-83, 45 Fed. Reg. 73189 (November 4, 1980); PTE 81-8, 46 Fed. Reg. 7511 (January 23, 1981), as amended by 50 Fed. Reg. 14043 (April 9, 1985); PTE 95-60, 60 Fed. Reg. 35925 (July 12, 1995); PTE 97-41, 62 Fed. Reg. 42830 (August 8, 1997); and PTE 2006-16, 71 Fed. Reg. 63786 (October 31, 2006).

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- Securities-related research (i.e., to what extent providers of securities-related research believe the issuer of the security will be able to meet its financial commitments, generally, or specifically, with respect to securities held);
- Internal or external credit risk assessments (i.e., whether credit assessments developed internally by a broker-dealer, or externally by a credit rating agency, express a view as to the credit risk associated with a particular security);
- Default statistics (i.e., whether providers of credit information relating to securities express a view that specific securities have a probability of default consistent with other securities with a determined amount of credit risk);
- Inclusion on an index (i.e., whether a security, or issuer of the security, is included as a component of a recognized index of instruments that are subject to a determined amount of credit risk);
- Priorities and enhancements (i.e., the extent to which a security is covered by credit enhancements, such as overcollateralization and reserve accounts, or has priority under applicable bankruptcy or creditors' rights provisions);
- Price, yield and/or volume (i.e., whether the price and yield of a security or a credit default swap that references the security are consistent with other securities that the broker-dealer has determined are subject to a certain amount of credit risk and whether the price resulted from active trading); and
- Asset class-specific factors (e.g., in the case of structured finance products, the quality of the underlying assets).

Written comments and requests for a public hearing must be received by the DOL by August 20. The DOL has specifically requested comments on the cost to comply with the proposed amendments and has invited proposed alternatives.

- The exemptions, by their current terms, tend to reference credit ratings for relatively narrow purposes.
- In carrying out this Congressional mandate to change those references, DOL followed its usual precepts about the operation of and the nature of responsibilities under the fiduciary standards of ERISA. This is perhaps to be expected.
 - For example, the proposal may foreshadow the approach DOL will take in its pending project to provide tools for fiduciaries evaluating the lifetime income solutions for defined contribution plans.
- Nonetheless, that Congressional mandate may well have unintended consequences. For example:
 - The proposal converts a ministerial element under the existing terms of the exemptions into a fiduciary determination and explicitly institutes a prudence component for prohibited transaction relief.

- To qualify for the exemptive relief under the proposed amendments, plan fiduciaries generally would take on the role of mini-credit rating agencies. There will be a cost to serving in that role – often, predictably, in fees for third-party providers performing the same analyses as credit rating agencies, on which the exemptions currently rely at no incremental out-of-pocket cost to the plan – and that cost, as always, will affect the value of plan benefits provided to participants.
- Moreover, prior experience has shown that attempts by DOL to describe the elements of a particular fiduciary process, while intended to be helpful, often have a perverse behavioral effect. Specifically, such a process, when reduced to writing by a regulator, appears so daunting and fraught with risk that fiduciaries are discouraged rather than assisted.
- As a result, the helpful transactions permitted by these exemptions may occur with less frequency or on more limited terms than in the past, as described in the attached overview.

Accordingly, it may be worthwhile to consider whether there are alternative ways to implement Section 939A in these exemptions that can be proposed to DOL – for example, a presumption that conclusively adopts for purposes of the exemption the creditworthiness determinations of a recognized expert (which could include but need not be limited to a credit rating agency) unless the plan fiduciary has reason to doubt that determination – that would be less disruptive and less expensive in practice.



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Overview of Proposed Amendments

PTE 75-1 Certain Transactions Between Plans and Broker-Dealers. This broad exemption permits a number of common commercial transactions between plans and broker-dealers, including a plan's acquisition of securities from a member of an underwriting syndicate of which a plan fiduciary or its affiliate is a member, and an employee benefit plan's purchase or sale of securities for which the plan's fiduciary is a "market maker," to or from such fiduciary or its affiliate. Each of these transactions contains a condition that the issuer has been in continuous existence for three years, but there are some exceptions to that requirement, and the creditworthiness standard appears in the exceptions.

- **Current Standard:** Non-convertible debt securities "rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization" are not subject to the three-year continuous operation condition.
- **Proposed Amendment:** A non-convertible debt security must be "(i) subject to no greater than moderate credit risk and (ii) sufficiently liquid that such securities can be sold at or near their fair market value within a reasonably short period of time."
- **Possible Consequences:** Because the requirement of a credit determination appears in an exception to a condition, the plan fiduciary may decide it is preferable to comply with the condition and enter into covered transactions only with issuers which have been in existence for three years. As a practical matter, the amendment may operate to write out the exception to the three-year continuous existence requirement or severely limit its use.

PTE 80-83 Use of Proceeds From Sale of Securities to Reduce or Retire Indebtedness. Under PTE 80-83, in certain cases a plan may purchase securities where the proceeds of the sale are used to pay down indebtedness of the issuer to a bank (or affiliate) that is a fiduciary to a plan. If the fiduciary knows that the proceeds will be used for this purpose, additional conditions must be satisfied, including a condition that the issuer has been in continuous existence for three years.

- **Current Standard:** An exception to the condition that the issuer be in continuous existence for three years is available for securities that are non-convertible debt securities "rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization."
- **Proposed Amendment:** Non-convertible debt securities must be "(i) subject to no greater than moderate credit risk and (ii) sufficiently liquid that such securities can be sold at or near their fair market value within a reasonably short period of time."
- **Possible Consequences:** Similar to PTE 75-1, a plan fiduciary may find it safer to limit dealings to issuers who have been in continuous existence for three years.

PTE 81-8 Short-Term Investments. This exemption permits plan assets to be invested in certain short-term investments issued by a party in interest, including commercial paper with a maturity date of nine months or less.

- **Current Standard:** The commercial paper must be ranked in one of the three highest rating categories by at least one nationally recognized statistical rating service.
- **Proposed Amendment:** Commercial paper must be "(i) subject to a minimal or low amount of credit risk based on factors pertaining to credit quality and the issuer's ability to meet its short-term financial obligations, and (ii) sufficiently liquid that such securities can be sold at or near their fair market value within a reasonably short period of time." Because the determination of creditworthiness under the new standard involves fiduciary discretion, a fiduciary independent of the issuer will have to make the determination of creditworthiness to qualify for another condition to the exemption.

- **Possible Consequences:** The very nature of short-term investments means that fiduciaries would be dealing with the new standard on a functionally continuous basis if the plan regularly uses the exemption.

PTE 95-60 Insurance Company General Accounts. This exemption was issued in response to the U.S. Supreme Court's decision in *John Hancock Mutual Life Ins. Co. v. Harris Trust & Savings Bank*, 510 U.S. 86 (1993) holding that certain assets held in insurance company general accounts may be "plan assets." The exemption permits transactions commonly entered into between a general account and parties in interest, including in connection with the servicing, management, and operation of a trust described in PTE 83-1 or in one of the Underwriter Exemptions,² in which an insurance company general account has an interest as a result of its acquisition of certificates issued by the trust and by plans holding certain asset-based pass-through certificates representing interests in those trusts.

- **Current Standard:** The conditions of either PTE 83-1 or an applicable Underwriter Exemption must be met, other than the requirements that the certificates acquired by the general account (A) not be subordinated to the rights and interests evidenced by other certificates of the same trust, and (B) receive a rating that is in one of the three highest generic rating categories from an independent rating agency.
- **Proposed Standard:** "[T]he conditions of either PTE 83-1 or the relevant Underwriter Exemption are met, except for the requirements that: (A) the rights and interests evidenced by the certificates acquired by the general account are not subordinated to the rights and interests evidenced by other certificates of the same Trust, and (B) the certificates acquired by the general account have the credit quality required under the relevant Underwriter Exemption at the time of such acquisition."
- **Possible Consequences:** The exemption contains an exception to a credit rating requirement. The new standard eliminates a reference to a credit rating but does not make a substantive change.

PTE 97-41 Collective Investment Fund Conversion Transactions. PTE 97-41 permits the purchase by a plan of mutual funds for which a bank is an investment adviser through an exchange of assets transferred in-kind from a collective investment fund (CIF) maintained by the fiduciary bank. One condition of the exemption is that exchanged securities must be divided pro rata among investing plans.

- **Current Standard:** The allocation among plans of small positions in fixed income securities held by a CIF will not fail to meet the requirements of the pro rata division rule if, among other things, such securities have the same coupon rate and maturity, and at the time of transfer, the same credit ratings from nationally recognized statistical rating organizations.
- **Proposed Amendment:** The allocation of fixed income securities held by a CIF among the plans will not fail to meet the pro rata requirements if, among other things "such securities have the same coupon rate and maturity, and at the time of transfer, the same credit quality."
- **Possible Consequences:** In this case the bank, rather than a responsible plan fiduciary, would likely have the functional responsibility of determining whether securities have the same credit quality. The purpose of the credit standard underlying this condition, however, is to save transaction costs. Requiring fiduciary determinations of credit quality would likely add transaction costs, undercutting the purpose of the exception to pro rata division.

² The Underwriter Exemptions refer to a number of individual prohibited transaction exemptions for specified types of transactions that permitted reliance on credit ratings.

PTE 2006-16 Certain Loans of Securities by Employee Benefit Plans. This exemption permits, in certain circumstances, a plan to lend securities to banks and broker-dealers that are parties in interest with respect to the plan. One condition involves the posting of collateral from the borrower. Creditworthiness standards appear in the definitions of acceptable collateral.

- **Current Standard:** The definition of “Foreign Collateral” includes “foreign sovereign debt securities provided that at least one nationally recognized statistical rating organization has rated in one of its two highest categories either the issue, the issuer or guarantor.” “Foreign Collateral” is also defined to include “irrevocable letters of credit issued by a [f]oreign [b]ank, other than the borrower or an affiliate thereof, which has a counterparty rating of investment grade or better as determined by a nationally recognized statistical rating organization.”
- **Proposed Amendment:** “Foreign Collateral” will include “foreign sovereign debt securities that are (i) subject to a minimal amount of credit risk, and (ii) sufficiently liquid that such securities can be sold at or near their fair market value in the ordinary course of business within seven calendar days.” It will also include letters of credit where “at the time the letters of credit are issued, the Foreign Bank’s ability to honor its commitments thereunder is subject to no greater than moderate credit risk.”
- **Possible Consequences:** The plan fiduciary authorizing the loan is responsible for determining whether the collateral meets credit quality criteria. It may be unwilling to engage in these sorts of transactions due to the increased costs and potential fiduciary liability.