



Pension Analyst

Compliance Bulletin

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Dodd-Frank Wall Street Reform and Consumer Protection Act orders study to determine whether stable-value products are swaps

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”). The stated intent of the new law is to promote the financial stability of the United States by improving the accountability and transparency of the financial system and protecting consumers from abusive financial services practices. Swaps are one of the financial transactions addressed by the new law. Normally, the vast majority of retirement plans do not directly employ swaps. However, the law’s definition of swap could include components of stable-value products, which have become a staple of many plans’ investment offerings in the current economic environment.

What is a “swap”?

Historically, a “swap” has been a type of derivative instrument that involves a privately negotiated contract between two parties to exchange cash flows at specified intervals during the life of the agreement. However, the Dodd-Frank Act defines “swap” very broadly to include almost any agreement where the value is determined by reference to an underlying asset.

How do retirement plans use swaps?

Very large defined benefit and defined contribution plans may enter directly into swap arrangements to reduce funding volatility. In addition, many participant-directed plans now use stable-value funds to preserve capital while providing a rate of return that is typically higher than the rate provided by money market funds. The investments underlying a stable-value fund are protected by the issuer’s guarantee to pay the book value of the investments if the market value is depleted. It is this protective “wrapper” that could be considered a swap under the Dodd-Frank Act.

How does the new law regulate swaps?

In general, the Dodd-Frank Act imposes new requirements and obligations on swaps transactions and certain swap market participants, which will ultimately be reflected in new regulations. Most swaps will need to be standardized and may have to settle through a registered clearinghouse. In addition, persons classified as “swap dealers” or “major swap participants” will have to register with the Commodities Futures Trading Commission (“CFTC”) or the Securities and Exchange Commission (“SEC”) and may be subject to new disclosure, reporting, recordkeeping, capital, business conduct and other rules.

How do these rules affect stable-value products?

The new law contains several special provisions relating to stable-value contracts.

Joint study

First of all, it directs the CFTC and SEC to jointly conduct a study to determine if stable-value contracts fall within the definition of a swap. In conducting this study, the regulators are to consult the Department of Labor, Department of the

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Treasury, and the State entities that regulate contract issuers. The regulators must conduct the study within 15 months after the date of the law's enactment (i.e., by October 2011).

Regulations

If the study concludes that stable-value contracts are swaps, the CFTC and SEC must determine if these products should be exempt from the new swap rules. The regulators must then issue regulations reflecting the determinations they make. Until the effective date of those regulations, stable-value contracts (as defined in the Dodd-Frank Act) will not be subject to the new legal requirements that apply to swaps.

Grandfathered Funds

Regardless of the outcome of the CFTC/SEC study, the law provides that stable-value contracts in effect before the effective date of new regulations will not be considered swaps and therefore will not be subject to the new rules. By definition, this safe harbor is available only for stable value contracts supporting investment options available in participant-directed retirement plans.

How do these provisions affect retirement plans?

For the foreseeable future, stable-value products will continue to be viable participant-directed plan investments and investment offerings and will not be affected by the new restrictions on swaps. Prudential will continue to monitor the progress of the CFTC/SEC joint study and related regulatory developments and will keep plan sponsors apprised of the outcomes.

Are there other potential impacts on retirement plans and plan sponsors?

The Dodd-Frank Act makes sweeping changes to the U.S. financial regulatory system and will have a direct impact on many retirement plan service providers, including banks, broker-dealers, insurance companies and other financial institutions. The law will take years to implement, with more than 300 rulemaking and study projects. Although the final impact remains to be seen, it is clear that regulatory agencies will be active for several years supporting the Act's implementation. We are monitoring and reviewing these regulatory developments and will provide updates in future publications.