The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 27367

July 10, 2013

DOL Proposes Amendments to Several Class Exemptions to Remove Credit Rating References -- Comments Requested by July 26

[27367]

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TO: PENSION COMMITTEE No. 17-13
PENSION OPERATIONS ADVISORY COMMITTEE No. 16-13 RE: DOL PROPOSES AMENDMENTS TO SEVERAL CLASS EXEMPTIONS TO REMOVE CREDIT RATING REFERENCES -- COMMENTS REQUESTED BY JULY 26

The Department of Labor (DOL) proposed amendments to several Class Exemptions (PTEs) to remove references to credit ratings pursuant to the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). [1] Section 939A of Dodd-Frank requires each Federal agency to review any regulation it issued that requires the use of an assessment of the credit-worthiness of a security or money market instrument, modify such regulation to remove any reference to or requirement of reliance on credit ratings and substitute in such regulations a standard of credit-worthiness as each respective agency deems appropriate.

According to DOL, in each of the class exemptions for which an amendment is proposed, DOL has conditioned relief on the financial instruments which are the subject of the exemption, or an issuer of such financial instrument, receiving a specified credit rating issued by a credit rating agency. DOL acknowledges that, in proposing the amendments, it considered alternatives to credit ratings set forth in three Securities and Exchange Commission (SEC) releases relating to credit rating alternatives and will consider the SEC's treatment of comments received in response to those proposals as part of its compliance with Dodd-Frank. [2]

Comments are due to DOL on or before August 20, 2013. As we are considering providing comments, we would appreciate receiving any comments on the Amendments by July 26, 2013.

DOL proposes to amend six class exemptions. Of those six, the following three proposed amendments may be of interest to Institute members. [3]

The Proposed Amendments

PTE 75-1

PTE 75-1 generally provides relief from ERISA's prohibited transaction provisions (and the taxes imposed by §4975 of the Internal Revenue Code) for certain transactions between plans and broker-dealers or banks if certain conditions are met. Included among the covered transactions are (1) a plan's acquisition of securities during the existence of an underwriting syndicate, from a person other than a plan fiduciary, where a plan fiduciary or its affiliate is a member of the underwriting syndicate, and (2) a plan's purchase or sale of securities from or to a "market maker" with respect to such security who is also a plan fiduciary or an affiliate of such fiduciary. Among the required conditions for each of the above two types of transactions is a requirement that the issuer of the securities (including any predecessors) must have been in continuous operation for not less than three years. However, several exceptions to this requirement exist, including an exception 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.

DOL proposes to replace the credit rating reference in this exception to require that "[a]t the time of acquisition, such securities are non-convertible debt securities (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."

PTE 97-41

PTE 97-41 generally provides relief from ERISA's prohibited transaction provisions (and the taxes imposed by §4975 of the Internal Revenue Code) for the purchase by a plan of shares of one or more mutual funds in exchange for the assets of the plan transferred in kind to the mutual fund from a collective investment fund ("CIF") maintained by a bank where such bank is a plan fiduciary and also the investment advisor to the mutual fund. Exemptive relief is conditioned upon a pro-rata division rule, which requires that the transferred assets must constitute the plan's pro rata portion of the assets that were held by the CIF immediately prior to the transfer. However, notwithstanding this rule, the allocation of fixed income securities held by a CIF among plans on the basis of each plan's pro rata share of the aggregate value of the securities will not fail to meet the pro rata division rule's requirement if (1) the aggregate value of such securities does not exceed one percent of the total value of the assets held by the CIF immediately prior to the transfer, and (2) such securities have the same coupon rate and maturity, and at the time of the transfer, the same credit ratings from nationally recognized statistical rating organizations.

DOL proposes to replace the existing credit rating reference with a requirement that such securities be of "the same credit quality." DOL notes that, in making a determination as to the credit quality of fixed income securities for purposes of this condition, a fiduciary should, to the extent possible, engage in credit quality comparisons using the same standards for each set of securities and may rely in this regard on reports and advice given by independent third parties, including ratings issued by ratings agencies.

PTE 2006-16

PTE 2006-16 generally provides relief from ERISA's prohibited transaction provisions (and the taxes imposed by §4975 of the Internal Revenue Code) for the lending of securities that are plan assets to certain banks and broker-dealers that are parties in interest to the plan and for the payment to a fiduciary of compensation for services rendered in connection with securities lending, if certain conditions are met. One condition is the plan's receipt

from the borrower, by the close of the lending fiduciary's business on the day in which the securities lent are delivered to the borrower, of either "U.S. Collateral" or "Foreign Collateral." Included within the definition of "Foreign Collateral" are "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." DOL proposes to change this definition to "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."

Also included within the definition of "Foreign Collateral" are "irrevocable letters of credit issued by a Foreign Bank, 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." DOL proposes to change this definition to "irrevocable letters of credit issued by a Foreign Bank, other than the borrower or an affiliate thereof, provided that, 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." DOL states that moderate credit risk would denote current low expectations of default risk, with an adequate capacity for payment of principal and interest.

Specific Comment Requests

In addition to comments regarding all aspects of the proposed amendments, DOL specifically seeks comments in the following areas:

- Whether the alternatives for credit ratings proposed in the amendments represent adequate substitutes for credit ratings by rating organizations, taking into account the different class exemptions' use of such ratings, and the cost to comply with the proposed alternatives.
- With respect to the term "moderate credit risk" used in some of the proposed amendments, whether average credit-worthiness relative to other similar issues or issuers is an appropriate point of reference to associate with a moderate level of credit risk.
- The inclusion of a liquidity requirement as part of its standard of credit-worthiness for use in the PTEs.
- The use of "fair market value" for purposes of establishing a liquidity requirement in the proposed alternatives to credit ratings.

Please feel free to contact me (howard.bard@ici.org or 202.326-5810) with any questions or comments on DOL's proposed amendments.

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endnotes

[1] The proposed amendments are available here: http://www.gpo.gov/fdsys/pkg/FR-2013-06-21/pdf/2013-14790.pdf. For more detailed information on Dodd-Frank, see Memorandum to Pension Members No. 30-10, et al. [24431], dated July 19, 2010.

[2] For the Institute's comment letters to the SEC regarding modifications to SEC regulations that contain references to or requirements regarding credit ratings that require the use of an assessment of the credit-worthiness of a security or money market instrument, see Memorandum to Money Market Funds Advisory Committee No. 28-11, Municipal Securities Advisory Committee No. 23-11, SEC Rules Committee No. 37-11 [25144], dated April 25, 2011; Memorandum to Compliance Advisory Committee No. 7-09, Equity Markets Advisory Committee No. 55-09, Fixed-Income Advisory Committee No. 30-09, Money Market Funds Advisory Committee No. 51-09, Municipal Securities Advisory Committee No. 59-09, SEC Rules Members No. 134-09 [24005], dated December 8, 2009; Memorandum to Accounting/Treasurers Committee No. 14-09, Bank Trust and Recordkeeper Advisory Committee No. 40-09, Broker/Dealer Advisory Committee No. 50-09, Money Market Funds Advisory Committee No. 35-09, Municipal Securities Advisory Committee No. 40-09, Operations Committee No. 16-09, SEC Rules Members No. 94-09, Small Funds Committee No. 16-09, Transfer Agent Advisory Committee No. 68-09, Variable Insurance Products Advisory Committee No. 15-09 [23769], dated September 9, 2009.

[3] The remaining three PTEs proposed to be amended are PTE 80-83 "Use of Proceeds from Sale of Securities to Reduce or Retire Indebtedness", PTE 81-8 "Short Term Investments", and 95-60 "Insurance Company General Accounts".
