

U.S. Department of Labor

Labor-Management Services Administration
Washington, D.C. 20216



Reply to the Attention of:
OPINION NO. 82-49A
Sec. 401(b), 403(a), 3(21)(A)(i),
3(21)(A)(ii), 3(14)(B), 3(38)

SEP 21 1982

Howard Pianko, Esq.
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299 Park Avenue
New York, N.Y. 10171

Dear Mr. Pianko:

This is in reply to your request on behalf of the Futures Industry Association, Inc. (FIA) for a number of advisory opinions and class exemptions under the Employee Retirement Income Security Act of 1974 (the Act) relating to employee benefit plan investments in futures contracts. You filed an initial application with the Department for an advisory opinion on October 17, 1980. By letter dated February 17, 1981, the Department informally notified you of its tentative assessment of the issues raised in your application. At the same time, the Department indicated that it would take no final action with regard to your application until you had submitted certain additional materials. You submitted these materials (which included requests for additional advisory opinions and for class exemptive relief) on May 12, 1981 and June 5, 1981. Further information was provided by you at a meeting with representatives of the Department on October 6, 1981. Pursuant to that meeting, you filed on November 10, 1981, a finalized application for advisory opinions and class exemptive relief.

As discussed at the October 6th meeting, the purpose of this letter is to reply to your advisory opinion requests. Your requests for class exemptive relief will be addressed separately.

A. Background.

You have provided the Department with extensive information regarding trading in futures contracts, which is summarized below.

It appears that a futures contract is basically an executory bilateral agreement pursuant to which a party agrees to buy or sell a specific quantity of a commodity for a stated price at a set time in the future. Pursuant to section 6 of the Commodity Exchange Act (CEA) (7 U.S.C. §6), dealings in futures contracts may lawfully occur only in a "contract market" designated by the Commodity Futures Trading Commission (CFTC) and governed by the CFTC's regulations. You represent that a contract market is the equivalent of a national security exchange. A person

buying a commodity futures contract is said to be taking the "long" position and is obligated to take delivery of a specific amount of the underlying commodity at the date indicated in the contract. A person selling a commodity futures contract is said to be taking a "short" position and is obligated to deliver a specific quantity of a given commodity on the date indicated in the contract. Trading in futures contracts does not necessarily involve the purchase or sale of the underlying commodity. Rather, futures contract trading concerns the buying and selling of the rights and obligations attendant upon making or taking delivery of a commodity at some date in the future. Since each futures contract represents such executory agreements to buy and sell, the number of short and long positions is equal at all times.

Futures contracts are bought and sold by open, competitive outcry on the floor of a contract market. A person wishing to trade in futures contracts will place an order with a futures commission merchant (FCM). The FCM will act as an agent for the customer and transmit the customer's order to a broker on the floor. A floor broker with a long order will shout the amount and price of his order, and a floor broker with a short order will do the same. Where the quantities and prices agree, a trade is executed. The respective long and short orders are recorded and transmitted to the clearing organization for the contract market. This clearing process severs the link between the two floor brokers, as long positions are matched with short positions of corresponding amount, price and maturity date without regard to the identities of the original traders. This is made possible because futures contracts in each commodity are in standard form and therefore fungible, varying only in amount, price and maturity date. The clearing firms for the buying and selling floor brokers accept the contracts and assume the responsibility for performance. When the contracts are submitted by the clearing firms to the clearing organization and accepted by the latter, the clearing firms are relieved of liability to one another. As a result of the clearance process, the parties involved in the transaction need only be concerned with the parties with whom they are in direct contractual relation. Thus, the buyer and seller look to their respective FCMs, the FCM looks to his client and to the clearing organization, and the clearing organization looks to both FCMs.

When a customer engages in a futures transaction through an FCM, the customer is required to pay to the FCM an amount equal to a small percentage of the contract amount. This payment is called initial margin, and the minimum amount of such margin is set by rules established by each contract market based on the volatility of the commodity underlying the futures contract. You state that, typically, the minimum margin is 3 to 10 percent of the contract amount. The FCM may require a higher amount of initial margin based on the creditworthiness of each customer, or other relevant characteristics. You represent that the nature of margin in futures transactions is different from that of margin in securities transactions in that futures contract margin does not involve the borrowing of funds by a customer to finance the transaction. Rather, you state that initial margin is in the nature of a performance bond or a good faith deposit on the contract made by the parties. Subsequent payments, called maintenance margin, to or from the FCM may be required as the price of the underlying commodity fluctuates, making the long and short positions in the futures contract more or less valuable. Thus, where a trader has taken a long position (that is, made a contract to buy a specified amount of a certain commodity at a future

date for a set price) and the price of the underlying commodity has risen, that position will have increased in value and the customer will receive from the FCM a maintenance margin payment (or a credit to the customer's account) reflecting that increase in value. Where a trader has taken the corresponding short position (that is, agreed to sell a specific quantity of a certain commodity at a future date for a set price) in the same commodity, his position would be less valuable since he would be obligated to sell his commodity for less than the current market price. As a result, the short trader would be required to make a maintenance margin payment to the FCM.

You note that in a large measure, FCMs are conduits for original and maintenance margin from customers since they in turn must make original and maintenance margin payments either to a clearing organization (if they are a clearing member) or to another FCM which is a clearing member (if they are not). Just as an FCM holds initial margin from customers to insure performance of the customers' obligations, the clearing organization holds original margin from clearing members to insure performance of their obligations.

It appears that there are two ways in which a futures contract position may be terminated. A customer may elect to make or take delivery of the underlying commodity according to the terms of the futures contract. Normally, however, the customer, through an FCM, will take an offsetting futures contract position. In other words, if the customer had previously gone long for a specified quantity of a certain commodity for a future maturity date, he would close out that position by going short for an equal amount of the same commodity on the same future date. Any variation in price between the long and short positions will already have been reflected in the customer's margin account through maintenance margin payments.

You indicate that, since 1979, plans have increasingly engaged in futures contract trading, especially with regard to financial futures (Treasury bonds and notes, GNMA certificates, commercial paper, etc.) Such plans have primarily utilized futures contract trading as a hedging tool in order to minimize risks associated with fluctuating interest rates.

B. Advisory Opinion Requests.

You represent that, as a result of increasing plan investment in this area, a number of questions have arisen with regard to the application of the Act to futures contract trading. You have requested the Department's opinion with regard to eight such issues:

- (1) whether initial and maintenance margin are plan assets for the purposes of Part 4 of Subtitle B of Title I of the Act;
- (2) whether initial and maintenance margin must be held in trust in accordance with section 403(a) of the Act;
- (3) whether regulation 29 CFR §2510.3-21(c)(1) will apply in determining whether an FCM has rendered investment advice to a plan;

- (4) whether the holding of margin by itself causes an FCM to be a fiduciary;
- (5) whether an FCM executing futures transactions pursuant to instructions from an independent plan fiduciary and under conditions similar to those contained in regulation 29 CFR §2510.3-21(d) will be deemed to be a fiduciary;
- (6) whether a clearing organization, or an FCM clearing a transaction for another FCM, will be a party in interest with respect to a plan engaged in a futures transaction;
- (7) whether an FCM will be a fiduciary if, pursuant to applicable law and the customer agreement, such FCM liquidates futures contracts in the plan's account and sells government securities or other securities posted as margin to satisfy losses suffered by the account; and
- (8) whether an FCM registered both under the Commodity Exchange Act and under the Investment Advisers Act of 1940 will be an investment manager within the meaning of section 3(38) of the Act when such FCM renders advice solely with regard to futures contracts.

Except as necessitated in response to these eight requests, the Department is offering no opinion with regard to the status of specific futures transactions under Part 4, Title I of the Act. Specifically, we note that Section 404(a)(1)(B) of the Act requires that a fiduciary discharge his or her duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Accordingly, the fiduciaries of a plan must act "prudently" when deciding whether to engage in futures contract trading as part of a plan's overall investment strategy. Similarly, the general standards of fiduciary conduct would apply to futures transactions effected by an FCM who, under the circumstances, is a fiduciary with respect to a plan. Further, nothing in this letter changes the fact that certain futures transactions between a plan and an FCM who is a party in interest (including a fiduciary) will be subject to the prohibitions of section 406 of the Act.

1. Margin and Plan Assets. You have represented that both initial and maintenance margin are in the nature of performance bonds or good faith deposits and indicate a customer's commitment to abide by his agreement with an FCM regarding his futures account. You state that, because of this, margin payments should not be classified as plan assets.

When an authorized FCM effects a futures transaction on behalf of any investor, including an employee benefit plan, the investor's rights and obligations with respect to any property held at any time in a margin account are fixed and determined in accordance with the provisions of the CEA, the rules and regulations of the CFTC and the rules of the applicable contract markets which are generally incorporated in the investor's agreement with its FCM. Both the buyer and

seller of a futures contract, their respective FCMs, and those clearing firms and clearing organizations necessary for the proper execution and clearance of a futures transaction assume obligations with respect to the other parties involved in the transaction which are designed to preserve the integrity of the trading process.

In this regard, it appears that margin fulfills a function central to the futures marketplace. Under section 6d(2) of the CEA, an FCM is required to "treat and deal with all money, securities and property received by such [FCM] to margin ... the trades or contracts of any customer ... as belonging to such customer That in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, such money, securities, and property of the customers of such [FCM] may be commingled ... with any other money, securities and property received by such [FCM] and required by the Commission to be separately accounted for and treated and dealt with as belonging to the customers of such [FCM]" Thus, you represent that all customers' assets received as margin by the FCM may be held in a single commingled account segregated from the funds of the FCM. It appears that Congress recognized that margin in connection with a futures transaction does not exist solely for the benefit of a customer, but is essential for the protection of all the investors and all the parties (FCMs, clearing firms and clearing organizations) that participate in such regulated transactions.

So long as a plan investor has not terminated its futures contract position by means of an offsetting transaction or by taking delivery of the underlying commodity, the plan has no right to any assets in the margin account except for those which are available for withdrawal by reason of favorable price fluctuation credits to the plan.

In view of the above, it is the opinion of the Department that the assets held by the FCM to fund a plan's margin account (consisting of initial and maintenance margin in connection with a future transaction) are not plan assets for the purposes of Part 4 of Subtitle B of Title I of the Act. When a plan engages in a futures transaction, its assets are the rights embodied in the futures contract as evidenced by a written confirmation and outlined in its agreement with its FCM, including such rights as the plan may have to make withdrawals from the account.¹

2. Trust Requirement. Section 403(a) of the Act provides that all plan assets must be held in trust. You have asked the Department's opinion as to the extent to which this trust requirement applies to the holding of margin. As noted above, it is the Department's opinion that the relevant plan asset is the plan's right to payment from the margin account under certain circumstances as

¹ With regard to such withdrawals, you indicate that the FCM and its customer may choose among several different methods of settling the margin account when maintenance margin has accrued to the customer's benefit. In situations where a plan is such a customer, the Department expresses no opinion as to the circumstances, if any, under which the failure by such plan to exercise its rights with regard to the margin account would violate the prudence requirements of section 404(a) or constitute a transaction prohibited under section 406 of the Act.

embodied in the futures contract and the agreement with the FCM rather than the assets used by the FCM to fund the account. Therefore, the trust requirement in section 403(a) generally would be satisfied, with respect to the holding of margin in connection with a futures transaction involving a plan, if the FCM maintains the account, including any agreements, confirmations, etc., relating to the account, in the name of the plan's trustees, as trustees of the plan. See 29 CFR §2550.403a-1 (47 FR 21241, 21247, May 18, 1982),

3. Investment Advice. Section 3(21)(A)(ii) of the Act states that a person is a fiduciary with respect to a plan to the extent that "he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so." Regulation 29 CFR §2510.3-21(c) states the circumstances under which a person will be deemed to be rendering investment advice for the purposes of section 3(21)(A)(ii) of the Act. You have requested our opinion as to extent to which this regulation applies to an FCM.

Paragraph 2510.3-21(c)(1)(i) of the regulation indicates that the standards contained in the regulation apply to an individual who "renders advice to the plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property." Paragraph 2510.3-21(c)(1)(ii) of the regulation outlines the degree of control, authority or influence such a person must possess to be deemed to be rendering investment advice.

Because futures contracts (as well as the underlying commodities) are "property", and because, according to your representations, part of an FCM's function may be to recommend investment action with regard to such property, a determination of whether an FCM is rendering investment advice within the meaning of section 3(21)(A)(ii) of the Act will be made in accordance with the standards set forth in regulation 29 CFR §2510.3-21(c)(1). Of course, the issue of whether an FCM's activities rise to the level of those outlined in paragraph 2510.3-21(c)(1) of the regulation is a factual determination to be made on the basis of the relevant facts and circumstances of each case.

4. Holding Margin. In addition to questions regarding the status of margin payments as plan assets to be held in trust, you have asked whether an FCM will be deemed to be a fiduciary merely because the FCM holds initial or maintenance margin. Specifically, you note that an FCM holding margin could be considered a custodian, and section 3(14)(A) of the Act includes as a party in interest "any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian)"

A person's status as a plan fiduciary is determined pursuant to section 3(21)(A) of the Act. Section 3(21)(A) provides in pertinent part that a person is a fiduciary to the extent he exercises any discretionary control or authority with respect to the management of the plan, or the management or disposition of plan assets. Since the assets held by the FCM to fund the initial

and maintenance margin are not plan assets, as noted above, an FCM would not be a plan fiduciary under section 3(21)(A) solely by reason of holding margin.

5. FCM Acting Pursuant to Instructions of an Independent Fiduciary. You have indicated that, in many cases, an FCM will execute transactions in the ordinary course of its business for the purchase or sale of commodity futures contracts on behalf of a plan pursuant to the instructions of a plan fiduciary who is independent of such FCM. You state that the instructions from such independent plan fiduciary to the FCM typically specify: (1) the commodity futures contract to be purchased or sold (including the delivery month stated in such contract); (2) the price range within which such futures contract is to be purchased or sold; (3) a time span during which such contract may be bought or sold (but never exceeding one business day); and (4) the minimum or maximum quantity of such futures contract which may be bought or sold within the indicated price range. You have requested an advisory opinion that, under such circumstances, an FCM would not be a fiduciary with respect to a plan within the meaning of section 3(21)(A) of the Act.

You have further indicated that the conditions applicable to an FCM acting pursuant to the instructions of an independent plan fiduciary are similar, in many ways, to the provisions of regulation 29 CFR §2510.3-21(d). Regulation 29 CFR §2510.3-21(d) outlines the circumstances under which a registered broker or dealer, a reporting dealer, or a bank will not be deemed to be a plan fiduciary when executing a sale or purchase of securities on behalf of a plan pursuant to the instructions of an independent plan fiduciary. This regulation was designed to deal with business practices prevalent in the securities industry, and does not, therefore, apply directly to the execution of a commodity futures transaction. However, you have argued that the futures transaction described above is sufficiently similar to the securities transaction described in 29 CFR §2510.3-21(d) to merit the same treatment.

Section 3(21)(A)(i) of the Act states that a person will be a fiduciary with respect to a plan to the extent such person "exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets." Under the conditions described in your submission and discussed above, it would appear that the FCM acts as an agent for the independent plan fiduciary. It is the independent plan fiduciary who determines the fundamental constraints, noted above, within which an investment of plan assets is made in a particular commodity futures contract. Under such conditions, therefore, it does not appear that the FCM would possess the authority, control or responsibility which would make him a fiduciary within the meaning of section 3(21)(A)(i) of the Act.²

² We note that, even when an FCM is not a plan fiduciary within the meaning of section 3(21)(A)(i), such FCM may still be deemed to be a fiduciary pursuant to section 3(21)(A)(ii) of the Act and regulation 29 CFR §2510.3-21(c) by virtue of rendering investment advice to the plan. See Opinion #3, supra. Such FCM may also be a party in interest with respect to a plan as defined in section 3(14)(B) of the Act.

6. Clearing Organizations. As noted earlier, you indicate that once a futures contract is established, the respective long and short positions are cleared through a clearing organization. This clearing process severs the relationship between the original traders and matches buy and sell orders without regard to the identity of the underlying customer. Where an FCM is not a member of a clearing organization, he must engage another FCM who is a clearing member to clear contracts through the clearing organization.

You have asked whether, by providing this clearing service, the clearing organization or the third-party clearing FCM will be a party in interest with respect to a plan by reason of section 3(14)(B) of the Act. Section 3(14)(B) states that a party in interest with respect to a plan includes "a person providing services to such plan." It appears that the services provided by the clearing organization or the third party clearing FCM are an integral part of the mechanics of the trading process common to all contract markets. A plan investor would expect its FCM, pursuant to its contractual agreement, to procure all clearance and other services incidental to the effecting or executing of a futures transaction. Those who provide these clearance services act in a mechanical fashion without regard to the identity of the investors. Accordingly, it is the view of the Department that neither the clearing organization nor the third party clearing FCM provides services to the plan, and neither will be deemed to be a party in interest with respect to the plan solely by reason of providing clearing services for the plan's FCM.

7. Liquidation of Plan Futures Accounts. You have noted that one way to close out a futures account is for a customer to take an offsetting position. Ordinarily, it appears that it is the customer itself who initiates such action. However, you represent that, pursuant to relevant contract market regulations, the FCM may sometimes close out a customer's account without the customer's prior order. You state that the majority of such instances occur when a customer has failed to meet a maintenance margin call. You also state that the FCM's ability to close out an account may also be governed by the terms of the agreement negotiated between the FCM and the customer. You further represent that any outstanding losses suffered on a terminated futures contract will be made up out of the margin posted by the customer. When the margin is in the form of cash, any balance after paying off the losses is returned to the customer. When a customer has posted government securities or other securities as margin, you indicate that the FCM will sell an amount of such securities sufficient to offset losses on the account and return the remainder to the customer.

You have requested an advisory opinion that, when an FCM liquidates the futures contracts in the account of a plan customer and sells securities posted as margin by the plan to meet losses experienced by the plan's account, such FCM is not a fiduciary within the meaning of section 3(21)(A)(i) of the Act as long as the FCM is acting in accordance with applicable law and the

Further, you should be aware that, when an FCM is deemed to be a fiduciary with respect to a plan, such FCM is a fiduciary only regarding those plan assets with respect to which such FCM has the discretionary authority, control or responsibility which cause him to be a fiduciary.

agreement negotiated with the plan customer. Section 3(21)(A)(i) of the Act states that a person will be a plan fiduciary to the extent such person exercises discretionary authority or control over the assets of the plan. As noted above, a plan's assets in a futures transaction are those rights embodied in the futures contract and granted pursuant to applicable law and the plan's agreement with the FCM. However, it appears that such laws and agreements place certain obligations on the plan and give the FCM certain rights vis-a-vis the plan customer. Thus, for example, whereas the FCM is obligated to act as the plan's agent pursuant to the customer agreement, the plan customer is required, by the agreement and by applicable contract market rules to make maintenance margin payments in a timely manner when called upon. Failure to meet a maintenance margin call will result in the FCM's closing out the plan's account and resorting to the initial margin (which is in the nature of a performance bond, as noted above) to make up losses suffered by the plan's account. Any remaining initial margin is then returned to the plan customer. It does not appear that such legally granted or contractual rights necessarily amount to the type of discretionary authority or control over plan assets contemplated in section 3(21)(A)(i) of the Act. As a result, it is the Department's opinion that an FCM acting in accordance with applicable law and pursuant to the agreement negotiated with the plan customer would not be a plan fiduciary within the meaning of section 3(21)(A)(i) solely by reason of liquidating the futures contracts in a plan's account and selling any securities posted as margin in order to pay off losses suffered by such account since the FCM would not be exercising any discretionary authority or control with regard to plan assets.

8. Applicability of Section 3(38) of the Act. Section 3(38) of the Act defines the term "investment manager" to mean any fiduciary of a plan who has the power to manage, acquire or dispose of any plan assets, and who is either a bank, an insurance company, or investment adviser registered under the Investments Adviser Act of 1940. You have requested an opinion that an FCM or other person registered as a commodity trading advisor (CTA) under the CEA who is also a registered investment adviser under the Investment Advisers Act of 1940 may be an investment manager within the meaning of section 3(38) of the Act even when such FCM or other person renders advice solely with respect to futures contract transactions.

The Department has taken the position that, except for banks and insurance companies, only persons registered under the Investment Advisers Act of 1940 may serve as investment managers as defined in section 3(38) of the Act. See ERISA Interpretative Bulletin 75-5 (29 CFR §2509.75-5), questions FR-6 and FR-7. Where an FCM or other person is registered under both the CEA and the Investment Advisers Act of 1940, such FCM or other person may serve as an investment manager under section 3(38) of the Act provided the other conditions of that statutory provision are met.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 FR 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 thereof relating to the effect of advisory opinions. As noted above, having issued this opinion, the Department will continue consideration of your class exemption requests.

Sincerely,

Jeffrey N. Clayton
Administrator
Pension and Welfare Benefits Programs