Client Alert

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Labor Department Amends Class Exemption for Qualified Professional Asset Managers

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On August 23, 2005, the Department of Labor ("DOL") published final amendments (the "Amendments") to prohibited transaction class exemption ("PTCE") 84-14, which covers transactions involving employee benefit plans managed by qualified professional asset managers as defined in the exemption ("QPAMs"). The Amendments generally reduce the administrative burdens associated with compliance with the exemption but also raise the standards that QPAMs must meet for independence, professional qualifications and financial strength.

At the same time as it published the Amendments, the DOL proposed an additional exemptive provision that would permit financial services entities to act as QPAMs for their own plans under certain circumstances.

Background

Section 406(a) of ERISA prohibits a wide range of transactions between a plan and "parties in interest" to the plan, such as fiduciaries and service providers. Section 406(b) of ERISA prohibits certain transactions by plan fiduciaries involving the plan that have a potential for self-dealing. The Internal Revenue Code of 1986, as amended (the "Code"), contains parallel rules, and the QPAM exemption applies to those rules as well. For convenience, this Client Alert refers only to the rules in Section 406.

Plans may have hundreds of parties in interest, and it is difficult and burdensome to keep track of all of them. Also, Section 406(a) and (b) are so broad that they prohibit many transactions that have little potential to harm the plan.

In recognition of this, the DOL adopted the QPAM exemption in 1984. The QPAM exemption exempts most transactions that otherwise would be prohibited under Section 406(a) and a more limited range of transactions that otherwise would be prohibited under Section 406(b), if the transactions are carried out at the direction of a QPAM. A QPAM is a professional asset manager that meets certain requirements set forth in the exemption relating to its independence, professional qualifications and financial strength.

Structure of the Exemption

The QPAM exemption consists of (1) a general exemption from ERISA Section 406(a)(1)(A) through (D)(Part I) (the "General Exemption"); and (2) limited relief from prohibited transactions under certain provisions of ERISA Section 406(a) and (b)

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for employers (Part II), lease transactions (Part III), and transactions involving services and facilities by places of public accommodation (Part IV) (collectively, "Limited Exemptions"). Definitions and general rules in Part V of the exemption apply to both the General and Limited Exemptions.

Amendments to Section I(a): Power of Appointment

Condition I(a) of the General Exemption formerly required that, at the time of the transaction, the party in interest and its affiliates did not have, and during the preceding one year period had not exercised, the authority to (1) appoint or terminate the QPAM as a manager of any plan assets, or (2) negotiate the management agreement with the QPAM. The Amendments delete the burdensome one-year look-back rule and also clarify that the authority in question covers only the assets involved in the subject transaction, and not any assets of the plan. The Amendments also add a provision deeming the requirements of Section I(a) satisfied in the case of a transaction involving assets of a plan that are held in a commingled investment fund that is managed by a QPAM and includes the assets of at least one other unrelated plan, if the assets of the first plan that are invested in the fund (plus the assets of all affiliated plans that are invested in the fund) represent less than 10% of total fund assets.

These changes increase the number of potential QPAMs with respect to a plan, and reduce the due diligence cross checking that must be done on behalf of collective investment vehicles managed by QPAMs.

The Amendments also narrow the definition of "affiliate" used for this purpose. Previously it encompassed (among other things) partnerships in which a person has a 5% or greater interest and employees generally. The Amendments increase the 5% threshold to 10% and include only those employees who are "highly compensated employees" under the Code.

Amendment to Section I(d): Definition of Related Parties

Condition 1(d) of the General Exemption requires that the party in interest involved in the transaction not be either the QPAM or a person related to the QPAM. The Amendments change the definition of "related to" for this purpose. Previously, a QPAM was "related to" a party in interest if the party in interest (or a person controlling or controlled by the party in interest) owned a 5% or more interest in the QPAM, or if the QPAM (or a person controlling or controlled by the QPAM) owned a 5% or more interest in the party in interest. Recognizing the administrative burdens of determining relationships between a QPAM and a party in interest at the former 5% threshold, the DOL adopted a multi-level inquiry. Now, a QPAM and a party in interest will be considered "related" if either the QPAM or the party in interest owns a 10% interest in the other entity; a person controlling or controlled by the QPAM or the party in interest owns a 20% interest in the other entity; or a person controlling or controlled by the QPAM or the party in interest owns less than a 20% interest but more than a 10% interest in the other entity but exercises control over the management or policies of such entity based upon such ownership. The ownership determination is to be made as of the last day of the most recent calendar quarter, and may exclude any ownership interest held in a fiduciary capacity.

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While the relaxed requirements should remove some obstacles to satisfying Condition 1(d), it is possible that the further refinement of the calculations and exceptions will create additional monitoring burdens for QPAMs attempting to verify compliance with this provision.

Amendments to the Definition of "QPAM"

The Amendments modify the definition of a QPAM in Section V(a) to provide that, as of the last day of the first fiscal year beginning on or after August 23, 2005, a registered investment adviser who wishes to qualify as a QPAM must have $85 million (increased from $50 million) in assets under management as of the last day of its most recent fiscal year, and $1 million (increased from $750,000) in shareholders' or partners' equity as of the most recent balance sheet date (rather than the last day of its most recent fiscal year). Note, however, that the Amendments do not change the parallel $50 million and $750,000 thresholds for registered investment advisers holding plan assets outside the United States under applicable regulations.

The Amendments also specifically require the QPAM to be an "independent fiduciary" as defined in new Section V(o): namely, a fiduciary independent of and unrelated to the employer sponsoring the plan, and not directly or indirectly controlled, controlling or under common control with the plan sponsor.

Financial Services Entity as a QPAM over Employer's Plan

The DOL viewed the independence requirements in new Section V(o) as a clarification of existing law. Nevertheless, after the proposed amendments to the QPAM exemption were published in September 2003, the DOL received a number of comments from financial services entities who had believed in good faith that they were qualified to act as QPAM for their own plans. In response, on the same date as it published the Amendments, the DOL proposed a further amendment to the QPAM exemption to allow such arrangements to continue under certain conditions. In the Amendments it also provided that the new independence requirements would not apply until the new proposed amendment was finalized.

The new proposed amendment would allow a QPAM to act on behalf of plans of its own employer and affiliates if:

- the QPAM has discretionary control over the plan assets involved in the transaction;
- the QPAM adopts written policies and procedures to ensure compliance with all applicable provisions of the QPAM exemption (Part I, III or IV, and the proposed new Section V), and any transaction to be covered by the exemption meets all such applicable requirements; and
- an experienced independent auditor conducts an annual exemption audit of the program to substantiate such compliance. The proposed definition of "exemption audit" sets forth a number of criteria for the audit including not only a review of the written policies and procedures and determination of whether the QPAM satisfies the definition of QPAM in Section V(a) but also the testing of a representative sample of plan transactions to determine compliance with policies and procedures and the applicable provisions of the exemption.

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These conditions are similar to those applicable to an INHAM, or in-house asset manager, under another class exemption, PTCE 96-23.

DOL Clarification of Other QPAM Concerns

In the preamble of the DOL notice of these proposed amendments published in September 2003, the DOL took the opportunity to clarify two areas that had been an apparent source of some uncertainty among practitioners.

Section I(b) of the QPAM exemption states that the exemption does not extend to transactions covered by three specified class exemptions, namely, PTCE 81-6 (relating to securities lending arrangements); PTCE 83-1 (relating to acquisitions of interests in mortgage pools); and PTCE 82-97 (relating to certain mortgage financing arrangements). The DOL indicated that the QPAM exemption would apply to transactions of the type covered by such exemptions where the transaction in question does not satisfy all of the conditions of such alternative exemption as long as the transaction was not designed to fail solely in order to rely on the QPAM exemption instead.

The DOL also clarified the definition in Section V(i) of "the time as of which any transaction occurs" for continuing transactions such as loans, leases and swaps. The DOL interprets the exemption as being available for continuing transactions if all applicable conditions are satisfied on the date the transaction is entered into and any renewal date requiring QPAM consent even if such conditions subsequently fail, as long as the requirement of Section I(e) (that the party in interest in the transaction is not a party in interest with respect to a plan that represents 20% or more of the assets managed by the QPAM) is satisfied at all times. In addition, the DOL clarified, that if, during the course of a continuing transaction, a QPAM is unable to continue to serve or is terminated, the exemption would continue to apply to the transaction as long as no discretionary decision by the QPAM is required until a replacement QPAM is appointed.

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