Client ALERT

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Department of Labor Proposes Amendments to QPAM Exemption

On September 3, 2003 the Department of Labor published a proposed amendment to the ERISA "QPAM Exemption", the class exemption from ERISA's prohibited transaction restrictions that is designed to permit a wide range of customary investment transactions engaged in by a plan managed by an independent financial institution qualifying as a "QPAM" under the terms of the exemption.

The Department indicated that it is proposing the amendment in response to changes in the financial services industry that have made certain conditions of the exemption difficult to comply with, and to update and clarify certain elements of the exemption (which was originally issued in 1984). Many of these changes proposed by the Department should make compliance with the exemption somewhat easier for most investment managers, in particular larger financial institutions with multiple affiliates (*e.g.*, relaxation of the definitions of "affiliate" and "related" person), while other changes will make compliance more difficult, particularly for smaller or start-up investment managers (*e.g.*, raising the minimum assets under management and capitalization requirements). On the whole, the Department's proposed changes appear likely to have an impact only at the margin; for most mainstream managers, the amendments are unlikely to have a significant effect on their management of plan assets except in specific and relatively unusual circumstances.

A brief summary of the key aspects of the Department's proposal, as well as some of the issues raised or not addressed by the proposal, is set forth below.

Proposed Changes to the QPAM Exemption

Eligible Parties In Interest – Power of Appointment of the QPAM

The QPAM Exemption currently does not permit transactions where the counterparty or its affiliate possesses, or has exercised within the past year, the authority on behalf of the plan to appoint or terminate the QPAM or negotiate the terms of the QPAM's investment management agreement.

The Department's proposal contains several changes to this condition:

- Deletion of the one year "look-back rule";
- Clarification that this condition applies only to the power to appoint the QPAM as the manager of the particular plan assets involved in the subject transaction (rather than *any* plan assets); and
- In the case of a commingled fund, the QPAM need not determine whether the counterparty or its affiliate has the authority to invest or redeem a plan's investment in the fund unless the plan has a 10 percent or more interest in the fund.

Comment: These changes will ease the compliance burden for QPAMs somewhat. The greatest impact is likely to be in two cases:

(1) In the case of pooled funds, QPAMs will no longer have to check for affiliates of plan sponsors for plan investors who own less than 10 percent of the fund.

(2) Many Taft-Hartley plans frequently enter into transactions with their affiliated unions (*e.g.*, leases of office space in buildings owned by the plan). The first two changes will facilitate hiring a QPAM to supervise these transactions.

Narrowing the Definition of "Affiliate"

As indicated above, the power to appoint the QPAM may not be held by the counterparty to a transaction or its "affiliate." Included in the current definition of affiliate is an entity in which a counterparty is a five percent or greater partner.

The Department's proposal would change the five percent partner rule to ten percent. It would also provide that an employee of an employer will be an "affiliate" of the employer only if such person is a "highly compensated employee" under the Internal Revenue Code.

Comment: This proposal is unlikely to significantly reduce the compliance burden of the exemption.

Narrowing the Definition of Party "Related" to the QPAM

The QPAM Exemption does not permit transactions where the counterparty is the QPAM or a party "related" to the QPAM. The definition of "related" party includes entities of which the QPAM (or a person controlling, controlled by, or under common control with the QPAM) owns a five percent or more interest (or vice versa). In addition, the definition of "interest" could be interpreted to include the right to exercise voting rights with respect to a person.

The Department's proposal would narrow the range of persons and entities that will be considered to be "related" to a QPAM thus expanding the coverage of the exemption. For example, the proposal provides that a QPAM and a counterparty will be deemed "related" only if:

- The QPAM or counterparty owns a 10 percent or greater interest in the other party (rather than the current five percent); or

- A person controlling or controlled by the QPAM or the counterparty owns a 20 percent or greater interest in the other entity (or, if a lesser interest, exercises control over the management of the other party by reason of its ownership interest).

- In addition, the Department specifically clarifies that a QPAM will not be deemed to hold an ownership interest in an entity by virtue of its exercise, in a fiduciary capacity, of voting rights with respect to the entity.

Comment: As with the definition of "affiliate," these modifications somewhat expand the scope of the exemption, particularly for large financial institutions with wide ranging affiliations and ownership relationships. The clarification with regard to voting rights is very helpful in this regard, as it confirms the prevailing interpretation of this rule.

Increase in Minimum Assets Under Management and Minimum Capitalization Requirements

Under the exemption, an entity may qualify as a QPAM only if it has, as of the last day of its most recent fiscal year, at least $50 million in assets under management, and has shareholders' or partners' equity in excess of $750,000.

The Department's proposal would increase these amounts such that a QPAM must have:

- $85 million in client assets under management instead of the current $50 million; and

- $1 million in shareholders' and partners' equity instead of the current $750,000.

In addition, the Department would clarify that the phrase "as of the last day of its most recent fiscal year" applies only to the calculation of assets under management; the shareholders' or partners' equity requirement is based on the most recent balance sheet prepared within the two years immediately preceding the transaction.

Comment: These changes would make compliance with the exemption somewhat more difficult for smaller or start-up investment managers.

QPAM Independence

- The proposal clarifies the definition of QPAM by specifically requiring that a QPAM must be independent of the employer sponsoring the plan whose assets are managed by the QPAM.

Comment: The Department's proposal may jeopardize reliance on the QPAM Exemption by a financial institution managing its "in-house" employee benefit plan funds, including "in-house" assets invested in a pooled fund arrangement. This aspect of the proposal may raise issues for managers and require further clarification.

Clarifications Provided by the Department in the Preamble to the Proposal

In addition to the proposed amendments to the text of the exemption, the preamble to the Department's proposal clarifies certain other matters relevant to the scope of the exemption.

For example, the QPAM Exemption currently excludes certain transactions that are covered by other exemptions granted by the DOL (relating to securities lending, plan investment in certain mortgage backed securities, and certain mortgage financing arrangements). Confusion has developed regarding whether this exclusion means that transactions similar to, but not specifically described in, such other exemptions, may instead be covered by the QPAM Exemption. In its proposal, the Department clarifies that the QPAM exemption does cover transactions that are similar to, but outside the scope of, transactions described in these other exemptions (as long as the QPAM does not fail to satisfy a condition of such other exemption merely in order to take advantage of the QPAM Exemption).

Comment: This interpretation by the Department is helpful since it clarifies that transactions that are similar to the excluded transactions can fall within the scope of the QPAM Exemption. This may be of practical significance to securities lending transactions involving foreign borrowers, and to acquisitions of mortgage and asset backed securities that are not specifically described in the exemptions referenced by the QPAM Exemption.

Provisions of the QPAM Exemption Unaffected by the Department's Proposal

Finally, we note that the Department's proposal leaves unchanged a number of important features of the QPAM Exemption that have created issues for managers over the years. Such provisions include:

- The requirement that neither the QPAM nor any of its affiliates have been convicted of certain crimes;
- The exemption's exclusion from coverage of transactions with any parties in interest who are related to a plan that accounts for more than 20 percent of the QPAM's assets under management;
- The "queen for a day rule", *i.e.,* the Department's position that the QPAM may not be appointed for the sole purpose of approving a specific transaction;
- The provision that permits the QPAM to satisfy the minimum shareholders' or partners' equity requirement where the payment of all of the QPAM's liabilities are unconditionally guaranteed by an affiliate.

The proposal does not specify the effective date of the amendments, leaving open the possibility that these changes might apply retroactively or only prospectively. Written comments on the exemption are due at the Department of Labor on or before October 20, 2003.

Should you have any questions regarding this proposal or the QPAM Exemption generally, please contact Larry Hass, Josh Sternoff, or any other members of the Paul, Hastings ERISA – Institutional Investment Group listed below:

Lawrence J. Hass (212) 318-6401
larryhass@paulhastings.com

Ethan Lipsig (213) 683-6304
ethanlipsig@paulhastings.com

Anthony A. Dreyspool
(212) 318-6601
anthonydreyspool@paulhastings.com

Susan G. Curtis (212) 318-6919
susancurtis@paulhastings.com

Mark Poerio (202) 508-9582
markpoerio@paulhastings.com

Jocelyn M. Sturdivant (202) 508-9567
jocelynsturdivant@paulhastings.com

Joshua H. Sternoff (212) 318-6011
joshsternoff@paulhastings.com

Eric R. Keller (202) 508-9524
erickeller@paulhastings.com

Stephen H. Harris (213) 683-6217
stephenharris@paulhastings.com

Beth Cheever (212) 318-6854
bethcheever@paulhastings.com

Nicole K. Watson (212) 318-6309
nicolewatson@paulhastings.com

Sergei A. Antonov (212) 318-6637
sergeiantonov@paulhastings.com

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