

perspective

ERISA for Money Managers: A Practical Workshop

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QPAM and INHAM Exemptions
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Why is it important for money managers to comply with ERISA?

- The primary reason is that ERISA provides for very detailed and onerous rules of behavior:
 - *Act as a prudent expert*
 - Each investment judged in light of the whole portfolio
 - *Diversify plan assets to prevent the risk of large losses*
 - *Act exclusively for the benefit of the plan*
 - *Act in accordance with the plan document, unless it is inconsistent with ERISA*

Why is it important for money managers to comply with ERISA?

- A fiduciary of an ERISA plan must also not cause the plan to engage in a nonexempt prohibited transaction
- These rules carry with them significant penalties as a result of noncompliance. If there is a “prohibited transaction” with the ERISA plan / IRA, it may be subject to
 - *Rescission*
 - *An excise tax of 15% of the amount involved for each year from the date of the transaction until the date the transaction is rescinded*
 - *If acting in a fiduciary capacity, there may be additional penalties, there may be additional requirements to make good any losses to the plan, disgorgement of profits, civil penalties (of up to 20%) and other equitable relief*
- Because excises taxes are imposed on financial counterparties, they will often require representations from managers as to the applicability of an exemption.

What is Prohibited?

- ERISA and Section 4975 of the Code **prohibit all transactions between a plan and a “party in interest” unless an exemption is available.**
- What is a “party in interest?”
 - *The employer (or a union, in the case of a union plan);*
 - *A fiduciary (e.g., investment manager, trustee, named fiduciary);*
 - **Any person providing services to the plan** (e.g., custodian; securities broker; futures broker; and
 - *A 10% shareholder of the employer or, for ERISA purposes but not IRA purposes, 10% shareholder in the service provider, and an entity 50% or more owned by a service provider, fiduciary or employer*
- Because of their market position, many financial counterparties simply assume (although they do not necessarily conclude) that they are or may become a party in interest to every plan.
- Accordingly, the markets have evolved to the point where each person effecting any transaction on behalf of a plan concludes there is an exemption available to the transaction.

What Are These Exemptions and When Are They Needed?

- There are two generic approaches to the exemption process
 - *Status-Based Exemptions* These are exemptions that depend on the status of the fiduciary or plan asset entity engaging in the transaction
 - *Transaction-Based Exemptions* These are exemptions that depend on the nature of the transaction
- *Status-Based Exemptions* The following are examples of class exemptions that depend on the status of the fiduciary or plan asset entity engaging in the transaction
 - *Qualified Professional Asset Manager (“QPAM”). PTCE 84-14*
 - *In-house Asset Manager (“INHAM”). PTCE 96-23*
 - *Bank collective trust fund. PTCE 91-38*
 - *Insurance company pooled separate account. PTCE 90-1*
 - *Insurance company general account. PTCE 96-50*

Transaction Based Exemptions

- **Transaction-Based Exemptions.** Examples include
 - *Principal transactions by U.S. broker-dealers in securities. PTCE 75-1 Part II. Numerous individual exemptions for foreign broker-dealer affiliates*
 - *Foreign exchange transactions PTCE 94-20 (but does not apply to IRAs); see also new statutory foreign exchange exemption*
 - *Securities lending transactions to U.S. banks and U.S. broker-dealers. PTCE 2006-16 (formerly PTCE 86-1)*
 - Individual exemptions available for certain foreign affiliates of U.S. broker-dealers.
 - *Repurchase agreements (not reverse repos where the plan is the borrower of cash) with U.S. banks and U.S. broker-dealers. PTCE 81-8*
 - *Agency execution of securities and futures by a non-fiduciary. ERISA §408(b)(2)*
 - *Purchase and holding of principal-protected debt of broker-dealer parent*

QPAM

- The principal exemption that investment advisers and managers have traditionally relied upon when conducting business on behalf of a plan/IRA is “PTCE 84-14” or the “QPAM Exemption”

QPAM

- QPAM stands for “Qualified Professional Asset Manager”
 - The QPAM must be a bank, savings and loan or insurance company with equity capital or net worth in excess of \$1 million or a registered investment adviser with assets under discretionary management in excess of \$85 million and equity in excess of \$1 million
 - The broker-dealer must not be the QPAM or related to the QPAM
 - The asset manager must represent in writing to the client that it acts as a fiduciary
 - The QPAM must negotiate the terms of the transaction and decide on behalf of the plan whether to engage in the transaction.
 - QPAM may not have been convicted of certain activities that could bear on financial trust.

QPAM

- Securities lending transactions and certain mortgage-related transactions are **not** covered by the QPAM exemption
- Assets of a plan entering into a transaction (and related plans) may make up no more than 20% of all assets managed by the QPAM
- The terms and conditions of the transaction must be at least as favorable to the plan as are available in an arm's-length transaction
- Neither the counterparty nor any affiliate may, at the time of the transaction, have the power to appoint or terminate the QPAM as manager of the plan assets involved in the transaction or negotiate on behalf of the plan the terms of the QPAM's management agreement .
 - *For private investment funds subject to ERISA, this condition only applies if the assets of such plan invested in the fund (combined with the assets of any related plans invested in the fund) represent more than 10% of the total assets of the investment fund*
- Transactions with financial counterparties requiring representations based on QPAM are often involved and complicated. Allocation of risk is often required

INHAM

- Similar to QPAM, except for U.S. registered investment advisers that are wholly-owned affiliates of the plan sponsor.
 - 20% diversification requirement would preclude QPAM for most otherwise qualified QPAMs with respect to plans sponsored by affiliates.
- Must directly manage at least \$50 Million of the plan.
- Requires annual audit
- Plan sponsor may veto transactions \$5 Million or more negotiated by the INHAM

Service Provider

- In 2006, in the broadest amendment to ERISA since its enactment, Congress enacted the Pension Protection Act of 2006 (“PPA”)
- One of the provisions of the PPA provides for a separate prohibited transaction exemption often referred to as “service provider”

Service Provider

- “Service provider” requires only that the fiduciary determine that:
 - *The transaction is for “adequate consideration,”*
 - *The counterparty is not itself a fiduciary with respect to the assets involved; and*
 - *The counterparty’s relationship is solely as a service provider for those assets.*
 - May be difficult to ascertain in fund context or for multiemployer plans.
- “Adequate Consideration” means the price prevailing for a security on an exchange or the offering price for securities on a recognized market that is not an exchange
 - *Factors such as transaction size and market liquidity may be taken into account in determining “adequate consideration”*
 - *For other transactions, a plan fiduciary must make a good faith determination of the fair market value in accordance with DOL regulations (not yet issued)*

PTCE 75-1

- Provides an exemption (other than QPAM or INHAM) for a party in interest (other than a fiduciary) with respect to a plan to:
 - execute securities transactions as agent on behalf of the plan;
 - perform clearance, settlement or custodial functions incidental to effecting such transactions; and
 - furnish such plan with advice as to the value of securities or other property and related investment matters, provided that the furnishing of such advice does not make such person a fiduciary with respect to the plan.
 - enter into principal transactions in securities with a person that is a U.S. registered broker dealer, a reporting dealer which makes primary markets in U.S. government or agency securities, reports daily to the Federal Reserve Bank of New York, or a federally or state supervised bank which customarily purchases and sells government or agency securities for its own account in the ordinary course of business
- The terms of the transaction must be at least as favorable to the plan as an arm's length transaction with an unrelated party would be.

Recent Practical Considerations

- New adviser
 - Client AUM/Owners' equity/20% limit
- Compliance
 - Parties with Power to hire and fire
 - 20% limit
 - 10% *de minimis* (GS&Co Letter)
- Derivatives/ISDAs
- Intersection of 81-6 (2006-16)
- Intersection of QPAM and INHAM

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