INVESTMENT MANAGERS BEWARE: DOL PROPOSES MAJOR CHANGES TO QPAM EXEMPTION

Date: 18 August 2022

U.S. Asset Management and Investment Funds and ERISA Fiduciary Alert

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EXECUTIVE SUMMARY

The Department of Labor's proposed amendment to the QPAM Exemption would impose stricter conditions and make it more difficult for managers to avail themselves of one of the most commonly utilized ERISA exemptions. All investment advisers and other financial institutions that manage plan assets, or may manage plan assets in the future, should understand the proposed changes and consider submitting comments on the proposal.

Prohibited Transaction Exemption (PTE) 84-14, more commonly known as the “QPAM Exemption,” is one of the most commonly relied on exemptions from the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code (Code).

Without an exemption, most transactions—including purchases, sales, leases, and loans—between a retirement or welfare plan (Plan) subject to ERISA or the Code and a “party in interest” of the Plan are prohibited.[1] The definition of party in interest is very broad, including any entity and most of their affiliates that provide any kind of service to a Plan. It can be very difficult to determine and keep track of which entities are parties in interest to a Plan, so many managers of Plan assets routinely rely on an exemption, frequently the QPAM Exemption, for all or nearly all transactions entered into on behalf of a Plan. For decades, investment advisers and other financial institutions that meet the requirements to be a “qualified professional asset manager” or “QPAM” have relied on the QPAM Exemption's relatively straightforward conditions in order to engage in a broad range of investment transactions on behalf of a Plan, generally without having to undergo the arduous process of determining whether the transaction involves an otherwise prohibited party-in-interest.

On 27 July 2022, on its own initiative, the Department of Labor (DOL) published a proposed amendment to the QPAM Exemption (Proposed Amendment). If the Proposed Amendment is adopted as proposed, the ubiquitous QPAM Exemption will have stricter conditions and will require additional, affirmative steps for those who seek to rely on the exemption. The Proposed Amendment would revise the QPAM Exemption's conditions to:

1. Require a one-time notice to DOL that a QPAM is relying upon the exemption. Each manager that relies upon the QPAM Exemption would need to notify DOL by e-mail, reporting the legal and operating names of each business entity relying upon the exemption. If an entity's name changed, it would need to update its notice.
2. Require the inclusion of specific terms in a written management agreement that apply in the event the manager becomes ineligible to serve as a QPAM due to a criminal conviction or written ineligibility notice

in connection with prohibited misconduct. Such provisions include (a) an agreement to allow a Plan to terminate its arrangement with the QPAM without fees or penalties, except for reasonable fees for limited purposes disclosed in advance, (b) an indemnification by the QPAM for any losses to the Plan arising out of the conduct that causes the ineligibility, including the costs of unwinding transactions and transitioning Plan assets to an alternative asset manager, and (c) an agreement not to employ any individual that has engaged in criminal or other conduct that would cause ineligibility.

3. Update the list of crimes that cause ineligibility to be a QPAM to explicitly include foreign crimes that are substantially equivalent to the previously listed crimes.
4. Expand the circumstances that may lead to ineligibility. This expansion would include (a) any conduct that forms the basis for a non-prosecution or deferred prosecution agreement (under either domestic or foreign jurisdiction) that, if successfully prosecuted, would have constituted a covered crime, not just a conviction; (b) intentionally violating or engaging in a systematic pattern or practice of violating the conditions of the QPAM Exemption in connection with otherwise non-exempt prohibited transactions; or (c) providing materially misleading information to DOL in connection with the conditions of the QPAM Exemption. Participating in prohibited misconduct would capture anyone not only actively participating, but also knowing approval of the conduct, or knowledge of the conduct without taking active steps to prohibit the conduct such as reporting the conduct to appropriate compliance personnel.
5. Provide a one-year winding-down period to help Plans avoid or minimize possible negative impacts of terminating or switching QPAMs or adjusting asset management arrangements when a QPAM becomes ineligible. During the one-year period, the QPAM could not enter into new transactions in reliance on the QPAM Exemption, but could continue to rely on the QPAM Exemption for existing transactions.
6. Provide guidance on the process for a manager that has become ineligible (or anticipates becoming ineligible) to be a QPAM to follow when requesting an individual exemption.[2]
7. Provide that for a QPAM to rely on the QPAM Exemption with respect to any transaction, the terms of such transaction and any associated negotiations must be the “sole responsibility” of the QPAM.[3]
8. Revise substantially upwards the amount of assets under management (AUM) and equity thresholds a QPAM must meet in order to qualify as a QPAM, and put in place a process for DOL to annually adjust these amounts.[4]
9. Add a requirement to retain records for six years.

Although the proposed expansions of QPAM ineligibility in the Proposed Amendment are important, particularly for QPAMs with foreign affiliates, the proposed changes to the other conditions should not be overlooked. As a whole, the Proposed Amendment has the potential to disrupt the operations of any manager of Plan assets and includes a number of traps for the unwary. A one-time notice to DOL may not be a difficult condition, but overlooking this condition, or not updating the notice when an entity changes its name, could result in the QPAM Exemption not being available and managers being exposed to liability for non-exempt prohibited transactions. The notice requirement also eliminates the ability to rely on the QPAM exemption retroactively, such as in a circumstance where a manager realizes it has been managing Plan assets unintentionally (e.g. through an error in calculating the “25 percent test”[5]). The requirement for specific terms to be included in the written management agreement between a QPAM and a Plan means that if the Proposed Amendment is finalized, the QPAM will need to amend all existing management agreements with Plans, which may be an arduous task for large managers with many clients (as most QPAMs are likely to be). The "clarification" in the Proposed Amendment that negotiation of transactions must be the "sole responsibility" of a QPAM may lead to doubt over whether the QPAM Exemption can apply when there are joint managers or sub-advisers, or for collective investment trusts where there is a separate trustee and investment manager.

The Proposed Amendment would make the QPAM Exemption more difficult to rely upon, and fewer asset managers may be able to qualify as QPAMs. This may force asset managers to rely on other available PTEs, such as the "service provider" exemption under Section 408(b)(17) of ERISA.[6] The Proposed Amendment also may result in increased hesitation by some asset managers to provide investment management services to Plans, resulting in less available capacity for Plan investments in certain pooled investment vehicles, or fewer investment opportunities for Plans.

Comments on the Proposed Amendment are due by 26 September 2022, and any manager that currently manages Plan assets, or that might manage Plan assets in the future, should consider submitting a comment.

FOOTNOTES

[1] Or "disqualified person" as defined in the Code. For purposes of this client alert, references to parties in interest should be read to include disqualified persons, and references to the prohibited transactions of ERISA should be read to include the parallel prohibited transactions of the Code.

[2] It is common for a manager that has become ineligible to be a QPAM after an affiliate has been convicted of a crime to apply to DOL for an individual exemption in order to allow the manager to continue entering into transactions on behalf of Plans. These individual exemptions used to be routinely granted, but DOL has increased scrutiny over these situations in recent years.

[3] The existing language in the QPAM Exemption provides that the terms of the transaction must be negotiated "under the authority and general direction of" the QPAM.

[4] The current AUM threshold of US$85,000,000 would be initially adjusted to US$135,870,000. Currently, any U.S. based asset manager that meets the AUM threshold required to register as an investment adviser with the Securities and Exchange Commission meets the AUM threshold for the QPAM Exemption; this would no longer be the case if the AUM threshold is adjusted as proposed. The shareholders' and partners' equity and the broker-dealer net worth thresholds of US$1,000,000 would be increased to US$2,040,000. Other equity or net worth thresholds for banks, savings in loan associations, and insurance companies, would be adjusted from US$1,000,000 to US$2,720,000.

[5] A private fund can avoid its assets being deemed to be Plan assets if equity participation by "benefit plan investors" (i.e. Plans subject to ERISA or the Code, or other entities deemed to hold Plan assets) is less than 25 percent of the value of any class of entity interests in the fund.

[6] While the service provider exemption in Section 408(b)(17) is similar in breadth to the QPAM Exemption, some asset managers have resisted relying on it, particularly for more exotic transactions, because of uncertainty with respect to a couple of its conditions and the absence of any clarifying regulations from DOL. These uncertainties

include (1) what is meant when the exemption refers to “securities,” and (2) the meaning of “adequate consideration” when there is no generally recognized market.

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