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DOL Proposes Stricter Requirements for All Managers Relying on the Qualified Professional Asset Manager (QPAM) Exemption

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On July 27, 2022, the U.S. Department of Labor (DOL) published in the Federal Register a proposed amendment to the qualified professional asset manager (QPAM) class prohibited transaction exemption 84-14 (PTE 84-14 or QPAM Exemption), which would make it more difficult to rely on the exemption in certain circumstances, including when the QPAM, its affiliates or any 5% or more owners have been convicted of certain crimes. The proposed amendment has been released against the backdrop of numerous global financial institutions having sought individual exemptive relief from the DOL over the past decult of criminal convictions stemming from the activities of their foreign affiliates. Beyond this expected focus on crimes, the proposed amendment includes multiple changes to the QPAM Exemption requirements that, if finalized, would impact any entity seeking to utilize the exemption, including a new requirement to register with the DOL. This alert provides a high-level summary of these non-crime related provisions, which we expect to have widespread implications for most asset managers. These changes would impose new compliance duties on managers and may cause greater use of other available prohibited transaction exemptions, such as the 2006 service provider exemption under Section 408(b)(17) of ERISA, as appropriate.

Background

If an investment fund holds plan assets subject to ERISA, then the manager (or any other entity that has discretionary authority over the investment of the fund's assets) is a fiduciary with respect to investing plans. Under ERISA Section 406(a), the fiduciary cannot cause the fund to engage in a sale or exchange, leasing of property, loan or extension of credit, or the furnishing of goods, services or facilities, between the plan and any party in interest. A party in interest with respect to a plan includes any fiduciary of the plan, any person providing services to the plan, any employer whose employees are covered by the plan and any of certain affiliates. Due to the breadth of these restrictions, managers often struggle to carry out core investment functions for ERISA accounts unless they can rely on an exemption.

A fund might engage in a prohibited transaction during its normal operations, because a transaction could involve an entity that is a service provider or other party in interest with respect to a plan that has invested in the fund. For example, the fiduciary could inadvertently engage in a prohibited transaction if it used fund assets to purchase an interest from a company that happens to provide services to an investing plan. One of the most commonly used exemptions is the QPAM Exemption. If the conditions of the QPAM Exemption are satisfied, most transactions with parties in interest will not be prohibited. Note, the QPAM Exemption does not apply to the acquisition or holding of employer securities or to fiduciary "self-dealing" transactions (including cross trades) as per ERISA Section 406(b).

The QPAM Exemption enables qualifying registered investment advisers, banks, savings and loan associations and insurance companies to engage in otherwise prohibited transactions with respect to the ERISA plan assets that they manage. It prescribes two sets of rules: one establishing the requirements for a so-called QPAM, the other limiting the transactional settings in which the exemption will apply.

In brief, the QPAM Exemption currently requires that:

- the manager is one of the following entities:
  - a bank with equity capital in excess of $1,000,000;
  - a savings and loan association with equity capital or net worth in excess of $1,000,000;
  - an insurance company with net worth in excess of $1,000,000; or

- an investment adviser registered under the Investment Advisers Act of 1940 that has more than $85,000,000 of total client assets under its management and control as of the end of its most recent fiscal year and either (1) shareholders' or partners' equity in excess of $1,000,000 or (2) payment of its liabilities guaranteed by an affiliate, another entity that could qualify as a QPAM, or a broker-dealer with a net worth in excess of $1,000,000;

- the QPAM must acknowledge in a written management agreement that it is a fiduciary with respect to each investing plan;

- the investment must be negotiated and decided upon by the QPAM, and the QPAM's decision cannot be subject to the approval or veto of another person;

- the QPAM Exemption will not be available for transactions with parties in interest if (i) the party in interest (or its affiliate) has the ability to appoint or terminate the investment manager (e.g., the employer and its affiliates) with respect to plan assets involved in the transaction; (ii) the transaction is with a party in interest of an ERISA plan investor whose assets (and its affiliates' assets) account for over 20% of the total client assets managed by the manager; or (iii) the party in interest is the QPAM (or a person "related to" the QPAM).

Proposed Changes

The proposed amendment includes a number of new requirements for entities that are seeking to rely on the QPAM Exemption. While some of these changes are not overly burdensome, others may affect whether a manager is able to rely on the exemption for a given transaction. We also note that these changes may have different impacts on funds that are set up with the intention of using the QPAM Exemption and funds which are not intended to hold ERISA plan assets but which reserve the right to rely on the exemption if they inadvertently hold plan assets.

- **Updated Asset Management and Equity Thresholds** – The proposed amendment increases certain thresholds in the QPAM definition as follows: the asset management threshold goes from $85,000,000 to $135,870,000; the equity capital threshold for banks, savings and loan associations and insurance companies goes from $1,000,000 to $2,720,000; and the equity capital threshold for registered investment advisers and broker-dealers goes from $1,000,000 to $2,040,000. The amendment also contemplates that the DOL would make subsequent annual adjustments to these figures to keep up with inflation.

- **One-Time Notice to the DOL** – The proposed amendment requires QPAMs to report to the DOL the legal name of each business entity relying on the exemption and any name under which the QPAM may be operating. The notification must be made via email and need only be made once unless there is a change to the legal or operating name of the QPAM, or if the QPAM is no longer relying on the exemption. According to the preamble, the DOL intends to keep a current list of entities relying upon the QPAM Exemption on its publicly available website. While this is not likely to be a major concern for managers intending to rely on the QPAM Exemption, it may create difficulty for managers who don't actively rely on the exemption but retain the ability to do so, if necessary. There is also the risk that the DOL may use this list of known QPAMs to target future investigations or enforcement actions.

- **Expansion of the Written Management Agreement; Indemnity** – The proposed amendment expands on the written management agreement component of PTE 84-14 by requiring that QPAMs abide by certain standards of integrity when acting on behalf of client plans. In particular, the written management agreement must provide certain terms upfront that will apply in the event of QPAM ineligibility, which include that the QPAM will not restrict the plans' ability to terminate or withdraw or impose fees, penalties, or charges in the event of ineligibility. Additionally, the written management agreement must require the QPAM to indemnify, and hold harmless, and promptly restore actual losses to each client plan for any damages directly resulting from a violation of applicable laws, a breach of contract, or any claim arising out of the failure of such QPAM to remain eligible for relief as a result of conduct that leads to a criminal conviction or ineligibility notice. The QPAM also must agree not to employ or knowingly engage any individual that participated in the conduct that is the subject of a criminal conviction or ineligibility notice. These terms must apply for a period of at least ten years from the ineligibility date. The proposed amendment does not include any grandfathering for existing arrangements, so managers would be required to amend all existing management agreements with ERISA plans to include this new language where the QPAM Exemption is or may be utilized. This may be a significant undertaking for managers with large numbers of ERISA accounts.

- **"Sole Responsibility" Requirement and Multi-tiered Management Relationships** – In a significant but somewhat obscure change, the proposed amendment revises Section I(c) of the QPAM Exemption to specify that the terms of the transaction, commitments, investment of fund assets, and any corresponding negotiations must be the "sole responsibility" of the QPAM in order for the transaction to qualify for relief. Approval of an investment by the QPAM is not sufficient to qualify as "sole responsibility" where the transaction is planned, negotiated, or initiated in whole or in part by a party in interest. While described as "clarifying updates" by the DOL, these proposed changes may have broader implications for collective investment trusts and other investment vehicles where the QPAM has a more limited role in the identification and negotiation of investments, such as under a model where the QPAM puts guidelines in place for a sub-adviser to follow and then checks the trades individually after trading has closed (i.e., end of day or end or week). This new requirement also raises questions about the ability of a new QPAM to step into existing arrangements maintained by a plan, since the new QPAM would not have negotiated the terms of those arrangements.

- **New Recordkeeping Requirement** – The DOL's proposal adds a new recordkeeping provision that requires QPAMs to maintain records necessary to enable the DOL, fiduciaries, contributing employers, and plan participants to determine that the exemption has been met with respect to a transaction. Records must be kept for six years from the date of the transaction. Any failure to maintain the records necessary to determine whether the conditions of the exemption have been met would result in the loss of the relief provided under PTE 84-14 only for the transaction or transactions for which such records are missing or have not been maintained. Such failure would not affect the relief for other transactions if the QPAM maintains required records for such transactions. Furthermore, participants and beneficiaries of a plan, IRA owners, plan fiduciaries, and contributing employers/employee organizations would be able to request only information applicable to their own transactions, and not a QPAM's privileged trade secrets or privileged commercial or financial information, or confidential information regarding other individuals.

Implications

As part of the DOL's effort to foster a culture of compliance at entities that are relying on the QPAM Exemption and preserve the integrity of the QPAM when acting on behalf of plans and IRAs, the proposed amendment significantly bolsters the ineligibility provisions of PTE 84-14 due to criminal convictions or other acts of prohibited misconduct. But in seeking to accomplish these objectives, the DOL has proposed various additional conditions that could make the QPAM Exemption—often regarded as the gold standard among asset managers when seeking relief from ERISA's prohibited transaction rules—potentially less appealing or even unavailable in some situations. If the proposed amendment gets finalized along the lines that have been proposed, managers may need to consider relying on other exemptions such as the service provider exemption set forth in Section 408(b)(17) of ERISA in certain situations.

There is a 60-day period to submit written comments and requests for a public hearing on the proposed amendment, which ends on September 26, 2022.

If you have any questions, please feel free to reach out to any of the attorneys listed above.