GROOM LAW GROUP

Publications

Amendment to QPAM Exemption

ATTORNEYS & PROFESSIONALS

Jennifer Eller
jeller@groom.com
202-861-6604

David Kaleda
dkaleda@groom.com
202-861-0166

Michael Kreps
mkreps@groom.com
202-861-5415

Eboni Onuoha
eonuoha@groom.com
202-861-6333

PUBLISHED

04/08/2024

SOURCE

Groom Publication

SERVICES

Retirement Services

- Investment of Plan Assets
- Financial Institutions & Advisers
- Plan Services & Providers

Employers & Sponsors

- Fiduciary & Plan Governance

On April 2, 2024, the Department of Labor ("DOL" or "Department") released an amendment (the "Amendment") to Prohibited Transaction Exemption 84-14 (the "QPAM Exemption" or "Exemption"). The changes were proposed by DOL in July 2022 (the "Proposal") and primarily aimed at expanding the QPAM Exemption's provisions disqualifying asset managers from relying on the Exemption if they or their affiliates engage in certain criminal activity or in other activity that, in the Department's view, should render an asset manager ineligible to be a "qualified professional asset manager" ("QPAM"). While the Amendment retains many of the changes in the Proposal, there are also several improvements to the Proposal, which should make complying with the Amendment less onerous on asset managers. The Amendment was published in the Federal Register on April 3, 2024, and will be effective on June 17, 2024.

Groom is hosting a webinar on Wednesday, April 10, 2024 from 2:00 – 2:45 p.m. ET to discuss these new requirements and the implications for forthcoming rules, including the fiduciary rule and PTE 2020-02. Learn more here.

I. Background

The QPAM Exemption is one of the most widely-used prohibited transaction class exemptions. If the conditions of the Exemption are met, it provides relief from the prohibitions under section 406(a) of the Employee Retirement Income Security Act of 1974 ("ERISA") and section 4975 of the Internal Revenue Code of 1986 (the "Code") for transactions between a plan or an investment fund and a party in interest to the plan or plans in the investment fund. In addition, many institutional investors, whether or not subject to ERISA, will expect a discretionary manager to represent that it qualifies as a QPAM, regardless of whether the manager intends to rely on the Exemption. The QPAM Exemption does not relieve discretionary managers from the conflict of interest prohibited transaction provisions in section 406(b) of ERISA and section 4975 of the Code.

In order to qualify for relief under the Exemption, an entity must be a QPAM. A QPAM must be a bank, savings and loan association, insurance company, or a registered investment adviser that meets certain asset and equity ownership thresholds. The QPAM must also have discretionary authority over asset management decisions.

Under section I(g) of the Exemption, an entity otherwise meeting the definition of a QPAM will be ineligible to rely on the exemption for a period of 10 years if the QPAM, any of its affiliates, or any owner of a direct or indirect 5 percent or more interest in the QPAM is convicted of certain crimes. As the asset management industry has consolidated globally, DOL has granted several individual prohibited transaction exemptions patterned after the QPAM Exemption to financial institutions who have lost QPAM eligibility. While the Department for years has generally taken the position that a QPAM will become ineligible by reason of both domestic and foreign convictions, it has not treated either foreign or domestic deferred prosecution or non-prosecution agreements ("DPAs" and "NPAs," respectively) as disqualifying events. Under the Amendment, domestic DPAs and NPAs are treated as disqualifying events, as are court findings of certain other types of conduct. In addition, QPAMs must promptly notify DOL of foreign DPAs and NPAs. These provisions and other key changes found in the Amendment are outlined below.

II. Key Amendment Provisions

The Amendment provides key changes and guidance in the following areas: (i) notification to DOL of reliance on the QPAM Exemption; (ii) QPAM ineligibility; (iii) QPAM conduct during a transition period; (iv) QPAM discretion and independence; (v) exemptive relief solely for investment purposes; (vi) increase of assets under management and capitalization thresholds; and, (vii) recordkeeping.

A. Notification to DOL of QPAM Reliance on QPAM Exemption

Consistent with the Proposal, the Amendment adds a condition to the Exemption requiring notice to DOL of the legal and d/b/a name of each business entity relying on the QPAM Exemption and of changes to the name of an entity relying on the Exemption changes. DOL will maintain a list of these entities on a publicly available website. The Amendment allows for a 90-day grace period for inadvertent notice failures, but notice failures extending beyond the grace period would appear to render the QPAM out of compliance with this condition, meaning it may not rely on the Exemption until the notice failure is cured.

B. QPAM Ineligibility

The Amendment retains the domestic criminal conviction ineligibility provisions that have been in place for the life of the Exemption and also clarifies that foreign criminal convictions will give rise to QPAM ineligibility under certain circumstances. In addition, the Amendment provides that certain other categories of misconduct that do not result in a criminal conviction can render a QPAM ineligible for the Exemption.

Foreign Convictions

The Amendment clarifies that, for the most part, foreign convictions or misconduct will be treated the same as domestic convictions or misconduct for purposes of the Exemption. As a result, a QPAM will be ineligible for relief under the Exemption, if it, an affiliate, or any owner of a five percent or more interest is convicted by a foreign court of competent jurisdiction of a crime substantially equivalent to a crime that would cause a QPAM to be ineligible by reason of a conviction by a U.S. federal or state court. Such crimes generally focus on crimes of dishonesty, such as fraud, theft, or similar criminal activity.

Responding to comments arguing that certain foreign governments may seek to use the QPAM ineligibility provisions for political ends, DOL revised the definition of "criminal conviction" in the Amendment to exclude foreign convictions in jurisdictions on the Department of Commerce's list of foreign adversaries (*e.g.*, China, Cuba, Iran, North Korea, Russia and the Maduro Regime of Venezuela) as amended from time to time.

Prohibited Misconduct

The Amendment provides that, if an entity engages in "Prohibited Misconduct," the entity will be ineligible to qualify as a QPAM. The Amendment expands the type of conduct that will disqualify a QPAM in two specific ways. A QPAM will be ineligible if it, its affiliate, or a 5 percent or more owner:

1. Enters into a domestic DPA or NPA with a U.S. state or federal prosecutor or a regulatory agency where the basis of the agreement are allegations that would constitute a disqualifying crime under the Exemption if the entity were convicted; or

2. Is found by a U.S. court, in a proceeding brought by certain federal or state regulators (*e.g.*, Securities and Exchange Commission ("SEC"), Commodity Futures Trading Commission) or a state attorney general to have:

- Engaged in a pattern or practice of conduct that violates the Exemption;
- Intentionally engaged in conduct violating the exemption; or
- Provided materially misleading information in connection with the conditions of the Exemption.

The Exemption provides that active or knowing participation by the QPAM or related entity in the conduct described above is sufficient to result in Prohibited Misconduct, irrespective of whether the court specifically considers the Exemption or its terms. A QPAM must promptly notify DOL of any conviction or Prohibited Misconduct.

The fact that the Amendment requires a finding by a court (including in a judgment or settlement) is an improvement over the Proposal, which would have given DOL significant authority to determine QPAM ineligibility. However, the Amendment expands on the Proposal by incorporating DPAs and NPAs entered into with regulatory agencies (such as the SEC).

Unlike the Proposal, the Amendment does not include a foreign equivalent to a domestic DPA or NPA as grounds for QPAM ineligibility, but it does require a QPAM to notify DOL of such agreements within 30 days of execution. DOL warns QPAMs and related parties to err on the side of caution when determining whether a foreign agreement is substantially equivalent to a domestic DPA or NPA. This condition is likely to present compliance challenges as it requires a U.S. asset manager to be almost immediately aware that one of its foreign affiliates or owners has entered into such an agreement.

C. QPAM Conduct During a Transition Period

In the event a QPAM becomes ineligible to rely on the QPAM Exemption by reason of a criminal conviction or Prohibited Misconduct, the Amendment provides for a one-year "Transition Period" during which the asset manager must meet certain conditions in order to continue to rely on the Exemption. There are a number of conditions applicable during the Transition Period.

Notice to DOL and Clients

Within 30 days from the ineligibility date, the ineligible QPAM must notify its plan clients and DOL of its ineligible status and that it: (i) will not restrict a client plan from terminating or withdrawing from its written management agreement ("WMA") with the QPAM, (ii) will allow such withdrawal from or termination of the WMA without penalty or fees (other than reasonable fees that have been disclosed in advance, are consistently applied and are designed to prevent recognized abusive practices or ensure that the withdrawal of some investors does not harm others); (iii) will indemnify, hold harmless, and restore any actual losses to client plans due to the misconduct notwithstanding any language to the contrary in the WMA; and (iv) will not employ or engage with any individual who participated in the misconduct that caused the QPAM's ineligibility. The ineligible QPAM must also include in the notice an "objective description" of the "facts and circumstances" on which a criminal conviction or determination of Prohibited Misconduct is based such that the fiduciaries of client plans have sufficient information to decide whether it would be appropriate to continue using the asset manager's services in light of ERISA's fiduciary duty provisions notwithstanding the QPAM's ineligibility and the reason for such ineligibility.

Importantly, the Department shifted away from its position in the Proposal that a condition for utilizing the Exemption would be to include in every WMA the provisions related to withdrawal/termination, penalties, and indemnification. This would have resulted in a significant amount of re-contracting work for QPAMs and their clients. The Amendment helpfully incorporates these contractual changes into what ineligible QPAMs must do during the Transition Period rather than what all QPAMs must do in order to rely on the Exemption.

Compliance With the QPAM Exemption's Conditions and ERISA During the Transition Period

During the Transition Period, the ineligible QPAM must continue to meet the conditions of the Exemption for its plan clients who are clients as of the ineligibility date in order to avoid the occurrence of non-exempt prohibited transactions. Additionally, the ineligible QPAM must comply with ERISA's fiduciary duty provisions during such period. Notably, the ineligible QPAM cannot rely on the QPAM Exemption with regard to any new client plans during the Transition Period. Thus, the ineligible QPAM would have to look to other exemption strategies with regard to new clients during the Transition Period and beyond.

Application for an Individual Prohibited Transaction Exemption

The Department states in the Amendment that ineligible QPAMs may submit to DOL Employee Benefit Security Administration's Office of Exemption Determinations a request for an individual prohibited transaction ("IPTE"). Such IPTE would be crafted in a manner that would allow the ineligible QPAM to continue to provide asset management services on behalf of plan clients and receive prohibited transaction exemptive relief comparable to that received under the QPAM Exemption. The Department notes that it has issued such IPTEs to asset managers who were ineligible under the current class exemption available to QPAMs. However, the Department noted in the Amendment that the exemptive relief available to ineligible QPAMs would end at the end of the Transition Period.

This is different from the current process whereby the ineligible QPAM continues to rely on the QPAM Exemption until the Department issues the IPTE with the intent that the IPTE will apply retroactively. Under the Amendment, the Department makes clear that the ineligible QPAM cannot rely on the Exemption after the last day of the Transition Period. Therefore, the Department encourages asset managers to begin the IPTE process as soon as possible after the ineligibility date. Indeed, discussions with the Department about an IPTE application could begin in anticipation of a QPAM becoming ineligible by reason of a criminal conviction or Prohibited Misconduct. The Department also noted that such applicants should look to the other IPTEs issued to ineligible QPAMs as the basis for their own IPTE requests. If an applicant requests conditions different from those found in prior IPTEs, the Department states in the Amendment that the applicant must provide detailed information regarding why the applicant should be treated differently. Thus, the Department signaled that it will take a hard look at IPTEs that differ from those that vary from those previously issued by the Department and that the Department may be willing to grant exemptions more quickly if there are few deviations from prior IPTEs.

D. QPAM Discretion and Independence

The Department has long held the view that in order for exemptive relief to be available, the QPAM must have complete discretion over the management of the assets of a plan or fund. Thus, the QPAM Exemption would not be available if another plan fiduciary (*e.g.*, the plan sponsor) pre-negotiated the terms of a proposed transaction and then asked a QPAM to approve the transaction. This type of transaction has colloquially become known as "QPAM for a Day." In the Amendment, DOL reemphasized the importance of a QPAM having discretion over the investment of plan assets and the QPAM's responsibility for negotiating the terms of the transaction without the influence of another fiduciary. That said, the Department confirmed that the establishment of investment guidelines by another fiduciary that may limit the discretion of the QPAM does not preclude reliance on the QPAM Exemption. The Department encouraged the submission of advisory opinion requests in the event that QPAMs or other plan fiduciaries had concerns regarding whether a proposed transaction would fit within the requirements that QPAM have sufficient discretion and independence.

E. Exemptive Relief Solely for Investment Purposes

Similar to the Proposal, the Amendment reiterated that the QPAM Exemption is not available unless the QPAM's account or fund is established for "investment purposes." A fund containing a small investment component will not qualify for the Exemption. However, the Department made clear that its position in this regard does not preclude reliance on the QPAM Exemption in the context of pension risk transfer transactions.

F. Increase of Assets Under Management and Capitalization Thresholds

Consistent with the Proposal, the Amendment provides for increases in the equity and assets under management thresholds applicable to banks, insurance companies, savings and loan associations, and registered investment advisers who wish to be QPAMs and rely on the QPAM Exemption. The Department noted that QPAM status is contingent on, among other things, the size of the financial institution because the Department believes large financial institutions are more likely to be independent from and not influenced by any particular party in interest to a plan. Although the Department believed that such increases were warranted, the Department chose to phase in the increases as follows:

- For registered investment advisers, the shareholders' and partners' equity threshold will be increased to $1,346,000 in 2024, $1,694,000 in 2027, and $2,040,000 in 2030 and the assets under management threshold will be increased to $101,956,000 in 2024, $118,912,000 in 2027, and $135,868,000 in 2030;
- For banks and savings and loan associations, the equity capital threshold will be increased to $1,570,300 in 2024, $2,140,600 in 2027, and $2,720,000 in 2030; and
- For broker-dealers and insurance companies, the net worth threshold will be increased to $1,570,300 in 2024, $2,140,600 in 2027, and $2,720,000 in 2030.

In subsequent years, DOL will publish a notice in the Federal Register adjusting these amounts for inflation on an annual basis. Subsequent threshold amounts will be rounded to the nearest $10,000 and published no later than January 31 of each year. These changes will result in smaller financial institutions not being able to rely on the QPAM Exemption or being able to rely on the Exemption for a period of time but not later if its business does not grow in step with the annual increases. Financial institutions that do not qualify as QPAMs will have to look to other exemption strategies.

G. Recordkeeping

Consistent with the Proposal, the Amendment implements a new recordkeeping requirement. The QPAM must make available to certain parties information sufficient to determine the QPAM complies with the conditions of the Exemption. These parties include (i) any authorized employee of DOL, IRS, or another state or federal regulator, (ii) any fiduciary of a plan to which the QPAM provides its services either directly or vis-à-vis a pooled investment fund, (iii) a contributing employer and any employee organization whose members are covered by a plan the assets of which are managed by the QPAM, or (iv) any participant or beneficiary of a plan the assets of which are managed by the QPAM. However, the Exemption provides that plan fiduciaries and plan participants may not examine records regarding an investment fund in which they are not invested, privileged trade secrets or privileged commercial or financial information of the QPAM, or information identifying other individuals. Nevertheless, asset managers may be concerned that this requirement will leave them open to requests for information that are made for the purpose of gathering information that may be used in support of litigation against the QPAM.

III. Observations

The Amendment is somewhat of a mixed bag in that it is a marked improvement from the Proposal but still includes new, potentially burdensome compliance requirements. Helpfully, unlike under the Proposal, the Amendment will not require wholesale revisions of management agreements by QPAMs and does not give the Department broad discretion in determining when a QPAM engages in Prohibited Conduct. However, the Amendment requires QPAMs to register with DOL and expands the types of conduct that will result in the loss of eligibility to be a QPAM. Additionally, the Amendment requires ineligible QPAMs to take substantial steps in a relatively short period of time to avoid the occurrence of non-exempt prohibited transactions once the QPAM becomes ineligible. Some smaller financial institutions may also be precluded from being QPAMs. Finally, QPAMs may have to review their recordkeeping procedures to ensure compliance with the QPAM Exemption.

Given the scope of the changes to the Exemption and the complexity of the issues involved, asset managers and plan sponsors should work with their counsel to ensure they are compliant with the Exemption by the effective date.