

DOL Proposes Amending QPAM Exemption

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The Department of Labor (“DOL”) recently proposed an amendment (the “Proposed Amendment”) to Prohibited Transaction Class Exemption 84-14 (the “QPAM Exemption”). The Proposed Amendment would –

- modify and expand the QPAM Exemptions’ ineligibility provisions by clarifying that disqualifying crimes include foreign convictions and by adding new circumstances that would trigger disqualification;
- require a notice to the DOL of an entity’s reliance on the QPAM Exemption;
- require that all qualified professional asset managers (“QPAMs”) amend their plan or IRA agreements to provide certain indemnification rights in the event of the QPAM’s ineligibility;
- raise the assets under management, capitalization, and net worth requirements for a QPAM; and
- make the exemption unavailable for any transaction that is not initiated and negotiated solely by the QPAM.

These changes would have a material impact on asset managers and benefit plan investors. Comments and requests for a hearing on the Proposed Amendment are due by September 26, 2022. The Proposed Amendment would begin to apply 60 days after the date of final adoption in the Federal Register.

I. Background

A. The QPAM Exemption

The QPAM Exemption is the principal source of relief for investment managers from the restrictions under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and the Internal Revenue Code against transactions by ERISA plans and IRAs (collectively, “Plans”) with

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certain related parties. The exemption permits a Plan to engage in an otherwise prohibited transaction where the transaction is effected on behalf of the Plan by a QPAM. As defined in the QPAM Exemption, a QPAM is a bank, insurance company, broker-dealer, or registered investment advisor that satisfies certain net worth, capitalization and/or assets under management requirements, and acknowledges its fiduciary status with respect to a Plan in a written management agreement. The QPAM Exemption does not offer relief from any of the self-dealing or conflicted transaction prohibitions in ERISA or the Code.

The QPAM Exemption provides an efficient way for investment managers to comply with ERISA while engaging in a wide variety of transactions on behalf of Plan clients. There are a number of transactions for which the exemption may be necessary, starting with even the simplest purchase of a stock from a party in interest all the way to derivative transactions, real estate transactions, and off-exchange securities and commodities transactions. In many cases, comparable relief may be available under other prohibited transaction exemptions, either alone or in combination. For example, where the party in interest is a service provider, the unaffiliated manager may look to the statutory exemption under section 408(b)(17) of ERISA and section 4975(d)(20) of the Internal Revenue Code for relief for certain arm's-length transactions. Nonetheless, the QPAM Exemption remains one of the most commonly used exemptions and it is typical for named fiduciaries of large ERISA Plans to delegate investment discretion only to managers who qualify as, and can represent that they are, QPAMs. Moreover, it is customary for Plan investment managers to represent their QPAM status to counterparties in certain types of institutional transactions.

B. Ineligibility Provisions

Among the conditions for relief under the QPAM Exemption is a requirement, under Section I(g) of the exemption, that neither the QPAM, any affiliate of the QPAM, nor any owner of a direct or indirect 5% or greater interest in the QPAM has been convicted of certain crimes within a ten year period preceding any transaction entered into in reliance on the exemption. There are, for purposes of Section I(g), two categories of crimes: (1) specifically listed crimes such as "any felony involving abuse or misuse of such person's employee benefit plan position or employment...", and (2) "any other crime described in section 411 of ERISA." Generally, disqualifying crimes include crimes arising out of the conduct of the business of an investment advisor, bank, insurance company or fiduciary, and any crime for which fraud is an element. QPAM Exemption § I(g); ERISA § 411. Upon a conviction, the QPAM is disqualified for a period of ten years.

An affiliate's criminal conviction disqualifies the QPAM regardless of whether the affiliate's criminal conduct relates in any way to the business of the QPAM.

Since the QPAM Exemption was issued in 1984, the DOL has granted a number of individual exemptions that allow investment managers to continue to rely on the QPAM Exemption notwithstanding an affiliate's criminal conviction. In granting the exemptions, the DOL recognized that disqualification of a QPAM may harm its Plan clients by, among other things, requiring the Plan to

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incur costs in transitioning to a new investment manager. However, beginning approximately ten years ago, the DOL began issuing individual exemptions with more onerous conditions, which last for periods of time shorter than the ten-year disqualification period (necessitating that the financial institution re-apply to the DOL for an additional individual exemption). The conditions that the DOL has imposed on applicants for an individual QPAM exemption include:

- notifying investor clients of the crime;
- adopting new written policies and procedures;
- developing an annual compliance training program;
- submitting to periodic compliance audits by an independent auditor;
- designating an officer responsible for completing an internal compliance review; and
- adding certain terms in its contracts with Plans.

As described below, the Proposed Amendment would expand the circumstances in which a QPAM may become ineligible and would add new conditions that would apply in the event of a QPAM's ineligibility.

II. Overview of the Proposed Amendment

A. Reporting to DOL

The Proposed Amendment would require every QPAM to report its reliance on the QPAM Exemption via email to the DOL. The QPAM would be required to report its legal business name and any other names it does business under and to provide updates in the event of changes to these names or if the entity no longer relies on the QPAM Exemption. The DOL states that it intends to post a publicly available list of all QPAMs on its website, and it might also find this information useful to the extent it intends to develop a targeted program to investigate compliance with the QPAM Exemption.

B. New Conditions Regarding the Ineligibility of a QPAM

The Proposed Amendment clarifies and expands the circumstances under which a QPAM may become ineligible to rely on the QPAM Exemption. The changes include a requirement to amend written investment management agreements with clients to provide certain rights to a Plan in the event of a QPAM's ineligibility. The changes also appear to more closely conform the QPAM's ineligibility provisions to those of PTE 2020-02.

1. *Written Management Agreement*

The Proposed Amendment would require every QPAM to make certain changes to their agreements with client Plans.

First, QPAMs would be required to explicitly provide for a penalty-free termination or withdrawal from a management agreement or QPAM-managed investment fund in the event that the QPAM, its affiliates, or a five-percent or more owner engages in conduct resulting in a "criminal conviction" or receipt of an "ineligibility notice", as described below. However, in a

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QPAM-managed investment fund, a QPAM could still charge client Plans certain fees that are disclosed in advance.

Second, a QPAM would also be required to contractually indemnify, hold harmless, and restore actual losses to client Plans for damages directly resulting from a violation of applicable law, a breach of contract, or any claims arising out of the QPAM's ineligibility. Actual losses would include losses and related costs arising from unwinding transactions with third parties and from transitioning a client Plan's assets to an alternative asset manager and any excise taxes from prohibited transactions under section 4975 of the Internal Revenue Code. The dollar amount of a QPAM's indemnification obligation, especially in connection with investment funds invested in illiquid assets, could be significant. Some QPAMs may be inclined to allocate the risk by increasing their fees charged to client Plans.

Third, the QPAM would need to agree to refrain from knowingly employing or retaining an individual who has participated in conduct that forms the basis of a conviction, non-prosecution, deferred prosecution agreement, or other disqualifying conduct that would make a QPAM ineligible, as described below, regardless of whether the individual was personally convicted of a crime.

2. Foreign Convictions

The Proposed Amendment would codify the DOL's view that a conviction handed down by a "foreign court of competent jurisdiction" would disqualify a QPAM, provided that the conviction is for a crime "substantially equivalent" to U.S. federal or state crimes already enumerated in the current definition of criminal conviction. Recognizing that there may be situations where a foreign criminal conviction raises unique issues when compared to U.S. criminal convictions, the DOL would also grant the QPAM a hearing with the DOL regarding the substantial equivalence of a foreign crime or misconduct. Whether a foreign conviction should make a QPAM ineligible has at times been controversial, as most such convictions do not have a direct link to the QPAM's Plan asset management business, and some foreign jurisdictions may not adhere to due process and rule of law conventions similar to those of the United States.

3. Other Prohibited Misconduct

The Proposed Exemption further provides that participating in "prohibited misconduct" would form the basis of disqualifying a QPAM:

- A domestic non-prosecution or deferred prosecution agreement or the foreign equivalent, for any act that would disqualify the QPAM if convicted;
- 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.

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- Providing materially misleading information to the DOL in connection with the conditions of the exemption.

The DOL would develop these findings in connection with an investigation of a QPAM. Prior to issuing a final ineligibility notice, the DOL would provide advance notice and an opportunity for the QPAM to explain in writing, in a meeting, or through a combination of both, why the QPAM did not engage in these categories of prohibited misconduct. The QPAM would be required to respond to the advance notice within 20 days, and the meeting would be scheduled within 30 days of the QPAM's response. These examples of prohibited misconduct that would make a QPAM ineligible to rely on the exemption are modeled from the ineligibility provisions of PTE 2020-02, although they are inherently more subjective determinations than the occurrence of a conviction.

The DOL interprets "participating in" prohibited misconduct broadly to include "knowingly approving of the conduct or having knowledge of such conduct without taking appropriate and proactive steps to prevent such conduct from occurring, including reporting the conduct to appropriate compliance personnel."

4. Winding-down Period in the Event of Ineligibility

The Proposed Amendment would prescribe a mandatory one-year winding-down period that would begin on the date of ineligibility for any QPAM that has triggered a disqualifying condition. For domestic and foreign criminal convictions, the date of ineligibility is the conviction date, and for prohibited misconduct, the date of ineligibility is the final ineligibility notice issuance date. The winding-down period is intended to allow existing client Plans (i.e., client Plans of the QPAM that had a pre-existing written management agreement on or prior to the ineligibility date) to end their relationship with the disqualified QPAM, while also providing a grace period of relief for past transactions and any transactions continued during the one-year winding-down period, so long as the other conditions of the QPAM Exemption remain satisfied.

Within 30 days of the date of ineligibility, the QPAM would be required to provide a notice to its clients Plans and the DOL containing the following:

- Notice that the QPAM is ineligible and that the one-year winding down period has begun;
- Sufficient detail to apprise client Plans of the nature and severity of the criminal conduct or prohibited misconduct so that fiduciaries of client Plans can prudently determine next steps in the best interest of the Plan;
- Notice of the client Plans' ability to terminate its agreement with the QPAM or withdraw from the QPAM's investment fund without fees or penalties; and
- Notice of the QPAM's contractual duty to indemnify, hold harmless, and restore actual losses to client Plans for damages directly resulting from a violation of applicable law, a

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breach of contract, or any claims arising out of the QPAM's failure to satisfy the conditions of the QPAM Exemption.

Importantly, the QPAM would not be permitted to continue to rely on the QPAM Exemption during the winding down period in the same way that it could prior to becoming ineligible. First, the QPAM could not rely on the QPAM Exemption in connection with new client Plans that have retained the QPAM following the date of ineligibility. Second, for existing client Plans, the QPAM would only be able to rely on the QPAM Exemption in connection with unwinding transactions that have previously been made – the QPAM could not make any new investment on behalf of the Plan.

5. Requests for Individual Exemptions Following a QPAM Becoming Ineligible

The Proposed Amendment would clarify that QPAMs that are ineligible or are anticipating becoming ineligible may apply for individual exemptive relief that would allow them to continue to act as a QPAM if certain conditions are met.

First, the DOL instructs prospective applicants to review the DOL's most recently granted individual exemptions involving QPAMs with the expectation that similar conditions will be required if an exemption is proposed and granted. Applicants would be permitted to request that the DOL exclude terms or conditions from its exemption by providing a detailed explanation as to why the exclusion is necessary and in the best interests of its client Plans.

Second, applicants would need to provide an economic explanation for the exemption, detailing, in dollar amounts, the harm to client Plans that would result if the individual exemption were not granted, including for foregone advantageous investment opportunities, along with any supporting evidence. Given that the Proposed Amendment would require the QPAM to indemnify client Plans for losses arising from the QPAM becoming ineligible, it is not clear how the loss to the Plans would be calculated.

Third, applicants would also be permitted to request limited relief for transactions that would extend beyond the winding-down period (e.g., ongoing real estate leases) by detailing the limited nature of the transactions and how relief for the otherwise prohibited transactions would be in the best interest of the client Plans.

The DOL noted that ineligible QPAMs should not assume that the DOL's acceptance of their applications will be guaranteed, and that the DOL may also condition individual exemptive relief upon certification by a senior executive officer of the QPAM (or comparable person) that: (1) all of the conditions of the winding-down period were met, and (2) an independent audit reviewing the QPAM's compliance with the conditions of the one-year winding-down period has been completed.

Finally, applying for an individual exemption would not toll the ten-year period of ineligibility or the restrictions that would arise during the one-year winding down period.

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C. Transactions Presented to a QPAM for Approval

The QPAM Exemption currently states that the terms of any transaction entered into in reliance on the exemption must be negotiated by, or under the authority and general direction of a QPAM. The Proposed Amendment would tighten this requirement by providing that the terms, commitments, investments, and associated negotiations of a transaction on behalf of client Plans must be the “sole responsibility” of the QPAM. Further, the Proposed Amendment would state that this requirement would not be met where a transaction has been “planned, negotiated, or initiated” by a party in interest and presented to a QPAM for approval.

In the preamble to the Proposed Amendment, the DOL explained that it was making this change because a QPAM should not be a “mere independent approver of transactions.” This change suggests that a QPAM should have an ongoing relationship with a client Plan rather than in connection with a specific transaction. This change may be directed toward providers of independent fiduciary services, which are often retained to evaluate and negotiate, on behalf of a Plan, a proposed transaction that could have the potential for conflicts of interest. The DOL has recently proposed more stringent requirements upon independent fiduciaries in connection with requests for prohibited transactions exemptions.

Moreover, it is not entirely clear how the requirement that a transaction not be initiated and presented by a party in interest to a QPAM could be met. The QPAM Exemption relies on the assumption that any counterparty to a Plan transaction could be a party in interest. If a party in interest cannot present or initiate a transaction with a QPAM, it might functionally mean that no one (other than the QPAM’s internal staff, presumably) could approach a QPAM with an investment idea. Uncertainties may also arise for sub-advised accounts and funds where QPAM responsibilities may be shared between a trustee and sub-adviser.

D. Relief Solely for Investment Purposes

The Proposed Amendment states that the QPAM Exemption is unavailable unless the QPAM’s account or fund is established for “investment purposes.” Therefore, it is unclear whether the exemption would apply in connection with certain insurance transactions, such as pension risk transfer, that do not contain an investment component.

E. Increase of Asset Management and Capitalization Thresholds

The QPAM Exemption requires that a QPAM meet certain minimum asset under management and capitalization requirements. The DOL states some of these amounts have not been adjusted since 1984, when the exemption was originally granted. The Proposed Amendment would raise the amounts as follows:

- For registered investment advisers, the assets under management threshold would be increased to \$135,870,000, and the shareholders’ or partners’ equity threshold would be increased to \$2,040,000;

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- For banks and savings and loan associations, the equity capital threshold would be increased to \$2,720,000; and
- For broker-dealers and insurance companies, the net worth threshold would be increased to \$2,720,000.

The DOL would annually adjust these amounts for inflation.

F. Recordkeeping

The Proposed Amendment would add a new recordkeeping requirement, mandating that QPAMs maintain records necessary to maintain compliance with the terms of the QPAM Exemption for six years. The records would need to be made available, to the extent permitted by law, to:

- any authorized employee of the DOL or the Internal Revenue Service or another federal or state regulator;
- any fiduciary of a Plan invested in an investment fund managed by the QPAM;
- any contributing employer and any employee organization whose members are covered by a Plan invested in an investment fund managed by the QPAM; and
- any participant, accountholder, or beneficiary of a Plan invested in an investment fund managed by the QPAM.

Participants, accountholders, and beneficiaries of a Plan, plan fiduciaries, and contributing employers/employee organizations would be able to request only information applicable to their own transactions, and would not be able to request a QPAM's privileged trade secrets or privileged commercial or financial information, or confidential information regarding other individuals. If the QPAM refuses to disclose information to a party other than the DOL on the basis that the information is exempt from disclosure, the DOL would require the QPAM to provide a written notice, within 30 days, advising the requestor of the reasons for the refusal and that the DOL may request such information. The requirement to provide information to participants, accountholders, or beneficiaries invested in a fund managed by a QPAM is notable because a similar right was removed from an investment advice related exemption after objections from commenters.

III. Observations

The Proposed Amendment would place significant new limitations on the availability of the QPAM Exemption and would raise the risks imposed on asset managers who operate as QPAMs. The changes might cause asset managers to migrate to reliance on alternate forms of prohibited transaction relief, such as section 408(b)(17) of ERISA or other exemption strategies. We encourage asset managers and plan sponsors to consider submitting comments to the DOL to express their views on how the proposed changes may affect them and their Plans.

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