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DOL Update

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DOL Proposes to Amend QPAM Exemption

On July 27, 2022, the Department of Labor (Department or DOL) published in the *Federal Register* proposed changes to the Prohibited Transaction Class Exemption 84-14, which is more commonly known as the qualified professional asset manager exemption (QPAM Exemption). As discussed in the February 2022 issue of *The Investment Lawyer*, the QPAM exemption is a key exemption upon which discretionary asset managers rely to minimize the occurrence of non-exempt prohibited transactions when they invest the assets of plans covered by the fiduciary provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA) or Section 4975 of the Internal Revenue Code of 1986, as amended (Code). The proposed changes are substantial and may significantly impact who in the future can meet or who is willing to meet the requirements of the QPAM Exemption.

Background

As was set forth in more detail in the February issue, a fiduciary may not cause an ERISA-covered account or an account covered by Code Section 4975, for example, an Individual Retirement Account (IRA), including accounts the assets of which are deemed to be "plan assets" for purposes of ERISA or the Code, to engage in the following transactions: (1) a direct or indirect sale or exchange of property between the account and a party in interest; (2) a direct or indirect lending of money or other extension of credit between the account and a party in interest; (3) a direct or indirect furnishing of goods, services, or facilities between the account and a party in interest; (4) a direct or indirect transfer to, or for the use by or for the benefit of, a party in interest of account assets; and (5) a purchase of employer securities or employer property by the account. A "party in interest" is defined broadly to include, among others, another fiduciary, a plan or IRA service provider and their affiliates, an employer whose employees participate in the plan and their affiliates, and IRA owners and beneficiaries. The Code mirrors these prohibited transactions of ERISA. However, the Code uses the term "disqualified person" rather than "party in interest," and defines the term "disqualified person" slightly differently.

Effectively, a vast majority of transactions between an account and a person or entity that has a relationship with the account or the underlying ERISA-covered investors or investors covered by Code Section 4975 result in prohibited transactions. Therefore, the fiduciaries must comply with a prohibited transaction exemption. The QPAM Exemption, which we described in detail in the February issue of *The Investment Lawyer*, exempts many of the

common prohibited transactions that can arise when a discretionary asset manager executes transactions including purchase and sale transactions on behalf of accounts when it manages such accounts on a discretionary basis so long as the conditions of the exemption are met. Many asset managers rely on the QPAM Exemption, particularly registered investment advisers, because another exemption strategy would require compliance with multiple exemptions. Moreover, these asset managers may need to employ other methods for addressing non-exempt prohibited transactions by altogether avoiding transactions with certain parties in interest. Doing so could significantly limit their investment activities and would also require maintaining a list of parties in interest and disqualified persons, which would be operationally challenging or even impossible in some circumstances to accurately maintain.

Definition of QPAM

A key condition of the exemptions is that the asset manager be a "qualified professional manager" or "QPAM." A QPAM is an entity with the power and respective legal authorization to manage, acquire, and dispose of assets of an account that is either (1) a bank that has the power to manage, acquire or dispose of assets of a plan and with equity capital in excess of $1 million, (2) a savings and loan association that has trust powers to manage, acquire or dispose of assets of a plan and with equity capital or net worth in excess of $1 million, (3) an insurance company that is qualified under the laws of more than one state to manage, acquire or dispose of the assets of a plan and with a net worth in excess of $1 million, or (4) a registered investment adviser under the Investment Advisers Act of 1940, as amended (Advisers Act) and with net capital and shareholders' equity of at least $1 million and has total assets attributable to clients under its management and control in excess of $85 million as of the last day of the adviser's most recent fiscal year.

The Department's thinking behind the assets under management and equity requirements is that larger asset managers will have a sufficient level of sophistication and the financial wherewithal to protect accounts in the event of a breach of fiduciary duty. To that end, the Department proposes to increase the aforementioned $1 million thresholds applicable to banks, savings and loan associations, and insurance companies to $2,720,000. Additionally, with respect to registered investment advisers, the Department is proposing to increase the $1 million equity threshold to $2,040,000 and the $85 million assets under management threshold to $135,870,000. In the event these increases become final, they could preclude some asset managers from acting or continuing to act as QPAMs. In our experience, while many advisers who wish to rely on the QPAM Exemption can meet the assets under management requirements, it is more difficult for them to meet the equity requirements. Consequently, an increase in the threshold would be difficult for many advisers to overcome.

Criminal Convictions

Additionally, in order to be a QPAM, the asset manager, certain affiliates of the manager, and certain owners of the manager cannot have been convicted of certain crimes within the 10 years immediately preceding the transaction with regard to which the asset manager intends to rely on the QPAM Exemption. Such crimes, which the Department defines as "Criminal Convictions" in the proposal, include, for example, any felony crime involving abuse or misuse of such person's employee benefit plan position; any felony arising out of the conduct of the business of a broker, dealer, investment adviser, bank, insurance company or fiduciary; income tax evasion; any felony involving the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; conspiracy or attempt to commit any such crimes or a crime in which any of the foregoing crimes is an element; or any other crime described in Section 411 of ERISA.

In recent years, there has been a lot of confusion over whether criminal convictions in foreign jurisdictions by affiliates would prevent a US affiliate from acting as a QPAM. As a result, many US managers have requested individual prohibited transaction exemptions in order to assure they can act as QPAMs and rely on the QPAM Exemption.

In this regard, the Department proposes to amend the QPAM Exemption to clarify and reaffirm its view that a foreign affiliate's conviction for certain crimes under non-US law can result in its affiliate not qualifying as QPAM. Specifically, the DOL proposes to add language to the QPAM Exemption that a conviction "by a foreign court of competent jurisdiction for any crime…however denominated by the laws of the relevant foreign government that is substantially equivalent to" one of the above-discussed crimes is sufficient to render the convicted party and certain affiliates ineligible to be a QPAM. The DOL states that in its view the conviction of a non-US affiliate by a non-US court for a comparable felony based on non-US law "call[s] into question a firm's culture of compliance just as much as domestic crimes" and therefore should impact the status of all affiliates' ability to act as a QPAM. Determining whether a crime is "substantially equivalent to" a US crime could be challenging. The DOL expresses in its proposal a willingness to discuss with asset managers whether the "substantially equivalent" standard applies, but getting that determination from the DOL in a timeframe that is helpful could be challenging under some circumstances, for example, a corporate transaction.

Prohibited Misconduct

The Department has also proposed to add a new condition related to the conduct of the asset manager seeking to utilize the QPAM Exemption. Neither the manager nor an affiliate may engage in "Prohibited Misconduct," which includes (1) any conduct that forms the basis for a non-prosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted one of the above-described crimes; (2) any conduct that forms the basis for an agreement, however denominated by the laws of the relevant foreign government, that is substantially equivalent to a non-prosecution agreement or deferred prosecution agreement; (3) engaging in a systematic pattern or practice of violating the conditions of the QPAM Exemption in connection with otherwise non-exempt prohibited transactions; (4) intentionally violating the conditions of the QPAM Exemption in connection with otherwise non-exempt prohibited transactions; or (5) providing materially misleading information to the Department in connection with the conditions of the QPAM Exemption.

The addition of the Prohibited Misconduct requirement is significant as it increases the opportunities for an asset manager to not qualify for the QPAM Exemption. No conviction for a crime has occurred in the case of a non-prosecution agreement or deferred prosecution agreement. Even so, asset managers will be required to determine whether they or their affiliates would have been convicted had they not entered the agreement. There could be reasons to enter such agreements, other than a belief that the accused is likely to be convicted; for example, reputational risk and costs of defense. Additionally, determining whether an agreement in a non-US jurisdiction to avoid or defer prosecution for a crime is the same as a US non-prosecution or deferred prosecution agreement could be even more challenging than determining whether the underlying alleged crimes are "substantially equivalent."

With regard to the other aspects of the Prohibited Misconduct definition, the Department intends to use its investigative and enforcement authority to identify such conduct and, pursuant to a process outlined in the proposal, issue an "Ineligibility Notice" pursuant to which the asset manager could no longer act as a QPAM. Not coincidentally, the Department intends to add a condition to the QPAM Exemption that an asset manager who wishes to rely on the QPAM Exemption must

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register as such with the DOL. Thus, the DOL will know the identity of QPAMs and potential targets for investigations. Also, the Department proposes to add a six-year recordkeeping requirement on QPAMs "to ensure that evidence of compliance is available for review…" by the Department's investigators.

Required Language in Agreements

The DOL also will require that all investment management agreements between the account and the QPAM include: (1) a provision providing that in the event the QPAM, its affiliates, and 5 percent or more owners engage in conduct resulting in a Criminal Conviction or receipt of a written Ineligibility Notice, the QPAM would not restrict client's ability to terminate or withdraw from its arrangement with the QPAM; and (2) a provision that requires the QPAM to indemnify, hold harmless, and promptly restore actual losses to each account for any damages directly resulting from a violation of applicable laws, a breach of contract, or any claim arising out of the failure of the QPAM to remain eligible for relief under the QPAM Exemption as a result of conduct that leads to a Criminal Conviction or an Ineligibility Notice. Thus, the client cannot be penalized for terminating the relationship (including withdrawal from a pooled investment fund the assets of which are deemed "plan assets") and should be indemnified for losses related to the asset manager's inability to rely on the QPAM Exemption. Additionally, the DOL has given the impression that the proposal will have the effect of ensuring that all QPAMs agree to extend the clause to any violation of applicable law or breach of contract in order to rely on the QPAM Exemption.

Wind Down Period

The DOL proposes to add to the QPAM Exemption a one-year mandatory wind down period for QPAMs that may no longer rely on the QPAM Exemption due to a Criminal Conviction or receipt of an Ineligibility Notice. Once the QPAM Exemption is no longer available, the asset manager may not (1) rely on the QPAM Exemption with regard to any new clients and (2) may not rely on the QPAM Exemption with regard to current clients to the extent the transaction occurs after the date the QPAM Exemption is no longer available. The fact that the asset manager will continue to provide discretionary advice for the one-year period but not rely on the QPAM Exemption is important to note. The asset manager would have to rely on other exemptions, identify parties in interest and not engage in transactions with such parties, or, according to the Department, "pursu[e] alternative investment strategies."

Under the proposed exemption, the asset manager also would have to provide written notice of its ineligibility to the client. The Department makes clear that the wind down period is for the benefit of the client so that the client has time to hire a new manager or to get assurances that the current manager is in a position to manage assets without causing non-exempt prohibited transactions by either relying on other exemptions or taking other appropriate actions. The concept of the one-year wind down period goes hand-in-glove with the above-discussed provisions that must be included in the QPAM's investment management agreement, that is, the client cannot be penalized for terminating the agreement and the asset manager must indemnify the client against any losses resulting from the inability of the manager to continue to rely on the QPAM Exemption.

The wind down process described in the proposal is very different from current practice. Often, QPAMs continue managing assets and otherwise comply with the QPAM Exemption while simultaneously attempting to get an individual prohibited transaction exemption (IPTE) retroactive to the conviction date because an affiliate, often located in a foreign jurisdiction, is convicted of a felony under non-US law. The proposed QPAM Exemption does

provide a procedure for getting an IPTE including what information should be provided to the DOL, but the DOL makes clear that the asset manager should operate during the winding down period and beyond "with the expectation that the Department may not grant further exemptive relief," Further, any such IPTE may require that a senior officer of the asset manager certify 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." It remains to be seen whether the Department will in fact issue IPTEs or how long it will take to receive such IPTEs.

Transactions Qualifying for the Exemption

Finally, the DOL intends to add language to the QPAM Exemption amplifying what it views as its long-standing position that the QPAM Exemption is available only for those transactions that the QPAM negotiates and authorizes on behalf of an investment fund. The Department in the past has expressed a view that the QPAM Exemption is not available in the event of mere approval by the QPAM of a transaction that has already been negotiated by another plan fiduciary. Such circumstances are sometimes described as "QPAM for a Day." The Department states in in the proposal, "The role of the QPAM under the terms of the exemption is not to act as a mere independent approver of transactions. Rather, the QPAM must have and exercise discretion over the commitments and investments of Plan assets and the related negotiations with respect to a fund that is established primarily for investment purposes in order for the relief provided under the exemption to apply."

Conclusion

The proposed changes to the QPAM Exemption are substantial. The result may be a reduction in the number of assets managers who are a "QPAM," the number of QPAMs that can otherwise meet the conditions of the exemption, or the number of assets managers who wish to comply with the exemption even if they may otherwise be a QPAM. We also may see an uptick in the reliance on the statutory exemption under Section 408(b)(17) of ERISA, which is commonly referred to as the "service provider exemption." An asset manager's inability to use the QPAM Exemption because a remote affiliate has a Criminal Conviction or an asset manager or its affiliate purchases a company that has a Criminal Conviction or has engaged in Prohibited Misconduct could result in an asset manager losing its ability to efficiently manage millions or even billions of dollars in assets. The Department asked for written public comments on the proposed changes to the QPAM Exemption, which were due on October 11, 2022, and the Department will hold an online public hearing on November 17, 2022. Asset managers who rely on the QPAM Exemption should pay attention to changes that may be forthcoming.

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