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DOL Grants Individual Exemptions to Allow Asset Managers to Use QPAM Exemption

The Department of Labor (“DOL”) recently issued a series of individual prohibited transaction exemptions (the “Individual Exemptions”) that will allow asset managers affiliated with five financial institutions (each, an “Affiliated QPAM”) – JPMorgan Chase & Co., Deutsche Bank AG, Citigroup, Barclays Capital Inc. and UBS AG – to continue managing assets of ERISA plans and IRAs (each, a “ERISA Plan”) in reliance on Prohibited Transaction Class Exemption 84-14 (the “QPAM Exemption”). 82 Fed. Reg. 61816 (Dec. 29, 2017). Because the financial institutions or affiliated entities had been convicted of certain crimes (each, a “Convicted Entity”), the Affiliated QPAMs were unable to satisfy one of the conditions for relief under the QPAM Exemption. The Affiliated QPAMs therefore required individual relief in order to continue using the QPAM Exemption. The DOL provided the requested relief, but at a substantial cost. In addition to meeting the remaining conditions for relief under the QPAM Exemption, each Affiliated QPAM must also satisfy additional conditions for relief under the applicable Individual Exemption, including:

- adopting written policies and procedures reasonably designed to ensure compliance with the conditions of the Individual Exemption and the fiduciary and prohibited transaction provisions of ERISA and the Internal Revenue Code (the “Policies and Procedures”);
- developing an annual compliance training program for relevant personnel (the “Training Program”);
- designating a senior compliance officer responsible for ensuring compliance with the Policies and Procedures and Training Program requirements (the “Compliance Officer”); and
- submitting to periodic compliance audits by an independent auditor (the “Compliance Audit”).

The Individual Exemptions extend relief previously granted by the DOL under temporary exemptions, issued in late 2016, that were set to expire.

QPAM Exemption

The QPAM Exemption is the principal source of relief from the prohibited transaction restrictions under ERISA and the Internal Revenue Code for financial institutions that manage assets of ERISA Plans. The exemption permits an ERISA Plan to engage in an otherwise prohibited transaction where the transaction is effected on behalf of the ERISA Plan by a “qualified professional asset manager” or QPAM. As defined in the QPAM Exemption, a QPAM is a bank, insurance company or registered investment advisor that

satisfies certain net worth, capitalization and/or assets under management requirements, and acknowledges its fiduciary status with respect to an ERISA Plan in a written management agreement. The QPAM Exemption is premised on the assumption that where a transaction is approved by an independent asset manager with a large and diverse client base, the potential for conflicts of interest or other abuses is significantly reduced.

The QPAM Exemption provides an efficient way for asset managers to engage in a wide variety of transactions and provide a breadth of investment choices to their ERISA Plan clients. There are a number of transactions for which the exemption may be necessary, including derivative transactions, real estate transactions, and off-exchange securities and commodities transactions. Comparable relief will often be available under other prohibited transaction exemptions, either alone or in combination. For example, the statutory exemption under Section 408(b)(17) of ERISA provides relief for certain arm's-length transactions between a plan and a person that is a party in interest solely by reason of providing services to the plan or a relationship to such a service provider and is unaffiliated with any fiduciary acting on behalf of the plan in connection with the transaction. However, the QPAM Exemption remains one of the most commonly used exemptions and it is typical for named fiduciaries of large ERISA Plans to only delegate investment discretion to managers who qualify as QPAMs. Moreover, it is customary for asset managers to make representations and covenants in their management agreements and investment transaction documents regarding their status as a QPAM and their ability to rely on the QPAM Exemption.

Impact of Criminal Convictions

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 the ten years preceding any transaction entered into in reliance on the exemption. Such crimes include "any felony arising out of the conduct of the business of a broker, dealer, investment advisor, bank, insurance company or fiduciary," and any crime for which fraud is an element. Section I(g) of the QPAM Exemption; Section 411 of ERISA. For these purposes, an "affiliate" of a QPAM includes:

- any person directly or indirectly controlled, controlled by, or under common control with the QPAM;
- any corporation, partnership, trust or unincorporated enterprise in which the QPAM owns a five percent or greater interest;
- any highly compensated employee of the QPAM; and
- any employee or officer of the QPAM that has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets.

Section V(d) of the QPAM Exemption.

There is no requirement that an affiliate's criminal conduct relate in any way to the business of the QPAM. There is also no requirement that an affiliate's criminal conviction occur while the entity was affiliated with the QPAM. For example, a violation of Section I(g) could result from the acquisition by a QPAM's parent company of a target that had previously been convicted of one of the crimes specified in the QPAM Exemption. In such circumstances, unless an individual exemption were obtained, the QPAM would become ineligible for the relief provided under the QPAM Exemption immediately upon the close of the transaction that resulted in the affiliation with the convicted entity.

During the first three decades following the issuance of the QPAM Exemption, the DOL routinely granted individual exemptions that allowed QPAMs to continue to rely upon the QPAM Exemption despite an affiliate's criminal

conviction. Recognizing the benefit for retirement plans to have a choice of asset managers and the potential transition and transaction costs plans could incur in finding a replacement manager, the DOL was amenable to granting an individual exemption as long as the QPAM had no involvement with the criminal activity and was able to demonstrate that granting the exemption was in the interest of plan clients and their beneficiaries and protective of their rights. In recent years, however, the process of obtaining individual exemptions has grown increasingly contentious, as members of Congress and financial watchdog organizations have pushed for tougher reviews of the exemption applications. As a result, obtaining an individual exemption is no longer a foregone conclusion. To the contrary, since 2015, the DOL has denied at least one exemption request and tentatively denied at least two other requests. And where the DOL has granted individual exemptions, the exemptions have included much more onerous conditions and have provided relief for limited periods of time rather than for the full ten-year period following the affiliate's criminal conviction. The Individual Exemptions continue this trend.

Conditions for Relief under Individual Exemptions

The Individual Exemptions contain many conditions that must be satisfied in order for an Affiliated QPAM to continue to rely on the exemptive relief available under the QPAM Exemption. The most significant of these conditions are summarized below.

- **Policies and Procedures.** The Affiliated QPAM is required to adopt and comply with written policies and procedures that are reasonably designed to ensure that:
 - the Affiliated QPAM's asset management decisions are made independently of the corporate management and business activities of any affiliated Convicted Entity;
 - the Affiliated QPAM complies with the terms of the Individual Exemption and with the fiduciary duty and prohibited transaction provisions of ERISA and the Internal Revenue Code;
 - the Affiliated QPAM does not knowingly participate in another person's violation of the fiduciary duty and prohibited transaction provisions of ERISA and the Internal Revenue Code;
 - any filings or statements made by the Affiliated QPAM to regulations (including the DOL) are materially accurate and complete; and
 - any violation of ERISA or the Internal Revenue Code or failure to comply with the Individual Exemption is corrected as soon as reasonably possible upon discovery.
- **Training Program.** The Affiliated QPAM is required to develop a training program, to be conducted at least annually for all relevant personnel (including asset/portfolio management, trading and legal/compliance personnel) by a professional (who may be employed in-house) who has been prudently selected by the Affiliated QPAM and has appropriate technical training and proficiency with ERISA and the Internal Revenue Code. The Training Program must, at a minimum, cover:
 - the Policies and Procedures;
 - ERISA and Internal Revenue Code compliance, including compliance with applicable fiduciary duty and prohibited transaction provisions;
 - ethical conduct;
 - the consequences of noncompliance with the Individual Exemption; and
 - prompt reporting of wrongdoing.

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- **Compliance Officer.** The parent company of the Affiliated QPAM must designate a senior compliance officer (“Compliance Officer”) who will be responsible for ensuring compliance with the Policies and Procedures and Training Program requirements. The Compliance Officer:
 - must be a professional who has extensive experience with the regulation of financial services and procedures, including regulation under ERISA and the Internal Revenue Code;
 - must have a direct reporting line to the parent company’s highest ranking corporate officer in charge of legal compliance for asset management;
 - must conduct an annual compliance review, including a review of any compliance matter that was identified by, or reported to, the Compliance Officer or others during the previous year; and
 - must prepare a written report for each annual compliance review, to be provided to appropriate officers of the parent company, that, among other things, identifies any instances of noncompliance disclosed during the preceding year and any related corrective action.
- **Compliance Audit.** The QPAM Affiliate must submit to a compliance audit, to be conducted every two years in the case of Affiliated QPAMs of JPMorgan Chase & Co., Citigroup, and Barclays Capital Inc., and annually in the case of Affiliated QPAMs of Deutsche Bank AG and UBS AG (entities with more than one criminal conviction). The audit must be conducted by an independent auditor who has been prudently selected by the Affiliated QPAM and who has appropriate technical training and proficiency with ERISA and the Internal Revenue Code (the “Compliance Auditor”). The Compliance Auditor is required to:
 - determine whether the Affiliated QPAM has adopted Policies and Procedures and developed a Training Program in accordance with the Individual Exemption’s requirements;
 - test the Affiliated QPAM’s operational compliance with Policies and Procedures and Training Program requirements;
 - issue a written report (to be provided to the Compliance Officer, the appropriate supervisory board or committee of the Affiliated QPAM’s corporate parent, and the DOL Office of Exemption Determinations (“OED”)) that includes the auditor’s specific determinations regarding the adequacy of the Affiliated QPAM’s Policies and Procedures and Training Program and identifies any instance of the Affiliated QPAM’s noncompliance with the Policies and Procedures and Training Program guidelines;
 - notify the Affiliated QPAM of any identified instance of noncompliance within five business days, regardless of whether the audit has been completed; and
 - provide to the DOL, upon request, access to all the work papers created and utilized in the course of the audit, to the extent such access is otherwise permitted by applicable law.

Congressional Response

In response to the issuance of the Individual Exemptions, U.S Senators Tammy Baldwin (D-WI) and Sherrod Brown (D-OH) introduced the Pension Stability Act (S. 2318). The bill would require the DOL to issue regulations establishing user fees that would be imposed on financial institutions that apply for individual prohibited transaction exemptions that allow continued reliance on the QPAM Exemption. The user fees would start at not less than \$1 million per application and would increase based on the severity of the crime related to the application. In the case of financial institutions that had previously applied for similar individual exemptions, the user fee would be multiplied by the number of prior applications. The bill provides that any user fees collected by DOL be transferred to the Pension

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Benefit Guaranty Corporation (“PBGC”) Multiemployer Program, which provides financial assistance to insolvent multiemployer plans. Once the PBGC’s multiemployer plan program reaches a funded status comparable to the PBGC’s Single-Employer Program, which funds guaranteed benefits under terminated single-employer defined benefit plans, the bill would require that the user fees collected by the DOL be allocated equally between the two programs. If enacted, the legislation is unlikely to have a material impact on the funding of the Multiemployer and Single-Employer Programs, which, as noted in the PBGC’s 2017 Annual Report, had deficits of \$65 billion and \$11 billion, respectively, as of September 30, 2017.

Considerations for Asset Managers

It should be noted that the Compliance Auditor’s written report, once submitted to the OED, becomes part of the public record. While the internal Compliance Officer’s annual report does not have to be submitted to the DOL, the Individual Exemptions expressly grant the DOL the right to review the Compliance Auditor’s work papers. These papers would almost certainly include the Compliance Officer’s reports for the period covered by the audit.

Given the significant amount of time, costs and internal and external resources that are now required to obtain an individual exemption, asset managers that rely on the QPAM Exemption may need to carefully consider whether obtaining the exemption is worth the costs. If an asset manager has primarily a retail base of retirement clients (IRAs and small employee benefit plans) with liquid strategies and neither the asset manager nor any of its affiliates typically takes 5% or more stakes in other asset managers with ERISA Plan clients, the manager may want to consider relying upon other exemptions for the ten-year period following conviction rather than expending the resources to obtain an individual exemption that would permit continued reliance on the QPAM Exemption.

Financial institutions should also keep in mind that the DOL reviews the specific facts and circumstances of each applicant and is likely to view an applicant with a parent level conviction or with more than one conviction more stringently than a first-time applicant with a conviction resulting from the activity of a rogue employee of a minor subsidiary. Applicants also need to be prepared to expect that their exemption application and submissions will be scrutinized by financial watchdog organizations, competitors as well as the press. There is also no guarantee that the DOL will provide applicants with an opportunity to withdraw an exemption application if it is likely to be denied.