CLIENT ALERT

DOL Proposes Substantial Amendment to Qualified Professional Asset Manager (QPAM) Exemption

August 12, 2022

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I. Introduction

On July 27, 2022, the U.S. Department of Labor (the "DOL") published a proposed amendment to the qualified professional asset manager ("QPAM") class prohibited transaction exemption (the "QPAM Exemption") promulgated under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The proposed amendment clarifies and adds certain criminal conduct-related components of the QPAM Exemption and adds several noncriminal conduct-related components. If adopted, the proposed amendment would be effective sixty (60) days after the date of publication of the final amendment in the Federal Register.

Written comments and requests for a public hearing on the proposed amendment must be submitted to the DOL on or before September 26, 2022.

II. Background

Title I of ERISA, prohibits certain transactions between an employee benefit plan subject to ERISA (e.g., a pension plan) and "parties in interest" (e.g., plan fiduciaries, plan service providers, and other parties with certain relationships to the plan). Title II of ERISA codifies parallel provisions in Section 4975 of the Internal Revenue Code (the "Code"), which prohibit transactions between certain tax-qualified plans, including IRAs, and "disqualified persons." "Disqualified person" has a definition that is similar, though not identical, to "parties in interest" under ERISA.[1] ERISA provides certain statutory exemptions from the prohibited transaction provisions. The DOL also has the authority to grant additional prohibited transaction exemptions on an individual or class basis.

Managers of investment funds that hold "plan assets" of ERISA plans (and certain tax-qualified plans) are fiduciaries under ERISA (and the Code) with respect to plan investors. And Section 406(a) of ERISA (and parallel provisions under Section 4975 of the Code) provides that a fiduciary cannot cause a plan to engage in a sale or exchange, leasing of property, extension of credit, furnishing of goods or services, or transfer of "plan assets" to or with a party in interest. While these prohibited transaction provisions protect plans (and their participants and beneficiaries) from abuse potential, they also preclude many benign and essential commercial transactions routinely carried out by managers of "plan assets."[2] The QPAM Exemption permits many of these transactions to go forward on an exempt basis, and many asset managers would be unable to manage "plan assets" without the QPAM Exemption.

III. Summary of Current QPAM Exemption Requirements

Currently, an investment manager relying on the QPAM Exemption must be one of the following: (1) a bank or savings and loan association with equity capital in excess of $1,000,000; (2) an insurance company with net worth in excess of $1,000,000; (3) a registered investment adviser with (a) more than $85,000,000 of total assets under management ("AUM") and (b) shareholders' (or partners') equity in excess of $1,000,000.[3]

In addition to the requirements regarding QPAM qualification described in the preceding paragraph, the QPAM Exemption requires the manager to acknowledge in a written agreement that it is a fiduciary with respect to investing plans. In order to utilize the QPAM Exemption, the manager must have the sole responsibility to negotiate and decide investments for the "plan assets" it manages (e.g., an employer sponsoring an investing plan may not negotiate an investment transaction and then present it to the QPAM for approval). Further, and particularly relevant to the proposed amendment, a manager is ineligible under the current QPAM Exemption if within the last ten (10) years such manager, any of its affiliates, or any of its direct or indirect five percent (5%) owners has been convicted (or released from prison, if later than the conviction date) of certain enumerated crimes.[4]

1 References throughout this Client Alert to "ERISA," "plan," and "party in interest" are intended to include the Code's parallel concepts.

2 For example, Section 406(a) of ERISA would, in the absence of an exemption, prohibit an investment fund holding "plan assets" from, in the normal course of its operations, entering into a transaction with another entity that happens to be a service provider with respect to an investing plan.

3 As an alternative to this shareholder equity requirement, an investment adviser can satisfy this requirement if payment of its liabilities is guaranteed by an affiliate, another entity satisfying the conditions of the QPAM Exemption, or a broker-dealer with a net worth in excess of $1,000,000.

4 These include: convictions for any felony involving abuse or misuse of a plan position or employment with a labor organization; 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 larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or

If a manager qualifies as a QPAM, not all transactions are exempt. The QPAM Exemption does not exempt transactions with a party in interest that (1) is the QPAM itself; (2) has the ability to appoint or terminate the QPAM (or is an affiliate of such an entity); or (3) is a party in interest with respect to a plan whose assets comprise more than twenty percent (20%) of the manager's total AUM.

IV. Summary of Proposed Changes

One of the primary changes in the proposed amendment relates to the QPAM Exemption's ineligibility provisions. Over the past decade, many global asset managers have requested, and often obtained, individual exemptive relief from the DOL to affirm eligibility under the QPAM Exemption notwithstanding criminal convictions of such managers' affiliates in non-U.S. jurisdictions. This focus on non-U.S. criminal convictions appears to be the primary impetus for the proposed amendment. However, the proposed amendment also includes several noncrime related changes that, if adopted, would impact asset managers relying on the QPAM Exemption.

A brief summary of the proposed amendment's crime and noncrime related changes follows:

a. Crime. The proposed amendment retains the list of crimes currently in the QPAM Exemption resulting in QPAM ineligibility, and, notably, clarifies that convictions of similar non-U.S. laws would also lead to QPAM ineligibility. This clarification is significant, because some market participants have understood that criminal convictions under non-U.S. laws would not result in QPAM Exemption ineligibility. For example, in early November, 2020, the DOL indicated that it would not view a conviction under foreign law as a disqualifying event under the QPAM Exemption. However, in March, 2021, the Biden Administration withdrew this statement.

   In addition to U.S. and non-U.S. criminal conviction ineligibility, the proposed amendment expands the categories of conduct that would result in ineligibility – referred to as "Prohibited Misconduct."

   Prohibited Misconduct includes participating in:

   - conduct forming the basis for a non-prosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted one of the QPAM Exemption's enumerated crimes;
   - a systematic pattern or practice of violating the conditions of the QPAM Exemption;
   - intentionally violating the conditions of the QPAM Exemption; 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 a crime identified in Section 411 of ERISA.

- providing materially misleading information to the DOL in connection with the conditions of the QPAM Exemption.

The proposed amendment also provides that "participating in" Prohibited Misconduct includes not only active participation but also knowingly approving such conduct or having knowledge of such conduct without taking proactive steps to thwart it.

With respect to ineligibility potentially stemming from Prohibited Misconduct, the proposed amendment includes certain due process provisions. Specifically, ineligibility begins on the date the DOL issues a written "Ineligibility Notice" to the QPAM. Before issuing an Ineligibility Notice, the DOL will issue a written warning to the QPAM identifying the conduct at issue and providing twenty (20) days for the QPAM to respond. If the QPAM does not respond within this time, then the DOL will issue an Ineligibility Notice. If the QPAM timely responds to the DOL's written warning, then the QPAM will be afforded an opportunity to be heard at a conference to be scheduled within thirty (30) days of the QPAM's response (the DOL will accommodate requests for a virtual conference). The proposed amendment contemplates the right to only one hearing (but the DOL may, at its discretion, schedule additional conferences). If the DOL maintains its determination, then the resulting Ineligibility Notice would explain the basis for the DOL's determination.

b. <u>Notice Requirement</u>. The proposed amendment requires QPAMs to report to the DOL by email the legal name of each business entity relying on the QPAM Exemption (and any name the QPAM may be operating under). This is a one-time requirement, unless there is a relevant name change (or unless reliance on the QPAM Exemption ceases).

The DOL states in the preamble to the proposed amendment that it intends to maintain a publicly available list of entities relying on the QPAM Exemption. Further, the DOL may utilize this QPAM list to aid its investigations and enforcement initiatives in this area.

c. <u>Increased AUM and Equity Thresholds</u>. The proposed amendment increases the minimum size thresholds in the QPAM definition. These thresholds are designed to ensure that QPAMs are large enough to withstand improper influence from parties in interest. If adopted, the proposed amendment would mark the first modification to the minimum size thresholds since 2005 (and only the second in the QPAM Exemption's nearly four-decade history).

The threshold increases in the proposed amendment are as follows:

- For registered investment advisers:

RIA Threshold	Current Amount	Proposed Amount
AUM	> $85,000,000	> $135,870,000
Equity Capital	> $1,000,000	> $2,040,000

- For banks, savings and loan associations and insurance companies, the equity capital threshold increases from $1,000,000 to $2,720,000.

The proposed amendment also provides that the DOL will annually (i.e., by January 31 of each year) publish in the Federal Register adjustments to the thresholds for inflation, rounded to the nearest $10,000.

The threshold increases may not be problematic for large asset managers currently relying on the QPAM Exemption. However, for QPAMs straddling the increased thresholds, it may be necessary to adopt enhanced accounting and monitoring procedures to ensure compliance. In addition, for startup asset managers looking to market to benefit plan investors, the increased thresholds may present a greater barrier to entry.

d. Written Management Agreement and Indemnity Requirements. The proposed amendment bolsters the current written management agreement element of the QPAM Exemption.[5] Notably, the proposed amendment requires QPAMs to include in "Written Management Agreements" certain upfront terms that would apply *in the event of* QPAM ineligibility. These terms are summarized as follows:

- The QPAM will not restrict a client plan's ability to terminate or withdraw from the investment fund(s) managed by the QPAM.

- The QPAM will not impose any fees, penalties, or charges in connection with a plan's withdrawing from an investment fund in the event of the QPAM's ineligibility. However, the DOL excepts certain reasonable fees disclosed in advance "that are specifically designed to prevent generally recognized abusive investment practices or specifically designed to ensure equitable treatment of all investors in a pooled fund. . ."

5 Currently, QPAMs are merely required to acknowledge in a written agreement their fiduciary status with respect to client plans.

- The QPAM will not employ or knowingly engage any individual that participated in the conduct resulting in the ineligibility.

- The QPAM will indemnify, hold harmless and promptly restore actual losses to each client plan for any damages directly resulting from a violation of applicable laws, 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 ineligibility.

  Such indemnity claims may include fees incurred by a client plan in connection with terminating a service provider relationship that is reliant on the QPAM Exemption, or potentially investment losses realized by client plans due to prematurely withdrawing from the QPAM's investment fund(s) in order to avoid prohibited transactions.

These required terms for the Written Management Agreement must be effective for a period of at least ten (10) years from the ineligibility date.[6]

The proposed amendment does not include grandfathering provisions. Thus, if enacted in its current form, it would require all QPAMs to update their agreements to conform to the Written Management Agreement standard.

Further, if enacted in its current form, plan sponsors and other non-investment manager fiduciaries (e.g., independent co-fiduciary investment advisers) should be prepared to review the Written Management Agreements of QPAMs they engage or recommend, and should diligently monitor investment manager compliance with the above-described requirements.

e. One-Year Winding-Down Period. The proposed amendment provides a one-year winding-down period, which commences on the date a QPAM becomes ineligible. During the winding-down period, the QPAM Exemption would continue to apply. This affords client plans with a preexisting Written Management Agreement a transition relief period during which otherwise nonexempt prohibited transactions could be unwound.

   The winding-down period relief extends both to past transactions and any transaction continued during the winding-down period. However, it does not extend to transactions entered into after the QPAM's ineligibility date.

   The relief is also conditioned on compliance with all other elements of the QPAM Exemption.

[6] That is, ten (10) years from the date of conviction or, in the case of Prohibited Misconduct, the date of the "Ineligibility Notice" issued by the DOL.

f. Sole Responsibility Requirement. The proposed amendment provides that, in order for the QPAM Exemption to apply to a transaction, the "terms of the transaction, commitments, and investment of fund assets, and any associated negotiations" must be the "sole responsibility" of the QPAM. The DOL positions this change as merely clarifying, and suggests that a manager's adherence to a plan's investment policy statement or similar set of guidelines is permitted. However, this change could significantly impact investment products for which sub-advisers are utilized or transactions in which a plan sponsor or other non-QPAM fiduciary has significant involvement.

g. Recordkeeping Requirement. The proposed amendment requires QPAMs to maintain for a period of six (6) years from the date of a transaction records necessary to enable the DOL, fiduciaries, contributing employers, and plan participants to determine that the QPAM Exemption requirements have been met with respect to such transaction. Failing this requirement would jeopardize exemption only for the specific transaction(s) affected by the recordkeeping failure (and would not result in a broader loss of relief under the QPAM Exemption). Note that other prohibited transaction class exemptions include similar recordkeeping requirements.

V. Takeaways

The proposed amendment includes not only clarifying guidance but also a number of new requirements for asset managers relying on the QPAM Exemption. Therefore, existing QPAMs, as well as asset managers who anticipate managing ERISA plan assets in the future, should familiarize themselves with the proposed amendment and closely track it through the DOL's rulemaking process. In addition to considering existing compliance strategies in light of the proposed amendment, asset managers should, with counsel, evaluate alternatives to QPAM Exemption reliance, should that become necessary. We are monitoring developments in this area.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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