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US DEPARTMENT OF LABOR PROPOSES EXTENSIVE CHANGES TO QPAM EXEMPTION

The US Department of Labor (DOL) published in the July 27, 2022, *Federal Register* a number of proposed changes to Prohibited Transaction Class Exemption (PTE) 84-14, the so-called "QPAM Exemption."[1] Investment managers of US employee benefit plan and retirement account assets commonly rely on this exemption to avoid potential violations of the prohibited transaction rules under the Employee Retirement Income Security Act of 1974 (ERISA) and parallel provisions in the Internal Revenue Code. As such, these changes, if adopted as proposed, will impact financial institutions such as SEC-registered investment advisers, banks, and insurance companies that manage the assets of ERISA plans and/or individual retirement accounts (IRAs) in, for example, separately managed accounts, collective investment trusts (CITs), and private investment funds (such as hedge funds) that are treated as holding "plan assets" of ERISA plans and/or IRAs.

If the changes go forward, they would, among other things,

- expand the scope of conduct that could disqualify a financial institution from being able to rely on the QPAM Exemption, including not only through criminal convictions but also through DOL administrative action;
- require specific provisions in QPAM investment management agreements to deal with potential disqualification, including indemnification by the QPAM for resulting client damages;
- require firms that rely on the QPAM Exemption to notify DOL that they are doing so; and
- increase the assets under management and owners' equity thresholds to qualify as a QPAM, and make those thresholds subject to annual inflation adjustments.

Comments on the proposed amendments are due on or before September 26, 2022, and final amendments, if granted, would be effective 60 days after the date of publication in the *Federal Register*.

BACKGROUND

The ERISA prohibited transaction rules prohibit most transactions between an ERISA plan and a "party in interest" to the plan unless an exemption applies. Because the term "party in interest" is very broadly defined, it is standard practice, particularly in managing assets for large pension plans, to rely on an exemption from the prohibited transaction rules rather than to determine whether the other party to the transaction is a party in interest.

The QPAM Exemption provides broad exemptive relief from the prohibited transaction rules for "qualified professional asset managers" (QPAMs), which are generally SEC-registered investment advisers, US banks or savings and loan associations, and US insurance companies that meet certain requirements. The QPAM Exemption permits a QPAM to enter into transactions generally without having to check whether the other party to the transaction is a party in interest, subject to a number of conditions and limitations. Additionally, to support compliance due diligence, it is common for managers to make representations regarding QPAM status in client agreements and side letters with plan investors and in other investment

[1] Proposed Amendment to Prohibited Transaction Class Exemption 84-14 (the QPAM Exemption), 87 Fed. Reg. 45,204 (July 27, 2022).

contract documentation, regardless of whether the exemption is being relied upon with respect to a particular client's investment transactions.

Recent Developments

One of the exemption's conditions disqualifies a QPAM from relying on the exemption if the QPAM, or an affiliate of the QPAM, has been convicted of certain crimes. There had been an ongoing question as to whether this disqualification provision applies to foreign (non-US) criminal convictions.

In 2020, under the prior administration, DOL's Office of the Solicitor took the position that foreign crimes were not covered, but that position was withdrawn the following year under the Biden-Harris administration. The current proposed amendment to the QPAM Exemption may have started as a means to formally clarify DOL's position on the foreign crimes issue but has gone much farther, proposing to make additional changes as well.

PROPOSED AMENDMENTS

The proposed amendments fall into two categories: (1) those addressing the disqualification provisions, including clarification of the types of crimes that will lead to disqualification and new procedural requirements; and (2) those addressing other provisions of the QPAM Exemption.

New QPAM Exemption Notice and Contracting Requirements and Changes to Disqualification Events

These proposed amendments would make a series of changes that, in addition to expanding the potential reasons for disqualification, also would add a series of procedural requirements for all QPAMs.

QPAM Procedural Requirements

These changes would require (1) a QPAM to notify DOL that it is relying on the exemption and to update DOL if there is a change to its legal or operating name(s), with the resulting list of QPAMs expected to be posted on the DOL website; and (2) a QPAM's investment management agreement to include a series of written terms that would apply upon a disqualifying event.

The agreement provisions would prevent the QPAM from restricting its client's ability to terminate or withdraw—for example, by imposing fees or penalties—in the event the client decides to terminate the QPAM because of the disqualification. In addition, the QPAM would be required to indemnify, hold harmless, and promptly restore actual losses to each client plan for certain damages arising out of the failure of the QPAM to remain eligible for relief under the QPAM Exemption.

> **Observation:** While the one-time notice of QPAM status would not appear to impose a significant burden, it would require all current QPAMs to notify DOL to continue to be able to rely on the exemption, and the adoption and implementation of compliance policies and procedures to renotify DOL if there is a change to the legal or operating names of the QPAM.
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> The management agreement changes, if adopted as proposed, are more onerous, in that they would (1) require changes to new and existing agreements—which will likely require review of existing agreements to make sure the changes comply with their respective amendment provisions, including whether amendments can be made by negative consent or require client signatures; and (2) likely increase the potential liabilities of a firm that becomes disqualified. For example, DOL has proposed for the indemnity to include costs for transitioning to a new investment adviser, which cost a QPAM would not

in the normal course be expected to incur. The potential liabilities may, however, be somewhat mitigated by DOL's proposal of a "winding down" provision (further described below), which would permit the QPAM in certain circumstances to continue to rely on the QPAM Exemption for existing, continuing transactions for a one-year period after the disqualification occurs. We note that DOL estimates one hour of in-house legal professional time and two minutes of clerical time to prepare and mail a one-page addition to each client agreement—both of which are likely much lower than will actually be the case.

Explicit Inclusion of Foreign Crimes

The changes would make clear that the criminal conviction disqualification applies to foreign convictions that are substantially equivalent to the currently listed disqualifying US federal or state crimes. DOL's position is that this change is a clarification, and thus applies even to misconduct that occurs prior to the date of a final amendment. DOL has asked for comment on whether there are additional categories of crimes that should be considered.

> **Observation:** A concern about foreign convictions is that it is often unclear what exactly is an equivalent "crime" under foreign law, and at what point in the foreign court process a "conviction" would be treated as having occurred. There is general guidance in the DOL notice on these points, but questions are likely to continue to arise, especially as DOL has said that the scope of what constitutes a foreign criminal conviction should be interpreted "broadly and consistent with the Department's statutorily mandated focus on the protection of plans." DOL has also suggested that, if in doubt, a QPAM may seek DOL's views on whether a foreign crime or conviction is "substantially equivalent" to a US federal or state crime. Monitoring for these occurrences may present challenges for QPAMs that are a part of global financial organizations or that have affiliates operating independently in foreign jurisdictions. DOL has asked for comment on whether it should create a formal process to deal with such questions and whether it should consider particular factors in making these determinations.
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> We further note that the proposal is a divergence from DOL's more limited approach to disqualifying crimes under another exemption, PTE 2020-02. Under PTE 2020-02, disqualifying convictions are limited to "any crime described in ERISA section 411 arising out of such person's *provision of investment advice to Retirement Investors*." (Emphasis added.) While this exemption was finalized under the prior administration, limiting disqualifying convictions to those involving fiduciary investment activities with respect to plans and retirement accounts may be an approach to consider raising in comments on the proposal.

Expansion of Circumstances That May Lead to Disqualification: 'Participating in Prohibited Misconduct'

DOL would add a new category to the disqualification provisions: "participating in Prohibited Misconduct." This is defined as any of the following:

1) Any conduct that forms the basis for a nonprosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted a covered crime, or for a substantially equivalent agreement under foreign law; note that these types of agreements were previously excluded by DOL interpretation from being considered disqualifying.

2) Engaging in a systematic pattern or practice of violating, or intentionally violating, the conditions of the QPAM Exemption in connection with otherwise nonexempt prohibited transactions.

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

Disqualification under this category would be initiated by DOL administrative action, generally following an investigation by a DOL field office and a written warning to the affected QPAM, and subject to due process procedures that would be spelled out in the exemption. DOL has asked for comments on these provisions, including whether to treat any additional activities as Prohibited Misconduct and how this process should apply to foreign convictions.

> **Observation:** This process is similar to the loss of eligibility process described in the 2020 DOL exemption for transactions based on fiduciary investment advice, PTE 2020-02. The main question will be how actively DOL would seek to impose such disqualifications. Noting that PTE 2020-02 was recently effective, we are not aware of any action taken by DOL to date to disqualify any financial institutions from using that exemption, so it is too early to use that as a guide to how DOL might implement a similar process in dealing with QPAMs.

Mandatory One-Year Winding-Down Period

If a QPAM becomes ineligible to use the exemption, the disqualification would not come into effect immediately—it would be subject to a one-year winding-down period. This is intended to permit time for existing plan clients of the disqualified QPAM to decide whether to terminate the manager, given that manager transitions can be complex and take time to put in place. However, the winding-down period as proposed could only be used to transition existing clients out of existing investments. It would not be available for any new transactions in existing client accounts, and also would not be available for transactions on behalf of any new clients.

The QPAM would be required to provide a detailed notice of its disqualification to its plan clients and to DOL within 30 days of its ineligibility date, describing, among other things, the required management agreement provisions described above allowing the plan to terminate the QPAM without penalties or charges and the indemnification obligation.

> **Observation:** This winding-down period is intended to take time pressure not only off the QPAMs that become ineligible to use the exemption and their client plans, but also off DOL in dealing with individual exemption requests to make exceptions for QPAMs facing criminal convictions. Many recent individual exemptions have granted transitional relief for a one-year period to give DOL additional time to consider whether to provide longer relief and under what conditions. However, because no new transactions would be permitted during the one-year winding-down period, it would still be in the interests of a QPAM subject to disqualification to have an individual exemption in place immediately upon its ineligibility date.

Requesting an Individual Exemption

Since the mid-1980s, financial institutions that lost the ability to rely on the QPAM Exemption due to a disqualifying crime have applied for, and often received, an individual exemption to permit them to use the QPAM Exemption despite the disqualification. Over the last decade, DOL has, based in part on the nature of the convictions involved, imposed additional conditions and restrictions, and also occasionally denied relief. Most significantly, while the earlier exemptions were granted for the full 10 years of the disqualification period, recent exemptions have been limited to five years or, in a number of instances, one year, requiring the financial institution to apply for additional relief to cover the full 10 years.

The proposed amendment would specifically permit a disqualified QPAM to apply for supplemental exemptive relief. It would require the QPAM to file its application based on DOL's most recently granted individual exemptions affording this relief, or otherwise explain in detail why a change is necessary and in the interests of, and protective of, the affected plans, plan participants and beneficiaries, and/or IRA owners. The application would also be required to provide detailed information quantifying the specific cost or harms, if any, that client plans would suffer if the firm could not rely on the QPAM Exemption after the winding-down period.

DOL added in the preamble that it might also require a certification and independent audit demonstrating that the firm met the QPAM Exemption conditions, including the winding-down conditions, during the one-year winding-down period. DOL further suggests that a QPAM could request more limited relief to cover specific transactions that could not be unwound during the one-year winding-down period without harm or losses to the plans.

> **Observation:** This provision would not appear to provide any special access, consideration, or assurances under the DOL exemption process beyond DOL's standard exemption application procedures—it specifically says that DOL's acceptance of an exemption application is no guarantee that DOL will grant the exemption. It would serve instead to place QPAMs on notice of what DOL would look for in such applications and the limits on what DOL may be willing to provide.

Clarifications and Updates to Other QPAM Exemption Provisions

QPAM Exclusive Authority Requirement

The DOL staff has had an ongoing concern about the so-called "QPAM for a day" or "rent-a-QPAM" scenario: where a QPAM is brought in to approve a fully negotiated transaction and is therefore not providing any independent fiduciary role in that transaction as a discretionary investment manager.

While this has been addressed in previous guidance, DOL is now proposing to formally amend the exemption to require that (1) the "terms of the transaction, commitments, investment of fund assets, and any corresponding negotiations on behalf of the Investment Fund are the sole responsibility of the QPAM," and (2) the prohibited transaction relief in the exemption applies "only in connection with an Investment Fund that is established primarily for investment purposes" and that "[n]o relief is provided under this exemption for any transaction that has been planned, negotiated, or initiated by a Party in Interest, in whole or in part, and presented to a QPAM for approval because the QPAM would not have sole responsibility with respect to the transaction."

According to DOL, this would make clear that (1) the QPAM may not act as a "mere independent approver of transactions," but must have and exercise discretion over the investment of the plan's assets and related negotiations for the exemption to apply; and (2) a party in interest should not be involved in any aspect of the transaction, aside from ministerial duties and oversight.

> **Observation:** As emphasized in a footnote to the description of this change in the preamble, the language would make the exemption unavailable for noninvestment transactions, giving as a specific example the hiring of a party-in-interest service provider for a welfare plan. As QPAMs currently rely on the exemption to hire service providers, this may require some clarification, such as whether hiring a sub-adviser for the particular investment fund would be a transaction that includes an "investment component" (the term DOL uses in the footnote to distinguish noninvestment transactions).

The other point made in this footnote is that the exemption would be unavailable "when a plan sponsor desires to enter into a party in interest transaction with its plan but leaves the ultimate determination and review to a QPAM." This would be contrary to current practice, where a plan sponsor may identify a possible transaction for which, on account of prohibited transaction issues, it turns to a QPAM to negotiate the transaction. In such instances, the QPAM is not a "mere approver," but rather has a substantive role in determining whether the transaction goes forward and on what terms. But the proposed language, excluding a transaction "that has been planned, negotiated, or initiated by a Party in Interest, in whole or in part, and presented to a QPAM for approval," appears to be quite broad. This also may require clarification.

The role of those providing oversight of a QPAM may also require clarification. For example, given the ongoing monitoring obligations of a fiduciary responsible for oversight of a QPAM, prior interpretations of the QPAM exemption have allowed for the QPAM to consult with the overseeing fiduciary, and for review by the overseeing fiduciary of contract documentation negotiated by the QPAM prior to execution.

Increase in Asset and Equity Thresholds

This amendment would make the following changes:

- Owners' equity for banks, savings and loan associations, and insurance companies: increase from $1 million to $2.72 million
- Registered investment advisers:
  - Assets under management: increase from $85 million to $135.87 million
  - Owners' equity: increase from $1 million to $2.04 million

In addition, going forward, DOL would be able to make annual adjustments for inflation to these thresholds, rounded to the nearest $10,000, no later than January 31 of each year.

Recordkeeping

The amendment would add a requirement for QPAMs to maintain records demonstrating compliance with the exemption for six years, consistent with a standard provision included in many other prohibited transaction class exemptions and individual exemptions.

GENERAL OBSERVATIONS

These changes to the QPAM Exemption, which was last amended in 2010, would significantly affect a wide array of parties, such as financial institutions that manage plan assets in reliance on the QPAM Exemption or represent to clients that they meet the requirements to be a QPAM, financial institutions that engage in transactions opposite ERISA plans in reliance on the QPAM Exemption, and plan sponsors, plan trustees, plan investment committees, and CIT trustees that rely on their investment advisers and independent fiduciaries to be QPAMs, including as independent fiduciaries to handle potentially conflicted transactions. All of these parties should consider the impact of these proposed changes and whether to submit comments to DOL.

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