Going Beyond One's "Conviction(s)"? DOL Proposes Significant Changes to QPAM Exemption

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The Department of Labor (the "DOL") on July 27, 2022, on its own initiative, proposed changes to Prohibited Transaction Class Exemption ("PTCE") 84-14, commonly referred to as the "QPAM Exemption" (the "Proposal"). In general terms, the QPAM Exemption offers relief from the "per se" prohibitions of Section 406(a) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the corresponding provisions of Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code") for transactions involving retirement plans and other entities that are subject to the prohibited transaction provisions of ERISA or the Code (collectively "Plans") with "parties in interest" (or "disqualified persons" within the meaning of the Code[1]), where the Plan is managed by a qualified professional asset manager (a "QPAM") and the other conditions of the QPAM Exemption are met. The Final Rule imposes a variety of new disclosure obligations on funds. The table below provides an overview of these new obligations and identifies some of the important aspects of the new disclosure requirements.

SUMMARY

The Proposal would generally:

- **Substantially Expand Disqualification Events**. The circumstances that vitiate the availability of the QPAM Exemption for a period of ten years are dramatically expanded, including foreign convictions, and other "Prohibited Misconduct" such as non-prosecution agreements and deferred prosecution agreements with respect to covered crimes and participation in certain other prescribed bad acts;

- **Impose a One-Year Winding-Down Period for the QPAM – Triggered on Covered Conviction or Prohibited Misconduct**. The Proposal imposes a one-year mandatory "winding-down" period and requirement to provide a detailed notice to clients following a covered conviction or the DOL's final determination of Prohibited Misconduct, during which only pre-existing transactions would obtain relief under the QPAM Exemption – unless the QPAM receives individual relief within such time period, which relief would likely be subject to substantial conditions and senior official certifications of compliance;

- **Require Written Assurances and Indemnities to Plan Clients**. The Proposal conditions relief on the provision of assurances in written management agreements with Plan clients that, in the event of the loss of the QPAM Exemption, the QPAM will not restrict the Plan's ability to terminate or withdraw from the arrangement with the QPAM and would be required to indemnify Plans for costs (including transition costs);

- **Mandate QPAM Registration with the DOL for National Database**. Each QPAM using the QPAM Exemption would be required to provide notice to the DOL of QPAM status, with the DOL to maintain a publicly available database of QPAMs;

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[1] For purposes of simplicity, the term "parties in interest" is generally used herein to refer to both parties in interest and disqualified persons

- **Impose Recordkeeping Requirements on QPAM Exemption Compliance and Compel Access by Regulators, Plans and Participants and Beneficiaries.** QPAMs would be required to maintain records to show evidence of compliance with the QPAM Exemption, and permit access to those records not only by regulators but also by Plan fiduciaries and Plan participants and beneficiaries;

- **Offer New Color on QPAM as Required Decision-Maker**. The Proposal offers important new color about the DOL's views about the QPAM's role as sole decision-maker for transactions entered into in reliance under the QPAM Exemption; and

- **Increase Client Assets Under Management and Shareholder Equity Thresholds**. The Proposal would increase the assets under management and shareholder capital requirements for eligibility.

BACKGROUND

ERISA and the corresponding provisions of the Code prohibit a wide range of transactions between Plans and parties in interest. Because the definition of "party in interest" includes not only a Plan's sponsor and fiduciaries, but also mere service providers (e.g., banks, broker-dealers, custodians, trustees, etc.) and certain of their affiliates, the prohibited transaction rules can apply extremely broadly, thus requiring that there be an exemption in order for the transaction to proceed.

While other exemptions may be available with respect to any given transaction, the QPAM Exemption is arguably the most utilized by managers of Plan accounts in the institutional market. In addition, some Plans may even use QPAM status as a type of proxy for assessing a given manager's sophistication, regardless of whether the QPAM Exemption actually needs to be used in any given case.

A QPAM is a U.S. registered investment advisor, U.S. bank or trust company or insurance company doing business with Plans in more than one state with substantial assets under management that meets certain minimum capital requirements. In granting the QPAM Exemption in 1984, the DOL indicated that, since such large regulated financial services institutions would be more likely to be independent of Plan sponsors and other parties involved in Plan transactions, they would be more likely to withstand improper influence from parties in interest.[2]

One of the conditions of the QPAM Exemption is that neither the QPAM nor certain of its affiliates be convicted of certain crimes. This issue has in the past required institutions to seek individual exemptive relief where an affiliate of the QPAM has been convicted of an enumerated crime, whether or not the crime occurred abroad or otherwise had anything to do with the management of ERISA assets. Sometimes, the issue arose by virtue of an acquisition of an entity that had (or that had affiliates that had) been convicted of an enumerated crime.

While historically the DOL had provided individualized relief in this regard without much controversy, over the past decade or so, the DOL has indicated that it believes greater emphasis should be placed on franchise-wide "integrity." Thus, the relatively recent individual exemptions have included more robust conditions than in the past. In some

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2 "This class exemption was developed, and is being granted . . . based on the essential premise that broad exemptive relief . . . can be afforded for all types of transactions in which a plan engages only if the commitments and investments of plan assets and negotiations leading thereto, are the sole responsibility of an independent investment manager . . . . [T]he underlying concept of the QPAM exemption [is] the transfer of plan assets to an independent, discretionary manager." 45 Fed. Reg. 9494, 9497 (Mar. 13, 1984), corr'd 50 Fed. Reg. 41430 (Oct. 10, 1985).

recent cases, the DOL has even declined to provide relief.[3] The DOL thus undertook the Proposal on its own initiative, in part, to address the growing number of institutions that have had to seek individual relief and because "[s]ubstantial changes have occurred in the financial services industry since the [DOL] granted the QPAM Exemption in 1984 . . . . [including] industry consolidation caused by a variety of factors and an increasingly global reach for financial services institutions, both in their affiliations and in their investment strategies, including those for Plan assets."

DISCUSSION

Expansion of the Scope of Disqualifying Events

Foreign Convictions. The Proposal would definitively confirm that foreign (as well as U.S.) convictions of the QPAM or covered affiliates can serve as disqualifying events. Under the Trump Administration, the DOL had issued a letter (the "2020 Letter") to the Securities Industry and Financial Markets Association stating that it would not view a conviction under foreign law as a disqualifying event. However, in a follow-up supplement issued under the Biden Administration, the 2020 Letter was essentially rejected because, according to the DOL, it was "issued through a flawed process and was based on a legal analysis that was inadequate to support abandoning the DOL's long standing position."

Thus, "although the DOL has a longstanding practice of considering individual exemption applications from QPAMs in connection with foreign convictions," the Proposal would "remove any doubt that [the disqualification condition] of the QPAM Exemptions applies to foreign convictions that are substantially equivalent to the listed U.S. federal or state crimes." The Proposal would cover the same U.S. federal and state crimes as are currently covered by the QPAM Exemption, and the proposed definition of "Criminal Conviction" would expressly cover foreign convictions that include those "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 U.S. federal or state crimes that serve as disqualification events.[4] The DOL acknowledged that interpretative issues may arise as to whether or not a given foreign crime would constitute an equivalent disqualifying U.S. crime. Accordingly, although the DOL states that "impacted QPAMs should interpret the scope of this provision broadly," it also provides that "the QPAM may seek the Department's view regarding whether the foreign crime, conviction, or misconduct is substantially equivalent to a U.S. federal or state crime."

It is important to emphasize that the disqualification rules are applicable to the QPAM and covered affiliates, which include, among others, five-percent owners and even in some cases individual employees. In the preamble to the

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3 See, e.g., Miles Weiss, *BNP Paribas Says It Will Lose Access to Some U.S. Pension Assets*, BLOOMBERG, December 20, 2018; Brian Croce, *DOL denies BNP Paribas exemption to manage U.S. retirement assets*, PENSIONS & INVESTMENTS, Dec. 21, 2018; Elizabeth Dexheimer & Greg Farrell, *U.S. Denies RBS Permission to Manage Some Pension Fund Assets*, BLOOMBERG LAW, Oct. 13, 2016 and; Hazel Bradford, *Labor Department denies RBS request for money management exemption*, PENSIONS & INVESTMENTS, Dec. 21, 2018. Certain Democratic Members of Congress and U.S. Senators have also been involved in the call for greater integrity. See, e.g., *Legal Democratic Lawmakers Raise Concerns over Banks' Efforts to Secure DOL Waivers*, U.S. COMMITTEE ON FINANCIAL SERVICES DEMOCRATS, June 4, 2015; Noor Zainab Hussain, *Senator Warren asks U.S. Labor Dept. to deny Credit Suisse exemption after bribery settlement*, REUTERS, February 11, 2022.

4 The Preamble states "changes also are intended to make clear that all crimes listed in the definition and applicable under Section I(g) are covered by the provision, regardless of whether they also are expressly referenced in ERISA section 411. Although the definition of Criminal Conviction broadly includes the convictions listed in ERISA section 411, the modified text makes clear that the listed convictions are not limited by any other part or aspect of ERISA section 411."

Proposal (the "Preamble"), the DOL specifically cautioned that "QPAMs should be careful when entering into joint ventures or other passive investment ventures where another entity's ownership interest could jeopardize the QPAM's ability to rely upon the QPAM Exemption."

Non-Prosecution Agreements, Deferred Prosecution Agreements and Participation in Other Prohibited Misconduct. The Proposal would add a new disqualification event where the QPAM or a covered affiliate participates in (which would expressly include knowingly approving of the conduct or having knowledge of such conduct from occurring without reporting the conduct to appropriate compliance personnel) any of the following (collectively referred to as "Prohibited Misconduct"):

- engaging in "any conduct that forms the basis for a non-prosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted a [disqualifying] crime [and similar arrangements under foreign law];"[5]
- "engaging in a systematic pattern or practice of violating the conditions of [the QPAM Exemption] in connection with otherwise nonexempt prohibited transactions;"
- "intentionally violating the conditions of [the QPAM Exemption] in connection with otherwise non-exempt prohibited transactions; or"
- "Providing materially misleading information to the [DOL] in connection with the conditions of the exemption."

"Participating in" means "not only actively participating in the Prohibited Misconduct, but also to knowing approval of the conduct, or knowledge of such conduct without taking active steps to prohibit such conduct, including reporting the conduct to appropriate compliance personnel." In addition, the Preamble states that the new inclusion of non-prosecution and deferred prosecution agreements in the list of disqualifying events is important because "simply by entering into non-prosecution and deferred prosecution agreements with prosecutors to side-step the consequences [of a conviction]" would frustrate the goal of promoting franchise-wide integrity.

New Requirements Where There Is a Disqualification Event

Covered Conviction and Notice of Prohibited Misconduct. Under the QPAM Exemption as currently in effect, the QPAM ceases to apply for a period of 10 years following a conviction. The Proposal reconfirms this point, and adds that, in the case of Prohibited Misconduct, the beginning date begins when the DOL sends a written notice of ineligibility (an "Ineligibility Notice"). Where the DOL concludes that Prohibited Misconduct has occurred, it would first send a written warning before issuing any such Ineligibility Notice. The QPAM would have 20 days to respond to the warning and would then have an opportunity to be heard "limited to one conference" to be scheduled within 30 days of the QPAM's request. (The DOL can decide to grant additional conferences). The DOL notes that it "intends to rely on its enforcement authority and program to detect a QPAM's participation in [Prohibited Misconduct]."

It is unclear whether the DOL's proposed timetable would reasonably permit the QPAM to timely gather, organize and marshal the necessary information. Indeed, one can imagine that the task could be even more daunting where the

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5 We have previously discussed deferred prosecution agreements in the context of the QPAM Exemption. See Andrew L. Oringer, *Maybe Not Such a Bad Actor – Department of Labor Clarifies,* DECHERT NEWS & INSIGHTS, November 11, 2013.

alleged malfeasance occurred at an affiliated entity, particularly where the affiliate is in a different business line or is a non-U.S. affiliate.

Mandatory One-Year "Winding-Down" Period. While the consequences of a disqualifying conviction under the QPAM Exemption as currently in effect are already severe, the Proposal would make a number of additional changes in the case of both disqualifying convictions and Written Notices of Prohibited Misconduct. Managers would not be able to engage in any transactions in reliance on the QPAM Exemption on or following the date on which the DOL sends an Ineligibility Notice (the "Ineligibility Date"). In addition, the QPAM Exemption would not be available for new client Plans. Instead, for existing Plan clients and for existing transactions only, a "one-year winding-down period" would be triggered in which QPAM Exemption eligibility status continues through a one-year winding-down period. The availability of the grace period would itself be conditioned on further ongoing avoidance of covered convictions and Prohibited Misconduct events. In addition, to ensure Plans are protected from bad actors, "the QPAM must not employ or knowingly engage any individual that participated in conduct that is the subject of a [covered criminal conviction] or Ineligibility Notice."[6]

The Proposal contemplates that many QPAMs would utilize the one-year winding-down period to obtain individual relief from the DOL. The Proposal prescribes a number of prerequisites for consideration of relief. To begin with, the Preamble cautions that applicants "review the DOL's most recently granted individual exemptions" for such relief "with the expectation that similar conditions will be required if an exemption is proposed and granted." Applicants would be able to petition for relief deviating from those conditions, but they would need to be prepared to provide a "detailed explanation" of the reason such changes are "necessary" and in the best interests of Plans. The Proposal also states that the relief would be conditioned on "a certification by a senior executive officer of the QPAM (or comparable person)" that "all" of the conditions of the winding-down period were met, and the completion of "an independent audit reviewing the QPAM's compliance with the conditions of the one-year winding down period." Then, within 30 days of the Ineligibility Date, the QPAM would have to provide written notice of its ineligibility under the QPAM Exemption and an "objective description of the facts and circumstances upon which the [covered conviction] or Ineligibility Notice is based" to be "written with sufficient detail, consistent with the QPAM's duties of prudence and undivided loyalty, to fully inform a Plan fiduciary of the nature and severity of the criminal conduct or Prohibited Misconduct."

A question may arise under these rules as to whether a manager might need, as a practical matter, to unwind transactions well in advance of the expiration of the winding-down period. The resulting required planning and coordination could be a challenge both for QPAMs seeking relief and for Plan fiduciaries charged with the decision of whether to retain the QPAM or seek other managers. While the Proposal uses the term "winding-down period," a Plan fiduciary would presumably have a duty independently to make decisions in the best interest of Plan participants and beneficiaries regarding, among other things, the decision to continue the retention of the existing manager. The timing and other issues regarding such a decision may be made more complicated the longer a final determination of the QPAM's individual exemption request remains outstanding due to the greater the potential for difficulties. It remains to be seen whether the DOL will consider practical problems of that nature in deciding how to finalize the Proposal.

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6 For covered criminal convictions, this applies regardless of whether the individual is separately convicted in connection with the criminal conduct.

New Notice to the DOL

The QPAM Exemption does not presently require any registration or other filings with the DOL. The satisfaction of the applicable conditions has been self-executing. The Proposal would add a new requirement requiring each entity that intends to rely on the QPAM Exemption to notify the DOL by email of the legal name of the entity and any name the entity may be operating under. The DOL notes that it "intends to keep a current list of entities relying upon the QPAM Exemption on its publicly available website."

New Requirements for Management Agreements Relating to Exits and Indemnification

The Proposal would require new written guarantees to Plan clients in applicable investment management agreements. The written provisions would need to make clear that the QPAM "will not restrict [the Plan's] ability to terminate or withdraw from the arrangement with the QPAM" in the event the QPAM Exemption becomes unavailable. In addition, the condition requires that the written agreement stipulate that the QPAM "indemnify, hold harmless, and promptly restore actual losses to each client Plan for any damages directly resulting from a violation of applicable laws, a breach of contract, or any claim arising" out of the QPAM's failure to meet the requirements of the QPAM Exemption by reason of a covered conviction or Prohibited Misconduct. "Actual costs" for this purpose "include losses and related costs arising from unwinding transactions with third parties and from transitioning Plan assets to an alternative asset manager" as well as any excise taxes that may arise.

Interpretive questions in this regard could particularly arise where, for example, there is an intent to utilize the QPAM Exemption but use of the QPAM Exemption is ultimately unnecessary (e.g., because the transaction turns out not to have been prohibited at all, or because another exemption is applicable).

Clarification Regarding the QPAM's Role

Part I(c) of the QPAM Exemption and prior DOL pronouncements have made clear that the QPAM must be responsible for the decision to negotiate and approve the transaction for which the QPAM Exemption is sought. The DOL has been historically concerned with so-called (as sometimes colloquially known) "rent-a-QPAMs," where a plan sponsor or other person may negotiate most (if not all) of the material terms of a given transaction and then present it to the QPAM to approve it. With the Proposal, the DOL would provide additional clarification regarding these matters, stating in the Preamble that no "relief is provided . . . for any transaction that has been planned, negotiated or initiated by a party in interest, in whole or in part, and presented for approval to the QPAM." Reasoning that the QPAM would not then have "sole responsibility," the Preamble states that "a party in interest should not be involved in any aspect of the transaction, aside from certain ministerial duties and oversight associated with plan transactions, such as providing general investment guidelines to the QPAM." In the Preamble, the DOL expressly states that the proposed regulatory "language is intended to preclude, for example, transactions that are negotiated by an employer but later presented to the QPAM for approval." Under the QPAM Exemption as currently in effect, Part I(c) may be satisfied where "a QPAM and those persons possessing the power to appoint the QPAM . . . engag[e] in discussions and establish[] guidelines (for purposes of insertion into a written management agreement . . .) with respect to the investment objectives and policies [of the Plan] and their relationship to the assets of the plan's portfolio as a whole."[7]

It remains to be seen whether the DOL will further clarify how the concepts of required unilateral QPAM authority, on the one hand, and permissible contractual guidelines, restrictions and delegations to and by non-QPAMs will

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[7] 49 Fed. Reg. 9494, 9497 (Mar. 13, 1984), corr'd 50 Fed. Reg. 41430 (Oct. 10, 1985).

integrate under the language of the Proposal as finalized. For example, presumably the DOL's blanket statement (quoted above) that a party in interest should not (with certain exceptions) "be involved in any aspect of the transaction" refers to the structure of the Plan's fiduciary decision-making, and, at a minimum, does not generally refer to (i) a party in interest that is a transaction counterparty acting for its own interest in a transaction or (ii) a party in interest that is attempting to make a Plan aware of or otherwise market an investment opportunity. While arguably the context of the DOL's Preamble is clear in this regard, additional clarification on these points in any finalization of the Proposal might be welcome.

New Recordkeeping Requirements; Access to Information by Plans and Plan Participants and Beneficiaries

The Proposal would mandate new recordkeeping requirements by which QPAMs would be required to keep records "demonstrating compliance" with the QPAM Exemption. It is not certain what the DOL envisions for firms to "demonstrate" compliance. The condition also requires that the records be "kept in a manner that is reasonably accessible for examination" to show compliance with the QPAM Exemption. The records generally would have to be made available not only to regulators, but to "any contributing employer and any employee organization whose members are covered by a plan" that is a client of the manager and "any participant or beneficiary" of those Plans and individual retirement account owners.[8]

Increased Eligibility Thresholds

The Proposal would increase two important eligibility thresholds for QPAM status. First, a QPAM would be required to have client assets under management over $135,870,000 (up from $85,000,000) as of the close of its last completed fiscal year. Second, the QPAM that is a U.S. registered investment adviser would be required to have shareholder's equity of over $2,040,000 (up from $1,000,000), and banks, savings and loan associations and insurance companies would need to have over $2,720,000 in owner's equity.[9] There would then be automatic cost-of-living increases. A question may arise as the DOL proceeds with finalization of the Proposal as to whether an adjustment to the current thresholds to make up for lost prior increases under an exemption that does not provide therefor (indeed, it is noted that the DOL did not build in automatic escalators even when the thresholds under QPAM Exemption were specifically amended) is fair, especially to smaller managers.

Comment Period

The comment period extends until September 26, 2022. In addition to comments to the proposed changes to the QPAM Exemption itself, the DOL has also asked for specific input on a number of questions.

CONCLUSION

The QPAM Exemption is arguably one of the more significant and widely used exemptions from the prohibited transaction rules of ERISA (and the Code). The Proposal contemplates significant changes to the QPAM Exemption.

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8 Compare the approach taken in Best Interest Contract Exemption, as finalized, prior to the revocation DOL's 2016 amended investment advice fiduciary rule, vacated by the Fifth Circuit.

9 In some cases, the QPAM Exemption permits alternative methods for compliance with the shareholders equity requirement through guarantees by certain affiliates and other parties

Although it is uncertain at this time whether or how the Proposal will ultimately be finalized, the scope of the changes would suggest that affected parties (including, for example, certain money managers, their Plan clients and, as applicable, transaction counterparties) should carefully consider the changes that would be made by the Proposal and monitor (and possibly consider commenting during) the DOL's administrative process as it progresses to possible finalization of the proposed changes.

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