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## ERISA

# DOL Proposes Significant Changes to the QPAM Exemption for Managing ERISA Assets

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On July 26, 2022, the U.S. Department of Labor (DOL) released a [proposal](#) (Proposal) to amend the Prohibited Transaction Class Exemption 84-14, known as the qualified professional asset manager (QPAM) exemption. Managers of pension and welfare funds – including managers of PE funds and hedge funds that are or may be deemed to have “plan assets” under the DOL’s plan asset regulations (collectively, Investment Managers) – should begin evaluating the possible impact of those revisions and assess what changes to processes and procedures will be required for continued reliance on the QPAM exemption if the Proposal becomes final.

This article lays out significant changes contemplated by the Proposal, including an increase in minimum capitalization and asset under management (AUM) requirements to qualify as a QPAM; new rules regarding notification, registration and recordkeeping; and additional terms for management agreements. In addition, the article offers an overview of the QPAM exemption, its significance to the private funds industry and suggestions for how fund managers can prepare for potential adoption of the changes in the Proposal.

For more on issues affecting pension funds, see [“DOL Proposes Rule Favoring Inclusion of ESG Factors in Pension Plan Investment Decisions, Further Negating Contrary Trump-Era Guidance”](#) (Nov. 30, 2021); and [“Marketing to Public Pension Plans: Municipal Advisors; Pay to Play Laws; and Gift and Entertainment Rules \(Part One of Two\)”](#) (May 28, 2019).

## Importance of the QPAM Exemption

The Employee Retirement Income Security Act of 1974 (ERISA) broadly prohibits transactions between a plan and a “party-in-interest” unless an exemption applies. Similarly, the Internal Revenue Code of 1986 (IRC) prohibits transactions between a plan and a “disqualified person” unless an exemption applies.

A party-in-interest or disqualified person generally includes a fiduciary of a plan; a person who provides services to a plan; and the employer that sponsors a plan and its affiliates. Although the terms party-in-interest and disqualified person are not exactly the same, for simplicity this article will refer only to parties-in interest. Given the broad scope of who qualifies as a party-in-interest, many typical investment transactions engaged in by managers of pension and welfare funds – including Investment Managers – would simply be prohibited.

First issued in 1984, the QPAM exemption allows Investment Managers meeting the qualification requirements for QPAM status to engage in a variety of transactions that might otherwise be prohibited by ERISA and the IRC. Absent reliance on the QPAM exemption, many Investment Managers would need to either restrict their scope of investments or rely on other narrower or vaguer exemptions. Further, without the QPAM exemption, Investment Managers would need to undertake the onerous task of determining whether their counterparties are parties-in-interest at the time of a transaction and monitor them thereafter for changes that could cause the counterparties to become parties-in-interest during a continuing transaction.

Note that prohibited transactions do not require intent or losses. Merely engaging in a transaction that is prohibited – even if it turns out to be an excellent investment for a client plan – is still prohibited and can result in excise taxes and other liability. Also, a fiduciary can face exposure to liability for a prohibited transaction engaged in by a co-fiduciary. Therefore, rather than run the risk of a prohibited transaction, many large pension plans will not invest in a PE or hedge fund unless the manager of the fund represents either:

1. that it will not hold plan assets for purposes of ERISA; or
2. that it will qualify as a QPAM.

Investment Managers of large pension and welfare funds generally will not be retained unless the Investment Manager qualifies as a QPAM. Further, prime brokerage agreements generally require similar representations by the fund manager.

See our two-part series: [“How PE Funds Can Navigate Fiduciary Duties and Controlled Group Liability Under ERISA”](#) (Nov. 3, 2020); and [“Tips for Avoiding ERISA Prohibited Transactions and for Satisfying Plan Asset Exemptions”](#) (Nov. 10, 2020).

## Existing QPAM Requirements

The existing QPAM exemption sets forth two sets of rules: criteria for qualifying as a QPAM (Qualification Requirements); and criteria for a transaction the QPAM engages in to be covered by the QPAM exemption (Transactional Requirements).

### Qualification Requirements

Under the existing QPAM exemption, an independent Investment Manager can qualify as a QPAM if it:

- is a registered investment adviser under the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, total AUM exceeding \$85 million; and
- has shareholders' or partners' equity in excess of \$1 million, as reflected in the most recent balance sheet prepared (in accordance with GAAP) within the two-year period preceding the particular transaction (or have an unconditional guarantee of all the fiduciary's liabilities by an affiliate meeting those equity criteria).

Because they are regulated by federal and/or state authorities, separate qualification requirements apply to banks; savings and loan associations; and insurance companies. A QPAM must acknowledge in a written management agreement that it is a fiduciary of each plan that it manages as a QPAM, but there is currently no filing requirement or approval process for an Investment Manager to be a QPAM.

## **Transactional Requirements**

For a specific transaction to qualify for the QPAM exemption, the transaction must meet each of the following criteria:

1. The party-in-interest must not have authority to appoint or terminate the QPAM or authority to negotiate the terms of the QPAM's engagement. In addition, the party-in-interest must not have exercised that authority within the one-year period preceding the transaction.
2. The terms of the transaction must be negotiated on behalf of the plan under the authority and general direction of the QPAM.
3. The party-in-interest cannot be the QPAM or its affiliate, nor may the QPAM generally have a 10-percent or more ownership interest in the party-in-interest.
4. The transaction cannot be entered into with a party-in-interest for any plan whose assets managed by the QPAM represent more than 20 percent of the QPAM's AUM at the time of the transaction.
5. The terms of the transaction must be at least as favorable to the plan as the terms generally available in an arms' length transaction between unrelated parties.
6. Neither the QPAM nor any affiliate of the QPAM can have been convicted of a felony within the 10-year period preceding the transaction.

A prohibited transaction that is ineligible for the QPAM exemption can also occur if, on behalf of a client plan or a plan assets fund, an Investment Manager engages in a transaction in which the Investment Manager has a conflict of interest or could benefit personally. Further, the QPAM ex-

emption does not apply to certain lending and mortgage financing transactions. Finally, the QPAM exemption does not shield a QPAM from breach of fiduciary duty claims.

See “[How Can Fund Managers Managing Plan Asset Funds Comply With the QPAM and INHAM Exemption Requirements?](#)” (Oct. 3, 2012).

## Proposed Changes to the QPAM Exemption

If adopted, the Proposal would, among other things:

- increase the minimum capitalization and AUM requirements for an Investment Manager to qualify as a QPAM;
- require QPAMs to register with the DOL; and
- require that agreements between QPAMs and their clients be amended to include specific indemnity terms and other contractual provisions.

As drafted, the final amendments will become effective 60 days after they are finalized and do not contain any grandfathering principles for existing QPAMs.

Interested parties originally had until September 24, 2022 – *i.e.*, 60 days from July 26, 2022 – to submit comments on the Proposal to the DOL. After receiving extension requests, however, on September 6, 2022, the DOL announced an extension of the comment period until October 11, 2022, which will be supplemented by a subsequent comment period beginning in mid-November 2022. The DOL also advised that it will hold an online public hearing on the Proposal on November 17, 2022.

The principal amendments to the QPAM exemption proposed by the DOL are as follows.

### New Notification Requirement

The Proposal requires any QPAM who wishes to rely on the QPAM exemption to notify the DOL via email ([QPAM@dol.gov](mailto:QPAM@dol.gov)) of its name, as well as any name the QPAM operates under. That notification only needs to be made once, unless the information changes or if the QPAM no longer intends to rely on the QPAM exemption.

The existing QPAM exemption does not require any filing or notice to the DOL. Although the Proposal requires notice to be delivered to the DOL, it does not require DOL approval of QPAM status.

### Increased AUM and Capital Requirements

The Proposal increases the total AUM requirement from \$85,000,000 to \$135,870,000 and the shareholder/partner equity requirement from \$1,000,000 to \$2,040,000. Under the Proposal, those

thresholds would be subject to annual adjustment for inflation.

## Expand the Scope of Disqualifying Conduct

The Proposal expands the list of disqualifying crimes to expressly cover foreign convictions, and it extends disqualification to “any conduct that forms the basis for a non-prosecution or deferred prosecution agreement that, if successfully prosecuted, would have constituted a crime.” Under the Proposal, an investment adviser cannot rely on the QPAM exemption if:

1. the adviser proactively participates in any of the prohibited misconduct;
2. knowingly approved the misconduct; or
3. has knowledge of the misconduct without taking proactive steps towards prevention.

See our three-part series “Navigating the SEC’s Interpretation Regarding an Investment Adviser’s Standard of Conduct”: [What It Means to Be a Fiduciary](#) (Dec. 3, 2019); [Six Tools to Systematically Identify Conflicts of Interest](#) (Dec. 10, 2019); and [Three Tools to Systematically Monitor Conflicts of Interest](#) (Dec. 17, 2019).

## Required Terms of Written Management Agreements

Under the existing rules, a QPAM must acknowledge in writing that it is a fiduciary of each plan that it manages. The Proposal would also require a QPAM’s written engagement agreement with its clients to include the following provisions:

1. terms that allow the client to terminate the QPAM without restriction or imposition of any fees, penalties or charges (other than reasonable charges disclosed in advance that are designed to prevent abusive investment practices or ensure equitable treatment among investors in a pooled fund) if the QPAM or its affiliates engage in conduct resulting in a criminal conviction or if the DOL issues a “written ineligibility notice” that the QPAM is ineligible to be a QPAM;
2. terms requiring the QPAM to 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 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 written ineligibility notice. Actual losses are defined to include losses and costs arising from unwinding transaction with third parties, as well as exposure to prohibited transaction excise taxes; and
3. terms restricting the QPAM from employing or knowingly engaging any individual that participated in conduct that is the subject of a criminal conviction or written ineligibility notice within the past 10 years.

## Wind-Down Period



The Proposal requires a QPAM that becomes ineligible due to a criminal conviction or a written ineligibility notice to engage in a wind-down period of no more than one year, including unwinding transactions existing at the time of disqualification. During the one-year wind-down period, the QPAM exemption can still apply as to clients in place before the wind-down period commenced. In addition, during the wind-down period the QPAM cannot rely on the QPAM exemption for transactions unrelated to the wind-down.

Within 30 days after becoming ineligible, the QPAM must also notify the DOL and each client plan of its ineligibility and detail the reasons for its ineligibility. After the wind-down period, the (former) QPAM may not rely on the QPAM exemption for ten years, unless it obtains an individual exemption from the DOL.

See [“How Fund Managers Can Address End-of-Life Issues in Closed-End Funds”](#) (Mar. 19, 2019).

## **New Recordkeeping Requirements**

Unlike some other prohibited transaction class exemptions, the existing QPAM exemption does not include a recordkeeping component. The proposed amendments will require QPAMs to maintain transaction records for a period of six years following the date of a covered transaction. The records must generally be made available to:

- the DOL, the IRS or other federal or state regulators;
- any fiduciary of a client plan;
- any employer or employee organization whose members are covered by a client plan; and
- any participant or beneficiary of a client plan or IRA.

## **What Should Investment Managers Do?**

Investment Managers relying upon the QPAM exemption should keep a close eye on future developments. After the DOL receives and reviews public comments, it will likely proceed to issue a final revised QPAM exemption. In its current proposed form, no provisions were included to transition from the existing QPAM exemption to the proposed requirements. Hopefully, the final exemption will address that omission and provide Investment Managers with a reasonable opportunity to modify procedures and investment management agreements (IMAs). Investment Managers should be ready, however, to move quickly to satisfy the new requirements, if needed.

Also, given the increase in AUM and shareholder/partner equity requirements, hopefully, the final exemption will either allow time for Investment Managers to conform or grandfather their status as QPAMs as to existing client plans. Otherwise, Investment Managers may need to take quick action, if possible, to comply with the AUM and shareholder/partner equity requirements. Plan fiduciaries would also no doubt feel the need to divest from Investment Managers who can no longer meet the new QPAM requirements.

If finalized in its proposed or similar form, a number of important changes to processes and procedures will be required to continue to rely on the QPAM exemption and prevent exposure to liability for non-exempt prohibited transactions. Investment Managers should be prepared to update compliance manuals to reflect the revised QPAM exemption and to establish new record-keeping procedures. In addition, Investment Managers should also be prepared to review IMAs, fund governing documents, counterparty agreements, side letters and other documents for QPAM descriptions, representations and other information that could be impacted by the revised QPAM exemption.

For many Investment Managers managing plan assets, preparing for the new QPAM requirements is likely to be a significant endeavor. Many ERISA clients of Investment Managers, including ERISA investors in PE and hedge funds that hold plan assets, will want assurances that the Investment Managers meet the new requirements. Investment Managers of plan assets funds will need to carefully communicate with ERISA clients and investors about the processes and procedures undertaken to meet the new requirements and engage client and investors.

See [“The Dos and Don’ts of Investor Calls That Investment Managers Must Consider”](#) (Jun. 16, 2020).

Although the amendments to the QPAM exemption have not been finalized and adopted by the DOL, Investment Managers could begin to evaluate the Proposal’s potential impact of them and what they would need to do to conform to the new requirements, especially to meet the increased AUM and shareholders’/partners’ equity requirements.

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