Simpson Thacher

Memorandum

Notable Changes to ERISA's QPAM Exemption

April 17, 2024

Firms that provide discretionary investment management services to ERISA-covered plans, individual retirement accounts ("IRAs") and other plans subject to Section 4975 of the Code, as well as funds or accounts deemed to constitute "plan assets" (each, a "Plan Assets Fund or Account") generally act as a fiduciary and must manage the Plan Assets Fund or Account in accordance with applicable fiduciary duties and rely on an "exemption" to avoid violating broad and complex prohibited transaction rules. Over the past 40 years, a popular exemption used by these investment managers has been the "QPAM Exemption" (Prohibited Transaction Class Exemption 84-14). On April 3, 2024, the U.S. Department of Labor ("DOL") finalized amendments[1]—which go into effect on June 17, 2024—that introduce new costs, burdens and risks to firms that rely on the QPAM Exemption.

Key Takeaways

1. Firms that manage a Plan Assets Fund or Account should review the amendments to the QPAM Exemption with ERISA counsel as soon as possible. Some firms may decide that the amendments are too burdensome and pivot to an alternative prohibited transaction exemption.
2. Generally, funds that are investment companies registered under the U.S. Investment Company Act of 1940, as amended, or that satisfy the "25% test," "venture capital operating company" ("VCOC"), "real estate operating company" ("REOC"), "operating company" and "publicly-offered securities" exceptions are unaffected by the amendments.
3. The amendments expand the circumstances under which a firm relying on the QPAM Exemption (*i.e.*, the "QPAM") will become disqualified from doing so. In broad strokes, a firm *may* become disqualified from the QPAM Exemption on or after June 17, 2024 if the firm, its affiliates, or a five (5) percent or more owner, is convicted of a crime, is adjudged by a regulator to be a "bad actor," or enters into a non/deferred-prosecution agreement or settlement with a prosecutor or regulator—anywhere in the world. The consequences of disqualification include:
    a. Notifying each client subject to ERISA or Section 4975 of the Code, including any investor in a Plan Asset Fund or Account that is subject to ERISA or Section 4975 of the Code (each, an "ERISA Investor"), as well as the DOL, that disqualifying conduct occurred;

[1] Available here.

b. Entering into a one-year "transition period," which triggers the firm's need to indemnify ERISA Investors for damages arising out of the misconduct, as well as potentially terminating the employment of those who participated in the misconduct;

c. Reputational harm and legal exposure for certain damages; and,

d. Potentially having to seek an individual exemption from the DOL, which is a costly, time-consuming and uncertain process.

4. Firms relying on the QPAM Exemption open up their trade secrets and other sensitive information to a wide range of federal and state regulators. Firms should consider the necessary steps to protect such information from disclosure to third-parties under FOIA and applicable state law.

5. The amendments may effectively require that most investment transactions involving a Plan Assets Fund or Account be undertaken by the entity relying on the QPAM Exemption, even currency hedging and other activities traditionally delegated to sub-advisers. Careful structuring of sub-advisory arrangements related to a Plan Assets Fund or Account, therefore, is imperative to ensure the QPAM Exemption remains applicable.

6. Sub-advisory agreements with bank-maintained collective investment funds should be scrutinized by ERISA counsel, as some may need to be amended.

7. Start-up and small investment managers, which may want to rely on the QPAM Exemption when managing a Plan Assets Fund or Account, should pay particular attention to the updated assets under management and equity threshold requirements.

ACTION ITEMS

1. Firms should review the constituent documents, related transaction agreements and side letters of each Plan Assets Fund or Account for representations and disclosures related to a firm's status as a "QPAM" or its current or potential reliance on the QPAM Exemption. Prior to June 17, 2024, the firm should discuss with ERISA counsel how to comply with the QPAM Exemption and/or whether reliance on an alternative exemption, such as the "service provider" exemption, may be more appropriate.[2] If a firm wishes to avoid having to register with the DOL, it may consider scrubbing references to "QPAM" and "QPAM Exemption" in fund documents, related transaction agreements and side letters.

2. All sub-advisory agreements related to a Plan Assets Fund or Account should be reviewed with ERISA counsel prior to June 17, 2024. This is especially true for any sub-advisory arrangements involving a bank-maintained collective investment fund.

---

[2] The "service provider" exemption refers to Section 408(b)(17) of ERISA and Section 4975(d)(20) of the Code. Generally speaking, this exemption provides broad prohibited transaction relief for arm's length transactions with counterparties, provided neither the counterparty nor its affiliates have or exercise any discretionary authority or control with respect to the investment of plan assets involved in the transaction, and that no more than adequate consideration is paid in connection with the transactions. Firms are urged to consult with ERISA counsel prior to relying on this exemption to confirm it may be relied upon for a transaction.

3. Credit agreements, ISDAs and similar agreements should be reviewed for representations, events of default and other provisions related to a firm's status as a QPAM and/or its ability to rely on the QPAM Exemption. These provisions may no longer be appropriate if a firm does not rely, or is unable to rely, on the QPAM Exemption in light of the DOL's amendments.
4. In M&A transactions, buyers should consider enhancing diligence of, and representations related to, the target's (and its affiliates') history related to criminal convictions (U.S. and foreign), the existence of any non-prosecution and deferred-prosecution agreements, and settlements and other issues related to federal and state regulators and prosecutors' offices. Buyers of financial services firms should augment diligence related to potential non-compliance of the QPAM Exemption.

BACKGROUND

The QPAM Exemption is a class exemption used by investment managers who exercise discretion over the assets of a Plan Assets Fund or Account. The Exemption provides relief for various prohibited transactions under Section 406(a) of ERISA and Section 4975 of the Code. It contains numerous conditions, some of which pertain to the investment manager relying on the exemption, whereas others are transaction-specific. This memorandum does not address conditions of the QPAM Exemption that were not amended by the DOL in these recent amendments.

As with all other exemptions under ERISA, every condition of the QPAM Exemption must be satisfied for the investment manager to rely on it for prohibited transaction relief. In other words, if just one condition is unmet, the investment manager runs the risk that it may be entering into non-exempt prohibition transactions, the consequences of which include the imposition of excise taxes, the need to unwind the transactions, reputational harm and civil liability on the investment manager.

KEY AMENDMENT #1—THE QPAM'S ROLE & SUB-ADVISORY ARRANGEMENTS

Before the amendments, the QPAM Exemption required that the "terms of the transaction" be negotiated by the QPAM and that the QPAM make the decision on behalf of the Plan Assets Fund or Account to enter into the transaction. The final amendments now provide that the QPAM must have and exercise sole discretion over (i) the "terms of the transaction," (ii) "commitments," (iii) "investment of fund assets," and (iv) "any associated negotiations." This presents the following issues:

1. The DOL does not define "commitments," "investment of fund assets," or "associated negotiations," leaving one to wonder how those terms differ from the "terms of the transaction" or even whether they are tethered to any particular transaction. Without understanding the contours of these terms, QPAMs may not be confident that this condition will be satisfied.
2. A QPAM's delegation of discretionary investment responsibility to a sub-adviser could result in neither the QPAM, nor the sub-adviser, being able to rely on the QPAM Exemption for transactions, if the sub-advisory agreement is not crystal clear as to which of the two parties has ultimate decision-making

authority regarding the investment decision itself and all "associated negotiations." This may also mean a QPAM's appointment of a currency manager to manage the fund's foreign exchange hedging could box out both the QPAM and the currency manager from relying on the QPAM Exemption. The DOL also noted that the appointment of another entity to vote proxies or otherwise exercise shareholder rights may not be covered by the QPAM Exemption.

3. Even the QPAM's appointment of a non-discretionary sub-adviser could also prove problematic if the QPAM mostly follows the recommendations of the sub-adviser. The DOL is concerned that some QPAMs serve as mere rubberstamps, which these amendments make clear is impermissible under the QPAM Exemption.
4. A QPAM may be unable to rely on the QPAM Exemption if it acts as a sub-adviser for a bank-maintained collective investment fund, a common wrapper for target date funds. This is because, as a matter of banking law, the bank/trustee must retain ultimate decision-making authority. If the QPAM makes day-to-day investment decisions, subject to an override by the bank-trustee, as is often the case, then potentially neither the bank nor the QPAM may rely upon the QPAM Exemption.[3]

The amendments also provide that transactions "initiated by" someone other than the QPAM may present challenges. The DOL even suggests that sales pitches and offers by financial services firms may render the QPAM Exemption unavailable for that transaction because the QPAM did not "initiate" it.

The amendments also require that, "[i]n exercising its authority, the QPAM must ensure that any transaction, commitment, or investment of fund assets for which it is responsible is based on its own independent exercise of fiduciary judgment and free from any bias in favor of the interests of the plan sponsor or other parties in interest." We suspect this condition is designed to pick up activity that does *not* rise to the level of a self-dealing prohibited transaction (because the QPAM Exemption never provided relief for self-dealing). Yet, the DOL declined to provide guidance on how this condition should be understood.

KEY AMENDMENT #2—REGISTRATION, DISQUALIFYING CONDUCT AND TRANSITION PERIOD

The amendments include numerous requirements at the firm-level (in contrast to most of the other conditions of the QPAM Exemption that are transaction-specific). These include:

[3] As a commercial matter, this may have a more muted effect as some bank-trustees rely on DOL Prohibited Transaction Class Exemption 91-38 for relief. The DOL attempted to allay concerns that sub-advisers of a bank-maintained collective investment fund could still rely on the QPAM Exemption under the right circumstances ("parties that participate in arrangements that do not clearly identify which party has the ultimate responsibility and authority to engage in a particular transaction should not assume that the transaction is permitted by the QPAM Exemption."). But bank-trustees of a collective investment fund generally cannot fully delegate their discretionary responsibility over the management of a fund to a third-party. *See*, *e.g.*, OCC Bulletin 2011-11 (while a bank may delegate specific management responsibilities for the fund if the board of directors determines that the delegation is prudent [under 12 C.F.R. 9.18(b)(2)], "[t]he bank, however, as fiduciary, retains the ultimate responsibility for the fund.").

- *Registration:* A firm must initially register the legal and operating names of each business entity that will act as the QPAM via an email to the DOL (QPAM@dol.gov).[4] Such names will be posted on a DOL website. This initial registration must be completed within 90 calendar days of the firm's reliance on the QPAM Exemption.

- *Disqualification:* A QPAM is disqualified from relying on the QPAM Exemption if the QPAM, any of its "affiliates," or a five (5) percent or more owner (direct or indirect) (each, a "Disqualifying Entity") (A) is convicted of federal, state or foreign crimes, (B) enters into a non-prosecution ("NPA") or deferred-prosecution ("DPA") agreement with a U.S. federal or state prosecutor's office or regulatory agency, or (C) is found or determined in final judgment or court-approved settlement to have intentionally engaged in conduct that violates the QPAM Exemption (or in a systematic pattern or practice of conduct that violates the QPAM Exemption), or provided materially misleading information to various state/federal regulators and prosecutors in connection with the QPAM Exemption (each, "Disqualifying Conduct"). A few things to note:

    1. Whether an entity is an "affiliate" of a QPAM is a function of control and whether the entity controls, is controlled by or is under common control with the QPAM.[5]
    2. The crimes referenced in (A) above encompass a wide range of crimes, such as fraud, theft, extortion, forgery, embezzlement and even certain misdemeanors. Firms should immediately engage ERISA counsel if any Disqualifying Entity is convicted of any crime, including crimes and convictions outside of the United States.
    3. Firms should also immediately engage ERISA counsel if any Disqualifying Entity enters into an NPA or DPA with any prosecutor's office or regulatory agency, including those outside of the United States.
    4. The conduct described in (C) above is particularly troublesome because its scope is currently indeterminate. For example, a judgment against a Disqualifying Entity for providing "materially misleading statements" to regulators and prosecutor offices "in connection with" the conditions of the QPAM Exemption is disqualifying, *even if* the court does not "consider [the QPAM Exemption] or its terms." Stringent compliance controls will be essential to ensure there is not a disqualification by reason of (C).

---

[4] Some investment managers represent in transaction agreements and side letters that they meet the definition of a QPAM. A plain reading of the amendments indicates that only firms that in fact rely on the QPAM Exemption need to register with the DOL. However, ambiguous language in the preamble suggests the DOL may also intend for firms that hold themselves out as a "QPAM," even if no reliance on the QPAM Exemption ever takes place, to also register. *See 89* Fed. Reg. 23090, 23093 (Apr. 3, 2024) ("The notice requirement provides the Department with knowledge of the investment managers that are relying on the exemption and will serve as an important reminder to investment managers relying on the QPAM Exemption that the "*QPAM" title and status are tied to an administrative prohibited transaction exemption that requires compliance with the exemption's conditions.")* (emphasis added).

[5] Convictions and bad conduct of certain QPAM employees—but not employees of the QPAM's affiliates or owners – should also be tracked, as this can also lead to disqualification under the QPAM Exemption.

- *Transition Period:* The amendments modify the QPAM Exemption by adding "transition period" provisions, which kick in if a Disqualifying Entity engages in Disqualifying Conduct. Within 30 days of the Disqualifying Conduct, the QPAM must provide notice to the DOL (QPAM@dol.gov) and each ERISA Investor stating:
    1. The QPAM has been disqualified under the QPAM Exemption and the one-year "transition period" has begun;
    2. That during the one-year transition period, the QPAM:
        - Agrees not to restrict the ability of an ERISA Investor to terminate or withdraw from the Plan Assets Fund or Account;
        - Will not impose any fees, penalties or charges on ERISA Investors in connection with the process of terminating or withdrawing from the Plan Assets Fund or Account, except for reasonable fees imposed under certain limited circumstances;
        - Agrees to indemnify, hold harmless, and promptly restore actual losses to ERISA Investors for any damages that directly result to them from a violation of applicable laws, a breach of contract, or any claim arising out of the Disqualifying Conduct. The amendments further provide that "actual losses" include losses and costs arising from unwinding transactions with third parties and from transitioning ERISA Investor assets to an alternative investment manager, as well as costs associated with any exposure to excise taxes as a result of a QPAM's inability to rely upon the QPAM Exemption; and,
        - The QPAM will not employ or knowingly engage any individual who participated in the Disqualifying Conduct.
    3. An objective description of the facts and circumstances upon which the Disqualifying Conduct is based, written with sufficient detail to fully inform the ERISA Investor's fiduciary of the nature and severity of the conduct.

As noted above, the QPAM must not employ or knowingly engage any individual who "participated in" the Disqualifying Conduct. Whether a person "participated in" such conduct turns on whether they actively engaged in the Disqualifying Conduct, knowingly approved of the conduct, or had knowledge of such conduct without taking active steps to prohibit or report such Disqualifying Conduct, and it is unclear whether constructive knowledge is sufficient for this purpose. The risk of this requirement is that it could ensnare senior personnel, including those who are treated as "key persons" in side letters.

A major limitation of the transition period is that it only provides relief with respect to ERISA Investors that were invested in the Plan Assets Fund or Account *prior to* the Disqualifying Conduct. A disqualified QPAM that manages an open-end fund that holds "plan assets," therefore, would need to immediately restrict new ERISA Investors until it is confirmed that an alternative exemption may be relied upon.

Once the one-year transition expires, the QPAM cannot rely on the QPAM Exemption for 10 years unless it secures an individual exemption from the DOL. Notably, it is within the DOL's discretion whether to grant an individual exemption to an applicant.

In addition to satisfying the foregoing requirements, the QPAM must still satisfy the remaining conditions of the QPAM Exemption during the transition period.

KEY AMENDMENT #3—RECORDKEEPING AND POTENTIAL DISCLOSURE OF TRADE SECRETS

The amendments require the QPAM to maintain all records necessary to demonstrate compliance with the QPAM Exemption for six (6) years after the date of the transaction. The following parties are entitled to this information:

- Employees of the DOL, IRS and any other state or federal regulator;
- Any fiduciary of an ERISA Investor that is invested in the fund;
- Any contributing employer and employee organization whose members are covered by the ERISA Investor that is invested in the fund; and,
- Any participant or beneficiary of an ERISA Investor invested in the fund.

Employees of the DOL, IRS and other federal and state regulators may also examine "privileged trade secrets," "privileged commercial or financial information" and other highly sensitive information of the QPAM. There is a risk that such information could be disclosed to a third-party by virtue of a request under the U.S. Freedom of Information Act ("FOIA") or similar state law request. Firms, therefore, should consider all tools that could protect such dissemination, including, for example, potential reliance on Exemption 4 under FOIA.[6]

KEY AMENDMENT #4—INCREMENTAL UPDATES TO ASSETS UNDER MANAGEMENT & EQUITY REQUIREMENTS

The QPAM Exemption currently requires the QPAM to meet certain equity and asset management thresholds. The final amendments provide for updates to these thresholds (adjusted for inflation) in three-year increments. Effective as of December 31, 2024, for example, the assets under management requirement increases from $85,000,000 to $101,956,000, and the equity requirement increases from $1,000,000 to $1,346,000.

[6] *See, e.g.,* 29 CFR 70.26 (Procedures for Disclosure of Records under the Freedom of Information Act – Confidential Commercial Information); *and Food Mktg. Inst. v. Argus Leader Media*, 139 S. Ct. 2356, 2366 (2019) ("At least where commercial or financial information is both customarily and actually treated as private by its owner and provided to the government under an assurance of privacy, the information is "confidential" within the meaning of [FOIA's] Exemption 4.")

For further information regarding this memorandum, please contact one of the following authors:

WASHINGTON, D.C.

Erica Rozow
+1-202-636-5961
erica.rozow@stblaw.com

George M. Gerstein
+1-202-636-5914
george.gerstein@stblaw.com

NEW YORK CITY

Brian D. Robbins
+1-212-455-3090
brobbins@stblaw.com

Jeanne M. Annarumma
+1-212-455-7395
jannarumma@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.