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DOL proposal may disrupt plan sponsors' investment arrangements

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The Department of Labor (DOL) recently proposed significant changes to a key ERISA prohibited transaction exemption widely used by asset managers for nearly four decades. The exemption allows qualified professional asset managers (QPAMs) to engage in many routine transactions that ERISA would otherwise prohibit. The proposal's changes to new and existing QPAM relationships might prove disruptive and increase costs for plan sponsors. For example, sponsors would have to take speedy action to maintain their existing QPAM relationships by amending their contracts to add new required provisions within 60 days. These provisions — which include a requirement that QPAMs reimburse plans for certain losses — might increase the cost of asset-management services. A separate provision clarifying that the exemption applies only to investment decisions that are the QPAM's sole responsibility might limit the investment opportunities available to plans. Comments are due by Oct. 11.

Background for the proposal

ERISA prohibits plan fiduciaries from engaging in transactions with a broad array of parties in interest — including employers, fiduciaries and service providers — unless a statutory or administrative exemption applies. In 1984, DOL granted a class exemption for QPAMs, allowing them to perform a wide range of transactions for ERISA plans, subject to certain conditions. While other ERISA exemptions may cover some of these transactions, the asset-management industry has come to rely heavily on the QPAM exemption because it provides a single set of uniform conditions that streamline compliance.

The proposal seeks to reflect the consolidation and increasingly global reach of the financial services industry in the nearly 40 years since DOL issued the QPAM exemption. The proposal also draws on DOL's experience considering individual exemptions for QPAMs that became ineligible for the exemption due to criminal convictions: The exemption currently provides that if an asset manager — or one of its

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affiliates or controlling persons — is convicted of any of a number of criminal violations, the manager immediately loses its ability to rely on the QPAM exemption for 10 years from the conviction date.

Proposed changes relevant to plan sponsors

DOL has made various changes to the QPAM exemption over the years, but none has been as significant as this new proposal, which would:

- Require written management agreements — including ones in place before the revised exemption takes effect — to contain certain contractual terms addressing the QPAM's potential ineligibility
- Clarify that a QPAM immediately loses the ability to rely on the exemption after a conviction in a foreign jurisdiction for any crime that is "substantially equivalent" to a wide variety of disqualifying US crimes
- Significantly expand the circumstances that would disqualify a QPAM from relying on the exemption
- Increase the information a QPAM would have to provide when applying for an individual exemption after a disqualifying event
- Clarify that the exemption is limited to investment decisions that are the QPAM's sole responsibility
- Raise certain monetary thresholds for asset managers to qualify as QPAMs
- Require asset managers relying on the exemption to notify DOL via email
- Require QPAMs to maintain records for six years showing compliance with the exemption

The remainder of this article highlights aspects of the proposal of most interest to plan sponsors.

Written contractual requirements addressing QPAM ineligibility

A QPAM's written management agreement with plan clients would have to include certain required contractual terms to address future ineligibility. Because the proposal doesn't provide a transition period for existing agreements, plan sponsors and QPAMs would have only 60 days after publication of the final exemption to add these provisions. Plan sponsors that have dozens of management agreements with various QPAMs may find it challenging to complete the required updates in such a short time frame. The agreement would have to include these features:

- **No restrictions on termination or withdrawal.** The QPAM would have to agree not to restrict a plan's ability to terminate or withdraw from the arrangement if the QPAM becomes ineligible.
- **No excessive fees, penalties, or charges on termination or withdrawal.** When a plan withdraws or terminates its arrangement with an ineligible QPAM, the QPAM could charge only certain reasonable fees that have been disclosed in advance. Such fees would have to be designed to prevent generally recognized abusive investment practices. QPAMs that manage pooled investment

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funds could also charge reasonable fees to ensure equitable treatment of all investors in the event of withdrawal, as long as the fees are applied consistently to all of the fund's investors.

- **Indemnification of plan losses.** The QPAM would have to agree to indemnify, hold harmless and restore actual losses to a plan for any damages due to the QPAM's ineligibility. These damages would include losses and related costs for unwinding transactions with third parties and the plan transitioning to another asset manager, as well as prohibited transaction excise taxes under the Internal Revenue Code. Because these potential liabilities may not be priced into existing arrangements and could be significant, this change could increase the cost of QPAM services.
- **Employment restrictions.** An ineligible QPAM couldn't employ or knowingly engage any individual who participated in the conduct giving rise to ineligibility. The agency says this restriction would extend to individuals who knew about the conduct and either approved or failed to take actions to address it.

Required one-year winding-down period after QPAM ineligibility

DOL proposes requiring a QPAM to implement a one-year winding-down period starting on the date the QPAM becomes ineligible. DOL says the new winding-down period would mitigate the cost and disruption to plans and provide fiduciaries time to consider whether to engage a new asset manager. Failure to comply with this condition could mean the exemption becomes retroactively unavailable for prior transactions entered into before the ineligibility date.

- **Written notice to plans and DOL.** A QPAM would have to notify its plan clients and DOL within 30 days of becoming ineligible. The notice would need to include an objective description of the circumstances of the QPAM's ineligibility, with "sufficient detail to fully inform the client Plan's fiduciary of the nature and severity of the conduct so that such fiduciary can satisfy its fiduciary duties of prudence and loyalty" and decide whether to retain the manager in a non-QPAM capacity.
- **No new transactions.** During the winding-down period, the QPAM couldn't rely on the exemption to enter into new transactions. This restriction may result in plans missing favorable investment opportunities that arise during that period or incurring losses on securities the manager would otherwise sell. Whether such opportunity costs would be included in the actual losses the QPAM would have to restore to a plan is unclear. DOL hasn't explained how this restriction would apply to continuing transactions entered into before the QPAM became ineligible — such as loans and leases, which are deemed to occur until terminated. The proposal is also silent on whether the QPAM could take actions necessary to renew those transactions during the winding-down period.

Relief limited to transactions within a QPAM's sole responsibility

The exemption currently covers transactions negotiated by the QPAM or under the QPAM's authority and general direction. Perceiving some ambiguity in the current exemption, DOL included language in the proposal "to make clear that a QPAM must not permit other parties in interest to make decisions regarding Plan investments under the QPAM's control." DOL says a QPAM must have and exercise discretion over plan investment decisions and can't simply be an independent approver of transactions.

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The proposal would require the terms of the transaction, as well as "commitments, investment of plan assets, and any corresponding negotiations," to be the QPAM's sole responsibility. DOL also proposes to exclude "any transaction … planned, negotiated, or initiated by a Party in Interest, in whole or in part." The agency says these changes align with its original intent in 1984 when first granting the exemption.

As written, these new provisions might raise broader questions about the scope of the exemption. A wide variety of routine investment transactions could involve nonemployer parties in interest pitching potential investment opportunities to a QPAM for consideration. Would DOL view these transactions as initiated by a party in interest, so the QPAM exemption wouldn't be available? If so, plans could lose out on a range of favorable investment opportunities.

The agency also notes that the exemption wouldn't cover transactions between a plan and its sponsor, even if a QPAM makes the ultimate determination. This restriction could cast doubt on an independent fiduciary's ability to rely on the exemption in some situations.

Request for comments

DOL requests comments on all aspects of the proposal, including the appropriateness of the one-year timeline for the winding-down period. DOL also is interested in whether it should consider additional protections for plan participants and beneficiaries. Comments originally were due Sept. 26, but DOL has extended the deadline to Oct. 11 and announced public hearings for Nov. 17 and 18.

Related resources

Non-Mercer resources

- Comment period extension and hearing notice for proposed amendment to prohibited transaction class exemption 84-14 (the QPAM exemption) (Federal Register, Sept. 7, 2022)
- Proposed amendment to prohibited transaction class exemption 84-14 (the QPAM exemption) (Federal Register, July 27, 2022)
- News release (DOL, July 26, 2022)

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- DOL proposes stricter standards for prohibited transaction exemptions (April 12, 2022)

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