Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 18
Preparing for Changes to the QPAM Exemption

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Taryn Cannataro: Welcome to the latest edition of Just Compensation. I'm Taryn Cannataro, an associate in Lowenstein's executive compensation and employee benefits group. I'm joined today by Andy and Megan, who I'll turn it over to introduce themselves.

Andrew Graw: Hi, I'm Andy Graw, chair of the employee benefits and executive compensation group.

Megan Monson: And I'm Megan Monson, I'm a partner in the same practice group as Andy.

Taryn Cannataro: I'd also like to welcome our special guest today, Marie, who we'll turn it over to introduce herself.

Marie DeFalco: Hi, I'm Marie DeFalco. I'm a partner and co-chair of the investment management group.

Taryn Cannataro: Today we'll be discussing the proposal to amend the prohibited transaction class exemption 84-14, known as the qualified professional asset manager or QPAM exemption. We will also be discussing how the proposal may affect current investment managers relying on the exemption. ERISA prohibits a wide range of transactions involving a party in interest to a plan. However, the Department of Labor, or the DOL, has granted a number of class exemptions which provide relief and if the conditions of an exemption have been satisfied, the transaction will not constitute a prohibited transaction. One of the most commonly used class exemptions is the QPAM exemption, which we'll focus on today. Today's discussion is intended to touch on the proposal in broad strokes and you should review the actual proposal for specific terms. Let's jump right in. What is the importance of the QPAM exemption?

Andrew Graw: Thanks, Taryn. Well, as you said at the outset, the importance of the QPAM exemption is to afford investment advisors and managements an exemption from restrictions under ERISA that would prohibit many day-to-day activities of managers. Under ERISA, when a manager is retained to hold plan assets and invest plan assets, they become a fiduciary because they have discretionary control over the management of those assets. Under ERISA, garden variety transactions that occur between a plan and what's referred to as a party in interest, which is a fiduciary or anyone who provides services to the plan, are prohibited. Fortunately, ERISA provides a number of statutory and administrative exemptions to the prohibited transaction rules. Otherwise, managers could not go about managing plan assets without fear of tripping over the prohibited transaction rules.

The QPAM exemption comes to the rescue. It's been in effect since 1984 and investment managers rely on the QPAM exemption so that they don't have to engage in a difficult task of determining whether or not all of the counterparties they engage with are parties in interest under ERISA. Without the QPAM exemption, essentially that's what investment advisors and managers would have to do. They would have to keep track of everyone that they deal with and confirm that those entities and individuals are not parties in interest.

Megan Monson: Absent having the QPAM exemption in place, similar to what Andy said, investment managers would really need to restrict the scope of their investments or try to rely on other narrower or vaguer exemptions. Undertaking on a transaction-by-transaction basis to see whether their counterparts or parties in interest would be very onerous for investment managers and so this really allows them to operate more efficiently and also engage with and take on clients who have investments in ERISA plan assets.

Marie DeFalco: That's so right, Megan and the parties in interest is such a broad group of virtually every service provider to the plan that it would be very onerous.

Andrew Graw: Yeah, exactly. It would be almost impossible for a fiduciary or an investment manager to be able to monitor all of those counterparties and see who is or who is not a party in interest and then go about retaining others when they fall on the party in interest list to engage in a transaction with. They may end up denying themselves the ability, for example, to use a broker or a bank or custodian that provides the best services.

Megan Monson: The QPAM exemption really seems to open up a lot of doors for investment managers and allows them to expand the scope of not only their business, but also the parties that they represent and the parties that they engage with.

Taryn Cannataro: You mentioned that it's important for investment managers, but is it also important for private equity or hedge funds only to the extent they hold plan assets?

Andrew Graw: It's certainly important and almost a necessity for general partners and investment managers of private equity and hedge funds that have plan assets. Even if they don't have plan assets today, it's also important for them to be able to qualify as a QPAM in order to attract pension fund investors because pension funded investors, their trustees and other fiduciaries, are going to want assurance that the manager of the fund will qualify as a QPAM in case the fund does have plan assets.

Marie, what have you seen in that regard?

Marie DeFalco: Yes, it's also important for the pension plans because it removes some of the potential liability of the trustees because they can rely on the qualification of the investment manager as a QPAM because as long as they choose the QPAM, the investment manager with prudence, then they are relieved of liability as well.

Taryn Cannataro: One question that we're commonly asked is how to qualify as a QPAM. Can you elaborate on this a little?

Megan Monson: As things stand today, under the existing QPAM exemption, there's only a couple of criteria that need to be met. First, you have to be a registered investment advisor and as of the last day of the most recent fiscal year you have total assets under management exceeding $85 million. This threshold is going to increase under the proposed regulation to $135,870,000. It's an odd number to remember, but really the key takeaway is the assets under management would be increasing under the current proposal. The other requirement currently to be a QPAM is also that you have at least $1 million dollars in shareholder or partners' equity as reflected on the most recent balance sheet. This threshold would also be increasing under the proposed QPAM proposal to $2,040,000 dollars.

Marie DeFalco: I'd like to add something to that. The increase from $85 million to $135,870,000 I don't think is a big issue because the assets under management requirement is not really that onerous. Most managers have at least $85 million or at least $135 million or $136 million under management. The shareholder or partners' equity is always the stumbling block because often, especially new managers, are rather thinly capitalized. The equity is the issue.

Andrew Graw: Also, it's important, this is a question that always comes up, when you determine the capital requirements you have to look at the prior fiscal year or even the prior two fiscal years. For a brand-new manager, they can't even possibly satisfy that requirement until they have a year under their belt.

Megan Monson: Yeah, and that's a great point, Andy. Under the QPAM proposal, there currently is not any grandfathering period and so if somebody has not met the shareholder equity requirement, they don't even have time because with the look back period that they could automatically be disqualified from being considered a QPAM.

Andrew Graw: Right, hopefully the Department of Labor will think better of that and some grandfathering role that will allow those registered investment advisors that currently satisfy the capitalization requirements to be a QPAM to continue to do so or at least time to increase their capital.

Marie DeFalco: Another issue that I run into, because I work with a lot of venture fund managers, is that they rely on an exemption from being registered with the SCC. That's an issue as well, is that they have to be registered investment advisors.

Megan Monson: That's a great point, Marie. Then one other point I wanted to touch on with respect to the existing QPAM exemption, the only other requirement is that the QPAM must acknowledge in a written management agreement that they're a fiduciary of the plan. That's just simply always going to be involved in the investment advisor agreement, that's a relatively low hurdle to reach. There is currently not any filing requirement or approval process for an investment manager to be considered QPAM.

Marie DeFalco: Aren't there additional record keeping requirements as well, if the proposal is adopted?

Megan Monson: Yeah, that's a great point, Marie. In addition to a couple of other things, there is a six-year requirement for keeping records with respect to any transaction. That's going to be additionally onerous for anybody who's relying on the QPAM exemption. They may not currently have those processes in place to keep those records, especially for that length of time.

Andrew Graw: One of the requirements under the proposal is new that the QPAM notify the Department of Labor that it is in fact a QPAM right now. As you said, Megan, there is no registration requirement. The notification requirement is just that, it's a notification requirement. It's not asking the Department of Labor for approval, but it is a ministerial item that those who want to be QPAMs have to be mindful of and not miss.

Taryn Cannataro: How frequently does the registration occur?

Andrew Graw: It's a one-time registration. Once you've done it, that's it. You don't have to go back and re-register each year. In addition, there's a written management agreement requirement. Megan, do you want to touch on that?

Megan Monson: Yeah, thanks Andy. This also may have been something that Marie was alluding to before, but in addition to the current rule that the QPAM must acknowledge in writing that they're a fiduciary, under the proposal they're requiring a whole host of additional terms that must be included in the written management agreement. To name a few, there's certain indemnification and hold harmless provisions that must be included, certain termination provisions that allow the client to terminate the QPAM without any restriction or imposition of fees. Other terms that restrict the QPAM from employing or knowingly engaging an individual that participated in any criminal conviction or is ineligible to rely on the QPAM exemption. While these in theory don't sound particularly problematic, they would require people who are relying on the QPAM exemption currently to go back and revise all of their underlying agreements to include all of these new requisite terms. That could be a really onerous task, in particular for investment managers who are advising a variety of clients that have ERISA plan assets.

Andrew Graw: Interesting that this follows a pattern that started maybe under the fiduciary role that was withdrawn a few years ago, in that the Department of Labor is requiring parties to enter into agreements with specific terms in order to give plans and plan fiduciaries contractual rights to bring claims. And in some cases, it's questionable whether or not those fiduciaries would have the ability to bring a claim, at least under ERISA, for certain breaches. But getting it in there through these rules which require contractual agreements will certainly make it easier for plan fiduciaries to seek damages from an advisor that fails to meet the requirements.

Megan Monson: Yeah, and I certainly agree with that, Andy. I think what at least is in my mind, the concerning point on this as the proposal stands as we mentioned earlier, number one, there's not currently a grandfathering period, so this could require investment managers to have to pretty quickly comply with these requirements. I would view that as pretty onerous to review their investment management agreements, fund governing documents, any counterparty agreements and side letters to not only make sure that they include all of these requisite representations and terms. I think ultimately, while it's going to be beneficial to all parties, there certainly is a cost associated with updating all of the documents and the timing element of that.

Taryn Cannataro: Is there anything else that investment managers should do to prepare for these regulations being finalized?

Marie DeFalco: I think that if they do manage plan assets, they should assume that these proposals are going to be adopted and start preparing now. If the proposal is scaled back before it's adopted, then they could always do a little less. But I agree completely with Megan that if it's adopted and there's no grandfathering period, they're going to be scrambling. So, I would say keep an eye out for updates and get ready.

Andrew Graw: Yeah, I wholeheartedly agree with that, Marie. It could be an onerous task for advisors and other managers to comb through their records and accumulate various agreements and even side letters and other documentation that needs to be reviewed and modified in order to conform to the new proposed rule. So managers could start to think about an action plan to do all of that.

Megan Monson: Marie touched on this earlier, that for some advisors that are relying upon the QPAM exemption, meeting the shareholder or partner equity requirements can be challenging, so if the proposal is adopted in the current form, and that seems to be an area of potential concern, those investment managers should really take a look at whether or not they would need to divest any investors or clients that have ERISA accounts if they're not going to be able to meet the QPAM requirements, at least as of day one. Really it's all about thinking about your current plan of action and what needs to be done in order to comply with the requirements as is.

I will add that the Department of Labor noticed that this is a significant area of concern in this practice area, and so they did extend the comment period for folks to send in comments with respect to the proposal, and they are having a hearing to hear additional comments on the proposal. I'd expect following that hearing in November we should hear more updates on what the path forward is and if it's expected to be adopted in the current form or more changes are contemplated.

Taryn Cannataro: Well, thank you very much for joining us today and thank you, Marie for joining us as a special guest. We'll continue to monitor the status of the QPAM proposal, so be on the lookout for a further episode on this topic once the proposal is finalized. For more information on the QPAM proposal, please see our client alert and article which should be linked to this episode and also available on our website. We look forward to having you back for our next episode of Just Compensation.

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