Hedge Fund Law Report hflawreport.com

May 23, 2024

ERISA

Impact of Amendments to QPAM Exemption on ERISA Funds

By Robin L. Barton, *Hedge Fund Law Report*

Pension plans commonly invest in hedge funds. Managers that accept investments from pension plans, however, may need to comply with the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). For example, if a benefit plan investor owns more than 25 percent of any class of a fund's equity securities, the fund could be deemed a "plan asset fund" subject to ERISA – including its prohibition against transactions with "parties in interest." Thus, many managers of plan asset funds rely on an exemption from ERISA's prohibited transaction rules for "qualified professional asset managers" (QPAM).

On April 3, 2024, the U.S. Department of Labor (DOL) made some fairly significant amendments to the QPAM exemption (Amendments), which take effect June 17, 2024. The Hedge Fund Law Report spoke to Bradley C. Fay, partner at Seward & Kissel, about those changes. This article summarizes the Amendments and shares Fay's perspective on them, as well as the steps fund managers impacted by the changes should take to comply with the new requirements.

For a look at pension plan investing, see "Family Offices, Endowments and Foundations Drive Interest in Hedge Funds, According to New Study" (Mar. 17, 2022).

Summary of the Amendments

A QPAM is defined as a bank; savings and loan association; insurance company; or registered investment adviser (RIA) that meets certain asset and equity thresholds specified in the QPAM exemption and that acknowledges in writing that it is a fiduciary as to each pension plan that invests with it. The Amendments change the QPAM exemption in the following ways:

- require a QPAM to notify the DOL that it is relying on the exemption;
- clarify that foreign convictions are included in the scope of the exemption's ineligibility provision;
- expand the ineligibility provision to include additional types of serious misconduct;

- add a one-year transition period when a QPAM becomes ineligible due to a conviction or participation in prohibited misconduct;
- update assets under management (AUM) and equity thresholds in the QPAM definition;
- clarify the requisite independence and control a QPAM must have as to investment decisions and transactions; and
- add a recordkeeping requirement.

See "Compliance Challenges in Records Management" (Oct. 12, 2023).

Importance of the QPAM Exemption

HFLR: What is the QPAM exemption, and why is it important for hedge fund managers?

Fay: The QPAM exemption has historically been widely relied on by ERISA fiduciaries, mainly due to its simplicity, broad coverage and clarity. A prohibited transaction under ERISA is any transaction between a plan and a party in interest. "Party in interest" is a very broad term that includes:

- fiduciaries of the plan;
- persons that provide services to the plan;
- the employer sponsor of the plan; and
- various other people who are picked up by the term.

Generally, determining whether a particular transaction is prohibited is quite time intensive because managers have to look at all the plans involved and confirm that, for example, a prime broker is not currently a party of interest to any of those plans. As you can imagine, that becomes very time consuming. As a result, managers of ERISA capital generally choose instead to confirm that an exemption applies to every transaction they undergo on behalf of a plan. So, hedge fund managers that are subject to ERISA commonly use the QPAM exemption to avoid the prohibited transactions rule. The exemption is also preferred by some plans and counterparties.

[See our two-part series "Structuring Private Funds to Avoid ERISA While Accommodating Benefit Plan Investors": Part One (Feb. 5, 2015); and Part Two (Feb. 12, 2015).]

HFLR: Why did the DOL decide to amend the QPAM exemption?

Fay: The DOL provided different reasons for different parts of the Amendments, but I think what originally drove the Amendments was the DOL's experience over the past maybe five years with felony convictions. Part of the QPAM exemption says that if you've been convicted of certain felonies, then you are no longer able to rely on the exemption. The problem is that in some foreign jurisdictions, large banks and other large investment managers had foreign affiliates that were convicted of felonies and were no longer able to rely on the exemption. The DOL had to quickly make determinations about individual exemptions for those entities. Many of the large banks that had foreign felony issues were granted individual exemptions, but the DOL made it clear that it felt a little rushed in that process.

Key Changes Made by the Amendments

HFLR: What are the key changes to the QPAM exemption in the Amendments?

Fay: The DOL clarified that foreign convictions are picked up by Section I(g). There was a lack of clarity about that for a few years due to guidance issued by the DOL in 2020 that provided contradictory information. Now, we know that a foreign conviction will result in a manager's being unable to rely on the exemption.

The Amendments also create the term "prohibited misconduct," which picks up things beyond the scope of felony convictions. Now, there are certain kinds of agreements with regulators, such as non-prosecution agreements, that can also result in a manager's being unable to rely on the QPAM exemption.

In addition, the DOL put in place a one-year transition period mainly to address the timing issue I mentioned earlier. If you are convicted of a felony or engage in prohibited misconduct that makes you unable to rely on the QPAM exemption, there essentially will be a one-year period during which you may approach the DOL and request an individual exemption or potentially seek to rely on an alternative exemption. During that one-year period, you'll be able to continue to rely on the QPAM exemption as long as you give certain rights to the plans that you manage.

HFLR: What are those rights?

Fay: The plan must be able to exit the relationship with the QPAM without any penalty. There is a little bit of language, however, protecting pooled vehicles, such as hedge funds. If a plan chooses to terminate or withdraw from a manager's hedge fund, the manager can't impose any fees or penalties on it except for reasonable fees, disclosed in advance, that are designed to prevent abusive investment practices or to "ensure equitable treatment of all investors in a pooled fund in the event such withdrawal or termination may have adverse consequences for all other investors, provided that such fees are applied consistently and in a like manner to all such investors."

[See "Becoming a Plan Assets Fund May Limit Hedge and Other Private Funds' Abilities to Charge Fees" (Apr. 21, 2016).]

Managers also need to notify plans that they are no longer able to rely on the QPAM exemption. And, managers will have to indemnify those plans for any costs associated with their conviction or loss of the QPAM exemption – which may include the cost of the plans' transitioning to a new manager.

HFLR: Will managers have to amend their documents to give plans those rights?

Fay: No amendment is required to contracts with existing plans due to the Amendments. In the proposal, there was a requirement that every contract with a plan had to be amended, but that requirement has been removed because the DOL received a lot of comments about it. Instead, if a manager is convicted or engages in prohibited misconduct so that it's no longer able to rely on the QPAM exemption and enter this transition period for a year, those rights must automatically be granted to the plans it manages without having to actually amend the agreements.

HFLR: Is this one-year transition period a major change, or does it really just codify an informal process that was already in place?

Fay: This is a major change because it is now available to everyone. Historically, the DOL has given some kind of transition period on a case-by-case basis while it determined whether a longer exemption would be issued; however, that was not available to all QPAMs that experienced ineligibility due to a felony conviction. Rather than having to make those decisions on an emergency basis, the DOL has now given itself a little bit of time to make those decisions.

HFLR: What are some other key changes made in the Amendments?

Fay: The AUM and partner equity thresholds have gone up. The QPAM exemption has two dollar-based requirements. One was that RIAs had to have $85 million in client AUM as of the end of the last fiscal year, and the other was that they had to have shareholder or partner equity in excess of $1 million. Those numbers were not adjusted for inflation; the last time they were updated was more than a decade ago.

The Amendments change those thresholds by stepping them up over a number of years through 2030. Then, starting in 2030 and on an annual basis going forward, the DOL will issue the dollar thresholds for the following year. By the end of 2030, the $85-million AUM threshold will be $135.87 million, while the shareholder and partner equity requirement will increase to $2.04 million – more than double its prior threshold.

HFLR: Was that element of the Amendments controversial?

Fay: A collection of promoters of small and mid-sized businesses argued that those thresholds will exclude many managers. But when I saw the proposal, I anticipated that some increase to the dollar thresholds would likely make it through to the final version because there had been no change to the figures despite high inflation over the last few years.

HFLR: There's also a new recordkeeping requirement. How onerous will that be?

Fay: It's a little bit uncertain currently because the DOL was not very clear on what records would need to be maintained and provided. Probably the most burdensome part of that requirement is that participants and beneficiaries of any plan invested in a fund managed by a QPAM can request the records directly. So, if you manage a pooled investment vehicle such as a hedge fund with dozens of plans invested in it, you might be required to respond to records requests from many participants from many different plans. The existing QPAM exemption has no such recordkeeping requirement.

HFLR: Most hedge fund managers are RIAs subject to various SEC recordkeeping requirements. So, will complying with the recordkeeping requirement be less of a lift compared to the other requirements because they may already be keeping many – if not all – of those records?

Fay: That is probably correct, although the format in which they're keeping those records and whether they're able to provide them upon request, as required by the Amendments, is something managers may need to work on.

HFLR: Are there any other material elements of the Amendments that we haven't talked about?

Fay: The notice to the DOL requirement. Fund managers are required to notify the DOL by email if they are relying on the QPAM exemption and any names that they are operating under. If they're currently relying on the exemption, they have until September 15, 2024, to make that notification. Otherwise, managers must notify the DOL within 90 days of their reliance on the exemption. Also, they must provide an updated notice to the DOL if the name of the QPAM changes or they're no longer relying on the exemption. The idea is that if you notify the DOL when you cease to rely on the exemption, your name will be removed from the list.

HFLR: The DOL has indicated that it plans on making a list of entities relying on the QPAM exemption available to the public on its website. Does the accessibility of that information raise any concerns for fund managers relying on the exemption?

Fay: Many managers may have concerns regarding providing their name publicly in that way or just providing their name directly to another regulator, because, historically, you were not required to tell the DOL explicitly that you are utilizing this exemption. Additionally, they may have concerns regarding plan expectations once they are publicly listed on the DOL website.

Compliance Challenges

HFLR: Of all these changes, which will be the most challenging to comply with and implement for fund managers relying on the QPAM exemption?

Fay: There will be different challenges depending on the manager. The new AUM and partner and shareholder equity thresholds could result in small and mid-size managers' being unable to rely on the exemption at all, and that's a big deal. If a manager has $1 million in shareholder equity and it has to go up to $2 million by 2030, there's a chance that won't be possible for certain smaller managers.

HFLR: So, it could exclude them now or possibly exclude them in the future.

Fay: That's right, because those thresholds are stepping up over a number of years. A manager may meet the 2024 number required but not the 2027 number. If a manager utilized the QPAM exemption and doesn't have a large base of plans it manages, this could force it out of the market.

The changes have also reduced the simplicity and clarity of the exemption, and therefore, managers should consider whether it is still the right option in their situation. Previously, managers had to meet some very clear requirements to utilize the exemption. Now, with the changes to, for example, the definition of prohibited misconduct, it's a lot less clear what gets picked up by that definition and what is not picked up – especially as it includes five-percent owners. If a firm's management company has complex ownership, then it may have concerns about its ability to continue relying on this exemption.

HFLR: What's the alternative to relying on the QPAM exemption?

Fay: There are other exemptions; QPAM is just one. So, managers could pursue an alternative exemption. The fund's strategy would be a major factor in determining which exemptions make sense.

[See "How Can Hedge Fund Managers Managing Plan Asset Funds Comply With the QPAM and INHAM Exemption Requirements?" (Oct. 3, 2013).]

HFLR: But there are reasons why the QPAM exemption has been the most commonly relied on by hedge fund managers and why those other exemptions are not as popular.

Fay: True. It used to be very clear whether you met the requirements of the QPAM exemption. Counterparties want assurances that a manager of plan assets is not committing a prohibited transaction, so those counterparties are very interested in the exemption's requirements being clear and easy to follow. That made the exemption attractive.

In addition, the QPAM exemption is not asset-specific, unlike other exemptions that apply only to, say, foreign exchange transactions or initial public offerings. The QPAM exemption can essentially be used for any transaction with a third party. There are other broad exemptions, but QPAM was broader than your average exemption.

[See "RCA PracticeEdge Session Highlights the Key Points of Intersection Between ERISA and Hedge Fund Investments and Operations" (Jul. 18, 2014).]

Takeaways for Fund Managers

HFLR: The Amendments take effect on June 17, 2024. What steps do hedge fund managers relying on the QPAM exemption need to take to comply with the new requirements?

Fay: Managers would need to notify the DOL that they're relying on the exemption, as well as confirm that they're going to meet the new requirements. I would also recommend they consider the new dollar thresholds that go into effect on December 31, 2024.

Managers should also check their current records and ensure they're keeping the records required by the exemption, as well as how they're storing those records. Records should be easily accessible if someone were to request them.

In addition, managers should be considering whether the QPAM exemption is the right path forward. This is a very big change, and it is going to potentially shift the market view of operating as a QPAM. Managers should be open to whether an alternative makes sense.

HFLR: Should managers have some sort of process in place to monitor for any felony convictions or prohibited misconduct that would make them ineligible for the exemption? If they already have such a system, do they need to change it so they're casting a wider net, given the expansion of that conduct by the Amendments?

Fay: Yes, that's right. Managers should consider what they currently have in place and whether it aligns with what's required by the QPAM exemption now. The old requirement related to felony convictions, so that was pretty straightforward, and people had access to that information. Now that it includes other kinds of regulatory actions, managers need to ensure they catch all of that.

HFLR: But if someone settles a claim in an administrative proceeding with a regulator or signs a non-prosecution agreement, that information may not be publicly announced or easily available. So how are entities going to monitor for prohibited misconduct?

Fay: The market is trying to determine how to look for that, particularly prohibited misconduct by an owner. Felony convictions are fairly straightforward and generally public record. These new types of prohibited misconduct are not, so managers may have to ask more detailed questions to make determinations on whether they meet the exemption's requirements.

HFLR: You mentioned some ambiguity in the Amendments. Do you expect the DOL to release additional guidance to clarify some of those ambiguities?

Fay: I don't anticipate guidance in the near term. One of the DOL's recent FAQs ended up in court, so it's likely to be very careful when releasing any additional guidance in the future.

[See our five-part series "Happily Ever After? – Investment Funds That Live With ERISA, for Better and for Worse": Part One (Sep. 4, 2014); Part Two (Sep. 11, 2014); Part Three (Sep. 18, 2014); Part Four (Sep. 25, 2014); and Part Five (Oct. 2, 2014).]

© 2024 Mergermarket Limited. All rights reserved.