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Are You Sure You Can Use the QPAM Exemption?

For many investment managers, the ability to act as "QPAM" is essential to managing retirement account assets. Indeed, status as a QPAM likely provides a sort of credentialing boost in the eyes of prospective plan clients and, more importantly, signals the investment manager's ability to rely upon the "QPAM Exemption," a highly versatile exemption used to cure various prohibited transactions under ERISA and Section 4975 of the Internal Revenue Code when it exercises discretion over plan assets. To be a QPAM, however, is not tantamount to satisfying the QPAM Exemption. Moreover, the QPAM Exemption itself is subject to myriad conditions, the failure to meet only one of which can wreak havoc on a compliance strategy. Here, we provide an overview and highlight potential trap doors in a Q&A format.

What is a QPAM?

A QPAM is a "qualified professional asset manager" within the meaning of Part VI(a) of the QPAM Exemption (Prohibited Transaction Class Exemption 84-14). An investment adviser registered under the Advisers Act, for example, is generally eligible to be a QPAM, provided it has total client assets under management of more than $85 million as of the last day of its most recent fiscal year and more than $1 million in shareholders' or partners' equity. Thus, newly formed investment managers may need to rely on an alternative exemption for trading, such as Section 408(b)(17) of ERISA, during its first year of operations.

What is the QPAM Exemption, and why is it important?

Fiduciaries of employee benefit plans subject to Title I of ERISA and plans subject to Section 4975 of the Internal Revenue Code (*e.g.*, IRAs) must avoid entering into prohibited transactions for which no exemption is available. A prohibited transaction includes the purchase and sale of securities or other property to a "party in interest." For example, a swap transaction with a bank would be a prohibited transaction if the bank is a party in interest to the plan client. Virtually all financial service firms will assume they are a party in interest. This is why nearly all ISDA Schedules will include representations from the investment manager that the QPAM Exemption will be met with respect to the transactions. Simply, an investment manager may be hard-pressed to enter into many types of transactions on behalf of plan clients without representing that it can satisfy the QPAM Exemption (while the bank-counterparty in this example may seek a representation from the investment manager that it is a QPAM, the bank would only be interested in knowing that in the context of ensuring the QPAM Exemption can otherwise be met).

To be fair, the QPAM Exemption is not the only game in town. It is, however, a tried and true exemptive approach that facilitates many types of trades an investment manager may want to conduct on behalf of a plan client. Reliance on alternative exemptions may be feasible from a legal standpoint but nevertheless could slow negotiations down. Practically speaking, then, it is important for most investment managers who have discretionary responsibility over plan assets to become familiar with the nuances of the QPAM Exemption and ultimately comply with it.

For purposes of the prohibited transaction rules, is it enough to be a QPAM?

An investment manager's status as a QPAM is important, but only insofar as the rest of the QPAM Exemption can also be satisfied. In other words, the QPAM Exemption contains several conditions; to meet the definition of a QPAM itself is but one condition.

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What are the other conditions of the QPAM Exemption?

Here is an overview of the other key conditions of the QPAM Exemption:

1. The investment manager (i.e., the QPAM) acknowledges in writing that it is a fiduciary to the plan client.

2. The entity appointing the QPAM (or entering into the investment management agreement with the QPAM) is not the counterparty (or affiliate) with respect to the transaction. There is a useful exception to this condition for commingled investment funds where no plan (or plans established by the same employer) holds a 10 percent or more interest in the fund.

3. The counterparty is not the QPAM or otherwise related to the QPAM (*i.e.*, the QPAM Exemption does not cover self-dealing prohibited transaction issues).

4. No plan, when combined with the assets of other plans established by the same employer, represents more than 20 percent of the QPAM's total client assets under management.

5. The terms of the transaction are negotiated by the QPAM, and the QPAM makes the decision to enter into the transaction on behalf of the plan.

6. The terms of the transaction are at least as favorable to the plan as the terms generally available in an arm's length transaction between unrelated parties.

7. Neither the QPAM, any affiliate, nor certain other persons have been convicted of certain U.S. or non-U.S. crimes (*e.g.*, larceny, forgery, theft, counterfeiting, etc.) within the past 10 years. This condition has proven challenging for some large financial services firms with affiliates around the globe that may have been convicted of non-U.S. crimes.

Each and every one of these conditions have to be met.

How should an investment manager proceed?

As evident from the conditions outlined above, the QPAM Exemption cannot be put on autopilot. Investment managers should be cognizant that satisfaction of the QPAM Exemption needs to be battle-tested prior to making a contractual representation to a client or a counterparty that the exemption can be complied with by the investment manager. Investment managers should also be sensitive to the fact that some clients of theirs may conflate an investment manager's status as a QPAM with the investment manager's ability to satisfy the QPAM Exemption. Should this occur, both parties may have a false sense of security that the QPAM Exemption can be met for the investment mandate. The existence of non-exempt prohibited transactions by an investment manager can result in severe monetary penalties and reputational harm. If the QPAM Exemption is unavailable for some reason, one or more alternative exemptions may be available, though they should be evaluated prior to entering into the investment management agreement and any trading.