EBEC EXPO2024

Proskauer's Perspective on Employee Benefits, Executive Compensation and ERISA Litigation

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Recent Developments in the Investment of Plan Assets (QPAM, The Fiduciary Rule and More)

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Meet Your Presenter

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Agenda

- QPAM Exemption Amendments
- The Fiduciary Rule
- And More (Artificial Intelligence, the Private Fund Adviser Rules and ESG)

QPAM Exemption Amendments

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Prohibited Transactions - Generally

- Two types of “prohibited transactions”
  - Party in interest prohibited transactions
  - Fiduciary self-dealing/conflict of interest prohibited transactions

- Determination of “party in interest” and “fiduciary” status is key as only fiduciaries are subject to the self-dealing/conflict of interest restrictions

Party in Interest Prohibited Transactions

- Fiduciaries cannot cause a plan to engage directly or indirectly in any of the following:
  - Sale, lease or exchange of property between plan and a party in interest
  - Lending of money or other extension of credit between a plan and a party in interest
  - Furnishing of goods, services or facilities between a plan and a party in interest
  - Transfer of plan assets to a party in interest or use of plan assets by or for the benefit of a party in interest

Party in Interest Prohibited Transactions (cont.)

- "Party in interest" – defined very broadly, and includes:
  - Any fiduciary
  - Any employer whose employees are covered by the plan
  - Any employee organization whose members are covered by the plan
  - Any service provider
  - Various affiliates of the foregoing categories
- Essentially have to assume every counterparty is a "party in interest"
- Accordingly, avoidance of "party in interest" prohibited transactions often involves compliance with an available exemption

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Self-Dealing/Conflict Prohibited Transactions

- Fiduciaries cannot:
  - Deal with the plan's assets for the fiduciary's own interest or own account ("self-dealing")
  - Act on behalf of, or represent (in any capacity) in any transaction involving the plan a party whose interests are adverse to the interests of the plan ("conflict of interest")
  - Receive any consideration from any party dealing with the plan in connection with a transaction involving plan assets ("kickback")
- Exemptions typically are not available

Types of Prohibited Transaction Exemptions

- Statutory exemptions (set forth in ERISA and/or the Code)
- Administrative exemptions (granted by the DOL)
  - Individual exemptions
    - Exemption to a particular party for particular transaction or set of facts
  - Class exemptions
    - Applies to any party in interest as long as conditions are met

- QPAM Exemption – commonly used administrative class exemption for “party in interest” prohibited transactions

"QPAM Exemption"

- Prohibited Transaction Class Exemption 84-14
- Provides broad exemptive relief from "party in interest" prohibited transactions, where the transaction is negotiated by a QPAM on behalf of the plan/fund and all other conditions of the exemption are satisfied
- Does not apply to fiduciary self-dealing/conflict of interest prohibited transactions
- Generally considered the "gold standard" exemption to avoid "party in interest" prohibited transactions
  - Commonly required by ERISA plans and counterparties
- Exemption only available to fiduciary managers that qualify as "QPAMs"

“QPAM Exemption” – Currently

- Currently, to qualify as a “Qualified Professional Asset Manager” (QPAM), generally must be a registered investment adviser, a bank, a savings and loan association, or an insurance company, and have:
  - RIA: AUM of at least $85m and shareholders’ or partners’ equity of at least $1m
  - Bank, S&L, Ins. Co.: Equity capital or net worth in excess of $1m
  - All: must acknowledge fiduciary status in writing

“QPAM Exemption” – Currently (cont.)

- Terms of the transaction must be negotiated by the QPAM, and the QPAM must have ultimate investment discretion over the decision to enter into the transaction
- No filing or DOL notice requirement
- Certain criminal convictions of the manager or an affiliate disqualify the manager for 10 years
  - Some ambiguity whether foreign convictions apply as well (guidance has ping-ponged back and forth)
  - Individual exemptions issued
- DOL proposed significant amendments to the conditions of the exemption in July 2022
- DOL finalized amendments in April 2024, to be effective on June 17, 2024

Final Amendments – Key Changes

- Increase the equity/net worth and AUM thresholds to qualify as a QPAM
- Add a new requirement for a QPAM to notify the DOL if it will be relying on the exemption, and the DOL will publish a list of QPAMs on its website
- Specifically include foreign criminal convictions in the list of criminal convictions that will make a QPAM ineligible to rely on the exemption for 10 years
- Add new types of “prohibited misconduct” that will make a QPAM ineligible to rely on the exemption for 10 years
- Provide for a one-year transition period following a QPAM’s criminal conviction or prohibited misconduct to minimize the impact of the QPAM losing the ability to rely on the exemption
- Clarify the requirement that the terms of the applicable transaction and related negotiations be the sole responsibility of the QPAM
- Add a recordkeeping requirement

Increase of Equity/Net Worth and AUM Thresholds

Bank, S&L, Ins. Co. – Equity/net worth threshold will increase from $1,000,000 to:
- As of 12/31/24: $1,570,300
- As of 12/31/27: $2,140,600
- As of 12/31/30: $2,720,000

RIA – AUM threshold would increase from $85,000,000 to:
- As of 12/31/24: $101,956,000
- As of 12/31/27: $118,912,000
- As of 12/31/30: $135,868,000

RIA – The shareholders' or partners' equity threshold would increase from $1,000,000 to:
- As of 12/31/24: $1,346,000
- As of 12/31/27: $1,694,000
- As of 12/31/30: $2,040,000

Increase of Equity/Net Worth and AUM Thresholds (cont.)

- The increases go into effect as of the last day of the QPAM's fiscal year ending no later than the date noted

- Thereafter, the threshold amounts will be subject to future annual inflation adjustments, which the DOL will publish no later than January 31st each year (to take effect as of the last day of the QPAM's fiscal year ending no later than December 31st of such year)

New Requirement to Notify DOL

- A QPAM must notify the DOL by email at *QPAM@dol.gov* that it is relying on the QPAM Exemption
  - Must report the legal and operating name of the QPAM entity relying on the exemption
  - Notice only needs to be provided once, unless the QPAM changes its legal or operating name
  - Notice must be provided within 90 days of relying on the exemption or a name change
  - DOL will publish a list of QPAMs on its website
  - If no longer using exemption, QPAM can notify DOL to remove its name from website

New Requirement to Notify DOL (cont.)

- QPAMs relying on the exemption as of the 6/17/24 effective date will need to submit the required notice to the DOL within 90 days thereafter

- DOL included a 90-day cure period for inadvertent failures to satisfy the notice requirement
  - To "cure" a failure, the QPAM must provide an explanation to the DOL of why it failed to provide the notice during the 90-day reporting period
  - "Isolated" instances of failing to report generally would not result in QPAM ineligibility

Foreign Criminal Convictions

- A QPAM will become ineligible to rely on the exemption for 10 years if the QPAM, or various affiliates or 5% or more owners, are convicted of certain crimes, including foreign criminal convictions
  - Removes any lack of clarity as to whether foreign criminal convictions also result in not being able to rely on the exemption
- Excludes convictions and imprisonments that occur within a country on the U.S. Department of Commerce's list of foreign adversaries (which currently include China, Cuba, Iran, North Korea and the Maduro Regime of Venezuela)

New Types of "Prohibited Misconduct"

- A QPAM will also become ineligible to rely on the exemption for 10 years if the QPAM, or various affiliates or 5% or more owners, participate in "prohibited misconduct"
  - Enter into a non-prosecution agreement ("NPA") or deferred prosecution agreement ("DPA") with a federal or state prosecutor regarding behavior that would have constituted a covered criminal conviction if successfully prosecuted; or
  - Found or determined in a final judgment or court-approved settlement in a proceeding brought by certain federal or state regulators that it:
    - Engaged in systematic pattern or practice of violating the conditions of the exemption;
    - Intentionally violated the conditions of the exemption; or
    - Provided materially misleading information to a federal or state regulator in connection with the conditions of the exemption

New Types of "Prohibited Misconduct" (cont.)

- "Participating in" misconduct includes not only active participation, but also knowingly approving of the conduct or having knowledge of the conduct without taking appropriate and proactive steps to prevent the conduct from occurring

- Foreign equivalent NPAs and DPAs do not trigger ineligibility like foreign criminal convictions, but still must notify DOL within 30 days

One-Year “Transition Period”

- Any QPAM that becomes ineligible to rely on the exemption on account of a criminal conviction or participating in prohibited misconduct must provide a one-year transition period for then-existing plan clients to the extent the QPAM desires to be able to rely on the exemption during the transition period
- Exemption will not be available for new clients during the transition period
- During the transition period, the QPAM must fully comply with exemption’s conditions, it must manage the plan’s assets prudently and loyally, and it must provide notice to the DOL and its plan clients of its ineligibility within 30 days

One-Year "Transition Period" (cont.)

The transition period ineligibility notice must include:

- Notice of the failure and the initiation of the one-year transition period;
- A statement that, during the transition period, the QPAM:
  - will not restrict the plan's ability to terminate or withdraw from its arrangement with the QPAM;
  - will not impose fees, penalties, or charges on the plan in connection with such termination or withdrawal (other than certain reasonable fees disclosed in advance that are designed to prevent abusive investment practices or to ensure equitable treatment of pooled fund investors);
  - will indemnify, hold harmless and promptly restore actual losses to the plan resulting therefrom (including the costs of unwinding transactions and transitioning to a new manager); and
  - will not employ or knowingly engage any individual that participated in the conduct that was the subject of the criminal conviction or the prohibited misconduct
- A detailed, objective description of the criminal conviction or prohibited misconduct so the plan's fiduciary can make prudent and loyal decisions on hiring, monitoring, evaluating and retaining the QPAM in a non-QPAM capacity

One-Year “Transition Period” (cont.)

- The proposed amendments to the exemption would have generally required QPAMs to include the transition period terms in all written management agreements, which would have required an amendment to all existing QPAM management agreements
- However, the Final Amendments do not include this requirement
- Instead, such requirements will apply only during the one-year transition period to the extent the QPAM desires to be able to rely on the exemption during the transition period
- QPAMs that become ineligible may apply to the DOL for an individual exemption, and should do so promptly

QPAM's Sole Responsibility for Transaction

- The terms of the applicable transaction must be determined by the QPAM (or under its authority and direction), and the transaction must not be designed to benefit a party in interest
- The transaction must be based on the QPAM's own independent exercise of fiduciary judgment
- The QPAM cannot be appointed to uncritically approve a transaction negotiated, proposed or approved by a party in interest
- No "rent-a-QPAM" or "QPAM-for-a-day" arrangements

New Recordkeeping Requirement

- QPAM must maintain records for 6 years demonstrating compliance with the exemption
- Extent to which transaction-by-transaction records are necessary depends on the facts and circumstances
- Records must be maintained in a manner that is reasonably accessible at a QPAM's customary business location for review by the DOL, IRS, plan fiduciaries, contributing employers, participating unions, and participants and beneficiaries
  - No need to provide access to privileged trade secrets or privileged commercial or financial information of the QPAM

The Fiduciary Rule

Who is an ERISA Fiduciary?

- Section 3(21) of ERISA generally provides that a person is a "fiduciary" with respect to a plan to the extent the person:
  - exercises any discretionary authority or control respecting management of the plan or the management or disposition of its assets;
  - ***renders "investment advice" for a fee or other compensation, direct or indirect, with respect to moneys or other property of the plan, or has any authority or responsibility to do so***; or
  - has any discretionary authority or discretionary responsibility in the administration of the plan

“Investment Advice” Fiduciary Rule “5-Part Test”

A person generally is providing “*investment advice*” if it:

- renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property,
- on a ***regular basis***,
- ***pursuant to a mutual agreement, arrangement or understanding*** with the plan or a plan fiduciary,
- that the advice will serve as a primary basis for investment decisions with respect to plan assets, and
- that the advice will be individualized based on the particular needs of the plan

“Investment Advice” Fiduciary Rule “5-Part Test” (cont.)

- US Department of Labor has attempted many times over the past 15 years to broaden what it means to be providing “investment advice” for these purposes
- DOL views 5-part test as too “narrow” and easy to avoid coverage
- DOL has long sought to treat IRA rollover advice as fiduciary investment advice (notwithstanding prior DOL guidance indicating such advice was not so covered)
- DOL issued proposed new rules in October 2023 that would have significantly expanded ERISA coverage to more advice providers/situations
- DOL finalized the new rules on April 23, 2024
  - Final rules replace the 5-part test with a broader, objective test
  - Narrower expansion than what the 2023 proposed rules contemplated, but still broader than the 5-part test
  - Generally effective 150 days after publication in Federal Register (9/23/24)

New Objective Test

A person renders “investment advice” with respect to moneys or other property of a plan or IRA if:

- the person makes a recommendation of any securities transaction or other investment transaction or any investment strategy involving securities or other investment property to a “retirement investor” (i.e., an ERISA plan or a participant, beneficiary or fiduciary thereof, or an IRA or a beneficiary, owner or fiduciary thereof); ***and***
- the person provides the recommendation in a manner that satisfies one of two enumerated conditions (see next slide)

New Objective Test (cont.)

An investment recommendation to a retirement investor will be considered “investment advice” if the adviser meets one of the following two conditions:

1. The adviser either directly or indirectly (through or together with any affiliate) makes professional investment recommendations to investors on a regular basis as part of their business ***and*** the recommendation is made under circumstances that would indicate to a reasonable investor in like circumstances that the recommendation:
   – is based on review of the retirement investor’s particular needs or individual circumstances,
   – reflects the application of professional or expert judgment to the retirement investor’s particular needs or individual circumstances, ***and***
   – may be relied upon by the retirement investor as intended to advance the retirement investor’s best interest; ***OR***
2. The adviser represents or acknowledges that it is acting as a fiduciary under Title I and/or Title II of ERISA with respect to the recommendation

New Objective Test (cont.)

- An investment recommendation will <u>not</u> be considered "investment advice" if the adviser does not meet at least one of those two conditions
- A salesperson's investment recommendation will <u>not</u> be considered "investment advice" if the person does not represent or acknowledge that they are acting as an ERISA fiduciary with respect to the recommendation and if the circumstances would not indicate to a reasonable investor in like circumstances that the recommendation is individualized based on the retirement investor's particular needs or circumstances or being provided in a manner intended to be relied upon to advance the retirement investor's best interest
- The mere provision of investment information or education, without an investment recommendation, is not "investment advice" under the final rules
  - Provides some clarity for human resources personnel providing only plan information or investment education to participants – not professional advice providers

New Objective Test (cont.)

- Requirement that advice be provided on a "***regular basis***" eliminated
  - One-time advice that meets the objective test can be considered "investment advice"
- "***Mutual agreement, arrangement or understanding***" requirement eliminated
  - Written statements by the adviser disclaiming that either of the covered contexts applies with respect to the advice will not control to the extent they are inconsistent with the adviser's oral or other written communications, marketing materials, applicable State or Federal law, or other interactions with the retirement investor
- Advice provided by a discretionary fiduciary ***not*** automatically covered
  - The proposed rules would have automatically picked up any investment recommendation provided to a retirement investor if the adviser either directly or indirectly (through or together with an affiliate) had discretionary authority or control with respect to purchasing or selling securities or other investment property for the retirement investor, ***even in a context unrelated to the advice***
  - Under the final rules, such advice would need to meet the objective test in order to be covered

“Recommendations”

- Threshold question is whether a “recommendation” has been made
- A “recommendation” is generally a communication that, based on its content, context and presentation, would reasonably be viewed as a suggestion that the retirement investor engage in or refrain from taking a particular course of action
- Objective determination that will turn on the facts and circumstances of the particular situation, including whether the communication reasonably could be viewed as a “call to action”
- The more individually tailored the communication is to a specific customer or a targeted group of customers about particular investments, the greater the likelihood that the communication may be viewed as a “recommendation”

Investment-Related Recommendations

- A "***recommendation of any securities transaction or other investment transaction or any investment strategy involving securities or other investment property***" means a "recommendation" as to:
  - The advisability of acquiring, holding, disposing of or exchanging, securities or other investment property, investment strategy, or how securities or other investment property should be invested after the securities or other investment property are rolled over, transferred or distributed from the plan or IRA;
  - The management of securities or other investment property, including, among other things, recommendations on investment policies or strategies, portfolio composition, selection of other persons to provide investment advice or investment management services, selection of investment account arrangements (e.g., account types such as brokerage versus advisory) or voting of proxies appurtenant to securities; and
  - Rolling over, transferring or distributing assets from a plan or IRA, including recommendations as to whether to engage in the transaction, the amount, the form, and the destination of such a rollover, transfer, or distribution

Investment-Related Recommendations (cont.)

- Recommendations as to health insurance policies, disability insurance policies, term life insurance policies or other property that ***do not contain an investment component*** are not covered
- Advice provided to a person (other than the retirement investor) who will then make the investment recommendation to the retirement investor is not covered
  - Focus is on the relationship between the person providing the investment recommendation and the retirement investor
- However, advice provided to a fiduciary with the power to make investment decisions for a plan or IRA is covered (as that advice recipient is a "retirement investor")

“For a Fee or Other Compensation, Direct or Indirect”

- Investment advice will be considered provided “***for a fee or other compensation, direct or indirect***,” if the adviser (or an affiliate) receives any explicit fee or compensation, from any source, for the investment advice, or receives any other fee or other compensation, from any source, in connection with or as a result of the investment recommendation
  - Includes commissions, loads, finder’s fees, revenue sharing payments, shareholder servicing fees, marketing or distribution fees, markups or markdowns, underwriting compensation, payments to brokerage firms in return for shelf space, recruitment compensation paid in connection with transfers of accounts to a registered representative’s new broker-dealer firm, expense reimbursements, gifts and gratuities, or other non-cash compensation

Prohibited Transaction Exemption Amendments

- DOL also finalized amendments to certain prohibited transaction exemptions (including PTCEs 2020-02 and 84-24, among others) which provide some relief to investment advice fiduciaries for certain compensation arrangements that would otherwise be prohibited, provided the adviser complies with certain "impartial conduct standards" and other exemption conditions
  - The "impartial conduct standards" include a best interest standard, a reasonable compensation standard, and a requirement to make no misleading statements about investment transactions and other relevant matters
- Investment advice fiduciaries that wish to receive otherwise prohibited variable compensation, generally will need to comply with PTCE 2020-02 or 84-24
- PTCE amendments also generally effective 150 days after publication in Federal Register
- Amended PTCEs 2020-02 and 84-24 include a one-year transition period after their effective dates under which parties have to comply <u>only</u> with the "impartial conduct standards" and provide a written acknowledgment of fiduciary status for relief

PTCE 2020-02

- Amended PTCE 2020-02 generally allows an investment advice fiduciary to receive compensation where its investment advice might otherwise be considered "conflicted," such as compensation that varies depending on the investments made/recommended
- The adviser must (among other things):
  - Comply with the "impartial conduct standards"
  - Acknowledge its fiduciary status in writing
  - Disclose its services and material conflicts of interest
  - Adopt policies and procedures prudently designed to ensure compliance with the impartial conduct standards and mitigate conflicts of interest
  - With respect to IRA rollover advice, it must document and disclose the reasons for the recommendation
  - Conduct an annual retrospective compliance review

PTCE 84-24

- Amended PTCE 84-24 generally allows an “independent producer” that provides fiduciary investment advice to a retirement investor (including in connection with a rollover) to receive reasonable compensation and to sell non-security annuity contracts or other non-security insurance products
- “Independent producer” generally means a person who is licensed to sell insurance contracts (including annuities) of multiple unaffiliated insurance companies to retirement investors, where the person is not an employee of any of such insurance companies
- The Independent Producer must (among other things):
  - Comply with the “impartial conduct standards”
  - Acknowledge its fiduciary status in writing
  - Disclose its services and material conflicts of interest
  - Adopt policies and procedures prudently designed to ensure compliance with the impartial conduct standards and mitigate conflicts of interest
  - With respect to IRA rollovers and annuity sales, document and disclose the reasons for the recommendation
  - Conduct an annual retrospective compliance review

And More (Artificial Intelligence, the Private Fund Adviser Rules and ESG)

Artificial Intelligence

- **How will AI affect ERISA fiduciaries?**

"AI can significantly impact ERISA fiduciaries by offering advanced tools for managing retirement plans, analyzing investment options, and assessing risks. AI can streamline administrative tasks, provide data-driven insights for decision-making, and help optimize investment strategies. However, it also raises questions about fiduciary responsibility, data privacy, and the need for human oversight to ensure compliance with ERISA regulations."

Artificial Intelligence (cont.)

- **How will AI affect ERISA fiduciaries *(but make the answer rhyme)*?**

"In the realm of ERISA fiduciary's fare, AI brings tools beyond compare.
Streamlining tasks with data's might, guiding decisions, shining light.

Yet, questions arise about the role, of humans in this digital stroll.
Responsibility and privacy in the mix, AI's impact, a fiduciary's fix.

So while AI offers a wealth to behold, human oversight remains as bold.
Navigating ERISA's intricate weave, with AI's help fiduciaries achieve."

Artificial Intelligence (cont.)

- AI is already here

- Ultimate uses and effect on the ERISA world is currently unknown, but it is likely coming soon to a theater near us!

- ERISA fiduciaries (along with everyone else) will eventually need to determine to what extent they should or need to use AI
  - Internal operations
  - Data privacy concerns
  - Plan investment decisions
  - Hiring service providers
  - Drafting plan documents
  - Monitoring the use of AI by investment managers and other service providers
  - Discrimination concerns

Private Fund Adviser Rules

- SEC's "no preferential treatment rule" takes effect on 9/14/24
- A private fund adviser generally may not grant to a private fund investor the right to redeem its interest on terms that the adviser reasonably expects to have a material, negative effect on other investors in that private fund, unless the investor is required to redeem due to applicable law (or all investors have the same right)
- What about ERISA-related withdrawal/redemption rights?
  - Not reasonably expected to be triggered?
  - Not reasonably expected to have a material negative impact on other investors?
  - Due to applicable law?
  - Grandfathering rules?
  - Only manager right to kick out?

2022 DOL ESG Final Rules – Refresher

- Current rules specifically allow ERISA fiduciaries to consider ESG factors, but retain ERISA's bedrock principle that you ***cannot sacrifice investment returns or assume greater investment risk*** to promote collateral objectives
  - ***Duties of prudence and loyalty generally require ERISA fiduciaries to seek to maximize risk-adjusted returns***
- "Appropriate consideration" of facts and circumstances relating to investment decisions requires an assessment of factors determined to be relevant to risk/return
- Risk and return factors ***may*** include the economic effects of climate change and other ESG factors
- Otherwise, ESG factors can generally only be considered in a tie-breaker context

2022 DOL ESG Final Rules – Refresher (cont.)

- Fiduciary investment management responsibility includes voting proxies
- Still no safe harbor; still no separate asset class for ESG
  - Litigation risk if ESG-based investment underperforms
- Congressional challenges have either failed or been vetoed
- Court challenges have also generally failed
  - However, in a recent case involving ESG-related breach of ERISA fiduciary duty claims, plaintiffs were able to survive a motion to dismiss, with the court setting a relatively low bar in order to do so

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Proskauer's Perspective on Employee Benefits, Executive Compensation and ERISA Litigation

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