INVESTMENT ADVISER
ASSOCIATION

April 18, 2008

Via Electronic Filing

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210

Re: Hearing on Proposed Regulation Under Section 408(b)(2)

Ladies and Gentlemen:

The Investment Adviser Association appreciates having had the opportunity to present testimony at the Department's hearing on its proposed regulation under Section 408(b)(2) of ERISA and related class exemption ("Proposed Regulation").[1] We write to provide supplemental information in response to certain questions the panel posed during our testimony.

Disclosures in Form ADV

We testified that the Department should include in the final regulation a "safe harbor" with respect to compensation and conflicts of interest disclosure. For investment advisers, the safe harbor should provide that the use of the adviser's Form ADV, along with its written contract with the plan, should be deemed to satisfy the disclosure requirements under section 408(b)(2). The panel asked a number of questions related to the information provided in Form ADV compared with information required by the Proposed Regulation.[2]

Compensation Disclosure

Primary compensation. As discussed in our testimony, the written contract between the investment adviser and the retirement plan typically states a formula under which the adviser's compensation will be determined, generally a percentage of the assets under management. Often, the rates are "tiered" such that a smaller percentage applies as the plan

[1] We limited our testimony to the defined benefit plan context, but our February 11 comment letter also addresses defined contribution plans.

[2] Unless otherwise specified, we discuss here the provisions of Form ADV, Part 2 as recently re-proposed by the SEC. *Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (Mar. 3, 2008). However, the current Form ADV, both Part 1 and Part II, contain extensive relevant disclosure information as well, as discussed in our previous submissions.

assets managed by the adviser exceed certain breakpoints. This asset-based compensation is the primary compensation received by the investment adviser in connection with managing the plan's assets. The contract also typically includes a representation that the adviser is providing investment management services as a fiduciary.

In addition, Form ADV, which is required to be provided to the retirement plan at or prior to the beginning of the advisory relationship, requires advisers to describe how they are compensated for advisory services and how any prepaid fees will be calculated and refunded upon termination, and to provide their fee schedule. Thus, the primary compensation received by an investment adviser in connection with services to retirement plans and related information already is disclosed in two separate existing documents that would satisfy subsections (c)(1)(iii)(A) and (B) of the Proposed Regulation.

Other forms of "compensation." Investment managers may also receive compensation related to the use of their own products and services or those of their affiliates in connection with fulfilling their advisory mandate. In the absence of an exemption, such use would result in a violation of ERISA's prohibited transaction rules. The Department has developed a comprehensive list of both class and individual exemptions to allow advisers to use such products or services while at the same time being protective of the interests of the retirement plan investor.[3] Among other conditions, the relief provided by these exemptions is conditioned on the disclosure by the adviser of the fees that it or its affiliates will receive in connection with the provisions of the products and services covered thereunder.

A secondary form of "compensation" that investment managers may receive in connection with their services to defined benefit plans is soft dollar products or services.[4] As discussed in our prior submissions, investment managers cannot provide specific information regarding the soft dollar products or services they may receive in the future at the time of contract with the client. In Form ADV, Item 12, however, the SEC requires substantial disclosures regarding research and other soft dollar benefits, as follows:

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[3] *See, e.g.*, PTE 77-4 (Purchase of Shares of Open-End Investment Companies); PTE 87-63 (Compensation to Fiduciaries for Securities Lending Services); PTE 86-128 (Executing Securities Transactions and Recapture of Commissions).

[4] We do not concede that soft dollar products and services should be deemed "compensation" to the adviser. *See* IAA Letter to DOL re 5500 Revisions (Sept. 19, 2006). Further, as discussed in our previous submissions, we strongly urge the Department not to consider meals or entertainment provided to investment managers as part of an overall relationship with a third party as "compensation" to the manager in connection with services to the plan. In the unlikely event that the meal or entertainment is in connection with a specific plan and over a certain threshold and we know it will occur in advance of the contract, we agree it should be disclosed. More likely, any such meal or entertainment would not be known in advance and would be reported after the fact for Form 5500 purposes. Apart from the "compensation" aspect, we note that if a broker provides an adviser with meals or entertainment that are so frequent or excessive that they rise to the level of a conflict of interest that may influence the selection of brokers, the adviser must disclose the conflict. *See, e.g., In the Matter of Fidelity Research & Management Co.*, SEC IA. Rel. 2713 (Mar. 5, 2008). In general, the SEC appropriately treats soft dollars, meals/entertainment, services performed by affiliates, and similar items as conflict of interest issues rather than taking the Department's approach to these items as a form of "compensation."

"If you receive research or other products or services other than execution from a broker-dealer or a third party in connection with *client* securities transactions ("soft dollar benefits"), disclose your practices and discuss the conflicts of interest they create.

Note: Your disclosure and discussion must include all soft dollar benefits you receive, including, in the case of research, both proprietary research (created or developed by the broker-dealer) and research created or developed by a third party.

a. Explain that when you use *client* brokerage commissions (or markups or markdowns) to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research, products or services.

b. Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than on your *clients*' interest in receiving best execution.

c. If you may cause *clients* to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollar benefits (known as paying-up), disclose this fact.

d. Disclose whether you use soft dollar benefits to service all of your *clients*' accounts or only those that paid for the benefits. Disclose whether you seek to allocate soft dollar benefits to *client* accounts proportionately to the soft dollar credits the accounts generate.

e. Describe the types of products and services you or any of your *related persons* acquired with *client* brokerage commissions (or markups or markdowns) within your last fiscal year.

Note: This description must be specific enough for your *clients* to understand the types of products or services that you are acquiring and to permit them to evaluate possible conflicts of interest. Your description must be more detailed for products or services that do not qualify for the safe harbor in section 28(e) of the Securities Exchange Act of 1934, such as those services that do not aid in investment decision-making or trade execution. Merely disclosing that you obtain various research reports and products is not specific enough.

f. Explain the procedures you used during your last fiscal year to direct *client* transactions to a particular broker-dealer in return for soft dollar benefits you received."[5]

Thus, the Form ADV approach is a practical and meaningful method of providing pension plans and other clients with "sufficient information to enable the responsible plan

[5] Form ADV, Part II, Item 12 currently requires this type of disclosure as well.

fiduciary to evaluate the reasonableness of such compensation"[6] and any resulting conflicts of interest with respect to soft dollars, as would be required by the Proposed Regulation.

Further, although generally not the case in the defined benefit plan context, Form ADV, Part 2 requires firms to disclose whether any of its supervised persons (*i.e.*, employees, officers, directors, or other individuals offering investment advice on the firm's behalf) accepts compensation for the sale of securities or investment products, and, if so, to provide an additional set of disclosures.

Compensation paid by plan to other parties. With respect to other fees paid by the plan that is *not* compensation to the adviser, Form ADV, Part 2 will also require advisers to describe any other types of fees or expenses that clients may pay in connection with the advisory services provided, such as custodian fees or mutual fund expenses. Firms must also disclose that clients will incur brokerage and other transaction costs and direct clients to the section of the disclosure that discusses brokerage practices, including the factors the advisers consider in selecting brokers and determining the reasonableness of their compensation.[7]

In summary, the compensation information addressed in the Proposed Regulation is entirely covered by disclosures that investment advisers are already required to provide to their retirement plan clients.

Conflict of Interest Disclosure

Form ADV requires advisers to "describe any relationship or arrangement that is material to your advisory business or to your clients, that you or any of your management persons have with any related person listed below [including broker-dealers, investment advisers, investment companies, insurance companies, banks, etc.]. Identify the related person and if the relationship or arrangement creates a material conflict of interest with clients, describe the nature of the conflict and how you address it." Form ADV also requires a host of other conflict of interest disclosures, including disclosures regarding referral arrangements, participation in client transactions, personal and proprietary trading, brokerage, proxy voting, and performance fees. Advisers must explain the nature of the conflicts involved and how the firm addresses these conflicts.[8] The type and nature of these disclosures - as well as their purpose and goals - are the same as those contemplated by the Proposed

[6] *See* subsection (c)(1)(iii)(A)(*2*) of the Proposed Regulation.

[7] As we have stated in prior submissions, this type of disclosure regarding brokerage compensation is the only useful information the manager can provide, not knowing in advance which brokers it will use or which trades it will execute in the coming year.

[8] The SEC originally proposed a requirement for advisers to describe their policies and procedures in Form ADV, but in the re-proposal recognized that such disclosures could be too voluminous and technical to be useful to investors. Instead, the SEC would require advisers "to explain succinctly how they address the conflicts of interest they identify," which could include discussion of specific policies or procedures. The re-proposal also continues the current requirement for advisers to describe their codes of ethics and offer to provide them upon request. We submit that the Department should clarify that its analogous requirement in proposed subsection (c)(1)(iii)(F) would be satisfied by such disclosure.

Regulation. To the extent that the Proposed Regulation would require additional disclosure, the proposal is too broad and would not provide meaningful information to plans.[9]

Treatment of Existing Contracts

We testified in support of a gradual implementation of the final regulation that would subject existing contracts and arrangements to the requirements of the final regulation upon their extension, explicit renewal (as opposed to automatic renewal), or material modification. We noted that the requested transition rule, however, need not inordinately delay plan fiduciaries' receipt of the disclosures under the final regulation.

The panel inquired regarding the appropriate treatment under our proposal of "evergreen" contracts (for example, a contract that automatically renews unless affirmatively terminated or a contract with no fixed period that is terminable on 30 days notice). We urge the Department to simply "grandfather" such contracts – that is, not require the contractual provisions to be amended as long as the plan receives the required disclosures, which is, after all, the critical component of the regulation. If, notwithstanding each plan's receipt of all relevant disclosures, the Department determines that existing evergreen contracts must eventually be amended, it could include a "sunset" provision by which all contracts must include the required provisions within three years from the date of the final regulation unless extended, explicitly renewed, or materially modified before that date.

Conclusion

Please do not hesitate to contact us if we may provide any additional information as you consider these important issues.

Best regards,

Karen L. Barr

Karen L. Barr

[9] These Form ADV disclosures appear substantially to cover proposed subsections (c)(1)(iii)(C) through (F). Subsection (D) appears to also cover material relationships or arrangements with "other service providers to the plan, or any other entity that creates or may create a conflict of interest for the service provider in performing services" for the plan. As we have previously noted, advisers typically are not aware of all of the other service providers to the plan or other entities that "may" create a conflict. We assume that the Department's intent is to require disclosure only of conflicts of interest of which the adviser is aware that relate to its performance of services to the client.