December 5, 2016

Via Electronic Mail (e-ORI@dol.gov)

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: RIN 1210-AB63; Annual Reporting and Disclosure

Ladies and Gentlemen:

The Investment Adviser Association[1] appreciates the opportunity to comment on the proposal by the Department of Labor, the Internal Revenue Service and the Pension Benefit Guaranty Corporation (collectively Agencies) to make changes to Form 5500, Annual Return/Report of Employee Benefit Plan.[2] Investment advisers serve as service providers to employee benefit plans, and provide plan administrators with information necessary to complete Schedule C of the Form and categorize investments on Schedule H, Financial Information. Our comments below are limited to these two Schedules.

Schedule C Reporting of Indirect Compensation

A plan administrator of a plan with 100 or more participants must include with its annual Form 5500 filing a Schedule C, Service Provider Information, to report amounts of at least $5000 paid by the plan to service providers during the plan year. Under the existing "alternative reporting option," if some or all of the service provider's compensation qualifies as "eligible indirect compensation," the plan administrator may report that the service provider has received the compensation, but is not required to detail the compensation or supply a dollar figure.

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA has more than 600 member firms that collectively manage approximately $20 trillion for wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. Almost three quarters of IAA members manage at least one pension or profit sharing plan. For more information, please visit www.investmentadviser.org.

[2] 81 Fed. Reg. 47534 (July 21, 2016) ("Proposal").

Instead, the plan administrator verifies that it has received certain required disclosures from the service provider.[3]

The Proposal would eliminate this option, however, citing the goal of "harmonizing" Schedule C reporting with the regulation under section 408(b)(2) of ERISA ("408(b)(2)"), which was adopted in 2012, after the most recent changes to Schedule C. The 408(b)(2) regulation requires advance disclosures concerning direct and indirect compensation paid to investment advisers and other covered service providers in order to exempt the provision of services to ERISA plans from the prohibited transaction rules.[4] As to indirect compensation, the 408(b)(2) regulation requires "a description of the arrangement…pursuant to which such indirect compensation is paid" reasonably in advance of entering into the agreement to provide services.[5]

We submit that the proposed elimination of this option and replacement with the new requirement would go well beyond what is required under 408(b)(2) in the context of soft dollar arrangements. Under the Proposal, an investment adviser would be required to furnish either a dollar amount representing the soft dollar benefits received during the plan year or an estimate of such amount along with the formula used to calculate the estimate.[6] In contrast, the 408(b)(2) disclosure requirements permit a description of the soft dollar arrangement rather than a dollar amount.

We agree that Schedule C reporting should be harmonized with the 408(b)(2) disclosures, but we submit that the Form 5500 reporting requirements should adopt the same language as the 408(b)(2) disclosures so that the requirements are in fact the same.[7] Using the same criteria for each would benefit both service providers and plans. Service providers could disclose and report one set of consistent information, and plans would not need to process and analyze two separate sets of information concerning the same soft dollar arrangements.

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[3] 72 Fed. Reg. 64731, 64826 (Nov. 16, 2007). The required disclosures are (a) the existence of the indirect compensation; (b) the services provided for the indirect compensation or the purpose for payment of the indirect compensation; (c) the amount (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation; and (d) the identity of the party or parties paying and receiving the compensation.

[4] 77 Fed. Reg. 5634 (Feb. 3, 2012). The regulation under section 408(b)(2) also requires as a condition to the prohibited transaction exemption that the covered service provider supply the plan administrator with information necessary to prepare the annual Form 5500 upon written request. 29 CFR § 2550.408b-2(c)(1)(vi). Therefore, a service provider must also supply the required Schedule C information on soft dollars in order to comply with 408(b)(2).

[5] 29 CFR § 2550.408b-2(c)(1)(iv)(C)(2).

[6] Line 3b – Proposal at 47578.

[7] In the alternative, the revised Form 5500 could retain the alternative reporting system for eligible indirect compensation, which service providers and plan administrators have relied on over the past seven reporting cycles.

Background on Soft Dollars and Investment Advisers Act Disclosures

The history of Schedule C disclosures reflects the difficulties with quantifying soft dollar arrangements. Initially, the Agencies had proposed to require that indirect compensation, including soft dollars, be reported in the same manner as direct compensation, but the IAA and others opposed the proposed requirement in their comments. As noted in the preamble to the final rule in 2007, commenters asserted, among other things, that "the proposed changes could result in duplicative, misleading and confusing reporting." The Department in response adopted the alternative reporting option in its current form.[8]

The list of "eligible indirect compensation" under the existing rule includes "research or other products or services, other than execution, that an investment adviser may receive from a broker-dealer or other third party in connection with securities transactions (soft dollars)."[9] In soft dollar arrangements, the investment adviser obtains products and services from a broker-dealer in exchange for client commissions paid to that broker-dealer for executing clients' securities transactions on an aggregate basis.

Such arrangements are specifically permitted under section 28(e) of the Securities Exchange Act, which provides a safe harbor from alleged fiduciary violations under federal law (including ERISA) if the adviser pays more than the lowest available commission cost for eligible brokerage and research services as part of a soft dollar arrangement. To rely on the safe harbor, an investment adviser must determine that the eligible products and services provide lawful and appropriate assistance in the performance of investment decision-making and must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of the products received or services rendered. The Department has indicated that investment advisers generally may not use commissions paid in connection with transactions in the plan to obtain products or services that are outside of the section 28(e) safe harbor.

Soft dollar research generally can be categorized as either "proprietary" or "third-party." When a broker-dealer executing a trade also provides internally generated research in exchange for one bundled commission price, the arrangement is referred to as "proprietary." Broker-dealers are not required to provide information to advisers for the various components of the bundled price, and may not separate out the cost of execution from research. And the value of the research cannot be ascertained by comparing the cost of these bundled services to "execution only" broker-dealers because, for example, the quality of the execution may not be equivalent in the two instances. In addition, the "pure" execution price of a trade may vary based on a number of factors, including the size of the transaction, the timeliness of execution, the ability to maintain the investor's anonymity, the difficulty of the trade, or unusual market conditions.

[8] 72 Fed. Reg. 64731, 64738 (Nov. 16, 2007).

[9] 2015 Instructions for Schedule C (Form 5500) at 25.

We also note that, even if broker-dealers were able and willing to provide a dollar figure, differences in their methodologies and assumptions could produce numbers that would not be useful in comparing broker-dealers or advisers. The value of these numbers to the plan, the Agencies, and the public therefore would be quite limited. For all these reasons, quantification of soft dollar benefits remains challenging.[10]

Furthermore, investment advisers already provide extensive information to their clients concerning their soft dollar arrangements. As fiduciaries under the Investment Advisers Act of 1940, investment advisers must act in the best interest of their clients, may not use client assets for their own benefit without consent, and must seek best execution of client transactions. They also are required to disclose any material conflicts of interest and how they mitigate these conflicts. In addition, investment advisers are explicitly required to disclose information related to brokerage commissions and soft dollar arrangements in Form ADV, Part 2, the brochure that advisers must provide to clients. Item 12 of Form ADV, Part 2 requires that the brochure discuss brokerage practices, including the factors that the adviser considers in selecting or recommending broker-dealers for client transactions, and provide specific information about the use of soft dollars.[11]

These disclosures already provide all clients, including ERISA plans, with full disclosure about their advisers' soft dollar arrangements. The 408(b)(2) disclosures supplement these already extensive disclosures with information tailored to ERISA plans. Accordingly, we submit that the final rule should rely on the 408(b)(2) disclosures to satisfy the Schedule C reporting requirements with respect to soft dollars.

Financial Information on Schedule H

Investment advisers may also assist plan administrators in categorizing the plan's investments in Schedule H to the Form 5500. As types of investments have proliferated, the catch-all category of "Other" on Schedule H has served as the repository for many diverse types of investments not anticipated in 2007. The Agencies have therefore proposed to add a number of new categories to the Schedule.

For example, plan administrators would need to separate out various types of funds, including private equity and hedge funds, which are defined in the proposal. We note that the definitions of private equity and hedge funds[12] do not conform with the definitions that such funds use when filing Form ADV (Uniform Application for Investment Adviser Registration and

[10] *See* Letter from Karen Barr, Investment Adviser Association, to Office of Regulations and Interpretations on the Revision of Form 5500 (Sept. 19, 2006), *available at* https://www.dol.gov/sites/default/files/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AB06/00016.pdf.

[11] The information required by Item 12 is listed in Appendix A.

[12] *See* Lines 1b(8)(A)(3) & (4) – Proposal at 47623.

Report by Exempt Reporting Advisers) and Form PF (Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors).[13] In order to promote consistency across these reporting regimes, we recommend that the Department adopt the Form PF definitions of these terms for purposes of the Schedule H definition.[14]

The proposed changes to Schedule H also would require at Line 4i that each investment listed indicate whether the asset is "hard to value." Under the definition, investments are hard to value if they are not listed on any national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System (NASDAQ).[15] We note that the value of certain securities are often set by independent, third-party pricing agents, and request the addition of this valuation method as an exception to the "hard to value" definition, as set forth in Appendix C.

* * *

We appreciate the opportunity to provide comments on the Proposal and would be pleased to meet with the Department regarding our comments and to provide any additional information. Please contact Kathy Ireland, IAA Associate General Counsel, or me at (202) 293-4222 with any questions concerning our comments.

Respectfully submitted,

Robert C. Grohowski
Robert C. Grohowski
General Counsel

cc: Joe Canary, Director, Office of Regulations and Interpretations
Mara Blumenthal, Office of Regulations and Interpretations

[13] Form ADV is available at https://www.sec.gov/about/forms/formadv.pdf and Form PF is available at https://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf. For ease of reference, we have included these Forms' definitions of private equity fund and hedge fund in Appendix B.

[14] The Agencies should also consider providing more detail as to the various categories in Schedule H. For example, the definition of derivative in Line 1b(11) of Schedule H includes forwards. Proposal at 47623. We request clarification that the term "forwards" for this purpose includes TBA (to-be-announced) securities, which involve forward trading of mortgage-backed securities (MBS).

[15] Proposal at 47630.

Appendix A

Item 12 of Form ADV, Part 2 requires disclosure of soft dollars as follows:

> 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 most favorable 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 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.

Appendix B

Forms ADV and PF define the term "hedge fund" as follows:

"any private fund (other than a securitized asset fund):

(a) with respect to which one or more investment advisers (or related persons of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses);

(b) that may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or

(c) that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration).

A commodity pool is categorized as a hedge fund solely for purposes of this question. For purposes of this definition, do not net long and short positions. Include any borrowings or notional exposure of another person that are guaranteed by the *private fund* or that the *private fund* may otherwise be obligated to satisfy."

Forms ADV and PF define the term "private equity fund" as follows:

"any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund, or venture capital fund and does not provide investors with redemption rights in the ordinary course."

Appendix C

[Proposed new text in red]

Line 4i of Schedule H, Element a(iv). Check here if the asset is a ‘‘hard-to-value’’ asset. Assets that are not listed on any national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, independent, third-party pricing agents, or the National Association of Securities Dealers Automated Quotations System (NASDAQ), are required to be identified as hard-to-value assets on the Schedule of Assets Held for Investment at End of Year.