

August 30, 2010

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: Reasonable Contract or Arrangement Under Section 408(b)(2) – Fee Disclosure

Ladies and Gentlemen:

The Investment Adviser Association appreciates the opportunity to provide comments concerning the interim final rule under section 408(b)(2) of ERISA.¹ We have identified certain implementation issues that may require further clarification, including (1) the use of the advisory contract and Form ADV as the primary disclosure documents, especially with respect to soft dollar disclosure; (2) the changes that service providers must report to fiduciaries within 60 days, and (3) the scope of relief under the class exemption. In addition, our submission responds to the Department's request for comments as to whether the final rule should include a requirement that covered service providers furnish a summary disclosure statement.

Implementation Issues

Use of Advisory Contract and Form ADV as Safe Harbor Disclosure Vehicles

In the typical arrangement between an investment adviser and a retirement plan, the parties enter into a written contract that states a formula under which the adviser's compensation will be determined, generally a percentage of the assets under management. In addition, Form ADV, Part 2, a narrative disclosure brochure that is required under Securities and Exchange Commission rules to be provided to the retirement plan at or prior to the beginning of the advisory relationship, requires advisers to (1) describe how they are compensated for advisory services and how any prepaid fees will be calculated and refunded upon termination; and (2) provide their fee schedule.²

¹ The IAA is a not-for-profit association that represents the interests of investment adviser firms that are registered with the SEC. For more information, please visit our web site: www.investmentadviser.org.

² Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities. The form consists of two parts. Part 1 requires information about the investment adviser's business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its

The preamble to the proposed regulation anticipated that advisers would incorporate Form ADV disclosures by reference in their section 408(b)(2) disclosures,³ but neither the interim final rule nor its preamble mentions Form ADV. The only reference to disclosure materials regulated by a state or federal agency (such as the SEC) appears in the provision describing the investment disclosures required of providers supplying recordkeeping or brokerage services.⁴ This provision allows such service providers to provide the current disclosure materials of the issuer of a designated investment alternative, provided that, among other things, the disclosure materials are regulated by a state or federal agency.

We request that the final rule (and/or preamble) contain a safe harbor, similar to that applicable to designated investment alternatives, allowing the use of Form ADV (along with the parties' investment advisory contract) to satisfy an investment adviser's disclosure responsibilities under section 408(b)(2). If the Department declines to provide a safe harbor for the use of Form ADV, it should, at a minimum, include language in the preamble stating that the type of disclosure typically included in Form ADV is the type of disclosure that satisfies the rule under section 408(b)(2).

Specific Example: Disclosures Concerning Soft Dollars

The use of Form ADV for section 408(b)(2) disclosure is particularly relevant for information related to soft dollars. In order for its arrangement to qualify as "reasonable" under the interim final rule, an investment adviser must provide a description of both direct and indirect compensation that the adviser, its affiliates, and its subcontractors reasonably expect to receive in connection with their services.⁵ The required information for indirect compensation includes "identification of the services for which the indirect compensation will be received and identification of the payer of the indirect compensation."⁶

The Department has indicated that soft dollar products or services that investment advisers (and their subadvisers) may receive from broker-dealers may constitute indirect compensation in connection with their services to plans. However, advisers typically do not have sufficient information about soft dollar products and services they may receive in the future and from whom they may receive them (*e.g.*, the "payer").

employees. Part 1 is organized in a check-the-box, fill-in-the-blank format. The SEC reviews the information from this part of the form to manage its regulatory and examination programs. Part 2 requires investment advisers to prepare narrative brochures that include plain English disclosures of the adviser's business practices, fees, conflicts of interest, and disciplinary information. The brochure is the primary disclosure document for investment advisers.

³ 72 Fed. Reg. 70990.

⁴ 29 C.F.R. § 2550.408b-2(c)(1)(iv)(G)(2).

⁵ *Id.* § 2550.408b-2(c)(1)(iv)(C).

⁶ *Id.* § 2550.408b-2(c)(1)(iv)(C)(2).

Investment advisers often exercise discretion in choosing the broker-dealers that will execute a particular securities transaction for their clients. In this type of arrangement, the broker's compensation is paid as part of each securities transaction.⁷ An investment adviser is responsible both under the Investment Advisers Act and ERISA fiduciary principles to seek best execution for securities transactions in the plan's account. As part of that duty, the adviser may select among hundreds of brokers on a transaction-by-transaction basis or an investment style-by-style basis (*e.g.*, international equity, small cap, municipal debt, etc.). Thus, the adviser does not know at the beginning of each contract, each year, or even each day, which broker (or which type of broker) it will choose to execute transactions for the plan. Further, any of these hundreds of brokers might send unsolicited soft dollar research, provide products and services as part of an overall relationship, or provide an adviser "credits" for future receipt of soft dollar products or services.

Accordingly, investment advisers cannot provide specific information regarding the payers of soft dollar products or services they (or their affiliates or subadvisers) may receive in the future at the time of contract with the client.⁸ In Form ADV,⁹ however, the SEC requires substantial disclosures regarding research and other soft dollar benefits, 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.

⁷ Brokers generally provide services directly to a plan and receive compensation directly from the plan, and would not be considered a subcontractor of the adviser with respect to its investment management services.

⁸ The same issue could arise under section 2550.408b-2(c)(1)(C)(iv)(3), which requires a description of compensation paid among the covered service provider, an affiliate or a subcontractor, if it is set on a transaction basis, including soft dollars.

⁹ Part 1 of Form ADV is filed and available to the public electronically through the Investment Adviser Registration Depository (IARD) at <http://www.sec.gov/IARD>. The SEC recently finalized rule amendments that will also require the filing of Part 2A of Form ADV through the IARD. See *Amendments to Form ADV*, SEC Rel. IA-3060 (July 28, 2010), available at <http://www.sec.gov/rules/final/2010/ia-3060.pdf>. In addition, Part 2A generally must be provided to clients and prospective clients at the time of or before entering into a contract, and must be promptly updated when the information becomes materially inaccurate.

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.

In addition, Item 12 of Form ADV, Part 2A requires extensive disclosure in an adviser's brochure concerning brokerage practices, including the factors that the adviser considers in selecting or recommending broker-dealers for client transactions.

Thus, the Form ADV approach is a practical and meaningful method of providing pension plans and other clients with sufficient information to evaluate in advance the adviser's brokerage procedures, including soft dollars. As we have noted in prior comment letters on this rule, this type of disclosure regarding brokerage compensation is the only useful information the adviser can provide, not knowing in advance which brokers it (or its affiliates or subadvisers) will use or which trades it will execute in the coming year.¹⁰

This approach is also consistent with the reporting requirements for Schedule C of Form 5500, in which advisers must provide a description of soft dollar services and products received during the plan year in a manner sufficient for the plan fiduciary to evaluate its reasonableness. We also note that the plan will receive this Schedule C information after the soft dollar payments have occurred. We submit that providing actual soft dollar information will be more helpful to plan fiduciaries than theoretical information about hundreds of potential brokers provided prior to the arrangement in section 408(b)(2) disclosure.¹¹

¹⁰ Similarly, the adviser cannot identify prospectively the payers that might provide non-cash compensation or the type or amount of such non-cash compensation, such as gifts and gratuities.

¹¹ In addition, we request confirmation that the selection of a broker for a particular transaction, and each occurrence of soft dollar benefits, need not be reported to the plan fiduciary as a "change" to the required

Disclosure of Changes to the Required Information

The proposed regulation would have required that a service provider disclose material changes to the required information within 30 days. We note that the Department extended this period to 60 days, properly recognizing that identification and communication of these changes might require more than 30 days, especially in the context of large institutions. In the interim final rule, however, the Department deleted the reference to “material” changes. The rule in its current form may result in a constant flow of minute changes, and therefore be of little use to the fiduciaries reviewing the changes. Accordingly, we recommend that the Department return the materiality standard to the rule, and, as we requested in our earlier comments, add to the final rule the helpful guidance in the preamble to the proposed regulation concerning the interpretation of “material.”¹²

Scope of Proposed Class Exemption

Our 2008 comments on the proposed class exemption requested that the relief extend to service providers that cannot provide the required information because of their inability to obtain the information from third parties. The Department, however, declined to expand the relief in the interim final rule beyond the responsible plan fiduciary, citing the new provision allowing the correction of errors and omissions. Given that the interim final rule will require advisers to provide information originating from affiliates and subcontractors, advisers still may face excise taxes if they cannot obtain the necessary information from these third parties, notwithstanding the new provision regarding the correction of errors and omissions. We therefore renew our request for relief for such service providers under the exemption.

Request for Comment Concerning a Summary Disclosure Document Requirement

The Department is considering whether to add a requirement that a covered service provider furnish a summary disclosure statement that would include key information intended to provide an overview for the responsible plan fiduciary, as a “roadmap” to the detailed elements of the disclosure. We are concerned that the development and implementation of this concept would be difficult, because of the variety of arrangements to which it would apply. The Department should also consider the added cost of the summary document, especially if the service provider would have to amend it frequently for the series of minor changes that may be necessary if the final rule does not include the “materiality” standard discussed above.

If the Department requires such a summary document, we urge that it not apply to defined benefit plans. As we previously commented and testified, the typical compensation arrangements applicable to defined benefit plans differ considerably from those in the defined

disclosures under the final rule. Indeed, the possibility that some may interpret the “change” rule to encompass such occurrences, supports limiting the reported changes to “material” changes, which we discuss in the following section.

¹² 72 Fed. Reg. 70992.

contribution context. The compensation received by an adviser typically will consist of a percentage of assets under management and possibly soft dollar benefits. Although a “roadmap” might be helpful in the more complex defined contribution context to facilitate comparisons among providers, platforms and investment alternatives, the evaluation and comparison of relatively simple defined benefit arrangements does not require summarization. A “one-size-fits-all” approach requiring a summary document for all plans would be neither appropriate nor practical in this context.

Conclusion

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

Best regards,

A handwritten signature in cursive script that reads "Karen L. Barr". The signature is written in black ink and is centered on the page.

Karen L. Barr