INVESTMENT ADVISER
ASSOCIATION

Statement of Mark F. Kemper
On Behalf of the Investment Adviser Association

Before the Employee Benefits Security Administration
U.S. Department of Labor
Hearing on Reasonable Contracts or Arrangements
Under Section 408(b)(2) – Fee Disclosure

April 1, 2008

I am Mark Kemper, Chief Legal Counsel of UBS Global Asset Management, Americas. I greatly appreciate the opportunity to appear before you today on behalf of the Investment Adviser Association to address the Department's proposed regulation under section 408(b)(2) of ERISA.

The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisers. Founded in 1937, the IAA's membership today is comprised of more than 500 firms that collectively manage in excess of $9 trillion for a wide variety of individual and institutional clients, including retirement plans governed by ERISA.

The IAA applauds the Department's efforts to ensure that plan fiduciaries receive the information they need in order to assess the reasonableness of the plan's arrangements with service providers. Plan fiduciaries' understanding of the fees paid by the plan is especially important, because such fees directly impact the investment returns realized by the plan, and, in the defined contribution plan context, the actual benefits received by participants.

As reflected in our previously filed comments, investment advisers provide services to both defined benefit and defined contribution plans. We incorporate our earlier comments by reference, but will devote our time today to the role of investment advisers in defined benefit plans and the application of the proposed regulation in this context.

Summary of Positions

- The Department should consider whether each of the proposed provisions is appropriate for defined benefit plans. For example, in the defined benefit context, an investment adviser is not usually considered to be providing a "bundle" of services; therefore, the application of the proposed regulation's

bundled services provision is unclear. This and other issues should be clarified in the final regulation to the extent that it applies to defined benefit plans.

- Investment advisers are already required to provide all clients, including retirement plans, with a comprehensive disclosure document, Form ADV. The Department should permit Form ADV to be used as a "safe harbor" vehicle for compensation and conflicts of interest disclosure under the final regulation.

- In the absence of a safe harbor, which will provide clarity and an understandable disclosure mechanism, the conflict of interest disclosures in the proposed regulation as drafted are overly broad and unworkable.

- The proposal also presents practical problems for investment advisers. The disclosures relate to future events; however certain costs and forms of non-monetary compensation, such as commissions and soft dollars, may not be ascertainable at the time the contract is executed. In addition, the Department should clarify that disclosures are not required regarding non-monetary compensation that is not received in connection with a specific plan.

- Finally, plan fiduciaries and service providers should not be required to amend existing contracts until they are extended, explicitly renewed, or materially modified. Required disclosures could be provided prior to such amendments.

Factual Background

Plan fiduciaries to defined benefit plans generally contract with investment advisers to provide investment management services to the plan. SEC-registered investment advisers that are investment managers under ERISA must satisfy fiduciary responsibilities both under the Investment Advisers Act and under ERISA. The investment adviser does not hold plan assets; plan assets generally must be held in trust. Therefore, a separate trustee usually holds plan assets, and charges a separate fee for its trust services pursuant to a separate contract between the trustee and the plan.

In the course of providing investment management services to a plan, the investment adviser determines the overall investment strategy for the plan or the portion of plan assets it is retained to manage, consistent with any written investment guidelines established by the plan fiduciaries. The adviser carries out this strategy in a variety of ways. In certain cases, the adviser may itself manage the plan's investments, while in other situations the adviser may select sub-advisers that specialize in particular types of investments to perform this function. For example, the adviser may contract with a sub-adviser that specializes in international investments, or a particular economic sector. In many cases, the sub-adviser does not contract directly with and is not paid separately by the plan. Instead, the adviser pays the sub-adviser from its overall fee, and is responsible for monitoring the activities of the sub-adviser as part of its overall fiduciary duties.

The adviser often also exercises discretion in choosing the broker-dealers that will execute the plan's securities transactions. In this type of arrangement, the plan typically does not have a contract with the broker; instead, the broker's compensation is paid as part of each securities transaction. An investment manager 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 manager 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.).

For example, if a particular trade does not constitute a high percentage of a security's average daily volume, then a full-service broker may not add value to the execution, and the manager might select a lower-cost electronic algorithm venue. If the trade involves the sale of a security involving a higher percentage of average daily volume, then the use of an algorithm might be considered risky in terms of the resulting price movement of the stock. A full-service broker in this situation might be able to seek more natural liquidity from buyers.

Thus, the manager 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. The flexibility to select a trading venue on a trade-specific basis is critical to a manager's ability to seek best execution and should not be limited by a requirement to identify and contract with specific brokers before agreeing to provide investment management services to a pension plan. We would be pleased to answer any questions you may have about the broker selection process and best execution.

Throughout the course of the plan's arrangement with the investment adviser, the plan receives comprehensive disclosure concerning the investment adviser and plan investments. First, most plans identify potential investment advisers through a detailed "request for proposal" (RFP) process, under which various advisers respond to numerous questions about the adviser and its services that are designed to assist plan fiduciaries in choosing among advisers. These questions cover a wide variety of topics, including the adviser's experience, expertise, past performance, compensation, brokerage practices, receipt of soft dollars, and compliance structure, and the advisers' responses are voluminous. The RFP process is often managed by the plan's pension consultant.

As a part of its RFP response, an adviser generally provides a potential client with its Form ADV, a comprehensive disclosure document required of all federally registered investment advisers by the Securities and Exchange Commission. Part 1 of Form ADV is available to all of an adviser's clients, as well as to the general public, electronically through the Investment Adviser Registration Depository (IARD). Part 2 of Form ADV must be provided to clients and prospective clients initially at the time of contract and offered annually. An adviser's Form ADV contains extensive disclosures, especially as to services, brokerage practices, soft dollars, direct and indirect compensation, and conflicts of interest, as well as the adviser's code of ethics.[1]

[1] The Securities and Exchange Commission recently re-proposed changes to Part 2 of Form ADV that would modify the disclosures that federally registered investment advisers currently provide to clients in

Plan fiduciaries and their consultants generally review materials from a number of advisers before making their selections. At this point, the investment adviser and the plan negotiate and execute a written contract. This contract 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 assets exceed certain breakpoints. The adviser, however, usually cannot predict the precise amount of its eventual compensation. This asset-based compensation is usually the only direct compensation received by the investment adviser in connection with managing the plan's assets.

Certain other fees will be incurred as part of a defined benefit plan's investments, primarily brokerage and custodial fees. As noted above, the custodial fee is subject to separate contract between the plan and the custodian or trustee. The brokerage fees will depend upon the types and amounts of securities that will be bought or sold, and cannot be disclosed precisely in advance by either the brokers that receive the fee or the advisers that are authorized to provide instructions to the brokers to execute the transactions.

During the course of the advisory relationship, the plan, either directly or through its custodian or trustee, receives on-going disclosures on a regular basis. For example, the plan's trustee receives a confirmation of each securities transaction, which identifies the executing broker, the number and price of the securities involved, and the broker's commission. In addition, the adviser and other service providers forward to the plan the information necessary for the completion of the plan's annual report on Form 5500, including fee and compensation information. For plan years starting in 2009, this information will also include disclosure concerning the adviser's "soft-dollar" and other non-monetary compensation.

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the areas of compensation and conflicts of interest. *Amendments to Form ADV*, Investment Advisers Act Release No. 2711 (Mar. 3, 2008). The SEC proposed changes to Form ADV in 2000, but deferred the changes to Part 2 when finalizing the changes to Part I in 2000. 65 Fed. Reg. 57438 (Sept. 22, 2000).

The newly proposed changes would require advisers to provide a narrative brochure describing the adviser's services, fees, business practices, and conflicts of interest, and file it electronically for inclusion on the SEC's website. The narrative would include descriptions of how the adviser is compensated for providing advisory services, as well as the types of other costs, such as brokerage fees, custody fees, and fund expenses, that clients may pay to third parties in connection with the advisory services. In addition, advisers would be required to describe material relationships or arrangements the adviser has with related financial industry participants, any material conflict of interest that the relationships create, and how they address the conflict. Advisers also would explain how they select brokers for client transactions and determine the reasonableness of brokers' compensation. The narrative would also cover how the adviser addresses conflicts arising from their receipt of soft dollar benefits such as research in connection with client brokerage.

The Department Should Consider How the Proposed Regulation Would Apply to Defined Benefit Plans.

The Department's main concerns about fees and expenses appear to relate primarily to defined contribution plans, under which the participants depend upon the investment returns of the assets in their individual accounts for their ultimate retirement benefit. The preamble and economic analyses repeatedly refer to the increasing complexity of retirement plan compensation arrangements. While defined contribution plan fee structures have changed markedly over the years, the defined benefit model has not changed significantly. Further, in many respects, the requirements of the proposed regulation simply do not work in the defined benefit context.

For example, in the defined benefit context, an investment adviser is not usually considered to be providing a "bundle" of services as is often found in the defined contribution context. In a sub-advisory arrangement, the sub-adviser is often paid from the adviser's fee, but such arrangements existed long before the concept of "bundling" services was introduced primarily in the defined contribution context. The provision of brokerage services under a defined benefit plan similarly does not fit the "bundled" model, because the plan pays for brokerage as part of its securities transactions rather than through the adviser, but usually does not contract directly with the broker.

In the experience of the IAA's members, plan fiduciaries' primary concern in the defined benefit context is the overall investment management of the plan and the compensation arrangement with the adviser. The adviser may contract with other parties, such as sub-advisers and proxy-voting specialists, to provide some investment-management-related services, but the overall cost to the plan generally remains the same. Under such circumstances, we submit that additional disclosure concerning the compensation paid by the adviser for such services is unnecessary.

We therefore suggest that the Department consider carefully whether the disclosure requirements of the proposed regulation are appropriate in the defined benefit context. Specifically, we request that the Department clearly identify which, if any, of the required disclosures should apply in the defined benefit context and which provider must make them.

Existing Disclosure Vehicles Should Be Utilized as Safe Harbors for Compensation and Conflicts of Interest Disclosure.

As described above, plan fiduciaries receive extensive disclosures concerning investment advisers' compensation, selection of brokers, and conflicts of interest in each adviser's Form ADV. The preamble to the proposed regulation anticipates that advisers will incorporate Form ADV by reference in their section 408(b)(2) disclosures. The preamble further states, however, that the proposed regulation would require that service providers "clearly describe these additional materials and explain to the responsible plan fiduciary the information they contain." We are concerned that the additional

descriptions and explanations would require the preparation of duplicative materials by investment advisers as well as superfluous reviews of these materials by plan fiduciaries.

We urge the Department, therefore, to include in the final regulation a "safe harbor" under which the adviser's Form ADV, along with its written contract with the plan, would be deemed to satisfy the disclosure requirements under section 408(b)(2). The type and nature of the disclosures in these documents – as well as their purpose and goals - are the same as those contemplated by the proposed regulation. Plan sponsors already receive and are familiar with Form ADV. Use of Form ADV disclosure will reduce the costs and burdens of the proposed regulation for both advisers and plans.

If the Department declines to provide a safe harbor for the use of Form ADV, it should, at a minimum, include language in the instructions or 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).[2] A similar analysis applies to mutual fund prospectuses and private placement memoranda provided by advisers to funds that are deemed to be plan assets.

Further, we strongly urge the Department to revise the proposed conflict of interest disclosures, which, as currently drafted, are overly broad and unworkable. For example, the proposed regulation could be read to require investment advisers and other service providers to track down all of the plan's service providers, even those of which it was not otherwise aware, in order to uncover and disclose any relationships with the other service providers. We submit that service providers should only be responsible for disclosing potential conflicts of interest of which they are aware that directly relate only to the services they provide to the plan.

The Proposal Presents Practical Problems for Investment Advisers.

We submit that the service provider disclosures required in connection with the plan's preparation of Schedule C of Form 5500 and the disclosures under the proposed regulation should be read together and interpreted consistently to the extent feasible. There is, however, one critical difference between the two disclosure initiatives: The required disclosures under the proposed regulation relate to future events, while the disclosures provided for Form 5500 reporting purposes are provided after the plan has incurred the service provider's fees and other expenses. Further clarification is needed with respect to the disclosure of items that are not ascertainable at the time the contract is executed.

[2] 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." The re-proposal also continues the current requirement for advisers to describe their codes of ethics and offer to provide it upon request. We submit that the Department should clarify that its analogous requirement in proposed subsection 4(F) would be satisfied by such disclosure.

For example, specific information related to soft dollars or other non-monetary compensation that may be received by the investment adviser in the future is not available to the adviser at the time that the parties enter into the advisory contract. We submit that the final regulation should permit a description of the soft dollar services and other non-monetary compensation sufficient for a plan fiduciary to evaluate their reasonableness such as is contained in the Form ADV. We also request clarification that service providers are not required to make disclosures regarding non-monetary compensation that is not received in connection with a specific plan, as well as guidance as to when such compensation would be considered to be received in connection with a plan.

Plan Fiduciaries and Service Providers Should Not Be Required to Immediately Amend Existing Contracts Upon Finalization of the Proposed Regulation.

We support 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. The simultaneous revision of thousands of contracts would be overwhelming for plan fiduciaries and service providers. The requested transition rule, however, need not inordinately delay plan fiduciaries' receipt of the disclosures under the final regulation.[3]

We appreciate the opportunity to provide our comments today and would be happy to address your questions.

[3] In addition, if immediate amendments are required, the contract provisions required by the proposed regulation cannot accurately represent that certain disclosures were provided before the contract was entered into, extended or renewed. We request that, if immediate amendments are required, the Department amend this provision to refer to such amendments.