

# INVESTMENT ADVISER ASSOCIATION

September 19, 2006

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Room N-5669  
U.S. Department of Labor  
200 Constitution Avenue, N.W.  
Washington, DC 20210

Attn: Revision of Form 5500 (RIN 1210-AB06)

Ladies and Gentlemen:

The Investment Adviser Association<sup>1</sup> appreciates the opportunity to provide comments regarding the Department of Labor's proposed revisions to Form 5500, the annual report and schedules required to be filed by pension plans subject to ERISA.<sup>2</sup> Our comments focus solely on the proposed revisions to Schedule C of Form 5500.

The proposed changes to Schedule C would require that pension plans identify each service provider that received "directly or indirectly, \$5,000 or more in total compensation (*i.e.*, money or anything else of value) in connection with services rendered to the plan or their position with the plan" and disclose the amount received. Schedule C would also require plans to indicate which of those service providers received compensation from a source other than the plan or plan sponsor in connection with services provided to the plan and to provide information for each such source from whom the provider received \$1,000 or more in consideration, including the amount and nature of the compensation. The proposed instructions to Schedule C state that "indirect compensation" received by service providers includes: "finders' fees, placement fees, commissions on investment products, transaction-based commissions, sub-transfer agency fees, shareholder serving fees, 12b-1 fees, soft-dollar payments, and float income."<sup>3</sup>

The Department has proposed these amendments "in an effort both to clarify the reporting requirements and to ensure that plan officials obtain the information they need to assess the reasonableness of the compensation paid for services rendered to the plan, taking into account

<sup>1</sup> 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 Association's membership today consists of more than 450 firms that collectively manage in excess of \$6 trillion for a wide variety of individual and institutional clients. For more information, please visit our web site: [www.investmentadviser.org](http://www.investmentadviser.org).

<sup>2</sup> Proposed Revision of Annual Information Return/Reports, 71 Fed. Reg. 41616 (2006) ("Proposed Revision").

<sup>3</sup> Proposed Revision, 71 Fed. Reg. 41649.

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revenue sharing and other financial relationships or arrangements and potential conflicts of interest that might affect the quality of those services.”<sup>4</sup>

As service providers, our member investment advisory firms will have no direct DOL reporting requirements under the proposed rules. However, should the changes be adopted, plan sponsors or administrators will request their plans’ investment managers to provide the information required to complete Form 5500. Further, Schedule C requires plans to identify any service provider who failed or refused to provide information necessary for the plan to complete the schedule. Accordingly, these proposed changes would have significant consequences for investment advisers.

We have the following comments about the proposed changes to the extent they create a new obligation on the part of plans to report information regarding “soft dollar” arrangements of investment advisers – an area subject to regulation by the SEC: (1) the DOL should defer to the SEC’s anticipated enhancements to the soft dollar disclosure requirements for investment advisers; (2) soft dollar disclosure should not be deemed “compensation” for purposes of Form 5500; (3) the type of soft dollar information required by the Form would be difficult for advisers to calculate and would be so imprecise as to be of limited usefulness to plans; and (4) the requirements may impose additional burdens on investment managers to provide information relating to other service providers.

## **Soft Dollars**

### Background

Soft dollar or “client commission” arrangements involve situations where an investment adviser obtains products and services in exchange for client commissions paid to a broker for executing clients’ securities transactions on an aggregate basis. Soft dollar arrangements 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.” In “third-party” arrangements, the executing broker provides independent research generated by third parties in exchange for commission dollars. Research is separately priced, rather than priced in a bundle in these “third-party” arrangements.

As fiduciaries, 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. Section 28(e) of the Securities Exchange Act provides a safe harbor from a breach of fiduciary duty claim if the adviser pays more than the lowest available commission cost for eligible brokerage and research services as part of soft dollar arrangements. 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 DOL has indicated that investment advisers

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<sup>4</sup> Proposed Revision, 71 Fed. Reg. 41621.

generally may not use plan commissions to obtain products or services that are outside the Section 28(e) safe harbor.<sup>5</sup>

As fiduciaries, investment advisers 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 II, which advisers must provide to clients. If the value of research products or services plays a role in an adviser's decision to use certain brokers, the adviser must describe: the research products and services; whether clients may pay commissions higher than those obtainable from other broker-dealers in return for those products and services; whether the research is used to service all of the adviser's clients or just those accounts whose commission dollars are used to acquire research products or services; and any procedures the adviser has used to engage in soft dollar arrangements.

In October 2005, the Securities and Exchange Commission (SEC) proposed interpretive guidance regarding the products and services that investment advisers are permitted to obtain using client commissions.<sup>6</sup> When the Commission adopted its interpretive guidance in July 2006<sup>7</sup> – the first formal guidance issued by the Commission in 20 years – SEC staff stated that it is in the process of drafting rules that would require additional disclosure regarding the use of client commissions. SEC staff indicated that it would propose these new rules by the end of 2006.

#### The DOL Should Defer to the SEC's Disclosure Rulemaking.

The IAA has actively supported full and fair disclosure of the use of client commissions for research and brokerage services under the safe harbor of Section 28(e).<sup>8</sup> In addition to enhanced disclosure requirements, we supported the SEC's efforts to clarify the types of products and services that constitute permissible research under current law.<sup>9</sup> Further, we commented during the U.K. Financial Services Authority's rulemaking regarding the FSA's decision to encourage an industry-led solution on transparency and accountability regarding softing and bundling arrangements.<sup>10</sup>

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<sup>5</sup> ERISA Technical Release No. 86-1 (May 22, 1986).

<sup>6</sup> *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Rel. No. 34-52635 (Oct. 19, 2005) (Proposal). The Proposal uses the phrase "client commission" practices or arrangements under Section 28(e) to avoid any confusion that may arise over the phrase "soft dollars." Proposal at 3, n. 2.

<sup>7</sup> *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Rel. No. 34-54165 (July 18, 2006).

<sup>8</sup> See ICAA Statement Re: Soft Dollars (Mar. 3, 2004) ("ICAA Statement"); Written Statement of Geoffrey I. Edelstein, Managing Director of Westcap Investors, "Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Examining Soft-Dollar Practices," Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 31, 2004) ("ICAA Testimony"). Both documents are available on our website under "Comments & Statements."

<sup>9</sup> See ICAA Statement and ICAA Testimony, *supra*, n. 3.

<sup>10</sup> See IAA Letter to UK FSA regarding CP 05/5 on Bundled Brokerage/Soft Commission (May 31, 2005) (commenting on final FSA proposed rules regarding eligible criteria for research and execution services). See also, ICAA Letter to UK FSA regarding PS 04/23 on Soft Dollars/Bundled Brokerage (Dec. 16, 2004) (commenting on policy statement regarding which products and services may be paid for with commissions); ICAA Letter to UK FSA regarding CP 176

Although we support enhanced disclosure of soft dollar arrangements, we do not believe that the proposed Schedule C to Form 5500 is the appropriate vehicle for such disclosure.

As discussed above, the SEC is actively developing a rulemaking related to disclosure of soft dollar arrangements. The SEC is responsible for administering the soft dollar safe harbor and has “exclusive authority to interpret the scope of Section 28(e) and the terms used therein.”<sup>11</sup> In the past several years, the SEC has studied soft dollar arrangements and disclosures closely, including initiating an inspection review of soft dollar practices, convening a task force that met with all relevant parties, and consulting with the FSA regarding bundled brokerage issues. As the regulator primarily responsible for governing soft dollar arrangements and having studied the issue extensively, the SEC is in the best position to formulate disclosure requirements in this area. Implicitly recognizing this point, as part of the comment process for the SEC’s recent interpretive guidance, the DOL requested the SEC to require investment managers to disclose with “greater specificity” the amount of commission dollars paid by their clients for brokerage and research services and how such expenditures benefit the accounts of their clients.<sup>12</sup>

Having requested the SEC to impose additional soft dollar disclosure requirements, the Department should refrain from effectively adopting its own requirements before the SEC acts. As the IAA has long advocated, investment advisers should be subject to one consistent and uniform requirement in this area.<sup>13</sup> There is no reason that an investment adviser’s disclosures regarding soft dollar practices to ERISA-covered pension plans should be materially different from such disclosures to other institutional and retail clients. Indeed, the Department’s letter to the SEC requests different disclosure than the Department’s proposed revision to Form 5500. The Department requested the SEC to require specificity regarding the amount of commission dollars paid by clients, while the Form 5500’s proposed requirement of “indirect compensation” appears to require calculation of the value of items received by the adviser rather than the amount of commissions paid by clients.

The DOL has recently increased its efforts at greater coordination with the SEC in addressing issues that affect both regulators.<sup>14</sup> There is no compelling reason for the Department unilaterally to jump into the soft dollar disclosure field at this moment, just as the SEC is poised to act on disclosure in the near term. Instead of imposing *de facto* disclosure requirements, the Department of Labor should consider issuing guidance to plan fiduciaries urging increased

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on Bundled Brokerage and Soft Commission Arrangements (Oct. 9, 2003) (commenting on proposal to mandate that the costs of non-execution services be rebated back to clients) (“2003 ICAA Letter to FSA”). Each letter is available on our website under “Comments & Statements.”

<sup>11</sup> ERISA Technical Release No. 86-1 (May 22, 1986).

<sup>12</sup> Letter from Ann Combs to Jonathan Katz (March 13, 2006).

<sup>13</sup> Statement of the Investment Counsel Association of America in connection with September 17, 1997 meeting of the DOL ERISA Advisory Council Working Group on Soft Dollars at 5 (Sept. 5, 1997) (objecting to differing sets of rules and regulations regarding soft dollar practices from the SEC and DOL); Letter from David Tittsworth, IAA Executive Director, to Thomas A. Bowman, President, AIMR (Feb. 26, 1998) (urging AIMR to refrain from setting separate standards from those administered by SEC).

<sup>14</sup> See, e.g., *Selecting and Monitoring Pension Consultants-Tips for Plan Fiduciaries*, jointly issued by the DOL and SEC (June 1, 2005).

monitoring of their service providers through review of information required to be disclosed by the SEC as well as discussions with advisers and any prudent follow-up requests for relevant information regarding soft dollars, best execution, and other important areas.<sup>15</sup>

The DOL should not deem Section 28(e) products and services to be “compensation.”

Products and services that are part of soft dollar arrangements protected by the Section 28(e) safe harbor should not be considered “compensation” for purposes of the proposed amendments to Form 5500. Any research and brokerage services obtained by investment advisers under Section 28(e) are required to be used in the investment decision-making process for the benefit of clients, not for the benefit of the adviser or its employees. Combining an estimate of the value of these products and services with management fees paid to the adviser for portfolio management as “total compensation” would be highly misleading. Disclosure regarding soft dollar arrangements may be useful as part of a plan fiduciary’s analysis of best execution, but wedging such disclosure into a mélange of items under a “compensation” bucket would confuse rather than assist such analysis.

The information required to be provided by investment advisers would be so imprecise as to be of very limited utility.

Currently, advisers are not required to provide clients with the level of detail regarding soft dollars proposed in Form 5500. Although advisers are required to determine that the commissions paid are reasonable in relation to the products and services received, no further specificity is required. Calculating the information required by the proposed amendments would be burdensome and difficult for several reasons. First, because brokers provide products and services based on aggregate commissions, it is difficult for an adviser to allocate particular products, services, or values to specific clients. Advisers may have to use a proportionate estimate for each client or other similarly imprecise calculation.

Second, should the Department continue to deem brokerage and research products and services obtained with client commissions to be “compensation” to service providers, the proposal may be interpreted as requiring advisers to break out or “unbundle” execution costs from research products and services received. This allocation would be necessary because even if brokerage and research is deemed “compensation” for Form 5550 purposes, use of client commissions for client trade execution is inarguably *not* compensation to the adviser. Advisers are not currently in a position, however, to determine the actual cost or value of any non-execution products or services provided as part of a bundled commission charge.<sup>16</sup> Broker-dealers often provide many products

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<sup>15</sup> The Department may wish to consider including such guidance in the context of anticipated Section 408 (b)(2) guidance.

<sup>16</sup> The complexity of unbundling is illustrated by the conclusions set forth in the November 11, 2004 NASD Mutual Fund Task Force Report on Soft Dollars and Portfolio Transaction Costs (“NASD Report”). The Task Force was comprised of senior industry executives from broker-dealers and mutual fund management companies, as well as representatives from the academic and legal communities. It considered whether it is possible for an adviser to provide a mutual fund board with a good faith estimate of the total dollar amount of proprietary research obtained with fund brokerage commissions. The Task Force determined it was unable to reach a consensus on the issue. It noted that sharp disagreement exists over the value to fund boards and investors of estimates of the amount of proprietary research (and presumably other non-execution or research items) obtained with fund brokerage. See NASD Report at 9, available at [http://www.nasd.com/web/groups/rules\\_regs/documents/rules\\_regs/nasdw\\_012356.pdf](http://www.nasd.com/web/groups/rules_regs/documents/rules_regs/nasdw_012356.pdf).

and services in addition to execution, *i.e.*, access to analysts, commitment of capital, advice regarding executions, access to investments, and capital introductions. There is no separate charge, line item, invoice, or discussion from broker-dealers regarding the costs of products or services that advisers may receive. No regulatory requirement exists for broker-dealers to provide invoices apart from commission charges for various components of the services they provide.<sup>17</sup> Nor are we aware of any evidence that bundled services provided by brokerage houses may be valued appropriately by comparing them to services offered by independent vendors.

The proposal may contemplate that advisers simply will be able to determine execution-only costs and report the remainder as indirect “compensation.” However, this calculation is problematic. For example, an adviser would not be able to use the bare minimum commission charged by a discount or on-line broker for large block trades, thinly-traded securities, and other instances where use of a discount or on-line broker is simply inappropriate or not feasible.

In addition, determining the “execution-only price” does not account for concepts of “best execution,” *i.e.*, the quality of execution in addition to commission cost. A manager should consider factors in addition to the lowest available commission rate to determine the “pure” execution cost of a trade. Factors may include the size of transaction, the timeliness of execution, the ability of the broker to commit capital, the ability to maintain the investor’s anonymity, financial responsibility, or the ability of the broker to handle difficult trades or unusual market conditions.<sup>18</sup> Different types of trades would have to be evaluated on a case-by-case basis, which would be very difficult operationally. Even if feasible, the internal compliance and back-office costs of determining and auditing the various values of components of bundled brokerage would be quite substantial.

Moreover, because execution is difficult to quantify, the resulting allocation between execution and non-execution portions of transaction costs necessarily will be at best subjective and at worst arbitrary. Different advisers will undoubtedly make different allocations, based on the relative value of the services provided regarding any particular transaction.<sup>19</sup> Accordingly, the utility of the information that would be provided is questionable.

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<sup>17</sup> In the UK, the Financial Services Authority withdrew a proposal that would have effectively required unbundling. CP 05/5, Bundled Brokerage/Soft Commission (March 2005). Instead, the FSA announced it expects that the Investment Management Association’s (an industry group) Disclosure Code (“IMA Code”) (Mar. 2005) will become the standard means of disclosure of client commissions for UK funds. The IMA Code requires negotiation between brokers and advisers over cost components.

<sup>18</sup> See, e.g., *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*, Rel. No. 34-54165 at n.149 (July 18, 2006); Association of Investment Management and Research, Trade Management Guidelines (available at: [http://www.aimr.com/pdf/standards/trademgmt\\_guidelines.pdf](http://www.aimr.com/pdf/standards/trademgmt_guidelines.pdf)); CP 154: Best Execution, Financial Services Authority (October 2002).

<sup>19</sup> We understand that, to date, disclosures under the IMA Code regarding bundled brokerage have been inconsistent and difficult to use for comparison purposes.

## **Other Compensation**

In addition to imposing burdens relating to soft dollars, the instructions to Schedule C specifically require information regarding "brokerage commissions or fees (regardless of whether the broker is granted discretion)." Unless pension plans are in direct communication with brokers as part of a commission recapture or other directed brokerage arrangement, plans may look to the adviser rather than the broker to provide the information they need to complete Schedule C. Information relating to these fees and commissions may prove difficult to track on a per plan basis. Therefore, provision of this information may pose an additional cost and burden on advisers that is not outweighed by the utility of the information.

## **Conclusion**

We respectfully submit that the Department of Labor should eliminate the proposed revision to Schedule C of Form 5500 requiring disclosure of soft dollar payments and commissions. At a minimum, the Department should defer to the anticipated disclosure rulemaking that the SEC is currently drafting.

Please do not hesitate to contact me if you have any questions or would like any additional information.

Sincerely,



Karen L. Barr  
General Counsel

cc: Andrew Donohue, Director, SEC Division of Investment Management  
Robert Plaze, Associate Director, SEC Division of Investment Management