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February 15, 2008

By electronic transmission to
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Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
United States Department of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

Re: Reasonable Contract or Arrangement under Section 408(b)(2): Fee Disclosure (Proposed amendment to 29 C.F.R. § 2550.408b-2)

Ladies and Gentlemen:

Covington & Burling LLP represents the managers of hedge funds, private equity funds, and other investment funds that are not registered under the Investment Company Act of 1940. Covington also represents the sponsors of employee benefit plans that invest in unregistered investment funds. We appreciate the opportunity to comment on the Department of Labor's proposed amendment to the regulation at 29 C.F.R. § 2550.408b-2 requiring disclosure of fees and other compensation by certain providers of services to employee benefit plans. Our comments concern the application of the fee disclosure regulation to unregistered investment funds in which employee benefit plans invest.

We recommend that the Department address the following points in the fee disclosure regulation:

- Clarify that the fee disclosure regulation does not apply to fund managers and other providers of services to investment funds that are deemed not to hold plan assets.
- If the Department extends the fee disclosure requirement to non-plan-asset funds, issue a separate proposed rule explaining the rationale for this position and allowing affected parties an opportunity to comment.
- Clarify that the fee disclosure regulation does not apply to service arrangements that are covered by a separate prohibited transaction class exemption.

- Clarify that compensation paid by an unregistered investment fund for accounting, actuarial, appraisal, auditing, legal, or valuation services provided to the fund is not treated as "indirect compensation" for purposes of the fee disclosure regulation.
- Provide that if the status of an investment fund under ERISA changes, the fund may comply with the fee disclosure rule when it first becomes subject to ERISA.
- Provide transition relief that will allow existing investment funds sufficient time to come into compliance with the fee disclosure regulation.

1. The Fee Disclosure Regulation Should Not Apply to Funds That Are Deemed to Hold No Plan Assets

The fee disclosure regulation interprets section 408(b)(2) of ERISA, which provides a statutory prohibited transaction exemption for reasonable service arrangements between employee benefit plans and their service providers. On its face, the fee disclosure requirement appears to apply only to a person or entity that enters into an arrangement to provide services to an employee benefit plan. In describing the regulation, however, members of the Department's staff have suggested that the fee disclosure requirement might also apply to a person or entity that provides services to a fund in which the plan invests, even if the fund is deemed not to hold plan assets (a "non-plan-asset fund"). The theory behind this application of the rule appears to be that providers of services to the investment fund might, in some circumstances, be deemed to provide services indirectly to any employee benefit plan that invests in the fund.

Extending the fee disclosure requirement to non-plan-asset funds would be contrary to the Department's longstanding position with respect to these funds. In 1986, the Department adopted a "look-through" rule to identify situations in which a plan's investment in an unregistered fund should be viewed as an arrangement by which the plan indirectly retained the fund manager to provide investment management services to the plan. 29 C.F.R. § 2510.3-101. The "look-through" rule made clear that when an employee benefit plan acquires an equity interest in an operating company, or in an entity in which equity participation by benefit plan investors is insignificant, the plan's assets do not include any of the underlying assets of the entity. 29 C.F.R. § 2510.3-101(a)(2). As a result, the manager of a non-plan-asset fund is not considered to provide investment management services to employee benefit plans that invest in the fund, and is not subject to ERISA's fiduciary duty provisions. In addition, a transaction between a non-plan-asset fund and a third party is not considered to be a transaction with any plan that invests in the fund, and is not subject to the prohibited transaction restrictions in ERISA and the Internal Revenue Code. *See* 29 C.F.R. § 2509.75-2(a).

The Department's "look-through" rule properly recognizes that when an employee benefit plan purchases an equity interest in a non-plan-asset fund, the plan is making an investment rather than hiring the fund's manager and its affiliates as service providers. Congress endorsed and expanded this principle in 2006 when it amended ERISA to add a new section

3(42). This recent amendment significantly increases the number of funds that can qualify as non-plan-asset funds.

In order to attract sophisticated investors, non-plan-asset funds typically include in their offering materials extensive information about the relationships among the fund's managers and their affiliates and the nature of their compensation. These issues are also addressed in the limited partnership agreement or other fund-formation documents. A fiduciary that authorizes a plan to invest in a non-plan-asset fund will consider the fund's expenses—including management fees, carried interests, and other forms of compensation paid to the fund's managers and their affiliates—in determining whether the investment is likely to provide an acceptable investment return. The fund's compensation-related expenses are not distinguishable from other expenses that might reduce the fund's investment return, and they do not require any special disclosure. Since the plan fiduciary is not entering into an arrangement to acquire services on behalf of the plan, the fiduciary does not need to evaluate whether the compensation paid to the fund's managers is reasonable, any more than the fiduciary would need to evaluate whether the compensation paid to the employees of an operating company was reasonable before buying stock in the operating company.

It is difficult to see how the Department could apply the fee disclosure requirement to non-plan-asset funds without also classifying the managers of these funds as fiduciaries for purposes of ERISA. If the manager of a non-plan-asset fund is deemed to be providing a service to employee benefit plans that invest in the fund, the "service" must be a form of investment advice or investment management. A fund manager who is deemed to provide investment advice to an employee benefit plan in return for compensation, whether direct or indirect, will be a fiduciary under section 3(21)(A)(ii) of ERISA. Similarly, a fund manager who is deemed to exercise *any* authority (even indirectly) over the management of a plan's assets will be a fiduciary under section 3(21)(A)(i). Both the Department and Congress have recognized that this result is inappropriate: the "look-through" rule (as modified by ERISA section 3(42)) is expressly designed to avoid treating the manager of a non-plan-asset fund as a fiduciary of the plans that invest in the fund.

Employee benefit plans have relied on the "look-through" rule to diversify their investment portfolios and to invest in sophisticated financial products. Managers of non-plan-asset funds have relied on the "look-through" rule to insure that they will not be subject to additional regulation or fiduciary liability under ERISA if they accept employee benefit plans as investors. This is especially true of non-U.S. funds, which are regulated by their home countries. If the Department extends the fee disclosure requirements to non-plan-asset funds, the additional compliance burden and the potential fiduciary liability might cause fund managers to exclude employee benefit plan investors from new funds and to require them to withdraw from existing funds. To the extent that managers of non-plan-asset funds continue to accept employee benefit plans as investors, the funds are likely to pass through the costs of compliance with the fee disclosure regulation to their investors, including plans. Accordingly, extending the fee disclosure requirement to non-plan asset funds will not advance any policy that the regulation is

intended to promote; and the consequences will be contrary to the interests of employee benefit plans that invest in these funds.

2. Any Proposal to Extend the Fee Disclosure Regulation to Non-Plan-Asset Funds Should Be Addressed in Separate Rulemaking

If, contrary to our recommendation, the Department concludes that there might be a need for additional disclosure of fees charged by fund managers and other providers of services to non-plan-asset funds, we urge the Department to undertake a separate rulemaking to explore this issue. The proposed fee disclosure regulation does not state that it applies to non-plan-asset funds, and the preamble of the proposed regulation does not explain why the Department might consider a fund's service providers to be within the scope of a rule governing service relationships with employee benefit plans. If the Department intends to apply the fee disclosure rule to some, but not all, service providers to non-plan-asset funds, the proposed regulation does not indicate which service providers will be subject to the rule. In addition, as we have explained, the proposed regulation does not state how the extension of the rule to non-plan-asset funds can be reconciled with the Department's "look-through" regulation or with the statutory definition of a plan fiduciary.

Our own discussions with managers of non-plan-asset funds and their advisers indicate that most of them are unaware that the Department might extend the fee disclosure rule to these funds. In view of the Department's longstanding position in the "look-through" rule, the managers of non-plan-asset funds naturally assume that they will not be affected by a regulation governing service relationships with employee benefit plans. If a provision extending the fee disclosure rule to non-plan-asset funds appears for the first time in a final regulation, we are concerned that many of the individuals and entities who will be directly affected by the rule will be taken by surprise. A change of this magnitude, which would impose substantial regulatory obligations on a group that has previously been free of ERISA regulation, deserves to be fully explored in a public rulemaking proceeding. It is particularly important that affected parties receive fair notice of the proposed rule and a meaningful opportunity to comment on it, to assist the Department in developing a final rule that is workable and achieves its policy objective.

We recognize that the Department considers it a matter of some urgency to issue a final regulation requiring more extensive fee disclosure by employee benefit plan service providers. This objective is not inconsistent with the course of action we have recommended. The Department could finalize the basic fee disclosure rule, as it applies to entities that provide services directly to employee benefit plans, and could issue a separate proposed regulation extending the fee disclosure requirement to certain persons whom the Department might regard as indirect service providers. Under this approach, the need to explore the potential application of the rule to non-plan-asset funds would not delay the issuance of a rule requiring more extensive fee disclosure from entities that indisputably provide services to employee benefit plans.

3. The Fee Disclosure Regulation Should Not Apply to Service Arrangements Covered by a Separate Class Exemption

The proposed fee disclosure regulation describes conditions that a service arrangement must meet in order to qualify for the statutory prohibited transaction exemption in section 408(b)(2) of ERISA. Not all service arrangements rely on the section 408(b)(2) service-provider exemption for relief, however. Under the Department's prohibited transaction class exemption for qualified professional asset managers ("QPAMs"), the prohibited transaction restrictions do not apply to a service relationship with an investment fund in which an employee benefit plan has an interest, provided that the service relationship is negotiated by the QPAM and satisfies the other conditions of the class exemption. *See* PTE 84-14. A similar class exemption applies to service relationships negotiated by qualified in-house asset managers ("INHAMs"). *See* PTE 96-23. The QPAM and INHAM exemptions do not require the extensive disclosure and documentation that would be required under the proposed regulation.

The preamble of the proposed regulation invites comments on the extent to which the fee disclosure rule will affect other ERISA statutory exemptions, but it does not mention the potential effect of the rule on ERISA class exemptions. 72 *Fed. Reg.* 70993 (Dec. 13, 2007). The preamble also observes that contracts or arrangements with service providers who are not subject to the fee disclosure requirements must still be reasonable "and otherwise satisfy the requirements of section 408(b)(2) of ERISA." 72 *Fed. Reg.* at 70989. We request that the Department make clear that service arrangements established in compliance with the QPAM or INHAM class exemptions are not required to satisfy section 408(b)(2) (including the fee disclosure rule) in order to qualify for prohibited transaction relief under the class exemptions.

4. Compensation Paid by an Investment Fund Should Not Be Treated As Indirect Compensation

Under the proposed regulation, entities that provide accounting, actuarial, appraisal, auditing, legal, or valuation services are subject to the fee disclosure rule only if they receive indirect compensation or fees. The proposed regulation defines "indirect compensation" as compensation from any source other than the employee benefit plan, the plan sponsor, or the service provider.

Unregistered investment funds hire professionals to provide a wide range of services to the fund. These professionals generally are paid from the assets of the fund. If investment in the fund by employee benefit plans exceeds 25% (and the fund is not an operating company), a proportionate share of the fund's assets is attributed to the benefit plan investors. *See* ERISA § 3(42). For example, if an employee benefit plan owns 30% of the equity in an unregistered investment fund and non-plan investors own the remaining 70% of the equity, 30% of the fund's assets are deemed to be plan assets. When the investment fund hires an accountant or other professional and pays the professional's fees with fund assets, 30% of the payment will be attributed to the benefit plan investor and 70% will be attributed to the non-plan investors. In

these circumstances, the proposed regulation appears to treat the professional as receiving "indirect compensation," since 70% of the professional's fee comes from sources other than the employee benefit plan, the plan sponsor, or a service provider.

Compensation paid directly by an investment fund in which an employee benefit plan invests should not be treated as indirect compensation. Each investor benefits from services provided to the fund in proportion to the investor's equity interest in the fund. Accordingly, in the example we have given, the plan investor benefits from the professional's services to the fund in proportion to the plan's 30% equity interest in the fund, and the non-plan investors benefit from the professional's services in proportion to their 70% equity interest. Each investor pays the portion of the professional's fee attributable to the services that investor receives. Accordingly, the compensation that the professional receives from the fund on behalf of non-plan investors is attributable to services that the professional provides to the fund on behalf of non-plan investors: it is not a form of indirect compensation for services provided to the employee benefit plan investor. The final fee disclosure regulation should make clear that compensation paid by an unregistered investment fund to a person or entity that provides services to the fund is not indirect compensation.

5. If a Fund's Status Changes, the Fund Should Be Able to Comply With the Fee Disclosure Rule After It Becomes Subject To ERISA

As we have explained above, an unregistered investment fund in which an employee benefit plan invests should not be subject to the fee disclosure rule as long as the fund is deemed to hold no plan assets. Although it is not common, the status of an investment fund under ERISA sometimes changes during the fund's existence. For example, if a fund has less than 25% equity investment by benefit plan investors at its formation, the fund will not be subject to ERISA. *See* ERISA § 3(42); 29 C.F.R. § 2510.3-101(a)(2). If new investment or a transfer of existing interests later increases the equity ownership of benefit plan investors, however, the fund will become subject to ERISA when the equity owned by benefit plan investors reaches 25%. *Id.* Similarly, a fund with benefit plan investors that originally qualified as an operating company might later cease to be an operating company, with the result that the fund would become subject to ERISA. *See* 29 C.F.R. § 2510.3-101(a)(2). The events that might cause a fund to become subject to ERISA are not always predictable or within the control of the fund manager.

The fee disclosure rule provides that an employee benefit plan must receive the required disclosure, and the service agreement must contain the necessary representations, before the employee benefit plan enters into the service arrangement. As we have explained above, however, an employee benefit plan does not enter into a service arrangement when it invests in a non-plan-asset fund. Accordingly, a non-plan-asset fund is not required to satisfy the fee disclosure and documentation requirements at the time of its formation. If the fund later becomes subject to ERISA, it is not clear how the fund can satisfy the advance-disclosure and advance-documentation requirements with respect to existing employee benefit plan investors.

The Department should make clear that a service relationship between an employee benefit plan investor and an unregistered investment fund is deemed to arise only when the fund becomes subject to ERISA, even if the employee benefit plan had invested in the fund previously. The Department also should provide a reasonable period of time after the fund becomes subject to ERISA during which the fund manager can provide the necessary disclosure to existing employee benefit plan investors and put the necessary documentation in place, since it will not always be possible for the fund manager to take these steps before the fund's change in status.

6. The Fee Disclosure Regulation Should Provide a Reasonable Transition Period for Existing Investment Funds

The proposed regulation is scheduled to become effective 90 days after it is published in final form. The fee disclosure rule appears to apply to service arrangements established before the regulation becomes effective as well as to service arrangements established after the effective date. Accordingly, service providers and plan fiduciaries might have only 90 days in which to bring thousands of existing service arrangements into compliance with the fee disclosure rule.

Ninety days is too short a period for service providers and employee benefit plans to identify, collect, describe, evaluate, and document the multitude of service relationships and compensation arrangements that apply to employee benefit plans. This is especially true for unregistered investment funds, which usually operate under limited partnership agreements that cannot be amended without the consent of a supermajority of partners, including non-plan investors. We respectfully request that the Department permit unregistered investment funds that are subject to the fee disclosure rule to bring their arrangements into compliance on the earlier of (1) the date on which the partnership agreement or other governing document is materially amended for other purposes, or (2) one year after the fee disclosure rule is published in final form.

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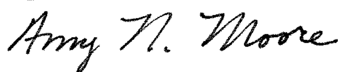
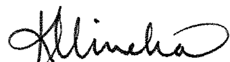
We appreciate the opportunity to submit comments on the proposed fee disclosure regulation. If you have questions or if additional information would be helpful, please contact Amy Moore at (202) 662-5390 or Katherine Mineka at (202) 662-5167.

Respectfully submitted,



Amy N. Moore



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