INVESTMENT ADVISER ASSOCIATION

2006 Comments & Statements

TABLE OF CONTENTS

January 6, 2006
IAA Letter to UK FSA re: CP 05/13 on Bundled Brokerage/Soft Commissions for Retail Funds

January 23, 2006
IAA Letter to SEC re: SIA Petition Requesting Delay of Broker Exception Rule

January 26, 2006
Comment Letter to Department of Labor re: Form LM 10

March 29, 2006
IAA Letter to SEC re: Deficiency Letters

July 23, 2006
IAA Letter to SEC re: Proposed RFP for Broker/Adviser Study

September 19, 2006
IAA Letter to DOL re: Revisions to Form 5500

October 23, 2006
IAA Letter to SEC re: Executive Compensation

November 1, 2006
IAA Letter to Ontario Securities Commission re: Proposed NI 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research

December 6, 2006
IAA letter to UK FSA re: CP 06/18 on Use of Dealing Commission

INVESTMENT ADVISER
ASSOCIATION

January 6, 2006

Via Electronic Filing (cp05_13@fsa.gov.uk)

Mark Glibbery
Retail Policy Division
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: Consultation Paper 05/13 *Bundled brokerage and soft commission arrangements for retail investment funds*

Dear Mr. Glibbery:

The Investment Adviser Association (IAA)[1] appreciates the opportunity to comment on the Financial Services Authority's Consultation Paper 05/13 (CP 05/13) entitled *Bundled brokerage and soft commission arrangements for retail investment funds* (September 2005).

The IAA is a U.S.-based not-for-profit organization that represents the interests of investment advisers registered with the U.S. Securities and Exchange Commission. The IAA has over 430 member firms that collectively manage more than $5 trillion in assets worldwide for a wide variety of individual and institutional clients, including pension funds, trusts, investment companies, endowments, foundations, and corporations. Many of our members conduct substantial investment advisory business in the United Kingdom, primarily through UK affiliates that are registered with the FSA, or provide investment management services to UK clients.

In CP 05/13, the FSA proposes to require that investment managers provide disclosure about their bundled brokerage and soft commission arrangements to certain identified "investor representatives" of retail investment funds. Investment managers must provide the same disclosure, including comparative disclosure of trading volumes, commissions generated, and how the commissions have been spent, to pension funds pursuant to the FSA's July 2005 Policy Statement 05/9 *Bundled brokerage and soft commission arrangements: Feedback on CP05/5 and final rule* (PS 05/9).[2]

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[1] Founded in 1937, the Investment Adviser Association was formerly the Investment Counsel Association of America. For more information, please visit our web site: www.investmentadviser.org.

[2] In PS 05/9, the FSA adopted new rules and published guidance on the treatment of goods and services received by investment managers in connection with dealing commission, including disclosure to institutional clients. PS 05/9 adopted new section 7.18.12R of the Conduct of Business sourcebook, which

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The retail investment funds to which disclosure is proposed to be provided include authorized unit trusts and open-ended investment companies, investment trusts, and the managed funds of life assurance companies. Specifically, the FSA has proposed the following individuals or bodies to be investor representatives of the respective funds: (i) for collective investment schemes, the depositary or trustee; (ii) for investment trusts, the directors of the company, in particular those who are independent of the investment manager; (iii) for with-profit funds, the committee or person appointed to review compliance with the Principles and Practices of Financial Management; and (iv) for unit-linked funds, either the with-profits committee if the company has one, the actuarial function, or the independent directors of the company.

The FSA asked in Question 2 of CP 05/13: "Do you agree that an investors' representative is, in principle, an appropriate model for considering the disclosures? Are there any other considerations regarding the representative's qualifications and duties?" We support the FSA's approach, and we generally agree that an investors' representative is an appropriate model for considering the manager's brokerage and soft commission disclosures. We suggest, however, that the individual or body selected as the investors' representative of the retail investment funds have a fiduciary duty to the fund and its underlying investors.[3] As a fiduciary, the investors' representative would provide the appropriate level of oversight of how the fund's commissions are managed, similar to pension fund trustees. Moreover, an investment manager will more likely accord appropriate consideration to discussions with a representative who the manager knows is truly acting for, and in the best interests of, the client.[4]

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provides that investment managers that enter into arrangements for the receipt of goods or services that relate to the execution of trades or the provision of research must include details in disclosure of the goods and services that relate to the execution of trades, and where appropriate, separately identify the details of the goods or services that are attributable to the provision of research. In PS 05/9, the FSA announced it expects the Investment Management Association (IMA) Pension Fund Disclosure Code (Second Edition – March 2005) (IMA Code) will generally become the standard means of disclosure of commission for UK institutional and retail funds. PS 05/9 at 8. Under the IMA Code, drafted jointly by the IMA and the National Association of Pension Funds, managers are required to provide comparative disclosure of trading volumes, commissions generated, and how the commissions have been spent. In PS 05/9, the FSA acknowledged the IMA Code may not be the most appropriate means of disclosure in cases, for example, of private client mandates where the proportion of commission paid to third party brokers is small.

[3] *See, e.g.,* CP 05/13 at 11 (depositary of UK authorized collective investment scheme must act in the "sole interests of investors"); CP 05/13 at 13 (directors of investment trusts must "put the interests of shareholders above all others and treat them fairly." Independent directors of the trusts are appointed "to bring appropriate expertise and unconflicted perspective" to ensure that "shareholders' interests are considered and protected.")

[4] Although we recognize that the FSA has already determined to endorse the IMA's disclosure approach, we remain concerned about how advisers will be able to value the component services they receive from broker-dealers as part of a bundled commission for the purpose of providing useful disclosure. We encourage the FSA to continue to monitor developments in this area.

We greatly appreciate the opportunity to provide our comments on CP 05/13, *Bundled brokerage and soft commission arrangements for retail investment funds*. Please do not hesitate to contact the undersigned, or Karen L. Barr, General Counsel, to discuss any questions the FSA or its staff may have.

Sincerely,

Monique S. Botkin

Monique S. Botkin
Counsel

INVESTMENT ADVISER
ASSOCIATION

January 23, 2006

Via Electronic Filing

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

RE: Petition by the Securities Industry Association for Additional Delay in the Compliance Date of Rule 202(a)(11)-1 (File No. S7-25-99)

Dear Ms. Morris:

On behalf of the Investment Adviser Association,[1] we are writing to respond to the petition filed by the Securities Industry Association to further delay implementation of Rule 202(a)(11).[2] We offer two points for the Commission's consideration.

First, we wish to clarify that the SIA is *not* requesting an additional delay with respect to the effective date of the rule as it pertains to whether an account will be treated as a brokerage account or an advisory account based on whether the broker exercises investment discretion. Given SIA's statement that brokerage firms will be able to comply with the discretionary brokerage aspects of the new rule by the January 31, 2006 compliance date, we assume that any action by the Commission on the SIA's most recent petition will not result in further delays in implementing these aspects of the rule.

Second, we take this opportunity to reiterate our views that the Commission needs to enforce the final rule and to educate investors about the practical implications of the rule. Last summer, we wrote to Chairman Donaldson about the study proposed in the

[1] 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 adviser firms. Founded in 1937, the Association's current membership consists of more than 425 firms that collectively manage in excess of $5.5 trillion for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See* Letter from Ira D. Hammerman, General Counsel, SIA, to Nancy M. Morris (Jan. 10, 2006). *See also*, Letter from Carl B. Wilkerson, General Counsel, American Council of Life Insurers to Nancy M. Morris (Jan. 13, 2006). The letters did not become publicly available until they were posted on the Commission's web site on January 18, 2006.

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release accompanying the final rule.[3] In addition to outlining our views on the proposed study, we urged the Commission "to dedicate adequate resources to ensure that the rule is properly implemented and that broker-dealers comply fully with its requirements." We also urged the Commission to "play a much more proactive role in educating investors and consumers about the fundamental issues involved in this rulemaking." We continue to believe that the Commission, consistent with its mission of investor protection, needs to take steps to ensure that the rule is being enforced and to educate consumers about the rule. To our knowledge, the Commission has not developed any document or resource for investors about the confusion that exists about the difference between brokers and investment advisers, when an account will be treated as a brokerage or an advisory account, or what disclosures they should expect to receive under the final rule. The Commission's own research has underscored the fact that investors are very confused about these issues and we believe the Commission can and should take action to help to address this confusion.

Please do not hesitate to contact us if you have any questions or need any additional information regarding this matter.

Sincerely,

DAVID G. TITTSWORTH
Executive Director

Cc: Hon. Christopher Cox
Hon. Cynthia A. Glassman
Hon. Paul S. Atkins
Hon. Roel C. Campos
Ms. Annette L. Nazareth
Ms. Susan F. Wyderko
Mr. Robert L.D. Colby
Mr. Robert E. Plaze

[3] *See* Letter from David G. Tittsworth, Executive Director, Investment Adviser Association to William J. Donaldson (June 22, 2005). The June 22, 2005 letter is attached and we ask that it be incorporated in the record relating to the SIA's current petition.

January 26, 2006

Ms. Kay H. Oshel
Director
Office of Policy, Reports and Disclosure
Office of Labor-Management Standards
U.S. Department of Labor
200 Constitution Avenue, N.W., Room N-5605
Washington, D.C. 20210

RE: RIN 1215-AB49

Dear Ms. Oshel:

On behalf of the Investment Company Institute, the American Council of Life Insurers, the Investment Adviser Association, and the Securities Industry Association, we are writing to comment on proposed amendments to Form LM-30 and related issues concerning Form LM-10.[1]

We represent financial services firms and professionals who provide support to pension plans, including Taft-Hartley plans whose trustees may include union officers. Our members have never before been subject to reporting requirements under the Labor Management Reporting and Disclosure Act ("LMRDA"), but will be subject to those requirements retroactively under the Department's newly-announced view. This dramatic and unprecedented expansion of the scope of LMRDA reporting—without appropriate notice and comment rulemaking for Form LM-10—will impose an extraordinary burden on financial services providers to maintain detailed records of ordinary business activities that is not justified by considerations of sound public policy. Further, the Department's legal justification for its actions cannot withstand scrutiny, and its strained imposition of the LMRDA's requirements in

[1] *See* Notice of Proposed Rulemaking and Request for Comments, 70 Fed. Reg. 51166 (Aug. 29, 2005).

this inapplicable context will cause much confusion. The LMRDA was designed to address labor relations matters, not service provider/plan trustee interactions, which are already governed comprehensively by ERISA and securities law.

I. We Represent Service Providers to Taft-Hartley Pension Plans Who Would Be Subject to LM-10 Reporting Requirements Under the Department's Unprecedented Expansion of the LMRDA

Our members include financial services firms and professionals who provide a significant amount of the financial services used by pension plans in managing their portfolios. Our members' pension plan clients include a variety of types of plans, including Taft-Hartley plans for which union officers serve as trustees. Under the Department of Labor's unprecedented reading of the Form LM-10 reporting requirements, these service providers—because they happen to be "employers" under "any law of the United States relating to the employment of any employees"—would be required to file reports regarding their ordinary educational, client service and marketing activities when dealing with plan trustees who are union officials. Our members engage in these activities in the normal course of business with all of their pension plan clients, not just those who happen to be Taft-Hartley plans with union officer trustees. Because the Department has chosen to pursue this expansive interpretation of the Form LM-10 requirements without notice and comment rulemaking, we are submitting these comments in response to the Form LM-30 rulemaking, the only current forum available for our formal input.[2]

The Investment Company Institute ("ICI") is the national association of the U.S. investment company industry. ICI members include 8,537 open-end investment companies (mutual funds), 669 closed-end investment companies, 157 exchange-traded funds, and 5 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $8.672 trillion (representing 98 percent of all assets of U.S. mutual funds); these funds serve approximately 89.5 million shareholders in more than 52.6 million households. Additional information regarding ICI is available at www.ici.org.

The American Council of Life Insurers ("ACLI") is a Washington, D.C.-based trade association whose 377 member companies account for 91 percent of the life insurance industry's total assets, 90 percent of the life insurance premiums, and 95 percent of annuity considerations in the United States. ACLI member companies offer life insurance; annuities; pensions, including 401(k)s; long-term care insurance; disability income insurance; reinsurance; and other

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[2] In its posting, "Frequently Asked Questions About Form LM-10," the Department encouraged persons interested in the Form LM-10 to submit comments in response to the Form LM-30 rulemaking. *See* Frequently Asked Questions Nos. 15, 25 (available at http://www.dol.gov/esa/regs/compliance/olms/LM10_FAQ.htm). As discussed below, the Department is required by law to provide a separate opportunity for LM-10 comments and we urge the Department to provide us with a timely opportunity to submit comments directly on Form LM-10.

retirement and financial protection products. Additional information regarding ACLI is available at www.acli.org.

The Investment Adviser Association ("IAA") is a not-for-profit organization that exclusively represents the interests of federally registered investment adviser firms. The Association was founded in 1937 as the Investment Counsel Association of America and played a major role in the enactment of the Investment Advisers Act of 1940, the federal law regulating the investment adviser industry. Today, the IAA consists of more than 400 investment adviser firms that collectively manage in excess of $5 trillion in assets for a wide variety of institutional and individual clients. Additional information regarding IAA is available at www.investmentadviser.org.

The Securities Industry Association ("SIA") was established in 1972 through the merger of the Association of Stock Exchange Firms (1913) and the Investment Banker's Association (1912). The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated $236.7 billion in domestic revenue and an estimated $340 billion in global revenues. Additional information regarding SIA is available at www.sia.com.

II. The Department's New View of LM-10 Requirements Represents a Sea Change in the Interpretation of the LMRDA

The Labor Management Reporting and Disclosure Act ("LMRDA"), or the Landrum-Griffin Act, was enacted in 1959 to curb union abuses. Among other things, the Act requires certain financial disclosures by unions, union officers and employees, employers and labor relations consultants. *See* 29 U.S.C. §§ 431-33. For the 40-plus years since its enactment, the regulated community has understood the reporting requirements of the LMRDA to focus on financial transactions involving unions and union-organized employers, as well as non-union employers that are the subject of union-organizing campaigns.

In June 2005, the Department announced for the first time—by way of guidance posted on the Office of Labor Management Standards website—that service providers to "trusts in which a labor organization is interested," including financial advisors, accountants and attorneys, would "most likely" be subject to the Form LM-10 reporting requirements. *See* Trusts and Form LM-30 and Form LM-10 (available at http://www.dol.gov/esa/regs/compliance/olms/

LM30_LM10_Trusts_Info.htm).[3] Never before had the Department sought to use the LMRDA to require financial disclosure reports from non-unionized service providers who do business with Taft-Hartley plans. The Department stated that receptions at educational conferences, dinners following trustee meetings, Christmas parties, and the like, provided by service providers to plan trustees who also serve as union officers, would be reportable payments on Forms LM-10 and LM-30 unless they qualify for the de minimis exception. *See id.*

Thus, under the Department's newly-announced view, the following would be reportable on Forms LM-10 and LM-30 if the aggregate de minimis limit is exceeded:

- A service provider sponsors an educational seminar or focus group at which food and drinks are served, and pension plan trustees, some of whom also serve as union officers, attend.

- A service provider sponsors a reception or meal at a conference, such as those held by the International Federation of Employee Benefit Plans, and pension plan trustees, some of whom also serve as union officers, attend.

- A service provider distributes novelty items at its booth at a trade show or conference to attendees, including pension plan trustees, some of whom also serve as union officers.

- A service provider serves coffee or provides meals during meetings with pension plan trustees, some of whom also serve as union officers.

These kinds of service provider activities, which have no connection to labor relations and which occur in the ordinary course of business interactions with pension plans (whether Taft-Hartley or not), have not previously been viewed as being subject to Form LM-10 reporting.

III. The Department Does Not Have the Legal Authority to Require Union Officers or Service Providers to Make Reports in Connection With Service Provider/Plan Trustee Interactions

A. The LMRDA Was Enacted to Address Union Abuses, Not Trust Fiduciary Issues

Interactions between service providers to Taft-Hartley trusts and trustees who happen to be union officers fall outside of the scope of the LMRDA. The Act was adopted not to address

[3] A "trust in which a labor organization is interested" is defined as "a trust or other fund or organization (1) which was created or established by a labor organization, or one or more of the trustees or one or more members of the governing body of which is selected or appointed by a labor organization, and (2) a primary purpose of which is to provide benefits for the members of such labor organization or their beneficiaries." 29 U.S.C. § 402(l).

the responsibilities of pension plan fiduciaries and service providers (a topic since comprehensively regulated by the Employee Retirement Income Security Act), but rather to address more traditional relations between management and organized labor. In particular, it was passed in 1959 in response to union abuses identified by the Select Committee on Improper Activities in the Labor or Management Field, or the McClellan Committee. 70 Fed. Reg. 51166, 51167 (Aug. 29, 2005).

As set forth in the Act, Congress found:

> from recent investigations in the labor and management fields, that there have been a number of instances of breach of trust, corruption, disregard of the rights of individual employees, and other failures to observe high standards of responsibility and ethical conduct which require further and supplementary legislation that will afford necessary protection of the rights and interests of employees and the public generally as they relate to the activities of labor organizations, employers, labor relations consultants, and their officers and representatives.

29 U.S.C. § 401(b) (emphasis added).

Congress further found and declared that the LMRDA was "necessary to eliminate or prevent improper practices on the part of labor organizations, employers, labor relations consultants, and their officers and representatives which distort and defeat the policies of the Labor Management Relations Act, 1947, as amended, and the Railway Labor Act, as amended, ..." *Id.* § 401(c) (emphasis added). The LMRDA was adopted within a very specific context—labor-management relations—and was not intended to reach activity beyond this scope.

B. The Statute Does Not Empower the Department to Require Reporting From Union Officials in Their Capacity as Pension Plan Trustees

The LMRDA authorizes the Department to require union officials to make certain financial disclosures on Form LM-30. *See* 29 U.S.C. § 432. The Department, however, went beyond the statutorily-prescribed list of LM-30 reportable transactions by including on the Form LM-30, "Interests in, income from, or transactions with, a business a substantial part of which consists of dealing with your union or a trust in which your union is interested."

To support this expansion of the scope of Form LM-30 reporting, the Department must rely on the supplemental authority granted to it by 29 U.S.C. section 438, which allows the Secretary to issue "reasonable rules and regulations (including rules prescribing reports concerning trusts in which a labor organization is interested) as he may find necessary to prevent the circumvention or evasion of [the LMRDA] reporting requirements." This anti-circumvention authority, however, is severely limited. It grants power to require reports relating to trusts in which a labor organization is interested only when necessary to avoid circumvention of the reporting requirements expressly delineated in the LMRDA, and only after the Secretary has made an express finding of such necessity. *See AFL-CIO v. Chao*, 409 F.3d 377, 390 (D.C. Cir. 2005).

Here, the Secretary has not made any such finding, nor could she. *See* 70 Fed. Reg. 51166.[4] The expansion of LM-30 (and LM-10) reporting requirements to trustee-service provider interactions is not designed to prevent circumvention of other reporting requirements; instead, it is designed to address a wholly independent concern about improper attempts to influence pension plan trustees. *See* 70 Fed. Reg. 51166, 51173. While this purpose may be salutary, it goes well beyond the purview of the LMRDA (and, as discussed below, is comprehensively addressed by ERISA and the Criminal Code). As the D.C. Circuit noted in striking down the Department's similarly unauthorized attempt to require reporting by Taft-Hartley trusts, "[S]ection 208 limits the Secretary's authority to require reporting on trusts to instances where necessary to avoid . . . circumvention or evasion of [the] Title II reporting requirements; the statute does not provide general authority to require trusts to demonstrate that they operate in a manner beneficial to union members." *AFL-CIO*, 409 F.3d at 390.

C. Neither Does the Statute Empower the Department to Require Reporting from Service Providers

1. The Department's Lack of Authority to Impose These Requirements on the Form LM-30 Leads to the Same Conclusion for the Form LM-10

The Department contends that reporting of service provider-plan trustee transactions on Form LM-10 is required to create a check and balance system for related LM-30 reports by plan trustees who are union officials. As the Department explained in a tacit acknowledgment of the sea change its new view of LM-10 reporting represented:

> Another Department form, long in existence, further indicates that payments from service providers to trusts are covered under the LMRDA. In some ways, the Form LM-30 is the counterpart to the Form LM-10. Broadly speaking, employers report payments to union officials on Form LM-10 and union officials report payments from employers on Form LM-30. The Form LM-30, which has been in effect since 1963, requires union officers and union employees to report payments from a "business . . . any part of which consists of buying from, selling or leasing to, or otherwise dealing with . . . a trust in which your labor organization is interested." Form LM-30 Instructions, Part B. Thus, since 1963, union officials have been specifically informed of the need to report payments from service providers to trusts, such as pension and welfare plans, in which their union had an interest. Although the language in the Form LM-10 is different, requiring reports of

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[4] The Department first imposed this requirement on the Form LM-30 in 1963 without making such a finding or soliciting comment on the exercise of the anti-circumvention authority. The language including transactions with "businesses . . . dealing with . . . a trust in which your labor organization is interested" did not appear in the LM-30 rule as originally proposed, *see* 27 Fed. Reg. 10459 (Oct. 26, 1962), and while the order publishing the final rule notes that as one of three differences between the proposed and final versions, it fails to offer any explanation for it. 28 Fed. Reg. 10333 (Sept. 21, 1963).

> payments from "any employer," its breadth plainly covers service providers. This inference is made unavoidable by the specificity of the Form LM-30, which expressly singles out these transactions.

Frequently Asked Questions About Form LM-10, Question No. 13.

This discussion is illuminating for two reasons. First, it underscores the fact that the Department's view regarding the reach of Form LM-10 with respect to these transactions is inextricably intertwined with its view regarding the reach of Form LM-30. As set forth above, the Department's authority to reach these transactions on Form LM-30 is non-existent. Thus, any derivative requirement that transactions be reported on Form LM-10 likewise lacks legal authority. Moreover, it would be non-sensical to require reports on Form LM-10 where they are not legally required (or permitted to be required) on the counterpart Form LM-30.

Second, contrary to the Department's view that the "inference" that Form LM-10 extends to service provider-trustee interactions is "made unavoidable by the specificity of the Form LM-30," the opposite is true. Because the Form LM-10 lacks the express reference to "trusts in which a labor organization is interested" that appears on the Form LM-30, and because, unlike union officials, service providers have not been "specifically informed" of the need to report payments to trustees who are union officials, the logical conclusion would be that the Department was <u>not</u> intending to exercise its anti-circumvention power to reach trust-related transactions on Form LM-10.

2. The Department's Reliance on the Broad Definition of Employer Under the LMRDA is Unavailing

The Department also contends that the use of the term "employer" in 29 U.S.C. section 433(a) authorizes it to require Form LM-10 reports from any entity constituting an "employer" under an employment law of the United States. This would presumably include every employer in the country, including traditional union employers, non-union employers, service providers with employees (but not sole proprietor service providers), and even Members of Congress (*see, e.g.*, 2 U.S.C. § 1301 *et seq.*).

At the same time, even the Department recognizes that there are some limits to the LMRDA, and that the use of the term "employer" in section 433(a) does not (and could not reasonably be interpreted to) extend the reach of the statute to every employer in the United States. Thus, the Department does not seek to impose Form LM-10 requirements on every employer, indicating instead that some nexus to a labor organization is required. *See* Frequently Asked Questions No. 6.[5]

Among its list of employers subject to Form LM-10 requirements, the Department includes employers dealing with a "trust in which a labor organization is interested,"—that is, service providers to Taft-Hartley trusts—as well as employers in competition with those service providers. These grounds can only be supported by an exercise of the anti-circumvention power set forth in 29 U.S.C. section 438. As discussed above, however, an express finding of the necessity for the anti-circumvention power is necessary to support its use, as is notice and comment rulemaking, neither of which is present here for the Form LM-10. *See AFL-CIO*, 409 F.3d at 390.

Moreover, section 433(a)(1), which provides for the collection of LM-10 reports from employers making payments "to any labor organization or officer, agent, shop steward, or other representative of a labor organization, or employee of a labor organization . . . .", is a "catch all" provision that must be read in concert with the remaining provisions of section 433(a). *See generally Breininger v. Sheet Metal Workers Int'l Ass'n*, 493 U.S. 67, 91 (1989). These surrounding provisions clearly limit the application of the LM-10 reporting requirement to payments made by employers in their capacity as employers for the purpose of influencing labor relations matters. *See, e.g.*, 29 U.S.C. § 433(a)(2), (3), (4), and (5) (all relating to payments with a nexus to labor relations).

The provisions of section 433(a) also must be read in concert with the parallel union officer reporting requirements of section 432. Those requirements, too, make clear that section 433 is intended to capture payments by employers in their capacity as employers. Indeed, in the Form LM-30 Notice of Proposed Rulemaking, the Department recognizes that the "catch all"

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5 In response to Frequently Asked Question No. 6, "Must every payment from every employer to any union officer be reported?", the Department replied:

No. Generally, payments from only the following employers are reportable:

1) An employer whose employees the recipient's labor organization represents or is actively seeking to represent;
2) An employer a substantial part of which consists of buying from, or selling or leasing directly or indirectly to, or otherwise dealing with an employer whose employees the recipient's labor organization represents or is actively seeking to represent;
3) An employer that buys from, or sells or leases directly or indirectly to, or otherwise deals with the recipient's labor organization;
4) An employer that buys from, or sells or leases directly or indirectly to, or otherwise deals with a trust in which the recipient's labor organization is interested; or
5) An employer in active and direct competition with an employer described in paragraphs 1 through 4.

provision of section 432 requires a nexus to labor relations activity (70 Fed. Reg. 51166, 51192-93); likewise, the "catch all" provision of section 433 requires such a nexus.[6]

The legislative history reinforces this conclusion. For example, the Senate Report characterizes the various types of payments for which LM-10 reporting is required, including those specified in section 433(a)(1), as "expenditures in connection with labor-management relations." (emphasis added).[7]

IV. Considerations of Sound Public Policy Weigh Strongly Against the Imposition of This Reporting Requirement on Plan Trustees and Service Providers

A. There is No Gap to be Filled Here; ERISA and Other Laws Comprehensively Regulate Plan Trustee/Service Provider Interactions

The Department offers only one example in the Notice of Proposed Rulemaking to support its view that including service provider-plan trustee interactions within the LM-30 (and LM-10) reports would be beneficial. This example involved "a contractor, an investment firm that managed pension and investment accounts for unions." As explained in the NPRM:

> This company collapsed in September 2000, costing its clients about $355 million. The company's former chairman was indicted on counts of fraud, money laundering, witness tampering and making illegal payments to union benefit plan trustees. As part of its scheme to buy the influence of pension fund trustees, who were union officers, the investment firm hired relatives of pension trustees as well as provided plan trustees with gifts including rifles, season tickets to sporting events, and fishing and hunting trips to various locations in the western U.S., Canada, Africa, Argentina and Mexico.

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6 Section 432, for example, uses "business," as distinguished from "employer," when it intends broader application. *See* 29 U.S.C. § 432(a)(3). There is no corresponding "business" reporting requirement in section 433.

7 The flaws in the Department's strained reading of this section are illustrated by its efforts to address section 302(c) of the Labor Management Relations Act. Section 433(a)(1) of the LMRDA generally requires reporting only of unlawful payments; those payments authorized by law—which fall under LMRA section 302(c)—are expressly exempted from reporting. Thus, to deem a payment reportable under section 433(a)(1) is to suggest, strongly, that it is criminal. In order to avoid the inference that ordinary and appropriate service provider marketing, client service and educational activities would be criminal violations under the LMRA, the Department simply notes that its guidance is not binding on the Justice Department "in carrying out its criminal enforcement responsibilities." *See* Frequently Asked Questions No. 26. This response, in the context of potential criminal liability, is woefully inadequate.

70 Fed. Reg. 51166, 51173.

Although the misconduct described in this example is clearly wrong, it would be just as wrong (and the Department would be equally as concerned) if it involved pension plan trustees who were not union officers, or if it involved a service provider, such as a sole proprietor, who was not an employer. These are ERISA issues, not labor-management issues, and ERISA, not the LMRDA, is the appropriate vehicle to address this scenario. The LMRDA approach unduly targets Taft-Hartley plans, which represent only a segment of the larger universe of pension plans.

This type of misconduct is already illegal for all types of pension plans. ERISA comprehensively regulates the conduct of pension plan fiduciaries and, in particular, prohibits self-interested transactions and conflicts of interest. *See* 29 U.S.C. § 1106. Reports of such transactions on Form 5330 are required, and an excise tax is imposed upon them. *See* 26 U.S.C. § 4975. Moreover, federal criminal law prohibits the offer, acceptance, or solicitation of improper payments intended to influence actions of benefit plan trustees, authorizing stiff penalties of up to three years imprisonment. *See* 18 U.S.C. § 1954.

In addition, many service providers are subject to comprehensive regulation under the federal securities laws, and are overseen by government regulators and self-regulatory agencies.[8] These regulators may impose their own restrictions and requirements with respect to gifts. The National Association of Securities Dealers, for example, requires members to maintain records of "all payments or gratuities in any amount" . . . "where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity." *See* NASD Conduct Rule 3060(a), (c). The NASD also generally prohibits gifts in excess of $100 per individual per year. *See id.* The NASD recently proposed interpretive guidance "to more explicitly outline the policies and procedures a member must adopt in connection with its business entertainment practices with employees of a customer." *See* "Gifts and Business Entertainment," NASD Notice to Members (Jan. 2006) (available at http://www.nasd.com/web/groups/rules_regs/documents/notice to members/nasdw_015876.pdf). As should be the case here with the Department's proposed expansion of the Form LM-10 requirements, the NASD is seeking comments before imposing its proposed guidance on the regulated community. *See id.*

Moreover, to the extent that the payments are marketing expenses, they are subject to the requirements of the Internal Revenue Code. *See* 26 U.S.C. § 162; *see also* Frequently Asked Questions Nos. 9 and 10 (recognizing that service provider payments to plan trustees may be deductible marketing expenses under the Internal Revenue Code).

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[8] For example, all investment advisers are subject to a strict fiduciary duty that is intended to eliminate or require disclosure of conflicts of interest and to prevent an adviser from overreaching or taking unfair advantage of a client's trust. As a fiduciary, the adviser must act in the best interests of the client and must disclose material information. *See, e.g.*, 15 U.S.C. § 80b-6; *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

B. The Rationale Offered for the Rulemaking Does Not Support the Application of LMRDA Reporting Requirements to Service Provider-Plan Trustee Interactions

The Department stated in the Notice of Proposed Rulemaking that two of its key objectives are to "alleviate confusion" and to "reduce errors." *See, e.g.*, 70 Fed. Reg. 51166, 51177, 51194, 51195. Forcing the square peg of service provider-plan trustee interactions into the round hole of the LMRDA, however, will inevitably create these very problems.

The lack of clear guidance for LM-10 filers, combined with the overlay of other regulatory schemes such as ERISA, securities laws and self-regulatory organization rules (like those promulgated by the NASD), will foster confusion in the regulated community and produce errors on Forms LM-10. As noted below, for example, the Form LM-10 instructions are not currently written to address service provider-plan trustee interactions, and the Frequently Asked Questions leave many likely service provider questions unanswered. Moreover, imposition of LMRDA requirements in an area already highly regulated under other statutes creates the potential for inconsistent and conflicting requirements.

As the Department acknowledges in the NPRM, "To be as effective as possible, a reporting and disclosure statute . . . depends on a known and easily applied standard regarding what must be reported." 70 Fed. Reg. 51166, 51179. Here, the Department is creating a vague standard for service providers without providing any clear regulatory guidance. Instead, the Department has undertaken to address some of the many questions that have arisen by publishing "frequently asked questions" on its website. As discussed below, regulation by "FAQs" is not appropriate, nor does it provide a "known and easily applied standard" upon which the regulated community can rely.

C. Imposition of LMRDA Reporting and Disclosure Requirements Will Have a Chilling Effect on Positive Interactions Between Service Providers and Plan Trustees

An unintended consequence of the Department's position will be the discouragement of productive dialogue between service providers and plan trustees that often occurs over meals or coffee. This dialogue includes periodic reviews of service provider performance, discussion of contract terms and other valuable relationship-building activities. The Department has specifically recognized the importance of such dialogue in its EBSA Fact Sheet. *See, e.g.*, "Tips for Selecting and Monitoring Service Providers for Your Employee Benefit Plan" (available at dol.gov/ebsa/newsroom/fs052505.html).

To require reporting of service provider entertainment of union trustees occurring in the normal course of business is to suggest that it is somehow improper, especially when communication is otherwise encouraged and no reporting of entertainment of management trustees is required. The stigma of reporting in accordance with the Department's interpretation would chill this individualized commercial dialogue between service providers and trustees that better informs plan decision-making. Moreover, as service providers struggle to find viable means of complying with these newly-imposed reporting requirements, some may choose to forego potentially reportable expenditures in order to avoid the burdens of recordkeeping.

V. The Department Must Engage in Notice and Comment Rulemaking in Order to Impose Form LM-10 Recordkeeping Requirements on Service Providers

A. Rulemaking is Required to Reach Trust-Related Activity

As discussed above, the Secretary is authorized to expand the LM-10 and LM-30 recordkeeping requirements to activities involving "trusts in which a labor organization has an interest" only by rulemaking, and only when she has made a finding that such an expansion is necessary to avoid circumvention of the primary reporting requirements. *See* 29 U.S.C. § 408; *AFL-CIO*, *supra*. With respect to the Form LM-10, she has done neither. Thus, the purported expansion of Form LM-10 requirements to service providers doing business with Taft-Hartley trusts without the requisite Administrative Procedure Act rulemaking is *ultra vires*.

B. Imposition of These Requirements Without an LM-10 Notice and Comment Rulemaking Would Violate the Paperwork Reduction Act

The Paperwork Reduction Act requires an assessment of, among other things, "the need for the collection of information" and "a specific, objectively supported estimate of burden," as well as consultation with the public through the notice and comment process. *See* 44 U.S.C. § 3506(c). The discussion of the paperwork burden for individual filers of <u>Form LM-30</u> in the NPRM cannot substitute for the required analysis with respect to the <u>Form LM-10</u>. Indeed, the Department even concedes that its estimates with respect to <u>Form LM-30</u> are subject to "considerable uncertainty." 70 Fed. Reg. 51166, 51199.

The challenges faced by service providers, many of whom have large workforces across the country (and even the globe), and who deal with a multitude of plan trustees, are radically different and substantially more difficult than those faced by an individual filer. The Department estimates that it will take a typical union officer eight additional minutes "to maintain and to gather the books and records . . . including those concerning the dealings between a business and . . . a trust in which the filer's union is interested." Even assuming that this estimate is accurate for Form LM-30 filers, it does not purport to address the burden imposed on service providers subject to Form LM-10 requirements, nor could it reasonably do so. Eight minutes grossly understates the burden that would be imposed on a service provider filer of Form LM-10, who would have to maintain and to examine a multitude of corporate records detailing transactions among many employees and many plan trustees.

Even a brief overview of service provider activities reveals the enormous burden this requirement will impose. As discussed above, service providers often engage in relationship-building and educational activities for pension plan trustees. They do not currently maintain detailed records of such activities to the extent necessary to support LM-10 reporting, and maintenance of these records would be extremely onerous and pose complex problems. Service providers, for example, may sponsor receptions or meetings for which attendance is not tracked. In some cases, no record may be kept at all. In others, RSVP responses, but not actual attendance, may be recorded. Moreover, even where attendance is tracked, service providers do not record whether particular attendees are union officials, and whether they availed themselves of the food and drink that might be available at the event.

In order to support executive level certifications by the president and treasurer of the service provider, particularly when such certifiers are subject to criminal penalty, Sarbanes-Oxley like internal controls and sub-certification systems will be required. As evidenced by the experience of companies under the Sarbanes-Oxley Act, the development and implementation of such control systems is very expensive. AMR Research, for example, estimated technology spending for Sarbanes-Oxley compliance at $1.7 billion for 2005. Foley & Lardner LLP, in a report on the costs of being a public company in the "Sarbanes-Oxley era," estimates a 33% increase from fiscal year 2003 to fiscal year 2004 in the compliance cost for a company with revenues less than $1 billion, and a 45% increase for companies with revenues of $1 billion or more over the same period. Financial Executives International estimated in 2004 that the cost of first-year compliance with Sarbanes-Oxley could exceed $4.6 million for each of the largest U.S. companies.

Before proceeding to impose such a burden on service providers, the Department is obligated by law to prepare an assessment of "the need for the collection of information" and a "specific, objectively supported estimate of burden," and to seek input from the regulated community in a separate rulemaking designed for that purpose.[9]

C. The Difficult and Complex Issues Posed by Imposition of LM-10 Requirements on Service Providers Deserve Their Own Notice and Comment Process

The Office of Labor Management Standards has never before regulated service providers to Taft-Hartley trusts. We respectfully submit that OLMS lacks the requisite expertise to impose regulatory requirements on this community without first engaging in an interactive dialogue to gain a better understanding of how service providers function. OLMS needs to engage the industry in order to appreciate the unique and difficult issues posed by the proposed expansion of the LMRDA to cover service provider-plan trustee interactions. Only through such dialogue—appropriately facilitated by the legally required notice and comment process—can OLMS properly evaluate the need for, and scope of, potential changes to the reach of the LM-10 reporting requirements.

The LM-30 rulemaking is not the appropriate context in which to undertake this necessary effort. The rulemaking itself does not address, much less resolve, the complex issues posed by imposition of LM-10 requirements on service providers. Indeed, the examples offered to clarify the Form LM-30 do not cover any of the typical service provider-plan trustee interactions mentioned above, such as educational conferences, marketing activities, client service meetings, and the like. Moreover, the current set of LM-10 Frequently Asked Questions do not fully resolve many of the issues that have arisen even at this early stage, much less the

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[9] The LM-30 NPRM also fails to address other required issues in the context of the LM-10, including the impact on small business or the ability of U.S. based businesses to compete with foreign-based businesses who may not be subject to Form LM-10 requirements. *See* 70 Fed. Reg. 51166, 51195.

multitude of other issues that will no doubt surface as service providers attempt to comply with these requirements. For example, although we understand from informal dialogue with the Department that the $250 de minimis limit is intended to be applied separately to each union and union official, this is not clear from the language of the FAQs. Moreover, the FAQs do not provide clear guidance on the treatment of payments from affiliated companies, or from brokers representing more than one affiliate. Furthermore, the FAQs do not explain how the grace period would apply, if at all, to a service provider with no reportable transactions for 2005. Nor do the FAQs address whether the Form LM-10 requirements would apply to gifts to plan trustees who are union members, but not union officers. These and potentially many other issues should be fully and thoroughly vetted in an LM-10 rulemaking.

Moreover, an LM-10 rulemaking is necessary to clarify the Form LM-10 and its instructions. As currently written, the Form LM-10 provides no clear guidance to service providers with respect to their filing responsibilities. It does not even contain, for example, the newly-minted $250 de minimis exception. It is unfair to ask the chief executive officers and chief financial officers of service providers to attest under penalty of perjury to the contents of Form LM-10 without providing clear instructions applicable to the nuances of service provider-plan trustee interactions, something the current Form LM-10 fails to do. Thus, the Form LM-10 must be updated, and, like its update to the Form LM-30, the Department's updating of the Form LM-10 must be accomplished through notice and comment rulemaking.

VI. The Proposed LM-30 Regulations and LM-10 Guidance are Deficient in Other Respects

A. Retroactive Application of the LM-10 Reporting Requirement to Service Providers is Unfair

Service providers to Taft-Hartley plans have never before been advised that they are subject to the Form LM-10 reporting requirements for activities in which they engage in their capacity as service providers (as distinguished from their activities as employers). Although the Department argues that its view of the LMRDA's requirements has always encompassed service provider-plan trustee interactions, it has identified no source of LM-10 guidance in which this view was articulated to the regulated community. Indeed, in recognition of the surprise with which its new position was greeted, the Department has adopted an enforcement "grace period" for new filers of Form LM-10 who did not know they were subject to these requirements.

Service providers do not currently maintain records sufficient to support Form LM-10 reporting. Their records of educational, client service and marketing activities do not typically contain the level of detail necessary to allow them to complete Form LM-10. Given the issuance of the Form LM-10 guidance on the OLMS website in late 2005, it would be manifestly unfair to require full compliance for 2006. It is unreasonable to expect large service providers with multiple offices, many employees, many pension plan clients, and numerous affiliates to develop and implement reporting and recordkeeping systems necessary for full compliance, with executive level certifications under penalty of perjury, as of the beginning of their 2006 fiscal year. Furthermore, for 2005, even with the relaxed requirements of the grace period, reasonable estimation and reconstruction of data will be difficult and time-consuming. (And, as noted above, it is unclear how the grace period will assist service providers who do not file for 2005 because they have no reportable payments above the de minimis threshold.)

We suggest that, at a minimum, the Department engage in a separate Form LM-10 rulemaking, and not impose these new requirements on service providers unless and until that process has been completed. Furthermore, we believe that substantial advance notice must be provided in order to allow for implementation of appropriate data collection and reporting systems.

B. The De Minimis Exception Does Not Relieve Service Providers of the Burden of Tracking Transactions of Insubstantial Value

The Department proposes to exclude from reporting those transactions with an aggregate annual value, per person or per union, of $250 or less. The Department proposes to require that employers track all expenditures, however small, in order to determine whether the $250 limit has been reached. Indeed, the Department's guidance could be read to require that employers (and union officials) track items as minimal in value as <u>a cup of coffee</u>. While they may not ultimately have to report such gratuities if they do not exceed the $250 limit, service providers and union officials will be subject to the tremendous burden of monitoring and keeping records of these day-to-day courtesies. Thus, requiring aggregation with no minimum threshold effectively negates any benefit of the $250 aggregation amount.

The Department should, at a minimum, adopt standards similar to those of the Office of Government Ethics, cited as a model in the NPRM. *See* 70 Fed. Reg. 51166, 51175-86. The Office of Government Ethics does not require federal employees to count gifts valued at $122 or less toward the reporting trigger. *See* 70 Fed. Reg. 12111, 12111-12 (Mar. 11, 2005). In this way, the Office of Government Ethics avoids imposing the burden of counting every cup of coffee or other minor courtesy.

In addition, the NPRM explains that the $250 exception is intended to avoid imposing reporting requirements for items of "insubstantial" value. Given the nature of ordinary service provider-plan trustee interactions, including educational conferences and the other activities described above, all of which are desirable and serve the interests of pension plans and their participants, the $250 aggregate amount is insufficient to capture the universe of "insubstantial" gifts. Many positive service provider activities, such as one or two day educational conferences with meals, may exceed $250 per person. We respectfully urge the Department to reconsider the $250 threshold for the de minimis exception, to solicit comment from LM-10 filers as to its application, and to re-set the amount at a higher level sufficient to exclude "insubstantial" transactions.[10]

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[10] Office of Government Ethics regulations currently establish a $305 reporting threshold, subject to periodic revision. *See* 70 Fed. Reg. 12111, 12111-12. The NPRM also notes, in the context of certain investments, that $1,000 would be considered an "insubstantial" amount. *See* 70 Fed. Reg. 51166, 51176, 51186.

* * * *

We urge the Department to withdraw the incredibly burdensome and unprecedented imposition of Form LM-10 requirements on service providers and not to proceed unless and until such time as it conducts a separate Form LM-10 notice and comment rulemaking, as legally required.

Thank you for the Department's consideration of these comments. Please feel free to contact us or our counsel, William J. Kilberg, P.C., of Gibson, Dunn & Crutcher LLP (202/955-8573), should you wish to discuss these issues further.

Respectfully submitted,

Mary P. Podesta

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Senior Counsel – Pension Regulation
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Liz Varley

Liz Varley
Vice President and Director, Retirement Policy
Securities Industry Association

March 29, 2006

Via Electronic Mail

Ms. Lori A. Richards
Director, Office of Compliance Inspections and Examinations
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Ms. Richards:

The Investment Adviser Association[1] is writing in response to the Office of Compliance Inspections and Examination (OCIE) staff's request for our comments on its initiative to review the language in its deficiency letters.[2] We applaud your efforts to ensure that the language is appropriate and fits the findings of the examination staff. We agree with your statement that deficiency letters "should summarize the relevant rule or standard of conduct, outline the facts found, and indicate the ways in which the conduct found during the exam deviates from that standard."[3]

Deficiency letters are an important tool in the inspection process and serve an essential purpose in the communication between the OCIE staff and advisers. When properly drafted, deficiency letters can serve as a primary method of achieving a number of important purposes, including protecting investors – by identifying significant conflicts of interest, frauds, and manipulation – as well as by helping the adviser strengthen its compliance program.[4]

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1 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 adviser firms. Founded in 1937, the IAA's membership today consists of more than 400 firms that collectively manage in excess of $5 trillion for a wide variety of individual and institutional investors. For more information, please visit our web site: www.investmentadviser.org.

2 Lori Richards, Director, Office of Compliance Inspections and Examinations (OCIE), U.S. Securities and Exchange Commission (SEC), *Remarks before the National Society of Compliance Professionals National Membership Meeting – Better Than 'Business as Usual'* (Oct. 25, 2005) (stating that OCIE has been reviewing the language in its deficiency letters).

3 *Id.*

4 *See* Lori A. Richards, Director, OCIE, *Remarks before the National Society of Compliance Professionals National Membership Meeting – Compliance Professionals Play Proactive Defense* (Oct. 18, 2001).

In conducting the current initiative, we believe it is important for OCIE to recognize changes that have occurred during recent years. In particular, it is critical to understand that deficiency letters are no longer relatively confidential communications between the SEC and advisers. Over the years, it has become an increasingly common practice for the contents of deficiency letters to be shared with certain parties who have an interest in the adviser's compliance practices. Fund boards, advisers with subadvisory relationships, and an increasing number of institutional clients now require their advisers or subadvisers to provide them a copy or description of their deficiency letters in order to fulfill their oversight role with respect to these advisers. Indeed, in some instances, OCIE staff has sent deficiency letters directly to fund boards or has required advisers to provide such letters to fund boards.[5]

Because of the importance of deficiency letters and the potential for their broad dissemination, it is imperative that such letters be consistent, transparent, and fair. The process should be based on articulated rules and regulations that are applied prospectively. To that end, we suggest that OCIE address the following issues during its review of deficiency letter language.

Enhance the clarity, consistency, and objectivity of examination findings

Deficiency letters often conclude that certain examination findings amount to a violation of the Investment Advisers Act of 1940 or a breach of fiduciary duty. Letters also frequently opine that certain matters represent "serious internal control issues," "serious risks," "material control issues," and "material deficiencies." Some letters make no such conclusions, but request that the adviser change its policies and procedures or make additional disclosures. It is difficult to discern a consistent standard by which OCIE staff decides what type of conduct merits these various opinions or labels. In many cases, matters that OCIE concludes are "violations" or "serious risks" do not appear to be more significant than matters cited but not identified as such.[6]

Moreover, a fund chief compliance officer (CCO) must report material compliance matters to the fund's board. Clients may also request that their advisers provide information to them regarding material compliance matters. It is the CCO's responsibility to determine what circumstances constitute a reportable material matter. When OCIE makes a determination as to materiality or seriousness in a deficiency letter, it creates a record of significance that could trigger required disclosure by the registrant or other collateral effects. Further, these OCIE determinations inadvertently may usurp the CCO's responsibility and raise a question regarding

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5 Lori A. Richards, Director, OCIE, *Testimony Concerning the Securities and Exchange Commission's Examinations of Mutual Funds*, before the Senate Committee on Banking, Housing and Urban Affairs (March 10, 2004) ("Recently, we have adopted new policies to enhance the speedy resolution of any problems found, including holding exit interviews with senior management of firms and providing deficiency letters directly to fund boards of directors.").

6 For example, in some deficiency letters OCIE staff may opine that a minor compliance infraction (*e.g.*, failure to produce a few monthly statements for one employee out of 100 over a review period of one year) amounts to a "serious risk to the firm," while in other letters under similar circumstances, no such conclusion is articulated.

the CCO's judgment and ability to make that determination. This practice may adversely affect the relationship between the CCO and OCIE staff.[7]

Similarly, in deficiency letters or during the inspection process, OCIE staff sometimes reaches findings or conclusions that are subjective and on which reasonable minds could differ. In the absence of illegal or fraudulent conduct, OCIE staff, in our view, should not substitute its judgment for that of the investment advisers' officers and fund directors who have made reasonable business judgment decisions.[8] Under the SEC's rules regarding development and implementation of compliance programs, advisers are accorded flexibility to tailor policies and procedures in the way that best suits the firms' business and operation.[9] That flexibility may be undermined when OCIE staff substitutes its subjective judgment for that of investment advisory personnel regarding reasonably designed controls and processes.[10]

We submit that the best way to enhance the consistency and clarity of deficiency letters is to remove the subjectivity from the conclusions regarding violations and materiality and adhere to the facts and the law. Accordingly, we propose that, consistent with your remarks, deficiency letters address: (i) applicable law; (ii) the conduct at issue; and (iii) why the conduct is "deficient" with respect to the law or why additional policies, procedures, or disclosures are required. This framework will clarify for advisers, fund boards, and clients not only which matters may be deficient, but also specifically why they are deficient. Such clarity will assist advisers in evaluating potential revisions to their compliance programs.

Address adviser counter positions

In certain instances, an adviser may disagree with OCIE staff findings regarding whether the adviser has violated the Advisers Act or breached its fiduciary duty. While we appreciate OCIE staff's time and willingness to listen to an adviser's argument, the staff will often continue to find a violation or breach, but fail to explain why the staff considered the adviser's viewpoint erroneous.[11] To the extent possible, especially in gray areas of the Advisers Act or SEC

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7 Indeed, use of the negative term "deficiency letter" may in and of itself adversely affect the OCIE-registrant relationship. A more neutral term, such as "report of examination," may create a more positive framework for interaction between OCIE staff and registrants.

8 For example, we are aware of circumstances where an adviser presented an investment-related issue to the independent directors of the fund it managed. After disclosure of all relevant facts and full discussion, the directors made a determination regarding the adviser's handling of this issue. During a subsequent examination, OCIE staff disagreed with the independent directors' business judgment in this matter, despite the fact that no rule violation had been implicated.

9 Final Rule: Compliance Programs of Investment Companies and Investment Advisers, SEC Rel. No. IA-2204 (Dec. 17, 2003) at 5.

10 For example, an OCIE examiner informed an adviser that it should select a different threshold for receipt of gifts in its code of ethics, even though advisers are not expressly required to have a gift policy at all, let alone a specific dollar threshold.

11 For example, one letter noted that OCIE staff had raised "concerns" regarding compliance with a particular rule and that the adviser had responded, but that the staff "remained concerned." The letter did not explain why or how the adviser's response had not addressed the concerns raised.

interpretation (*e.g.*, advertising), the staff should make an effort in the deficiency letter to explain why the staff believes that the adviser's viewpoint is incorrect or inadequate. Alternatively, the staff should make every effort during the exam process to discuss matters that may be included in the deficiency letter so that the adviser is not surprised by the findings or analysis stated in it.[12]

Avoid inconsistent directives

Deficiency letters, in some instances, present inconsistent directives to advisers. For example, with respect to class actions, OCIE staff has stated in letters that advisers "should consider" whether it is appropriate to implement written policies and procedures regarding participation in class action lawsuits. However, the same letters have raised this issue for "immediate corrective action." These contradictory phrases instill confusion among advisers. Requesting immediate corrective action implies that that adviser must do more than just "consider" the matter. We request, therefore, that the staff avoid inconsistent statements, and, in particular, exercise judgment with respect to the use of boilerplate language such as "immediate corrective action."

Endeavor to keep deficiency letters succinct and focused on ongoing deficiencies

Deficiency letters sometimes include lengthy recitations of the law with respect to minor matters, including matters that the adviser immediately corrected while the staff was on site. The letters may also include a lengthy discussion of shortcomings that the adviser detected on its own, remedied, and reported to OCIE staff during the examination. Further, deficiency letters may cite broad legal principles (often noting the problematic conduct or risk in the industry generally that may have been the motivation for the examination or sweep letter) that are not related to specific findings regarding the adviser's operations.[13] The sheer length of these letters combined with inclusion of insignificant points may detract from the main findings or focus of the examination. A succinct letter would better enable management and fund boards to focus on significant issues without getting diverted by minor matters.

Continue to work with the Division of Investment Management to form consistent legal and regulatory positions

We understand that the Division of Investment Management and OCIE communicate and coordinate regularly regarding matters of mutual interest. We are aware of occasions, however, where deficiency letters have misinterpreted the law or incorrectly implied that certain practices are requirements. For example, both orally and in deficiency letters, advisers have been cited for failure to adopt and implement class action and anti-money laundering policies and procedures. In fact, neither the Advisers Act, nor the Treasury Department, nor well-established

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12 OCIE staff may also wish to consider a process used by other regulators whereby registrants are provided with a copy of the draft examination report to facilitate discussion about any potential areas of disagreement before the final report is issued.

13 We request that the staff use care in its opening paragraphs in deficiency letters and refrain from recitations of law that are unrelated to the specific findings being communicated in the letter. If indeed there are no findings, the deficiency letter should state this fact in plain language.

interpretations of fiduciary duty currently require an adviser to implement such policies or procedures.

It is essential that OCIE staff work closely with the Division of Investment Management to ascertain the Division staff's position on such policy matters. The SEC and its staff should endeavor to communicate legal requirements and standards to registrants separately from the examination process. The deficiency letter should not be used as a means to dictate new law or best practices.

Our members are, however, very interested in OCIE staff's views regarding best practices outside the deficiency letter context. For example, we found the internal controls that OCIE compiled and provided in Appendix F of its 1998 Soft Dollar Inspection Report[14] to be very helpful for advisers. We hope that OCIE will continue to communicate information about sound internal controls through these types of vehicles and through the CCO Outreach program.

Indeed, we submit that for each significant sweep exam, OCIE should publish a report outlining the staff's findings, any critical compliance issues found, and the controls the staff believes were most effective for addressing these compliance issues. These types of communications will help foster a more constructive relationship between CCOs and OCIE by providing additional information to compliance professionals that may be reviewed and implemented, as appropriate.

Review all surrounding or supporting documentation

During the examination process, OCIE staff typically review advisory contracts, offering documents, Form ADV, and other documents. Deficiency letters sometimes state that these documents contain improper disclosures or omit required disclosures. On occasion, however, these deficiencies could be resolved by reviewing the document in question in its entirety as opposed to referencing selected sections of the document. We suggest, therefore, that the staff discuss any potentially inadequate or improper disclosure or contract matters with the adviser prior to issuing a deficiency letter to ascertain if any other language in the document could satisfy the requirement.[15] This might enable the staff to resolve a deficiency in its entirety or find that any deficiency is less serious, *e.g.*, inadequately placed disclosure as opposed to improper or non-existent disclosure.

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14 *See* Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22 1998).

15 Lori Richards, Director, OCIE, *Remarks before the IAA/IA Week Eighth Annual Investment Adviser Compliance Summit: Fiduciary Duty: Return to First Principles* (Feb. 27, 2006) (discussing disclosure as the most commonly found deficiency).

Continue to disclose common deficiencies found at registrants

From time to time, OCIE issues letters to all registered advisers regarding OCIE's inspection findings and common deficiencies found at registrants. OCIE staff also often includes this information in speeches at industry conferences. We applaud these efforts and urge OCIE to continue issuing this type of guidance, which may help advisers improve their compliance programs.

We truly appreciate your consideration of these matters. Please do not hesitate to contact me or David Tittsworth if you have questions or would like additional information.

Sincerely,

Karen L. Barr

Karen L. Barr
General Counsel

cc: Christopher Cox, Chairman
Cynthia A. Glassman, Commissioner
Paul S. Atkins, Commissioner
Roel C. Campos, Commissioner
Annette L. Nazareth, Commissioner
Gene Gohlke, Associate Director, OCIE
John Walsh, Chief Counsel, OCIE
Susan Wyderko, Acting Director, Division of Investment Management

July 19, 2006

Via Electronic Mail

Ms. Sandy Wright
Securities and Exchange Commission
6432 General Green Way
MS 0-20
Alexandria, VA 22312

Re: Request for Information/Draft Solicitation; Rel. No. 34-54077

Dear Ms. Wright:

The Investment Adviser Association[1] appreciates the opportunity to provide comments regarding the Request for Information/Draft Solicitation[2] (RFI) proposed by the Commission.

We commend the Commission for moving forward with a study "that will involve collecting, categorizing and analyzing empirical data regarding the marketing, sale, and delivery of financial products, accounts, programs and services offered to individual investors by broker-dealers and investment advisers."[3] We have reviewed the draft RFI and believe that it sets forth appropriate and relevant issues for the study. We offer the following brief comments and suggestions for your consideration.

Core Objectives. We agree with the core objectives listed in the RFI, including the objective of identifying "information provided to individual investors…regarding the products, accounts, programs, and services provided, including the nature of the responsibilities that the broker-dealer or investment adviser owes to the investor and any contractual limitations on those responsibilities." We believe this objective, however, also should explicitly encompass a requirement to provide factual information about if and how broker-dealers are providing disclosures required by the Commission's rule relating to fee-based compensation and the broker-dealer exemption under the Investment Advisers Act.[4] Numerous news reports have indicated that the brokerage community has

[1] The Investment Adviser Association 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.

[2] Request for Information/Draft Solicitation; Rel. No. 34-54077 (June 30, 2006).

[3] *Id.*

struggled to comply with requirements of the new rule. In addition, we believe the study should include a requirement to provide information about whether and how the Commission is enforcing the broker-dealer fee-based compensation rule. We previously have urged the Commission to "dedicate adequate resources to ensure that the rule is properly implemented and that broker-dealers comply fully with its requirements."[5] To our knowledge, however, no credible study has been performed about whether and how brokers are complying with the rule and whether and how the Commission is enforcing the requirements of the rule. A factual report on both is necessary to determine if further policy adjustments are necessary and appropriate.

We also agree with the core objective of determining "how and from what sources broker-dealers, investment advisers and their associated persons are compensated for the different financial products, accounts, programs and services provided." We assume that the determination of compensation will encompass both cash and non-cash incentives.

Finally, we agree with the core objective of evaluating "individual investors' expectations regarding the obligations owed to them by the investment professional who provided the financial products, accounts, programs and services." We believe it also would be interesting and relevant to ask investors what they would *like* to know about various financial services providers and the products and services they provide. We urge the Commission to revise this core objective to ensure that investors have an opportunity to discuss what information is important to them, both in terms of selecting an investment professional as well as understanding the services and products that are offered.

Contractor Eligibility. Finding the appropriate contractor to perform the study is perhaps the single most important aspect of the RFI. The bottom line is that the purposes of the study will only be achieved if the contractor selected is a credible and disinterested entity. We applaud the RFI's intent to exclude from consideration a large number of parties that may have a direct interest in the outcome of the study. We also believe that the entity selected should be urged to demonstrate independent judgment relating to any aspects of the study that may implicate previous Commission policy judgments. While we certainly understand and agree that the Commission needs appropriate authority to determine the scope and methodology of the study (including all costs related to the performance of the study), we believe it is important to emphasize the Commission's expectation that the contractor will exercise independent and neutral judgment in performing all aspects of the study (including any positions taken by the Commission).

Timing. We urge the Commission to proceed expeditiously with the final solicitation for the study. Our organization and others have expressed dissatisfaction with the delays associated with the fee-based broker-dealer rule.[6] We believe the

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[4] *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Rel. Nos. IA 2376; 34-51523; File No. S7-25-99 (Apr. 12, 2005).

[5] *See Letter from David G. Tittsworth, Investment Adviser Association to Chairman William H. Donaldson, Securities and Exchange Commission* (July 22, 2005).

interests of consumers and other interested parties will best be served if the study is not used to further delay meaningful action on these important issues.

Public Availability. We strongly urge the Commission to make the study available to the public.

We look forward to working with the Commission and the contractor on the study.[7] Please do not hesitate to contact us if we may answer any questions or provide any additional information.

Sincerely,

David G Tittsworth

DAVID G. TITTSWORTH
Executive Director

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[6] The original proposed rule was released in November 1999. The final rule was approved in April 2006, after the Financial Planning Association filed a lawsuit challenging the SEC's actions.

[7] We assume that our organization will be treated as an "interested party" with whom the contractor will conduct interviews.

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[1] 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.[2] 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."[3]

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

[1] 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.

[2] Proposed Revision of Annual Information Return/Reports, 71 Fed. Reg. 41616 (2006) ("Proposed Revision").

[3] Proposed Revision, 71 Fed. Reg. 41649.

revenue sharing and other financial relationships or arrangements and potential conflicts of interest that might affect the quality of those services."[4]

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

<u>Background</u>

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

[4] 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.[5]

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.[6] When the Commission adopted its interpretive guidance in July 2006[7] – 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.

<u>The DOL Should Defer to the SEC's Disclosure Rulemaking.</u>

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).[8] 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.[9] 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.[10]

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[5] ERISA Technical Release No. 86-1 (May 22, 1986).

[6] *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.

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

[8] *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."

[9] *See* ICAA Statement and ICAA Testimony, *supra*, n. 3.

[10] *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."[11] 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.[12]

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.[13] 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.[14] 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."

[11] ERISA Technical Release No. 86-1 (May 22, 1986).

[12] Letter from Ann Combs to Jonathan Katz (March 13, 2006).

[13] 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).

[14] *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.[15]

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.[16] Broker-dealers often provide many products

[15] The Department may wish to consider including such guidance in the context of anticipated Section 408 (b)(2) guidance.

[16] 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.

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.[17] 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.[18] 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.[19] Accordingly, the utility of the information that would be provided is questionable.

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[17] 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.

[18] *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); CP 154: Best Execution, Financial Services Authority (October 2002).

[19] 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

Karen L. Barr
General Counsel

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

INVESTMENT ADVISER
ASSOCIATION

October 23, 2006

Via Electronic Mail

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Executive Compensation and Related Party Disclosure (File No. S7-03-06; Release Nos. 33-8735; 34-54380; IC-27470)

Dear Ms. Morris:

We appreciate the opportunity to comment on the Commission's new rules on executive compensation and related persons disclosure. The Investment Adviser Association[1] supports the Commission's efforts to provide greater transparency in the area of executive compensation. We believe the new Rule adopted by the Commission in August (the "Executive Compensation Rule"),[2] will greatly assist the investing public in assessing whether the compensation packages for senior management at a company establish appropriate economic incentives for management to act in the best interests of shareholders.

However, we do not believe the Commission should adopt its proposal to require additional disclosure of the job descriptions and total compensation received by up to three additional employees if such employees exert significant policy influence at the company, at a significant subsidiary of the company or at a principal business unit, division or function or the company and such individuals' total compensation is greater than that of any of the named executives (the "Proposal").[3] We respectfully urge the Commission to reject the Proposal as currently framed because we believe the negative impacts that the Proposal will have on the financial services industry, including the investment advisory profession, greatly outweigh any benefit to the investing public to be gained from the disclosure of such compensation information.

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[1] 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 adviser firms. Founded in 1937, the Association's current membership 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.

[2] *Executive Compensation and Related Person Disclosure;* SEC Release Nos. 33-8732A, 34-54302A, IC-27444A, File No. S7-03-06 (Aug, 29, 2006).

[3] *Executive Compensation Disclosure,* SEC Release Nos. 33-8735, 34-54380, IC-27470, File No. S7-03-06 (Aug. 29, 2006).

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The Proposal Is Overbroad and Lacks Clarity.

The Proposal's disclosure requirement focuses on highly compensated employees "who exert significant policy influence by having responsibility for significant policy decisions." The Proposal does not define "responsibility for significant policy decisions," but requires publicly traded advisers to consider, and select from, various senior professionals across multiple functions. Particularly troublesome is the Proposal's suggestion that an investment professional's duties may rise to the level of such responsibility. Within investment management firms, this will be a difficult task fraught with ambiguity, because the business model employed by many firms vests significant investment autonomy with portfolio managers and other related professionals. Such autonomy should not be equated with exercising a significant policymaking role. Indeed, we are concerned that portions of the release accompanying the Proposal could be read to suggest that senior investment professionals (such as chief investment officers or head traders) should be *presumed* to have responsibility for significant policy decisions.[4] For example, a senior investment professional may play an active role in the investment oversight process, including setting investment policies, in addition to handling portfolio management responsibilities. We do not believe, however, that these additional oversight responsibilities make them policy-setters from a corporate governance perspective. The Proposal's discussion of "significant policy decisions" provides no compelling rationale for this result.

Further, the disclosure requirement contemplated by the Proposal is arbitrary, in the sense that it singles out a small number of non-executive employees for disclosure about their compensation. As currently drafted, the Proposal may result in compensation disclosure for three individuals who have no influence on the strategic direction of the issuer, contrary to the Proposal's stated goals. As noted below, this disclosure could have significant adverse effects, including making it easier for others to poach investment talent, creating internal conflict among employees, and producing an unfair competitive disadvantage for companies that make such disclosures.

Similarly, the Proposal's focus on highly compensated employees at "significant subsidiaries" is potentially overbroad and not reasonably designed to elicit information important to shareholders. Compensation determinations at a subsidiary have little relevance, and provide no useful context, for shareholders of the parent company. It is not unusual for investment management operations to be organized as separate operating companies under a single corporate umbrella. The levels and approaches to control over

[4] "Nor, as a general matter, would investment professionals (such as a trader, or a portfolio manager for an investment adviser who is responsible for one or more mutual funds or clients) be deemed to have responsibility for significant policy decisions at the company, at a significant subsidiary or at a principal business unit, division or function simply as a result of performing the duties associated with those positions. *On the other hand, an investment professional, such as a trader or portfolio manager, who does have broader duties within a firm (such as, for example, oversight of all equity funds for an investment adviser) may be considered to have responsibility for significant policy decisions*." Proposal, at 6 (emphasis added).

the subsidiaries' operations can vary dramatically from firm to firm, providing little or no basis for comparison of compensation practices, much less context for shareholders who are reviewing the disclosures.[5]

The Proposal Will Not Provide Additional Meaningful Information to Investors.

The Proposal will not add anything significant or meaningful to the total mix of information that will already be provided to the investing public under provisions of the newly adopted Executive Compensation Rule. Because non-executive compensation is generally set by management rather than the board of directors, the information will not shed any light on the functioning of the board. Such compensation is simply one component of a company's operating expenses. Further, the proposed disclosure will not provide investors and research analysts with any additional insight into a company's management structure or governance practices. The Proposal assumes a connection that does not exist between compensation determinations with respect to executive management of an issuer, and those of subsidiaries or business units, no matter how distant or different in management, organization, or structure. Depending on the type of business a company is in, the individuals covered by the Proposal may change from year to year in light of market conditions and other factors, giving no basis for a comparison from one year to the next. Moreover, the compensation structures for a company's top producers may be structured so differently from management's that a comparison is at best meaningless and at worst misleading.[6] In its Release, the Commission suggests that such disclosure would be useful because it would assist in placing into "context" the compensation structure for a company's named executive officers and directors. We respectfully disagree as investors typically evaluate management compensation by comparing companies in the same sector or industry – and not by comparing management's compensation on an intra-company basis. We submit that the new disclosure requirements for management's Compensation Disclosure and Analysis will more than adequately serve to place a company's compensation structure into the appropriate context.

The Proposal Will Have Adverse Consequences for the Investment Advisory Profession.

The Proposal would also create an unfair competitive disadvantage for publicly traded asset management firms. The investment advisory profession is highly competitive and firms are constantly under pressure to recruit and retain talented

[5] We note that the Proposal does not speak to and should not reach subsidiary operations that are both independent and autonomous from an operational, regulatory, and most importantly, structural perspective, where an issuer has no connection to or impact on the compensation arrangements and the shareholders of the issuer have no rights to nor would they ever receive any portion of such compensation expenses should they be decreased. This structure arises principally in acquisition settings, where the acquiring issuer (which functionally becomes a partner rather than a parent to the acquired firm) structurally relinquishes any rights to (i) oversee the allocation of the operating expenditures of the acquired entity, and (ii) recapture as cash flow or profit any portion of the operating expense not used for compensation.

[6] For example, an employee's compensation may be sales-based, while executive management's compensation is tied to performance of the issuer's stock relative to other companies in the industry.

investment professionals. Even though the Proposal only requires disclosure of the job descriptions of the three most highly compensated non-executive employees, it is highly likely that the identity of an asset management firm's three most highly compensated "portfolio managers" will be readily ascertainable by the firm's employees and competitors. Disclosure of such highly sensitive information could cause substantial harm to our profession. For example:

- Disclosure of such information would make it easier for one company to "poach" investment talent from other firms and thus would have the perverse effect of increasing total compensation costs, as companies would be forced to spend even more to retain talent.

- Such disclosure would also create internal conflict among a disclosing company's employees who will be given knowledge of their peers' total compensation.

- The Proposal would also create an unfair competitive disadvantage for publicly traded investment advisory firms and could accelerate an exodus of investment talent to private firms and hedge fund managers.

We also note that many publicly traded investment adviser firms have worldwide operations that are subject to foreign laws and jurisdictions. Global employers with large worldwide operations will have to examine, track, and maintain detailed payroll and compensation plans and information worldwide. This will place a significant burden and unnecessary cost on such firms.

Conclusion

The newly adopted Executive Compensation Rule will provide investors and research analysts with appropriate and useful information in assessing publicly traded companies. We urge the Commission to give the new rule an opportunity to work before imposing requirements that will have negative effects on investment advisory firms. If the Commission nevertheless decides to proceed with the Proposal, we request that it more narrowly tailor its scope to achieve its stated policy goals and remove any references to senior investment professionals from the final release.

Please do not hesitate to contact us if we may answer any questions or provide any additional information regarding these important issues.

Sincerely,

David G. Tittsworth

DAVID G. TITTSWORTH
Executive Director

Cc: Hon. Christopher Cox

Hon. Paul S. Atkins
Hon. Roel C. Campos
Hon. Annette L. Nazareth
Hon. Kathleen A. Casey

November 1, 2006

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
New Brunswick Securities Commission
Securities Office, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Nunavut
Registrar of Securities, Yukon Territory

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Re: Notice of Proposed NI 23-102 Use of Client Brokerage Commissions as Payment for Order Execution Services or Research ("Soft Dollar" Arrangements)

Dear Mr. Stevenson and Madame Beaudoin:

The Investment Adviser Association ("IAA") welcomes the opportunity to comment on the proposed National Instrument 23-102 ("Proposed Instrument") issued by the Canadian Securities Administrators ("CSA") regarding the use of client brokerage commissions as payment for order execution services or research.

The IAA is a not-for-profit organization that exclusively represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA was founded in 1937 as the Investment Counsel Association of America and played a major role in the enactment of the Investment Advisers Act of 1940, the law regulating the investment adviser industry in the United States. Today, the IAA consists of more than 450 investment adviser firms that collectively manage in excess of $6 trillion in assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment companies, endowments, foundations and corporations. The IAA's membership includes Canadian-based investment advisory firms as well as U.S.-based firms that conduct investment advisory business in Canada, primarily through affiliates providing investment management services to Canadian clients.

During the past few years, the IAA has been actively involved in discussions related to soft dollar issues in the United States. For example, our organization testified before the Senate Banking Committee and has submitted numerous comment letters to the Securities and Exchange Commission regarding soft dollar interpretations and proposals.[1] In doing so, we have consistently voiced our support for full and fair disclosure of the use of client commissions for research and brokerage services in the United States and abroad. In addition, the IAA 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.[2]

We commend the CSA for considering these important issues and we appreciate the opportunity to provide input regarding the Proposed Instrument.

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[1] *See* 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); IAA Letter to U.S. SEC on Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (Nov. 23, 2005), ICAA Statement Re: Soft Dollars (Mar. 3, 2004).

[2] *See* IAA Letter to UK FSA re CP 05/13 on Bundled Brokerage/Soft Commissions for Retail Funds (Jan. 6, 2006), IAA Letter to UK FSA regarding CP 05/5 on Bundled Brokerage/Soft Commission (May 31, 2005). *See also*, ICAA Letter to UK FSA regarding PS 04/23 on Soft Dollars/Bundled Brokerage (Dec. 16, 2004); ICAA Letter to UK FSA regarding CP 176 on Bundled Brokerage and Soft Commission Arrangements (Oct. 9, 2003). Each letter is available on the IAA Web site (www.investmentadviser.org) under "Comments and Statements."

Suggested Revisions To The Disclosure Requirements Of The Proposed Instrument

The IAA appreciates the CSA's desire to clarify the goods and services that may be acquired with client brokerage commissions and to increase accountability and transparency with respect to brokerage commissions. The IAA consistently has supported accurate and informative disclosure of client commissions for research and brokerage services so that clients can be knowledgeable about how their commission dollars are being used. We are concerned, however, that the requirements set forth in Section 4 of the Proposed Instrument with respect to the disclosure of commission practices will not serve to increase accountability and transparency. We understand that clients generally have not requested information of the type and level of detail proposed to be disclosed and that clients receiving such information have not appeared to find it meaningful. For example, the Proposed Instrument would require disclosure to clients of all broker-dealers used and their products and services provided. Providing such lengthy lists (some investment advisers may utilize the services of hundreds of broker-dealers a year) would only distract clients who would be better served by receiving information generally describing services offered and the types of broker-dealers utilized. In addition, providing extensive details of each service or product received in consideration for client commissions would be unnecessarily burdensome in relation to its limited value to clients given the difficulty of quantifying certain services or products.

Instead, we respectfully suggest that clients would be better served by brokerage commission disclosure that supplies information about an investment adviser's general trading practices, including the adviser's policy with respect to research and the way in which brokerage allocation decisions are made. Investment advisers should be required to provide information to clients about services rendered, but with some flexibility with respect to compliance with disclosure obligations. A narrative format, similar to the disclosure required by the SEC in Form ADV Part II,[3] and suggested by the Investment Management Association in the Level 1 framework,[4] allows for a flexible disclosure regime that is informative and relevant for clients. Such a framework clearly addresses the CSA's goal of increased transparency and accountability with respect to brokerage commission practices without overwhelming clients with unnecessary details or potentially inaccurate or inconsistent information.

Suggested Clarifications To The Framework of the Proposed Instrument

The IAA supports the CSA's goal of providing a specific framework for the use of client brokerage commissions by investment advisers, as set forth in the Proposed Instrument, the Notice of the Proposed Instrument, and the Companion Policy to the

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[3] Form ADV Part II is a written disclosure statement containing information about an investment adviser's background and business practices that is required to be delivered to each client or prospective client.

[4] The Investment Management Association is a trade association that represents the U.K. investment management industry. Level I is a general description of a firm's brokerage practices.

Proposed Instrument ("Companion Policy"). We agree with the framework set forth in the Proposed Instrument to the extent it provides that order execution services and research acquired with brokerage commissions benefit the adviser's clients and add value to investment or trading decisions, and that the commissions paid are reasonable in relation to the value of the products and services received. We request clarification, however, that investment advisers would not be required to allocate benefits received with client commissions to particular clients.[5] Investment advisers typically use research for the benefit of more than one client. Specific allocation of the benefit of research services or products to particular clients would be burdensome to investment advisers and imprecise given that goods and services received benefit a number of clients.

Regulatory Consistency Is Essential

Given the increasing globalization of the asset management industry, we cannot overstate the need for consistency between the client brokerage commission disclosure requirements imposed by regulators in Canada, the United States, and the United Kingdom. Many investment advisers are subject to regulation to some extent in all three jurisdictions and it would be very difficult, time-consuming, and expensive for them to comply with disparate regulatory regimes, particularly when rules differ on the same subject matter. The IAA has long emphasized that securities regulators should work together to ensure uniformity in the approach to rules regarding client commissions and brokerage so that investment advisers with operations in several different countries can operate under consistent regulatory frameworks. We recognize and commend the CSA's desire to provide regulatory consistency with the SEC and the FSA. It is our understanding that the SEC is currently in the process of drafting disclosure guidelines for brokerage commissions. We think it is essential that the CSA coordinate with the SEC (and the FSA) to ensure that the disclosure guidelines regarding client brokerage commissions are consistent and assist in uniform implementation, especially for investment advisers with operations in multiple jurisdictions.

Additional Clarifications Or Revisions To The Proposed Instrument

Finally, we concur with many of the points raised in the letters to you from Robert Grohowski of the Investment Company Institute, from Henry Hopkins of T. Rowe Price (each dated October 19, 2006) and from Katie Walmsley of the Investment Counsel Association of Canada (dated October 30, 2006) regarding the Proposed Instrument. Specifically, with respect to the application of the Proposed Instrument, we agree with the other commenters that it should be limited to transactions where there is an independent pricing mechanism to enable investment advisers to accurately and consistently determine the amount of the commission that a dealer is charging for a

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[5] This need for clarification is raised by a comment in the Companion Policy that advisers should have policies and procedures "to allocate, on a fair and reasonable basis, the good and services received to its clients whose brokerage commissions were used as payment for those goods and services." Companion Policy, Part 4.1(2).

transaction. We also concur that, with respect to the definition of order execution services and research, the proposals regarding order management systems, proxy voting services, publicly available information or publications, and raw market data should be clarified or revised to enhance consistency between the U.S., U.K., and Canadian markets.

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We appreciate the opportunity to provide our views on this important issue. Please do not hesitate to contact us if we may supply additional information or assistance to you regarding these issues.

Sincerely,

Valerie Baruch

Valerie Baruch
Assistant General Counsel
Investment Adviser Association

INVESTMENT ADVISER ASSOCIATION

6 December 2006

Via Electronic Filing (cp06_18@fsa.gov.uk and christopher.preston@fsa.gov.uk)

Mr. Christopher Preston
Institutional Business Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Re: Consultation Paper 06/18 – *Proposed amendment to the Conduct of Business sourcebook (COB 7.18 - Use of Dealing Commission)*

Dear Mr. Preston:

The Investment Adviser Association (IAA) appreciates the opportunity to comment on the Financial Services Authority's Consultation Paper 06/18 (CP 06/18) entitled *Quarterly Consultation (No. 10)* (October 2006).[1] We are writing to comment specifically on the proposal in Chapter 5, *Proposed amendment to the Conduct of Business sourcebook (Use of Dealing Commission)*, to amend COB 7.18.8G to exclude "computer software including order and execution management systems" and "connectivity services such as electronic networks" as "execution" or "research" eligible to be paid for with client commissions.[2]

The IAA is a U.S.-based not-for-profit organization that exclusively represents the interests of investment advisers registered with the U.S. Securities and Exchange Commission (SEC). The IAA was founded in 1937 as the Investment Counsel Association of America and played a major role in the enactment of the Investment Advisers Act of 1940, the law regulating the federal investment adviser industry in the United States. Today, the IAA consists of more than 450 investment adviser firms that collectively manage in excess of $6 trillion in assets worldwide for a wide variety of individual and institutional clients, including pension plans, trusts, investment companies, endowments, foundations, and corporations. Many of our members conduct substantial investment advisory business in the United Kingdom, primarily through U.K. affiliates

[1] Consultation Paper 06/18 (CP 06/18), *Quarterly Consultation (No. 10)* (October 2006). This consultation paper follows Policy Statement 05/9 providing final rules on the use of dealing commission and amending the Conduct of Business (COB) sourcebook, effective in January, 2006. *See* FSA Policy Statement 05/9, *Bundled brokerage and soft commission arrangements: Feedback on CP05/5 and final rules* (July 2005) (PS 05/9).

[2] CP 06/18 at pp. 18-20.

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that are registered with the FSA, or provide investment management services to U.K. clients.[3] We also have several members that are located in the U.K.

In CP 06/18, the FSA proposes to add "computer software including order and execution management systems" and "connectivity services" as examples of goods and services that do not meet the requirements of the FSA's tests for the execution of trades or provision of research.[4] The FSA concludes, without explaining its rationale, that such goods and services fail the temporal test for execution, are inconsistent with the duties owed clients, and raise potential conflicts of interest.[5]

We appreciate the FSA's efforts to clarify which goods and services are eligible to be acquired with commissions. However, we are concerned that the FSA's approach is overly restrictive and unnecessary and will result in inconsistent global regulation in an increasing global asset management business. In particular, the FSA's proposal is in direct conflict with the SEC's recently adopted interpretation for the use of client commissions.[6] Moreover, these goods and services may meet the standards set out in PS 05/9 for research or execution. Therefore, we urge the FSA to reconsider its proposal to exclude these services and instead, consistent with its previous approach, permit investment managers to make reasonable determinations as to whether the goods and services fall within the applicable standards.

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[3] For more information about the IAA, including a membership directory, please visit our web site at www.investmentadviser.org.

[4] CP 06/18 at 19 (proposing to amend Code of Business Sourcebook (COB) section 7.18.18G(c) and (g), respectively to prohibit use of commission to purchase these items). Under COB 7.18.4E(1), goods and services relate to the *execution* of trades if they are: (a) linked to the arranging and conclusion of a specific investment transaction (or series of related transactions); and (b) provided between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction is concluded. Under COB 7.18.5E(1), goods and services relate to the provision of *research* if the research: (a) is capable of adding value to the investment or trading decision by providing new insights that inform the manager when making decisions about customers' portfolios; (b) represents original thought, in the critical and careful consideration and assessment of new and existing facts, and does not merely repeat or repackage what has been presented before; (c) has intellectual rigour and does not merely state what is commonplace or self-evident; and (d) involves analysis or manipulation of data to reach meaningful conclusions. *See* PS 05/9, Annex B, Amendments to the Conduct of Business sourcebook, at p. 8.

[5] CP 06/18 at 19 (citing COB Section 7.18.3R(3)(b), which requires that the goods and services "will reasonably assist the *investment manager* in the provision of its services to its *customers* on whose behalf the orders are being *executed* and do not, and are not likely to, impair compliance with the duty of the *investment manager* to act in the best interests of its *customers*."). The FSA specifically excluded from permissible research or execution "dedicated telephone lines" and "office administrative computer software, such as word processing or accounting programmes." *See* PS 05/9, COB 7.18G(c) and (g), respectively.

[6] *See* SEC Release No. 34-54165, *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act* (July 18, 2006) ("SEC Interpretation"). U.S. money managers must comply with the SEC Interpretation by January 24, 2007.

Regulatory Consistency

We understand the FSA and SEC have had a continuing dialogue regarding client commission arrangements. We applaud the FSA for engaging in this dialogue to coordinate efforts regarding client commission rules and regulations affecting international asset managers. Many U.K. advisers are part of global entities that are regulated in various jurisdictions. Thus, coordination with other regulatory entities, including the SEC and European regulators, is critical to facilitating compliance with these rules and encouraging further globalization and growth of the asset management industry.[7] Accordingly, we respectfully request the FSA give due consideration to consistency with the SEC's recent Interpretation before eliminating connectivity services and order management systems as permissible goods and services.

Order and Execution Management Systems

Order and execution management systems have numerous components and functionalities, some of which may include research or execution. Therefore, we urge FSA to permit managers to include those functionalities that meet the standards of research or execution set out in PS 05/9 as permissible goods and services.

Research. We submit that certain components of order management systems would constitute research under the FSA's definition. For example, as acknowledged in the SEC's Interpretation, market research[8] that may be eligible as research can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies.[9] The SEC noted that market research may be obtained through *order management systems* and trade analytical software. In addition, the SEC indicated that *software* that provides market research such as advice on order execution, including advice on execution strategies, market "color," and availability of buyers and sellers, may be eligible research.[10] In order to address the possibility that some functions of an order management system may not meet the definition of research, the SEC noted that if the products and services contain functionality that is not eligible brokerage or research, the

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[7] For example, we note that the SEC, in an effort to harmonize global regulation, adopted an approach to commission-sharing arrangements in its interpretation to reflect much of the commission-sharing practices in the U.K. In response to commentators identifying the U.K.'s current regulatory regime for commission-sharing arrangements and the industry practices prevalent in the U.S., the SEC revised its interpretation of the statutory safe harbor to permit the industry to structure flexible arrangements that are consistent with the U.S. statute and that best serve investors. SEC Interpretation at 52.

[8] Market research is that which provides advice, analysis or reports regarding the market for securities. SEC Interpretation at 34.

[9] *Id.*

[10] *Id.*

manager may treat them as having a mixed-use and pay for the non-eligible portion with its own money.[11]

We request the FSA to adopt a similarly flexible approach to permit investment managers the ability to determine which portion of the order or execution management system provides eligible goods and services under PS 05/9. Prescriptive exclusions of certain goods and services may lead to uncertainty regarding other goods and services not identified in the list as well as other unintended consequences.

Execution. Computer software, including order and execution management systems, also may meet the standard for execution under PS 05/9. In proposing to add these systems to the non-permitted list, the FSA asserts they are not related to a specific transaction. However, software made available through these systems may be linked to the arranging and conclusion of specific investment transactions, even though the software may not be provided to the manager on an order-by-order basis. The systems provide services applicable to each order entered into the system between the point at which the investment manager makes an investment or trading decision and the point at which the investment transaction is concluded, thereby meeting the temporal test. We believe that the manner in which the FSA proposes to apply the temporal standard to these systems would result in too narrow an interpretation of the standard.

In that regard, we urge the FSA to take an approach similar to that taken in the SEC Interpretation. The SEC Interpretation also sets out a temporal standard for brokerage.[12] The portion of the SEC's temporal standard regarding transmitting "an order" is similar to the FSA's standard regarding "a specific investment transaction." The SEC, however, concluded that trading software used to route orders to market centers and software used to transmit orders to direct market systems are within the temporal standard and are eligible brokerage.[13] Accordingly, we request the FSA to refrain from adding computer software, including order and execution management systems, to the list of non-permissible goods and services.

Connectivity Services

We recognize that in PS 05/9, the FSA took the position that dedicated telephone lines are not permitted goods or services and may be extending that analysis here to all connectivity services. However, since then, the SEC has taken a different approach based on the temporal standard, which, we submit is well-reasoned and bears consideration.

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[11] *Id.* at note 105.

[12] The SEC Interpretation provides that brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. SEC Interpretation at pp. 40-41.

[13] SEC Interpretation at 41.

Under this standard, the SEC determined that communications services related to the execution, clearing and settlement of securities transactions and other functions incidental to effecting securities transactions, *i.e.*, connectivity service between the money manager and the broker-dealer and other relevant parties such as custodians (including dedicated lines between the broker-dealer and the manager's *order management system* and others) are eligible brokerage.[14] The SEC reasoned that the "transmission of orders has traditionally been considered a core part of the brokerage service."[15]

Accordingly, we respectfully request that the FSA reconsider its proposal to exclude connectivity services, such as electronic networks. Connectivity services should fall within the temporal standard for execution set out in PS 05/9. Connectivity services provide the manager with the ability to arrange, and the broker-dealer to conclude, specific investment transactions and the services are provided between the time the manager makes an investment decision and the time the transaction is concluded.

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We greatly appreciate your consideration of our comments on CP 06/18. We respectfully request the FSA give due consideration to consistency with the SEC before determining that computer software, including order and execution management systems, and connectivity services are impermissible goods and services. Please do not hesitate to contact the undersigned, or Karen L. Barr, General Counsel, if we may provide additional information or assistance to you regarding these issues.

Sincerely,

Monique S. Botkin

Monique S. Botkin
Counsel

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[14] *Id*.

[15] *Id.* at n.124.