PICKARD AND DJINIS LLP
ATTORNEYS AT LAW
1990 M STREET, N.W.
WASHINGTON, D. C. 20036

TELEPHONE
(202) 223-4418

TELECOPIER
(202) 331-3813

MEMORANDUM

February, 2010

Disclosure Responsibilities of Asset Managers to Assist ERISA Plans in Reporting Information Regarding Client Brokerage and Commission/Research (Both Third Party and Proprietary Research) Arrangements on Schedule C of DOL Form 5500

For plan years commencing on or after January 1, 2009, asset managers will be asked by their ERISA plan accounts to provide information to the plan about brokerage and third party and proprietary research arrangements involving plan commissions. In turn, the plan will use this information to meet its reporting obligations to the DOL on Schedule C of DOL Form 5500. This memorandum provides several alternatives for plan asset managers to meet the requests of plans for information about brokerage paid to broker-dealers and compensation to the asset manager in the form of research. The memorandum was prepared by Lee A. Pickard and William D. Edick of Pickard and Djinis LLP for the Alliance in Support of Independent Research to assist asset managers in making such disclosures of their brokerage/research arrangements.

EXECUTIVE SUMMARY

For plan years commencing on or after January 1, 2009, asset managers will be asked by ERISA plan accounts to provide information to the plan about brokerage and research (both third party and proprietary research) obtained with plan commissions. By receiving this information from plan asset managers, plans will be able to avoid disclosing details about such arrangements in their Form 5500, Schedule C annual report.

The following categories of information may be requested by plans:

(i) Plans may ask whether the asset manager has received research or non-execution "brokerage" services[1] derived from plan commissions, through either proprietary or third party arrangements, and, if so, the purpose of receiving such research. Plans may further request information about the value of such research, or an estimate of the value, or, alternatively, a determination of the formula used to calculate or determine the value of the research. If it is not practical to provide the value, an estimate, or a formula, the DOL permits the asset manager to provide the plan with a description of the eligibility conditions for receiving the proprietary or third party research sufficient to allow a plan fiduciary to evaluate such conditions for reasonableness and potential conflicts of interest.

(ii) The plan may request the asset manager to identify each broker-dealer from whom the asset manager received proprietary or independent research based on compensation paid by the plan.

(iii) The plan may request the asset manager to disclose an amount or estimate of the commissions or markups or markdowns paid by the plan to each broker-dealer used to execute transactions for the plan or the commission rates, or a range of commission rates, charged by such broker-dealers.

As described below, the purpose of providing such information is not so that it will be disclosed by the plan on Schedule C of Form 5500, but so that the plan may avoid having to disclose details of research/commission arrangements on the form. We note that a good portion of the information sought by plans may have already been disclosed in trade confirmations, the asset manager's Form ADV brochure, or other materials already provided to the plan. If such information has not already been disclosed to the plan in the Form ADV or elsewhere, the Form ADV could be amended or the information could be provided to the plan through other reasonable methods.

---

[1] See, SEC Rel. No. 34-54165, 71 Fed. Reg. 41978 (July 24, 2006) for a discussion of the types of brokerage services an asset manager may receive from a broker-dealer with respect to execution of transactions for managed accounts.

Introduction

In October 2007, the United States Department of Labor adopted amendments to Schedule C of DOL Form 5500 to require more disclosure regarding fees and expenses paid by large pension or welfare benefit plans and certain other plans in order for plan officials to obtain information they need to assess the compensation paid for services rendered to plans. The revised Schedule C is effective for plan years which commence on or after January 1, 2009.

Included among the items to be disclosed on the Form 5500 Schedule C annual report is compensation to asset managers derived from research services provided under proprietary and third party client commission ("soft dollar") arrangements involving plan accounts. Plans may also be required to disclose information regarding commissions paid to broker-dealers in respect of securities transactions effected for plan accounts. However, the DOL has indicated that as long as certain information is provided to the plan regarding commission/research arrangements entered into by the plan asset manager, only minimal information regarding such activities would be required to be listed on Schedule C by the plan.

Plans must file a Schedule C – "Service Provider Information" – to report information about each service provider who receives, directly or indirectly, $5,000 or more in total compensation (i.e., money or anything else of monetary value) in connection with services rendered to the plan. Most plan managers will exceed this threshold because of the asset management fee they receive from the plan. Once the $5,000 threshold is met, all compensation received by a manager is potentially subject to Schedule C reporting requirements.

As discussed below, the DOL has indicated that proprietary or third party research received by a plan asset manager from broker-dealers in consideration of securities transactions executed for the plan is considered compensation to the asset manager, and that this compensation must be disclosed on Schedule C if the value of such research, combined with other compensation received by the plan manager in connection with services rendered to the plan, exceeds $5,000. Fortunately, the DOL has also created an exception from most of the Schedule C disclosure requirements regarding the receipt of research which applies if

the asset manager provides certain information to the plan about its commission/research arrangements.

The DOL has also indicated that commissions paid to a broker-dealer with respect to transactions executed for managed plan accounts may be required to be disclosed to the extent that such commissions exceed $5,000.[2]

Information Required to be Disclosed on Schedule C by Plans About Research as Compensation to Asset Managers

The new Form 5500 Schedule C requires a plan to disclose information regarding plan asset managers who receive, directly or indirectly, $5,000 or more of compensation from the plan. The DOL considers the receipt of research or other services qualifying under the Section 28(e) safe harbor for commissions from plan accounts to be "indirect compensation" to the asset manager because the research and other services are received from a source (a broker-dealer) other than a plan or a plan sponsor in connection with services rendered to the plan and is based upon compensation derived from plan assets (i.e., commissions).

The DOL has made it clear that the reporting requirements for research compensation encompass both proprietary (bundled) research arrangements and third party research arrangements.[3] It would also encompass non-execution "brokerage" services (e.g., order routing software, connectivity services, etc.) received by plan asset managers from broker-dealers in exchange for plan commissions. Accordingly, if an asset manager receives proprietary research or non-execution "brokerage" services from broker-dealers, and the manager received $5,000 or more in total compensation for providing services to the plan,[4] the proprietary research and other services would be required to be disclosed on Schedule C even if one or more of the broker-dealers do not explicitly place a cost on the research.

---

[2] As discussed below, there is some uncertainty as to whether information with respect to commissions for managed plan accounts must be disclosed on Schedule C; however, plan asset managers should be prepared to respond to requests from plans for information with respect to commissions paid to broker-dealers doing transactions for their managed plan accounts.

[3] *Revision of Annual Information Return/Reports*, 72 Fed. Reg. at 64742 (Nov. 16, 2007); DOL FAQ No. 39 available at http://www.dol.gov/ebsa/faqs/faq_scheduleC.html

[4] As discussed above, most plan asset managers will meet this $5,000 threshold, regardless of the value of proprietary and third-party research they receive, because of the asset management fee they receive with respect to the plan.

The DOL has, however, created a category called "Eligible Indirect Compensation," which, if complied with, in respect of commission/research arrangements essentially requires a plan to list on Schedule C only the name of the asset manager receiving research compensation, but not the value of the research, provided the asset manager has previously disclosed to the plan certain information regarding the manager's arrangements for obtaining research for commissions.[5] Thus, asset managers who use commissions of ERISA plans to obtain research should be prepared to provide the following information to the plans (the "Eligible Indirect Compensation Disclosures") to allow the plans to characterize such research as Eligible Indirect Compensation and to avoid further disclose of such arrangements on Schedule C:

(a) The existence of the indirect compensation;

(b) The services provided for the indirect compensation or the purpose for payment of the indirect compensation;

(c) The amount of (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation[6]; and

(d) The identity of the party or parties paying and receiving the compensation.

The DOL has not dictated how the Eligible Indirect Compensation Disclosures must be made to the plan. The disclosures may be made by more than one party (e.g., for a proprietary or third party research arrangement, the asset manager or the broker-dealer) and in more than one document, including electronically. The DOL has indicated that the Eligible Indirect Compensation Disclosures may be made though the asset managers' Form ADV and/or the advisory contract, as long as these documents contain the information set

---

[5] Eligible Indirect Compensation is defined as "[i]ndirect compensation that is fees or expense reimbursement payments charged to investment funds and reflected in the value of the investment or return on the investment of the participating plan or its participants finders' fees "soft dollar revenue, float revenue, and/or brokerage commissions or other transaction based fees for transactions or services involving the plan that were not paid directly by the plan or plan sponsor (whether or not they are capitalized costs)."

[6] The amount or estimate of indirect compensation or the formula used to calculate indirect compensation may be based for Schedule C reporting purposes on an asset manager's fiscal or other reporting year that ends with or within the plan year, as long as the selected method is used consistently from year to year.

forth above.[7] Because Part II of an asset manager's Form ADV (the "ADV Brochure") likely already contains most of the required disclosures, and asset managers are required to provide the ADV Brochure to the plan on an annual basis, the easiest way for an asset manager to make the Eligible Indirect Compensation Disclosures may be for the asset manager to do so through the ADV Brochure. Following are some examples of how plan asset managers may comply with the Eligible Indirect Compensation Disclosures.

Examples of Eligible Indirect Compensation Disclosures for Client Commission Arrangements Involving the Receipt of Research

(a) The existence of the indirect compensation

This essentially requires the asset manager to disclose that the manager is receiving third party or proprietary research.[8] This information is already required to be disclosed on Item 12. B. of the ADV Brochure.

(b) The services provided for the indirect compensation or the purpose for payment of the indirect compensation

The DOL has indicated that this prong could be satisfied by advising the plan manager of "the reason [the asset manager] is receiving 'soft dollars.'" Although no more specific guidance has been offered, it would appear that this item could be satisfied by disclosing that the asset manager is receiving third party and proprietary research to assist the manager in the investment-decision making process. Alternatively, the asset manager could disclose the research services received through proprietary and third-party arrangements involving the plan's commissions. In this regard, we note that the "products, research and services" received from broker-dealers are already required to be disclosed on Item 12. B. of the ADV Brochure.

(c) The amount of (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation

According to the DOL, an asset manager that provides an estimate of its indirect compensation may use any reasonable method for developing an estimate, as

---

7 DOL FAQ No. 29.

8 72 Fed. Reg. 64742.

long as the method is disclosed with the estimate. Where more than one reasonable method is available for generating an estimate, it would be appropriate for the plan and the asset manager to consider the relative costs involved in selecting a method.[9] The DOL has also indicated that it recognizes that it may not be practical to provide a formula or estimate of certain types of research compensation received for commissions. As such, the DOL has indicated that in such circumstances the asset manager may disclose "a description of the eligibility conditions sufficient to allow a plan fiduciary to evaluate them for reasonableness and potential conflicts of interest."

Accordingly, disclosure of the information to the plan by the asset manager could take several alternative forms:

- The asset manager could provide a formula used to calculate the value of the research. With regard to third party research where a formula determines the portion of the commission attributable to research, the asset manager could disclose the formula used to calculate the research portion (*e.g.*, ratio of 1.5 to 1; 2 cents for research for every 4 cents charged by the broker on a trade, etc.).[10] Note, however, that where more than one broker-dealer receiving plan commissions provides the research, the asset manager may be required to disclose multiple formulas for its commission/ research arrangements or multiple eligibility conditions.

- The asset manager could request each broker-dealer (both broker-dealers providing third party research and those providing proprietary research) to provide the amount (or estimate) of research provided for portfolio executions. The aggregate amount would then be apportioned among the asset manager's accounts based on reasonable criteria to arrive at the amount attributable to the plan which would then be provided by the asset manager to the plan. While this would be a relatively simple calculation to perform for third party research, this methodology would require the asset manager to obtain information from broker-dealers offering proprietary research about the research component of the commissions charged by them (i.e., to

---

[9] DOL FAQ No. 27.

[10] The advantage to disclosing a formula, as opposed to an amount or estimate of compensation received, is that by disclosing a formula the asset manager need not determine how the value of the research it receives with commissions is allocated between the plan and other managed accounts. This is consistent with the treatment of research received under the safe harbor of Section 28(e) of the 1934 Act, which does not require an asset manager to determine the relative value of research to an account when the research may benefit more than one account.

unbundle the research cost from the execution cost). Alternatively, the asset manager could compare the commission rate paid to a broker-dealer offering proprietary research with the comparable "execution only" rate offered by competing broker-dealers.

- If the asset manager determines it is not practical to provide a formula or estimate of research received, the manager could fulfill its requirement to provide a description of the "eligibility conditions" by, for example, disclosing whether the asset manager is required by a broker-dealer, formally or informally, to meet minimum annual, monthly or other periodic commission targets to receive proprietary or third party research, or to receive access to additional levels of research services.

- As part of the process of providing a description of "eligibility conditions" for proprietary and/or third party research arrangements to a plan it may be helpful for an asset manager to discuss the manager's internal review process for approving brokers or allocating commissions (such as issues considered by the manager's best execution committee or in reaching commission/research "voting" decisions.)

While the information discussed above may not currently be required to be disclosed on an asset manager's ADV Brochure, certain of these alternatives lend themselves to being added to the disclosure in Item 12. B. of that document. Alternatively the information could be provided to the plan through another method.

(d) The identity of the party or parties paying and receiving the compensation.

This final item may require the asset manager to identify to the plan each broker-dealer which provided research (or non-execution brokerage services) to the asset manager based upon compensation paid by the plan. While this information is not currently required to be disclosed on an asset manager's ADV Brochure, it could be added to the disclosure in Item 12. B. of that document, or provided to the plan through another method.

Information Required to be Disclosed on Schedule C by Plans About Commissions Paid to Broker-Dealers

The DOL has made numerous statements regarding the disclosure of brokerage

commissions and other compensation paid by plan accounts on Schedule C. Due to the tangled language of relevant DOL guidance, there is a split of opinion about whether, and in what circumstances, brokerage commissions need to be disclosed. The confusion stems from two FAQs the DOL published regarding the 2009 Form 5500 Schedule C.[11]

It appears clear from the language of FAQ No. 4 that if an ERISA plan invests in a pooled investment vehicle, such as a mutual fund or a hedge fund, commissions paid by the pooled investment vehicle need not be disclosed by the plan on Schedule C or treated as eligible indirect compensation. One could also interpret the language of FAQs 3 and 4, when read together, to mean that Schedule C (or eligible indirect compensation) reporting is not required for commissions paid to broker-dealer by separately managed accounts of ERISA plans. Yet, the overall intent of the DOL amendments to Schedule C appears to be to require plans to consider brokerage commissions paid with respect to separate accounts as compensation, but to allow it be treated as "eligible indirect compensation."[12] Accordingly, following are examples of how plan asset managers may comply with the Eligible Indirect Compensation Disclosures with respect to brokerage commissions paid on behalf of plan accounts.

Examples of Eligible Indirect Compensation Disclosures for Brokerage Commissions Paid by Plan Accounts

(a) The existence of the indirect compensation

This requires disclosure of the fact that brokerage commissions were paid by plan accounts to broker-dealers for portfolio transactions.

(b) The services provided for the indirect compensation or the purpose for payment of the indirect compensation

Although no specific guidance has been offered, it would appear that this item could be satisfied by merely disclosing that the compensation was paid in exchange for execution services or other services (e.g., research, underwritings) provided by the broker-dealer(s).

---

[11] DOL FAQ No. 3 and DOL FAQ No. 4

[12] Of course it is ultimately the plan's responsibility to determine whether and how to report brokerage commissions paid with respect to plan accounts.

(c) The amount of (or estimate) of the compensation or a description of the formula used to calculate or determine the compensation

According to the DOL, an asset manager or other service provider that provides an estimate of its indirect compensation may use any reasonable method for developing an estimate, as long as the method is disclosed with the estimate. Where more than one reasonable method is available for generating an estimate, it would be appropriate for the plan and the asset manager to consider the relative costs involved in selecting a method.[13] To satisfy this condition, it would appear an adviser could either disclose an amount or estimate of the commissions or markups or markdowns paid by the plan to each broker-dealer used to execute transactions for the plan, or the commission rates, or a range of commission rates, charged by each broker-dealer used to execute transactions for the plan. Spreads earned by a broker-dealer on principal transactions involving the plan would not need to be included in the reporting of compensation to the broker-dealer. The DOL has stated that accurate post-trade confirmations may be relied upon to provide adequate written disclosure of brokerage fees if, either alone or in conjunction with other documents, the plan administrator receives the required information.[14]

(d) The identity of the party or parties paying and receiving the compensation.

This final item may require the asset manager to identify to the plan each broker-dealer which executed transactions for the plan and, under some circumstances, the compensation paid to the broker-dealer. This is so because, although only broker-dealers who received compensation of $5,000 or more from the plan need by disclosed on Schedule C, in situations where a plan uses more than one asset manager, the commissions paid to a broker-dealer by all plan accounts would need to be aggregated to determine whether the $5,000 threshold is met.

---

13 DOL FAQ No. 27.

14 DOL FAQ. No. 32.

Date Information to be Furnished

The date upon which the Eligible Indirect Compensation Disclosures must be transmitted to the plan is not specified by the DOL but should be sufficiently in advance of the date the Form 5500 is due or filed so as to enable the plan administrator to conclude that the conditions for using the alternative reporting option have been met and timely file a complete and correct Form 5500.[15]

The DOL points out in its FAQs with respect to these disclosure items that there is no specific form or method of disclosure required for disclosures to satisfy the alternative reporting option requirements, and the disclosures do not have to come from a particular party. Plans and plan service providers thus have substantial flexibility in establishing programs to provide the necessary disclosures.

* * * * *

This memorandum furnishes asset managers with some options for meeting the requests of ERISA plan accounts for information about the use of client commission arrangements and the payment of brokerage commissions. The alternatives discussed in this memorandum have not been reviewed or approved by the Department of Labor and reflect only our best efforts judgment as to disclosures which might meet the requirements of Schedule C of Form 5500. This memorandum does not discuss disclosure of other arrangements between ERISA plans and asset managers and/or broker-dealers which may be required to be disclosed on Schedule C. Parties who seek specific guidance regarding Form 5500 and Schedule C disclosure and reporting requirements should consult with legal counsel.

---

[15] As noted above, if the plan does not receive the Eligible Indirect Compensation Disclosures from the asset manager or another source the plan cannot rely on this reporting option and would be required to report on Schedule C the total indirect compensation (e.g., third party and proprietary research) received by the asset manager, a description of the research and each source (e.g., broker-dealer) from whom the asset manager received $1,000 or more of research.