U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210

AUG 29 1986

OPINION NO. 86-20A
Sec. 406(b), 404(a), 405

Mr. Charles B. Schaffran
Shulte, Roth & Zabel
900 Third Avenue
New York, NY 10022

Re: BDN Advisers, Inc.
Identification Number: F-3257A

Dear Mr. Schaffran:

This is in response to your request for an advisory opinion on behalf of BDN Advisers, Inc. (BDN) that the payment of incentive compensation to BDN by employee benefit plans will not result in a violation of section 406(b) of the Employee Retirement Income Security Act of 1974 (ERISA) or section 4975 of the Internal Revenue Code of 1954 (the Code).[1]

You represent that BDN is a corporation registered as an investment adviser under the Investment Advisers Act of 1940. BDN will manage plan investments in securities on a discretionary basis for individual accounts and/or as general partner of limited partnerships having plan investors. The decision to retain BDN and to pay an incentive fee will be made by a plan fiduciary who is independent of BDN. Plans retaining BDN as investment manager (or investing in limited partnerships to which BDN is a general partner) will be large plans having total plan assets of $50,000,000 or more, and no plan will be permitted to place more than ten percent of its total assets under BDN's management.[2]

[1] Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor.Therefore, the references in this letter to specific sections of ERISA refer also to the corresponding sections of the Code.

[2] You further indicate that plans of this size generally operate through investment committees, whose members are often senior financial officers of the corporate plan sponsor who have considerable business and investment acumen. These committees take an active role in determining where and in what fashion plan assets should be invested.

BDN's fee structure will consist of an "incentive fee" and, in most instances, a "base fee." You contemplate that the base fee, subject to arm's-length negotiation in the case of each client, will be a percentage of the average of the account's net asset value at the beginning and end of each quarter during which BDN serves as investment manager and will be paid on the first day of the following quarter. The base fee will be charged irrespective of whether BDN has earned an incentive fee for the same period.

The incentive fee, if any has been earned, will be paid by the client at the end of each year. You anticipate that this fee will be a percentage, subject to arm's length negotiation in the case of each client, of the "net capital appreciation" of the client's assets. "Net capital appreciation" is defined to mean the increase in the value of the assets in the client's account from the beginning of each year of investment management through the valuation date which is set forth in the contract pursuant to which BDN is retained.

In calculating net capital appreciation on all securities (including any securities for which market quotations are not readily available), all realized and unrealized gains and losses experienced during the year, as well as income received during the year, will be taken into account.[3] In the event that the assets in the client's account have not appreciated during the year, no performance fee will be paid to BDN.

You anticipate that BDN will generally invest plan assets in securities for which market quotations are readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940 (17 CFR §270.2a-4).

For purposes of calculating BDN's fee, securities which are listed on a national securities exchange will be valued based on their last sales price on the national securities exchange on which such security is principally traded or, if trading in such securities on such exchange was reported on the consolidated tape, the last sales price on the consolidated tape (or, in the event that the valuation date is not a date upon which such exchange was open for trading, on the last prior date on which such exchange was so open).

In the event that no sales of securities listed on a national securities exchange occurred on either of the foregoing dates, such securities shall be valued based on the mean between the last "bid" and "asked" prices on the national securities exchange on which such securities are principally traded, or, if "bid" and "asked" prices in such securities were reported on the consolidated tape, the mean between the last “bid” and “asked” prices on the consolidated tape (or, in the event that the valuation date is not a date upon which such exchange was open for trading, on the last prior date on which such exchange was so open). Securities which are not listed on a national

[3] You represent that the base fee paid to BDN will be subtracted from the appreciation in the client's account in order to arrive at "net capital appreciation."

securities exchange shall be valued based upon the mean of their representative last closing "bid" and "asked" prices unless they were included in the NASDAQ National Market, in which case they shall be valued based upon their last sales prices (if such prices are available).

For securities for which market quotations are not readily available, valuation will be made by the plan's custodian, trustee or other qualified party selected by the plan, which party will be independent of BDN. The plan will have the exclusive authority to terminate the party who will value these securities. The valuation by the independent party will be binding upon BDN.[4]

You represent that the right of a plan to terminate an investment management agreement will meet the requirements of the Department's regulation section 29 CFR 2550.408(b)-2(c), which requires that service contracts must be terminable by plans "on reasonably short notice under the circumstances."

In the event that an investment management agreement is terminated during the first year, BDN will be paid a fee based upon a percentage of assets under management which will be negotiated in advance and set forth in the investment management agreement. In the event that an investment management agreement is terminated on other than an anniversary date, net capital appreciation will be determined for the period from the commencement of the preceding full year of management of the client's assets through the termination date. BDN's incentive fee for the prior year will be readjusted in accordance with such calculation. Should the net capital appreciation for the new period be less than the net capital appreciation which had previously been calculated for the prior year, BDN will refund to the client any excess fee it had received.

You represent that BDN's incentive compensation arrangement will comply with the terms and conditions of SEC Rule 205-3 governing performance compensation arrangements (50 FR 40556 (1985) (to be codified at 17 CFR §275.205-3)). You further state that the total fee paid to BDN for each year's performance (the base fee plus the incentive fee) will in no case exceed reasonable compensation for services performed by BDN.

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[4] For purposes of this opinion, the Department assumes not only that the custodian, trustee or other qualified party selected by the plan is independent of BDN but also that it will make independent valuations of the securities on behalf of the plan. In this respect, the issue of whether a person is independent of an investment manager and the issue of what constitutes an independent valuation are factual questions to be resolved on the basis of all the surrounding facts and circumstances. The Department ordinarily does not issue advisory opinions on inherently factual issues. See section 5.01 of ERISA Procedure 76-1 (41 FR 36281, August 27, 1976).

You have asked for an advisory opinion that the payment by plans to BDN of an incentive fee in accordance with the arrangement described above will not constitute a violation of section 406(b) of ERISA.

Section 406(a)(1)(C) and (D) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest or transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA provides that a fiduciary with respect to a plan shall not deal with plan assets in his own interest or for his own account. Section 406(b)(2) of ERISA provides that a fiduciary with respect to a plan shall not in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants and beneficiaries.

Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary and a person providing services to a plan.

Section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. Regulations issued by the Department of Labor (the Department) clarify the terms "necessary service" (29 CFR 2550.408b-2(b)), "reasonable contract or arrangement" (29 CFR 2550.408b-2(c)) and "reasonable compensation" (29 CFR 2550.408b-2(d) and 2550.408c-2) as used in section 408(b)(2). In this regard, you have not requested an opinion that the proposed provision of services by BDN complies with the requirements of section 408(b)(2) of ERISA. As a general matter, whether the requirements of this section are met in each case involves questions which are inherently factual in nature. As noted above, the Department ordinarily does not issue opinions on such matters.

With respect to the prohibitions in section 406(b), the regulation under section 408(b)(2) of ERISA (29 CFR 2550.408b-2(a)) states that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2).

As explained in regulation section 29 CFR 2550.408b-2(e), the prohibitions of section 406(b) are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes them fiduciaries when they have interests which may conflict with the interests of the plans for which they act. Thus, a fiduciary may not use the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay an additional fee to such fiduciary, or to a person in which he has an interest which may affect the exercise of his best judgment as a fiduciary, to provide a service. However, regulation section 29 CFR 2550,408b-2(e)(2) provides that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility which makes him a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest which may affect the exercise of his best judgment as a fiduciary.

You represent that BDN's fee will be based upon a percentage of the net appreciation of plan assets, taking into account both realized and unrealized gains and losses during a pre-established valuation period. You further represent that investments will be made in securities for which market quotations are readily available or that persons appointed by the plan and independent of BDN will make an independent valuation of securities for which market quotations are not readily available.

Based on the representations contained in your submissions, it is the Department's view that the payment of an incentive fee pursuant to the arrangement described above would not, in itself, constitute a violation of section 406(b)(1) of ERISA. The amount of compensation which BDN would earn depends solely on the changes in value of the securities in the individual account or limited partnership, as determined by readily available market quotations or independent appraisals.[5] Therefore, in the situation you describe, it appears that BDN would not be exercising any of its fiduciary authority or control to cause a plan to pay an additional fee. Moreover, it does not appear that BDN would be acting on behalf of, or representing, a person whose interests are adverse to the plan merely because it enters into an agreement to provide investment management services pursuant to the arrangement described above. Accordingly, based on your representations, it is the Department's view that payment of an incentive fee pursuant to such arrangement would not, in itself, constitute a violation of section 406(b)(2) of ERISA. However, because violations of sections 406(b)(1) and 406(b)(2) could occur in the course of the provision of services by BDN, the Department is not prepared to rule that the described arrangement, in operation, would not violate those sections. Thus, for example, the Department is not addressing issues relating to a fiduciary's allocation of investment opportunities among accounts over which he has discretion.

ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Section 404 requires, among other things, a fiduciary to discharge his duties respecting a plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion. Accordingly, the plan fiduciary must act prudently with respect to the decision to enter into an

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[5] We note that you represent that BDN will not be a market maker with respect to securities in which it causes plan assets to be invested.

incentive compensation arrangement with an investment manager, as well as to the negotiation of the specific formula under which compensation will be paid. The Department further emphasizes that it expects a plan fiduciary, prior to entering into an incentive compensation arrangement, to fully understand the compensation formula, and the risks associated with this manner of compensation, following disclosure by the investment manager of all relevant information pertaining to the proposed arrangement. In addition, such plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. Thus, in considering whether to enter into an arrangement of the kind described in your letter, a fiduciary should take into account its ability to provide adequate oversight of the investment manager. Finally, we also note that, under section 405(a) of ERISA, any plan fiduciary (including an investment manager) will have co-fiduciary liability for any breach of fiduciary responsibility of another plan fiduciary: (1) if he knowingly participates in or conceals such breach; (2) if by his failure to comply with section 404(a)(1), he enables another fiduciary to commit such a breach; or (3) if he has knowledge of the breach of another fiduciary and he fails to make a reasonable effort to remedy the breach.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions. This letter relates only to those issues that you expressly raised in your request.

Sincerely,

Dennis M. Kass
Assistant Secretary