U.S. Department of Labor Pension and Welfare Benefits Administration
Washington, D.C. 20210

AUG 29 1986

OPINION NO. 86-21A
Sec. 406(b), 404(a), 405

Mr. John J. Cleary
Goodwin, Procter & Hoar
Exchange Place
Boston, MA 02109

Re: Batterymarch Financial Management
Identification Number: F-3355A

Dear Mr. Cleary:

This is in response to your request for an advisory opinion on behalf of Batterymarch Financial Management (Batterymarch) that the payment of incentive compensation to Batterymarch by employee benefit plans will not result in a violation of section 406 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 Batterymarch is registered as an investment adviser under the Investment Advisers Act of 1940. Batterymarch presently receives compensation for the provision of investment management services to individual plan accounts based solely on a percentage of assets under management. Batterymarch proposes to give each client plan which has aggregate assets of at least $50,000,000[2] the option to pay Batterymarch an incentive fee as an alternative to its standard assets under management fee arrangement. The decision of whether to engage Batterymarch as an investment manager pursuant to the incentive fee arrangement will be made by an independent plan fiduciary.

[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 represent that if Batterymarch manages assets of a number of different plans which are maintained by a single plan sponsor and its affiliates (typically invested on a commingled basis through a master trust), Batterymarch will consider all of such plans to be a single plan for purposes of determining whether the $50,000,000 threshold has been satisfied.

Client plans which elect to enter into an incentive fee arrangement with Batterymarch would pay Batterymarch a "fulcrum fee" which measures the time-weighted total rate of return[3] on the account (including both realized and unrealized gains and losses, and income) in relation to the performance of the Standard and Poor's (S&P) 500 Index over a one-year computation period commencing on the date the incentive fee arrangement becomes effective. During the computation period, each of these plans will pay quarterly fees for Batterymarch's services in accordance with the fee schedule based upon a percentage of assets under management (Base Fee). At the end of the computation period, on a set valuation date, Batterymarch's performance with regard to each plan account will be measured. If that performance exceeds the S&P 500 Index by more than 100 basis points, Batterymarch will be entitled to a bonus calculated as a percentage of the Base Fee. This bonus will be paid by the plan to Batterymarch in equal installments during the four quarters following the initial computation period. Conversely, if Batterymarch's performance during the computation period falls short of the S&P 500 Index, the plan would receive a credit against fees for services performed by Batterymarch in the following year. This credit will be applied in equal quarterly installments over the four quarters following the computation period. The incentive fee schedule is as follows:

Incentive Fee Schedule

Client's Return vs. S&P 500		Fee Bonus
Plus	0 - 100 Basis Points	0% (of Base Fee)
	101 – 300	5%
	301 – 400	10%
	401 – 500	20%
	501 or greater	30%
		Fee Credit
Minus	0 - 300 Basis Points	5% (of Base Fee)
	301 – 400	10%
	401 – 500	20%
	501 or greater	30%

[3] You represent that "time weighted rate of return" is a method of calculating the rate of return directly attributable to the performance of an investment manager by "neutralizing" contributions and withdrawals of money by plan sponsors which affect the overall amount of plan assets managed by the investment manager. This measurement methodology is recognized by the Bank Administration Institute and is widely used throughout the investment industry.

You represent that securities in which Batterymarch will invest plan assets will be almost exclusively 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), although securities for which market quotations are not readily available may comprise a small percentage (typically no more than one percent) of plan account holdings.

Batterymarch will compute the rate of return on its client plans' accounts as of the last day of the computation period by performing mathematical computations on raw data provided to it by pricing services. Interactive Data Services, Inc., a pricing service, obtains objective information regarding securities for which market quotations are readily available from the National Quotations Bureau tape and provides this information to Batterymarch without charge.

A security listed on a national securities exchange or on the NASDAQ National Market system will be valued based on its last sales price on the national securities exchange on which such security is principally traded. In determining the value, the absolute last sales price on whatever date the last prior sale on that exchange occurred is used.

Securities which are traded in the over-the-counter market (other than securities listed on the NASDAQ National Market) will be valued on the basis of the mean between their last "bid" and "asked" prices.

Each client plan electing the incentive fee arrangement will select (and will have the exclusive authority to terminate) the pricing service, independent of Batterymarch, to value securities for which market quotations are not readily available. Batterymarch will pay the fee of such pricing service.[4]

Computation of the total return (taking into account appreciation or depreciation, and income) for the S&P 500 during the computation period will be performed by Batterymarch using purely mathematical computations based upon objective raw data.

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[4] For purposes of this opinion, the Department assumes not only that the pricing service is independent of Batterymarch 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 will not issue advisory opinions on inherently factual issues. See section 5.01 of ERISA Procedure 76-1 (41 FR 36281, August 27, 1976). However, in the Department's view, the independence of a pricing service and the independence of its valuations are not necessarily affected by Batterymarch's payment of the pricing service's fee under the circumstances you describe.

Either Batterymarch or plans electing the incentive compensation arrangement may terminate the investment management contract upon sixty days' notice. If the investment management contract is terminated by either party prior to the end of any one-year computation period, the incentive fee will not apply to that period, and Batterymarch's fee for that period will be limited to the Base Fee. However, if a plan continues the investment management relationship beyond the initial one-year period and terminates at any time during a succeeding one-year period, the plan would be obligated to pay to Batterymarch any remaining bonus which had been earned in the preceding computation period, but would forfeit any remaining fee credit accrued during such preceding computation period. If Batterymarch continues the relationship beyond the initial period and terminates the relationship during a succeeding period, any remaining bonus payments with respect to the prior period would remain due and Batterymarch would be liable to pay the client any remaining fee credit. Such payments would be due within ten days after termination of the investment management contract.

Up to thirty days prior to the end of any computation period, a plan will have the option to elect the incentive fee arrangement or the assets under management fee arrangement for the next computation period. Plans which choose to determine Batterymarch's fees under the assets under management fee arrangement will be permitted to switch to the incentive fee arrangement at any time and trigger the start of a new one-year computation period to begin on the first day of the next calendar quarter.

You represent that Batterymarch's incentive fee 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 Batterymarch for each year's performance (the Base Fee adjusted, as applicable, by a penalty or bonus) will in no case exceed reasonable compensation for services performed by Batterymarch.

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

The provision of investment management services by Batterymarch to plans would be exempt from the prohibitions of section 406(a) of ERISA provided the conditions of section 408(b)(2) are met. Whether the conditions are met in each case involves questions which are inherently factual in nature. As noted above, the Department generally will not issue opinions on such questions. Therefore, plan fiduciaries must determine, based on all the relevant facts and circumstances, whether the conditions of section 408(b)(2) are satisfied.

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 Batterymarch's fee will be based upon its performance in relation to the Standard & Poor's 500 Stock Index, a predetermined index, 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 Batterymarch 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 Batterymarch would earn depends solely on the changes in value of the securities in the individual account, as determined by readily available market quotations or independent appraisals, by comparative reference to a predetermined index.[5] Therefore, in the situation you describe, it appears that Batterymarch 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 Batterymarch 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 Batterymarch, 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 incentive compensation arrangement with an investment manager, as well as to the negotiation of the specific formula under which compensation will be paid (including, where relevant, the choice of an appropriate index in relation to which the investment manager's performance is to be compared). 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

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

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