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

SEP 25 1989

ERISA OPINION 89-28A
Sec. 406(b), 408(b)(2)

Mr. J. Hamilton Crawford, Jr.
Senior Vice President and General Counsel
Alliance Capital Management Corporation
1345 Avenue of the Americas
New York, NY 10105

Re: Identification Number: F-3362A

Dear Mr. Crawford:

This is in response to your request for an advisory opinion that the payment of performance-based compensation to Alliance Capital Management Corporation (Alliance) 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 1986 (the Code).[1]

Alliance, which provides equity and fixed-income management services primarily to institutional clients including employee benefit plans, is registered as an investment adviser under the Investment Advisers Act of 1940. Currently, individual plan accounts retaining Alliance as investment manager pay Alliance a fee based solely on a percentage of assets under management. Alliance proposes to give each client plan which has aggregate assets of at least $50 million[2] the option to pay Alliance a performance fee, as an alternative to its standard assets under management fee, with respect to the client's account or a portion thereof. The decision of

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[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] Your application states that fiduciaries of plans of this size are sophisticated in their ability to select and monitor the performance of investment managers. In many instances, the plan fiduciaries also hire consultants to aid them in selecting investment managers and monitoring their performance. Moreover, in most cases the portfolio Alliance manages will consist of only a portion of the assets of the client plan.

whether to engage Alliance as an investment manager pursuant to the performance fee arrangement will be made by a plan fiduciary who is independent of Alliance.

Clients plans which elect to enter into a performance-based compensation arrangement with Alliance would pay Alliance in accordance with one of the following three basic fee structures: (1) a "percentage of appreciation" fee, (2) a "base plus" fee, or (3) a "fulcrum" fee.

The percentage of appreciation fee will constitute a specified percentage of the appreciation in the value of assets in the managed account.

The "base plus" fee would provide for a minimum fee, calculated as a percentage of assets under management, at levels of performance up to a specified percentage (e.g., 1 percent) over the performance of a designated index.[3] If Alliance's performance exceeds this specified percentage, the performance fee would increase by increments to a mutually agreed upon maximum percentage of assets in the client plan's account. In your submissions to the Department, you set forth the following example of a "base plus" performance fee structure:

Performance of Client Plan Portfolio Relative to Index (in Percentages)	Fee as a Percentage of Assets Under Management
minus .01 or more	.20%
plus -0- - 1.00	.20%
1.01 - 2.00	.40%
2.01 - 3.00	.60%
3.01 - 4.00	.80%
4.01 or more	1.00%

[3] From your representations, it is contemplated that, and our opinion addresses only the situation where, the base fee will be a specified percentage somewhat lower than the non-performance-based percentage of assets under management fee charged clients who do not wish to participate in a fee structure with a performance feature.

The fulcrum fee would be a fee which increases or decreases with Alliance's performance relative to the performance of a pre-established index of securities. This fee would be computed as a specified percentage of the standard assets under management fee customarily used by Alliance for its equity oriented institutional accounts managed on a discretionary basis. This percentage would vary depending on Alliance's actual performance versus the index and will represent the sole fee for accounts which choose this fee structure. You set forth the following example of a fulcrum fee structure:

Performance of Client Plan Portfolio Relative to Index (in Percentages)	Performance Fee Multiple as a Percentage of Assets Under Management Fee
minus 2.01 or more	25%
1.01 - 2.00	50%
.01 - 1.00	75%
plus -0- - 1.00	90%
1.01 - 2.00	100%
2.01 - 3.00	110%
3.01 - 4.00	125%
4.01 - 5.00	150%
5.01 - or more	175%

The length of the valuation period for determining performance-based compensation may vary, depending upon the terms negotiated with a particular client. However, Alliance represents that such period will be set forth in the investment management agreement.[4]

[4] We assume that Alliance's performance will be computed as of a set valuation date specified in the investment management agreement.

The index against which Alliance's performance will be measured for purposes of computing Alliance's "base plus" or fulcrum fee will be negotiated between Alliance and its client plans. The index may be a generally accepted standardized index of securities of the type in which the client's assets are invested (e.g., the Standard & Poors (S&P) 500 Index, the Wilshire 5000 Index, the Hambrecht & Quest Technology Index, or the Salomon Brothers High Grade Long Term Bond Index).[5] Alternatively, the index may be a "normal portfolio," which would be a customized index specifically tailored to Alliance's investment approach and/or to the client's specific investment objectives. A client plan and Alliance could also agree to measure Alliance's performance against a standardized index or normal portfolio with some specified increment added. For example, Alliance's performance could be measured against the performance of the S&P 500 index increased by one percentage point.

You have asked us to specifically consider the use of an "asset list normal portfolio" as an index against which Alliance's performance will be measured. In creating this form of normal portfolio, Alliance selects screening criteria (e.g. historical data, average capitalization yield, book price, dividend payout ratio, earnings variability) consistent with its stated investment philosophy and with empirical analyses of Alliance's historical portfolio characteristics. These criteria are then applied to a universe of approximately 1,400 stocks prepared by BARRA, a Berkeley, California consulting firm.[6] This screening is conducted on the basis of statistical data without any subjective judgment as to the future performance of any particular security. Stocks that pass these screening criteria are assigned portfolio weights, also based on Alliance's philosophy of portfolio composition and the empirical observation of its portfolios over a span of many years.

You represent that the screening criteria and weighting procedures used in structuring Alliance's asset list normal portfolio are always reviewed in advance by the client. You expect that these criteria and procedures will remain constant over time, unless Alliance alters its investment philosophy. Alliance will not change the screening criteria and weighting procedures without advance approval by the affected client plan.

You state that the actual composition of Alliance's asset list normal portfolio is fluid, because the historical characteristics of securities continually change and some securities cease to exist. You represent that periodic rebalancing of the normal portfolio is appropriate to delete securities no

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[5] We assume that any standardized index against which Alliance's performance will be measured will be composed of securities for which market quotations are readily available, and that the computation of the return for such index will be performed by an entity independent of Alliance, or will be performed by Alliance using purely mathematical computations based upon objective raw data.

[6] We assume that BARRA is independent of Alliance.

longer meeting the screening criteria and to include other securities that do. Because this rebalancing is made pursuant to predetermined criteria, Alliance would have no subjective involvement in the rebalancing process. Alliance will fully disclose to client plans the rebalancing criteria, prior to a performance-based compensation arrangement becoming effective.

The securities comprising the asset list normal portfolio index will be securities for which market quotations are readily available. Furthermore, measurement of the fee payable under a performance-based compensation agreement incorporating a normal portfolio index would in all instances be verified by the client's plan custodian, trustee or some other qualified party that is independent of Alliance. The client plan will have the exclusive right to select and to terminate the party who will perform the verification.

Alliance's performance fee under any of the three basic structures will be based upon all realized capital gains and losses, and all unrealized capital appreciation and depreciation, as well as interest payments, cash and stock dividends, and any rights, warrants or other distributions received by the plan account during the period covered by the performance fee. You have represented that, in all three fee structures, the assets in a client plan account during the relevant measurement period will be appropriately adjusted so that the performance feature of the fee structure will not be triggered solely by a contribution or a withdrawal with respect to that account.

You anticipate that Alliance will generally invest the assets of managed accounts subject to performance-based compensation arrangements 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, although securities for which market quotations are not readily available may comprise a small percentage of the assets of the accounts.

The value of securities will be determined in the following manner (unless modified in a manner mutually acceptable to the client plan involved and Alliance):

Any security listed on a national securities exchange will be valued based on its last sales price on the national securities exchange on which the security is principally traded on the day the security is being valued, or, if trading in the security on that day on that exchange was reported on the consolidated tape, the last sales price on that day as reported on the consolidated tape. In the event the valuation date is not a date upon which the exchange was open for trading, the value shall be determined in an identical manner as if the last prior date the exchange was so open was the valuation date.

In the event that a sale of a security listed on a national securities exchange did not occur on either of the foregoing dates, the security will be valued based on the mean between the last "bid" and "asked" prices of the security on the national securities exchange on which the security is principally traded, or, if "bid" and "asked" prices of the security were reported on the consolidated tape, the mean between the last "bid" and "asked" prices of the security on the consolidated tape. In the event that the valuation date is not a date on which the exchange was open for trading, the value will be determined in the same manner as if the valuation date was the last prior date on which the exchange was open.

Any security which is not listed on a national securities exchange will be valued based upon the mean of the representative last closing "bid" and "asked" prices preceding the close of business on the valuation date involved, unless on that day the security was included in the NASDAQ National Market system (in which case the security will be valued based upon its last readily available sales price).

Any security for which a market quotation is not readily available will be valued by the client plan's custodian, trustee or some other qualified party that is independent of Alliance, at the expense of Alliance. The client Plan will have the exclusive right to select and to terminate the party who will value any such security.[7]

The right of a client plan to terminate an investment management contract will meet the requirements of the Department's regulation, 29 C.F.R. §2550.408(b) - 2(c), which requires that service contracts be terminable by plans "on reasonably short notice under the circumstances".

In the event that an investment management contract is terminated by either party during the first year, Alliance will be paid a fee based upon a percentage of assets under management or some other fee that is not a performance fee which is negotiated in advance and set forth in the applicable investment management contract. In the event that an investment management contract is terminated after the first year on other than a scheduled performance fee measurement date, Alliance would receive a pro rata share of its performance fee for the relevant valuation period. The method of proration will vary depending upon whether the investment management

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[7] 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 Alliance, but also that it will make independent valuations of the securities on behalf of the client 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).

contract provides for performance to be measured monthly or quarterly. In any event, the proration method will be negotiated in advance with the client plan and set forth in the investment management contract.

You represent that Alliance's performance-based compensation arrangements will comply with the terms and conditions of SEC Rule 205-3 governing such arrangements (17 C.F.R. §275.205-3 (1976)). You further state that the total compensation paid to Alliance will in no case exceed reasonable compensation for services performed by Alliance.

Although Alliance has requested an advisory opinion only with respect to the specific fee structures set forth above, you indicate that Alliance contemplates entering into many diverse types of performance-based compensation arrangements with its client plans, and that many of these arrangements will diverge from these structures. We emphasize that the analysis set forth below relates only to the three basic fee structures referred to above as illustrated by the examples you provided. To the extent that Alliance modifies the structures of these arrangements in any manner, those modifications would be beyond the scope of this letter.[8] Moreover, since Alliance's asset list normal portfolio is the only type of normal portfolio described in your submissions, we are limiting our analysis to the use of either a generally accepted standardized index or Alliance's asset list normal portfolio as a benchmark against which Alliance's performance will be measured.

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.

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[8] We do not mean to suggest that we would reach a contrary conclusion if Alliance and a client plan agree in advance to a performance-based compensation arrangement which merely modifies the percentages but otherwise contains one of the three specific fee structures described in your request.

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 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 Alliance 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. 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.

Your application states that Alliance’s fee will be based upon either (1) a percentage of the net appreciation of plan assets under Alliance’s management; or (2) Alliance’s performance in relation to a predetermined index. In computing Alliance’s performance under such arrangements, both realized and unrealized gains and losses during a pre-established valuation period will be taken into account. Investments will be made in securities for which market quotations are readily available or persons independent of Alliance 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 a performance fee pursuant to the specific arrangements described above would not, in itself, constitute a violation of section 406(b)(1) of ERISA. It appears that the amount of compensation which Alliance would earn depends solely on the changes in value of the securities in the individual plan account, as determined by readily available market quotations or independent appraisals, and, in the case of a "base plus" or fulcrum fee, by comparable reference to a predetermined index.[9] Therefore, in the situation you describe, it appears that Alliance would not be exercising any of its fiduciary authority or control to cause a plan to pay an additional fee.[10]

Moreover, it does not appear that Alliance 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 arrangements described above. Accordingly, based on your representations, it is the Department's view that payment of a performance fee pursuant to such arrangements 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 Alliance, the Department is not prepared to rule that the described arrangements, in operation, would not violate those sections. Thus, for

[9] We note that you represent that Alliance will not make a market in any security included in an index against which its performance may be measured or in which managed account assets may be invested.

[10] With regard to the use of Alliance's asset list normal portfolio as an index, you have represented that the selection criteria for securities composing the index and the way in which these securities would be weighted would be set forth in the investment management agreement and would not be adjusted by Alliance except after consultation with the client plan. We assume that the screening criteria and weighting procedures used to create an asset list normal portfolio index, and the computation of the return for such index, will be determined using purely mathematical computations based upon objective raw data. Moreover, we assume that the investment management agreement would set forth the specific dates on which the asset list normal portfolio will be rebalanced. We note that if Alliance exercises its fiduciary authority to affect any component of the index against which its performance is to be measured (e.g., BARRA's asset list, the screening criteria, the weighting procedures, the value of securities included in the index, or the timing of the rebalancing), then it would be exercising its fiduciary authority to affect the amount of its fee, thus violating section 406(b)(1) of ERISA.

example, the Department is not addressing issues relating to a fiduciary's allocation of investment opportunities among accounts over which he has discretion.[11]

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 a performance-based 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 a performance-based 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, the 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 participants 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.

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[11] We note, furthermore, that where many clients retain the same investment manager pursuant to individual arrangements, whereby the investment manager's compensation is based upon its performance relative to a normal portfolio, additional issues arise under ERISA. For example, if the investment manager so structures the individual portfolios of his clients in such a way that when combined and viewed as a single portfolio they are identical to the normal portfolio, the investment manager may be receiving compensation for passive management. In such case, the fee paid by at least some clients may not constitute "reasonable compensation" for services. Additionally, this situation would raise serious issues under ERISA section 406(b)(1) and (b)(2).

Sincerely,

Robert J. Doyle
Director of Regulations and Interpretations