The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Department of Labor Issues Final Rule on Cross Trading Policies and Procedures for ERISA Plans

[22977]

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TO: PENSION MEMBERS No. 62-08
INVESTMENT ADVISER MEMBERS No. 14-08
SEC RULES MEMBERS No. 118-08
EQUITY MARKETS ADVISORY COMMITTEE No. 53-08
CHIEF COMPLIANCE OFFICER COMMITTEE No. 15-08 RE: DEPARTMENT OF LABOR ISSUES FINAL RULE ON CROSS TRADING POLICIES AND PROCEDURES FOR ERISA PLANS
The Department of Labor released a new final regulation on the prohibited transaction exemption for cross trading under section 408(b)(19) of ERISA. [1] The Pension Protection Act ("PPA") added the exemption to allow an investment manager to cross trade securities on behalf of an employee benefit plan with assets of at least $100 million and any other client managed by the same investment manager. [2] The exemption requires an investment manager to adopt written policies and procedures that are fair and equitable to all accounts and that include a description of the manager's pricing policies and procedures and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross trading program.

Under the PPA, the Department of Labor was required to consult with the SEC and issue regulations on the content of cross trade policies and procedures within 180 days of enactment of the PPA, or February 13, 2007. [3] Given this deadline and the immediate need for guidance on cross trading, the Department issued an interim final rule on February 12, 2007 that became effective on April 13, 2007 (the "interim rule"). [4] The Department requested comments on the interim rule and stated that it would issue a final regulation taking those comments into account. The Institute submitted a comment letter requesting several changes to the interim rule to streamline the required content of the policies and procedures and enhance their compatibility with SEC Rule 17a-7, which governs cross trading by mutual funds. [5]

The Department's new final regulation is substantially the same as the interim rule. Importantly, however, the Department changed the final regulation to allow annual verification of the minimum asset test (i.e., assets of at least $100 million), rather than quarterly verification. This change was requested by the Institute.

Initial Disclosure Statement

Under ERISA section 408(b)(19)(D), in advance of any cross trades, an investment manager must provide the authorizing plan fiduciary with initial disclosure of the conditions under which cross trades may take place and a copy of the written policies and procedures. The interim rule required that the initial disclosure to the authorizing plan fiduciary, regarding the conditions under which cross trades may take place, include a statement that any investment manager participating in a cross trading program will have a potentially conflicting division of loyalties and responsibilities to the parties involved in any cross trade transaction. The final rule eliminates this requirement from the initial disclosure statement, but requires instead that the statement on conflicting loyalties and responsibilities be included in the written policies and procedures, along with a description of how the investment manager will mitigate these conflicts. (Incidentally, the Department notes in footnote 7 of the preamble that it eliminated the word "potentially" from the operative language on conflicting loyalties and responsibilities, because it believes there is an inherent conflict of interest when there is a common investment manager for both sides of the transaction.)

Content of Policies and Procedures

As a general matter, like the interim rule, the final rule requires cross trade policies and procedures to be clear and concise and written in a manner calculated to be understood by the plan fiduciary authorizing cross trading. No particular format is required, but the policies and procedures must be sufficiently detailed to enable periodic review and determination by the compliance officer that the cross trades comply with the policies and procedures. The policies and procedures must be fair and equitable to all accounts participating in the cross trading program and reasonably designed to ensure compliance with the requirements of the exemption.

The final rule requires the following information be included in the written policies and procedures:

- A statement of policy describing the criteria that will be applied by the investment manager in determining that execution of a securities transaction as a cross trade will be beneficial to both parties to the transaction;
- A description of how the investment manager will determine that cross trades are effected at the independent "current market price" of the security (within the meaning of SEC Rule 17a-7(b) and SEC no-action and interpretative letters thereunder) as required by the PPA, including the identity of sources used to establish this price;
- A description of the procedures for ensuring compliance with the $100 million minimum asset size requirement. Like the interim rule, the final rule provides guidance on determining whether the $100 million threshold is met. A plan (or master trust) will be considered to meet the threshold if it has assets of at least $100 million upon its initial participation in the cross trading program and on an annual basis thereafter. As mentioned earlier, this is a change from the interim rule, which required quarterly verification of the minimum asset test;
- A statement that any investment manager participating in a cross trading program will have conflicting loyalties and responsibilities to the parties involved in a cross trade transaction and a description of how the investment manager will mitigate these conflicts;
- A requirement that the investment manager allocate cross trades among accounts in

an objective and equitable manner and a description of the allocation method(s) available to and used by the investment manager for assuring an objective allocation among accounts participating in the cross trading program. If more than one allocation methodology may be used by the investment manager, a description of what circumstances will dictate the use of a particular methodology;
- Identification of the compliance officer[6] responsible for periodically reviewing the investment manager's compliance with the policies and procedures and a statement of the compliance officer's qualifications for this position;
- A statement specifically describing the scope of the annual review conducted by the compliance officer. The interim rule indicated that this statement of scope must specify whether the annual compliance review is limited to compliance with the policies and procedures or extends to the overall level of compliance with the statutory exemption. The Department explained that while it continues to believe that the disclosure of the scope of the compliance officer's review is an important consideration for the authorizing plan fiduciary, it does not mean to imply that review only for compliance with the policies and procedures would be deficient in some way; and
- A statement that the cross trading statutory exemption requires satisfaction of several objective conditions in addition to the requirements that the investment manager adopt and effect cross trades in accordance with written policies and procedures. This statement was added to the final rule in order to make clear to the plan fiduciary that other conditions of the statutory exemption must be satisfied, to compensate for the revised statement of scope above.

The Department declined to adopt a suggestion from the Institute to clarify that a compliance officer of an SEC-registered investment adviser may operate in a manner consistent with the SEC rules regarding the role of a chief compliance officer under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. In response to this suggestion, however, the Department mentions in the preamble that nothing in the final rule prevents a compliance officer from delegating responsibilities it has under ERISA section 408(b)(19)(I), although the compliance officer is ultimately responsible for the compliance review under penalty of perjury. In addition, the Department notes that nothing in the final rule would preclude the compliance review from using an appropriate sampling methodology, provided that the sampling methodology is disclosed in the investment manager's policies and procedures. The Department stated that it "expects auditors to ensure that the sample selected is an appropriate representation of the total universe of transactions engaged in over the entire test period."

Other Issues

The Institute and other commenters suggested several changes or clarifications to the statutory cross trading exemption, most of which the Department declined to adopt.

Affiliated Investment Managers

The Institute requested that the Department clarify that the cross trading exemption under ERISA section 408(b)(19) covers cross trades between affiliated investment managers. The Department declined to make this clarification, but noted that "an investment manager's exercise of discretionary authority, on behalf of an account it manages, to effect a purchase or sale of a security with another account over which an affiliate of the manager exercises discretionary authority would not, in itself, constitute a violation of 406(b)(2) of ERISA." The Department goes on to state that "a violation of ERISA's prohibited transaction provisions

could arise in operation if, in fact, there was an agreement or understanding between the affiliated entities to favor one managed account at the expense of the other account in connection with the transaction."

Administrative Exemption for Small Plans

The Institute asked the Department to issue an administrative prohibited transaction exemption for cross trading for plans with assets below $100 million. Given the cost savings and efficiencies associated with cross trading, the Institute explained that these benefits should be available to smaller plans not permitted to take advantage of the statutory exemption. Although the Department has not issued the requested administrative class exemption, the preamble notes that this does not foreclose future consideration of administrative relief if the required findings under section 408(a) of ERISA can be made.

Quarterly Report

Section 408(b)(19)(F) of ERISA requires the investment manager to make a quarterly report to the plan fiduciary detailing all of the cross trades executed by the manager in which the plan participated during the quarter. The quarterly report is required to contain several pieces of information, including the identity of the securities bought or sold, the parties involved in the cross trade, and the trade price. One commenter requested that the Department clarify that the actual names of the parties involved in the cross trade are not required to be provided, as this could violate confidentiality agreements with clients. The Department stated in the preamble that it disagrees with the commenter's suggested clarification, but did not add anything to the text of the regulation in this regard, as the regulation does not address the quarterly report.

Effective Date

The final rule is effective February 4, 2009. The preamble states that an investment manager that obtained a fiduciary's authorization of cross trading prior to February 4, 2009, based on compliance with the interim rule, will not be required to obtain a re-authorization following disclosures that reflect the new final regulation.

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Attachment

endnotes

[1] A copy of the final regulation is attached.

[2] See Memorandum to Pension Members No. 48-06, Federal Legislation Members No. 5-06, and 529 Plan Members No. 13-06 [20250], dated August 4, 2006.

[3] The Institute testified on cross trading before the ERISA Advisory Council in 2006, recommending among other things that the Department issue regulations consistent with SEC Rule 17a-7. See Memorandum to Pension Members No. 61-06 [20433], dated October 3, 2006.

[4] See Memorandum to Pension Members No. 11-07, Investment Adviser Members No. 3-07, and SEC Rules Members No. 18-07 [20865], dated February 13, 2007.

[5] See Memorandum to Pension Members No. 22-07, Investment Adviser Members No. 12-07, SEC Rules Members No. 46-07, Equity Markets Advisory Committee No. 21-07, and Chief Compliance Officer Committee No. 11-07 [21055], dated April 16, 2007.

[6] ERISA section 408(b)(19)(H) requires the investment manager to designate an individual responsible for periodically reviewing cross trades to ensure compliance with the written policies and procedures. The final rule, like the interim rule, defines this individual as the "compliance officer." Under the exemption, the compliance officer must issue an annual report to the authorizing plan fiduciary detailing the level of compliance and signed under penalty of perjury.
