

MEMO# 14453

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DEPARTMENT OF LABOR ISSUES FINAL CLASS EXEMPTION 2002-12 PERMITTING CERTAIN PASSIVE CROSS-TRADES

[14453] February 12, 2002 TO: EQUITY MARKETS ADVISORY COMMITTEE No. 8-02 INVESTMENT ADVISER ASSOCIATE MEMBERS No. 5-02 INVESTMENT ADVISER MEMBERS No. 8-02 PENSION MEMBERS No. 5-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 11-02 RE: DEPARTMENT OF LABOR ISSUES FINAL CLASS EXEMPTION 2002-12 PERMITTING CERTAIN PASSIVE CROSS-TRADES The Department of Labor has issued prohibited transaction class exemption 2002-12, which permits cross-trades of securities among Index and Model-Driven funds ("Funds" or "passive cross-trades").¹ The final exemption includes a number of conditions that differ from those contained in the 1999 proposed class exemption,² and will become effective on April 15, 2002. A copy of the final exemption is attached. The final exemption follows the proposed exemption in providing relief from sections 406(a)(1)(A) and 406(b)(2) of ERISA³ for (1) the purchase and sale of securities between an Index Fund or Model-Driven Fund and another Fund where at least one of the Funds holds plan assets subject to ERISA; and (2) the purchase and sale of securities between a Fund and a Large Account (as defined in the exemption) where at least one of the funds holds plan assets subject to ERISA, pursuant to a portfolio restructuring program of the Large Account, subject to certain conditions. The final exemption, however, expands the scope of the relief, beyond that originally proposed, to cover cross-trades between two or more Large Accounts pursuant to a portfolio restructuring program if such cross-trades occur as part of a single cross-trading program involving both Funds and Large Accounts for which securities are cross-traded solely as a result of the objective operation of the program. In addition, the final exemption includes a number of modifications to the conditions to exemptive relief that were included in the proposed exemption. For example, as proposed, the exemption would have required a 10-business-day blackout period for cross-trades following 1 67 Fed. Reg. 6613 (February 12, 2002). ² For a detailed discussion of the proposed class exemption, see Institute Memorandum to Investment Adviser Members No. 28-99 and Pension Members No. 48-99, dated December 20, 1999. ³ The exemption also provides relief from the prohibited transaction provisions of the Federal Employees' Retirement System Act (FERSA), and from section 4975(c)(1)(A) of the Internal Revenue Code. ² any change made by the manager to the model underlying a Model-Driven Fund. The preamble to the proposed exemption indicated that this restriction was intended to prevent managers from making model changes to deliberately create additional cross-trading activity. Under the final exemption, this blackout period has been reduced to three business days. Furthermore, the preamble to the final exemption states that any change to a model that is not the result of an exercise of discretion by the manager would not require a blackout period for cross-trades by such Fund. Another condition of the

proposed exemption would have excluded from exemptive relief cross-trades of any security issued by the manager, unless the manager had obtained a separate prohibited transaction exemption. The Department deleted this provision from the final exemption in response to comments opposing its inclusion as unnecessary. The preamble to the exemption notes, however, that it does not provide relief for any discretionary changes in an Index or Model-Driven Fund or any other discretionary decisions by the manager that are designed to result in cross-trades of the manager's stock for the benefit of the manager. The final exemption also includes several changes to the conditions relating to disclosure to and authorization by independent plan fiduciaries. For example, the Department has revised these conditions to clarify that the notice and disclosure requirements, like the authorization requirement, apply only to those Index and Model-Driven Funds that hold plan assets. In addition, under the final exemption, the ongoing notices of information concerning the addition of Funds or changes in "triggering events" under the cross-trade program need only be furnished to those fiduciaries whose plans are invested in the affected Funds, i.e., Funds added to the program or whose "triggering events" have been changed. The final exemption also clarifies that the requirement that the authorizing fiduciary be independent of the manager does not apply in the case of a plan maintained by the manager for its own employees (a "Manager Plan"). In addition, the final exemption: (1) requires that all cross-trades by a Fund be executed within three (rather than two) business days of the "triggering event;" (2) requires that no more than 20 (rather than 10) percent of the assets of any Fund or Large Account engaging in a cross- trade may be comprised of assets of Manager Plans for which the manager exercises investment discretion; and (3) modifies the definitions of Index Fund, Model-Driven Fund, Triggering Event, Large Account, and Portfolio Restructuring Program. Kathy D. Ireland Associate Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 14453, or call the ICI Library at (202) 326-8304 and request the attachment for memo 14453. Attachment (in .pdf format)