

MEMO# 11478

December 17, 1999

DEPARTMENT OF LABOR RELEASES PROPOSED CLASS EXEMPTION ON PASSIVE CROSS-TRADES AND NOTICE OF HEARING ON ACTIVE CROSS-TRADES

[11478] December 17, 1999 TO: INVESTMENT ADVISERS COMMITTEE No. 17-99 PENSION COMMITTEE No. 71-99 PENSION OPERATIONS ADVISORY COMMITTEE No. 57-99 RE: DEPARTMENT OF LABOR RELEASES PROPOSED CLASS EXEMPTION ON PASSIVE CROSS-TRADES AND NOTICE OF HEARING ON ACTIVE CROSS-TRADES

The Department of Labor has released a proposed class exemption that would permit cross-trades of securities among Index and Model-Driven funds ("Funds" or "passive cross-trades"). In its proposed exemption, the Department includes many of the same conditions that appear in individual exemptions previously granted, with certain modifications, as well as certain new conditions and definitions that respond to concerns raised since the release of individual exemptions for passive cross-trades. Note that the release of this class exemption does not automatically invalidate previously released individual exemptions for passive cross-trades. Before revoking or modifying an exemption, the Department must publish a notice of its proposed action in the Federal Register and provide interested persons with an opportunity to comment on the proposed revocation or modification. The proposed exemption does not provide relief for transactions involving actively-managed funds. However, the Department has also released a notice of a hearing on the issue of "active" cross-trading of securities by investment managers scheduled for February 10, 2000 and if necessary, February 11, 2000, beginning at 10 am and ending at 4 pm each day. The purpose of the hearing is to discuss issues impacting potential future individual or class exemptions for active cross-trades. Those interested in testifying at the hearing must submit a written request and a discussion outline to the Department by January 20, 2000. The elements of the proposed class exemption for passive cross-trades are summarized below: I. Exemption A. Sections 406(a)(1)(A) and 406(b)(2) of ERISA, and section 8477(c)(2)(B) of FERSA shall not apply to: 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 or FERSA or 2. The purchase and sale of securities between a Fund and a Large Account (as defined in Section IV below) where at least one of the funds holds plan assets subject to ERISA or FERSA, pursuant to a portfolio restructuring program of the Large Account, if the following conditions listed in Sections II and III are met: 2II. Conditions A. The cross-trade is executed at the closing price (defined in the proposed exemption); B. Any passive cross-trade of securities by a Fund occurs as the direct result of a "triggering event" (defined in Section IV below) and it executed no later than the close of

the second business day following such “triggering event”; C. If the cross-trade involves a Model-Driven Fund, the cross-trade does not take place within 10 business days following any change made by the manager to the model underlying the fund; D. The manager has allocated the opportunity for all Funds or Large Accounts to engage in the cross-trade on an objective basis, which has been previously disclosed to the authorizing fiduciaries of plan investors, and which does not permit the exercise of discretion by the manager, i.e., a pro rata allocation system; E. No more than 10% of the assets of the Fund or Large Account at the time of the cross- trade are comprised of assets of employee benefit plans maintained by the manager for its own employees for which the manager exercises investment discretion (“Manager Plan”); F. Eligible Securities: 1. Cross-trades of equity securities involve only securities that are widely-held, actively- traded and for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public and are widely recognized as accurate and reliable sources for such information. The terms “widely-held” and “actively-traded” mean any security listed in an Index (defined in the proposed exemption); and 2. Cross-trades of fixed income securities involve only securities for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public and are widely recognized as accurate and reliable sources for such information; G. The manager receives no brokerage fees or commissions as a result of the cross-trade; H. The cross-trade does not involve any security issued by the manager unless the manager has obtained a separate prohibited transaction exemption for the acquisition of such security; I. As of the date the proposed exemption is granted, a plan’s participation in the manager’s cross-trading program involving an Index or Model-Driven Fund that holds plan assets is subject to a written authorization executed in advance of such investment by a fiduciary of the plan, which is independent of the manager engaging in the cross-trade; 3J. With respect to existing investors in any Index or Mode-Driven Fund as of the date the proposed exemption is granted, the independent fiduciary is furnished with a written notice, not less than 45 days prior to the implementation of the cross-trading program, that describes the Fund’s participation in the manager’s cross-trading program, provided that: 1. Such notice allows each plan an opportunity to object to the plan’s participation in the cross-trading program as a Fund investor by providing the plan with a special termination form; 2. The notice instructs the independent plan fiduciary that failure to return the termination form to the manager by a specified date, which shall be at least 30 days following the plan’s receipt of the form, shall be deemed to be an approval by the plan of its participation in the manager’s cross-trading program; 3. If the independent plan fiduciary objects to the plan’s participation in the cross- trading program as a Fund investor by returning the termination form by the specified date, the plan is given the opportunity to withdraw from each Index or Model-Driven Fund without penalty prior to the implementation of the cross- trading program within such time as may be reasonably necessary to effectuate the withdrawal in an orderly manner. K. Prior to obtaining the above-mentioned authorization, the manager must provide the following statement to the independent plan fiduciary: “Investment decisions for the Fund, (including decisions regarding which securities to buy and sell, how much of a security to buy or sell, and when to execute a sale or purchase of securities for the Fund) will not be based in whole or in part by the manager on the availability of cross-trades opportunities and will be made prior to the identification and determination of any cross-trade opportunities. In addition, all cross-trades by a Fund will be based solely on a “triggering event” set forth in this exemption. Records documenting each cross-trade transaction will be retained by the Manager.” L. Prior to any authorization set forth above, at the time of the above-mentioned notice, the independent fiduciary must be furnished

with any reasonably available information necessary for the fiduciary to determine whether the authorization should be given, including, but not limited to, a copy of this exemption, an explanation of how the authorization may be terminated, detailed disclosure of the procedures to be implemented under the manager's cross-trading practices (including the "triggering events" that will create the cross-trading opportunities, the independent pricing services that will be used by the manager to price the cross-traded securities, and the methods that will be used for determining closing price) and any other reasonably available information regarding the matter that the fiduciary requests. The manager must also provide the independent plan fiduciary with a statement that the manager will have a potentially conflicting division of loyalties and responsibilities to the parties and to any cross-trade transaction and must explain how the manager's cross-trading practices and procedures will mitigate such conflicts. With respect to Funds that are added to the manager's cross-trading program, or changes to, or additions of, triggering events regarding the Funds, following the authorizations received above, the manager shall provide a notice to each relevant independent plan fiduciary prior to, or within 410 days following such addition of Funds or change to, or addition of, triggering events. Such notice will also include a statement that the plan has a right to terminate its participation in the cross-trading program and its investment in any Index or Model-Driven Fund without penalty at any time, as soon as it is necessary to effectuate the withdrawal in an orderly manner. M. At least annually, the manager notifies the independent fiduciary for each plan that has previously authorized participation in the manager's cross-trading program as a Fund investor, that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index or Model-Driven Fund without penalty at any time, as soon as it is necessary to effectuate the withdrawal in an orderly manner. This notice shall also provide each independent plan fiduciary with a special termination form and instruct the fiduciary that failure to return the form to the manager by a specified date (which shall be at least 30 days following the plan's receipt of the form) shall be deemed an approval of the plan's continued participation in the cross-trading program. Such annual re-authorization must contain disclosures regarding any new Funds that are added to the cross-trading program or any new triggering events that may have been added to existing Funds since the time of the initial authorization. N. With respect to a cross-trade involving a Large Account: 1. The cross-trade is executed in connection with a portfolio restructuring program with respect to all or a portion of the Large Account's investments which an independent fiduciary of the Large Account has authorized the manager to carry out or act as "trading adviser" in carrying out a Large Account-initiated liquidation or restructuring of its portfolio; 2. Prior to the cross-trade, a fiduciary of the Large Account, who is independent of the Manager, has been fully informed of the manager's cross-trading program, has been provided with the information described in Section L above and has provided the manager with advance written authorization to engage in cross- trading in connection with the restructuring, provided that: a. Such authorization may be terminated at will by the Large Account upon receipt by the manager of written notice of termination; b. A form expressly providing an election to terminate the authorization, with instructions on the use of the form, is supplied to the authorizing Large Account fiduciary concurrent with the receipt of the written information describing the cross-trading program. The instructions for such form must specify that the authorization may be terminated at will by the Large Account, without penalty, upon receipt by the manager of written notice from the authorizing Large Account fiduciary; 3. The portfolio restructuring program must be completed by the manager within 30 days of the initial authorization (or initial receipt of assets associated with the restructuring, if later) to engage in such restructuring by the Large Account's independent fiduciary, unless such fiduciary agrees in writing to extend this period for another 30 days; and 54. No later than 30 days following the completion of the Large Account's portfolio

restructuring program, the Large Account's independent fiduciary must be fully apprised in writing of all cross-trades executed in connection with the restructuring. Such writing shall include a notice that the Large Account's independent fiduciary may obtain, upon request, the information described below (Section III(A)). However, if the program takes longer than 30 days to complete, interim reports containing the transaction results must be provided to the Large Account fiduciary no later than 15 days following the end of each 30 day period.

III. General Recordkeeping Conditions A. The manager maintains or causes to be maintained for a period of 6 years from the date of each cross-trade the records necessary to enable the persons described below (Section III(B)) to determine whether the conditions of the exemption have been met, including records that identify: 1. On a Fund by Fund basis, the specific triggering events which result in the creation of the model prescribed output or trade list of specific securities to be cross-traded; 2. On a Fund by Fund basis, the model prescribed output or trade list which describes (A) which securities to buy or sell; (B) how much of each security to buy or sell, in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events; and 3. On a Fund by Fund basis, the actual trades executed by the Fund on a particular day and which of those trades resulted from triggering events. The records must be readily available to assure accessibility and maintained so that an independent fiduciary or persons described in Section III(B) below may obtain within a reasonable period. However, a prohibited transaction will not be deemed to occur if, due to circumstances beyond the control of the manager, the records are lost or destroyed prior to the end of the 6-year period. B. Such records must be unconditionally available at their customary location for examination during normal business hours by: 1. Any duly authorized employee or representative of the Department or the Internal Revenue Service; 2. Any fiduciary of the plan participating in the cross-trading program who has the authority to acquire or dispose of the assets of the plan, or any duly authorized employee or representative of the fiduciary; 3. Any contributing employer with respect to any plan participating in a cross- trading program or any duly authorized representative of such employer; and 64. Any participant or beneficiary of any plan participating in a cross-trading program, or any duly authorized employee or representative of such participant or beneficiary. C. If persons described in Sections B(2) - (4) above seek trade secrets or commercial or financial information that is privileged or confidential pursuant to inspecting records maintained by the manager in connection with this exemption, the manager is permitted to withhold such information, provided that by the close of the 30th day following the request, the manager gives a written notice to such person advising the him of the reasons for the refusal and that the Department may request such information. D. The information required to be disclosed to persons described in Sections B(2) - (4) above shall be limited to information that pertains to cross-trading involving a Fund or Large Account in which they have an interest. IV. Definitions See attachment for complete list of definitions in the proposed exemption. Note that the Department has modified the definition of Index and Model-Driven Funds from previously released individual exemptions. Certain terms are defined as follows: A. Triggering event: 1. A change in the composition or weighting of the Index underlying a Fund by the independent organization creating and maintaining the Index; 2. A specific amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that (A) such specified amount has been disclosed in writing as a triggering event to an independent fiduciary of each plan having assets held in the Fund prior to, or within 10 days following its inclusion as a triggering event for such Fund; and (B) investments or withdrawals as a result of the manager's discretion to invest or withdraw assets of a Manager Plan, other than a participant-directed Manager Plan, will not be taken into account in determining the specified amount of net change; 3. An accumulation in the Fund of a specified amount of

either: (A) cash that is attributable to interest or dividends on and/or tender offers for portfolio securities, or (B) stock attributable to dividends on portfolio securities, provided that such specified amount has been disclosed in writing as a triggering event to an independent fiduciary of each plan having assets held in the Fund prior to, or within 10 days after, its inclusion as a triggering event for such Fund; or 4. A change in the composition of the portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model underlying the Fund where the basic factors for making such changes (and any fixed frequency for operating the computer model) have been disclosed in writing to an independent fiduciary of each plan having assets held in the Fund prior to, or within 10 days after, its inclusion as a triggering event for such Fund. 7B. Large Account: Any investment fund, account or portfolio that is not an Index or Model-Driven Fund sponsored, maintained, trustee'd or managed by the manager that holds assets of either: 1. An employee benefit plan within the meaning of section 3(3) of ERISA that has \$50 million or more in total assets; 2. An institutional investor that has total assets in excess of \$50 million, such as an insurance company separate account or general account, a governmental plan, a university endowment plan, a charitable foundation fund, a trust or other fund that is exempt from taxation under section 501(a) of the Code; or 3. An investment company registered under the Investment Company Act of 1940 other than an investment company advised or sponsored by the manager, provided that the manager has been authorized to restructure all or a portion of the portfolio for such Large Account or to act as a trading adviser in connection with a specific liquidation or restructuring program for the Large Account. Written comments on the proposed class exemption are due by February 14, 2000. Copies of the proposed class exemption and notice of hearing are attached. Kathryn A. Ricard Associate Counsel Attachments