

MEMO# 20205

August 8, 2006

ICI to Testify Before ERISA Advisory Council Working Group on Cross-Trading

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TO: PENSION COMMITTEE No. 27-06 PENSION OPERATIONS ADVISORY COMMITTEE No. 26-06 RE: ICI TO TESTIFY BEFORE ERISA ADVISORY COUNCIL WORKING GROUP ON CROSS-TRADING

The ERISA Advisory Council has identified cross-trading as an area for study this year. The Advisory Council intended to consider whether to recommend that the Department of Labor issue broader exemptive relief for cross-trading beyond the existing class exemption for cross-trading by index/model-driven pension funds.¹ Last week, Congress included a statutory exemption for active cross-trades in the Pension Protection Act of 2006² and the President is expected to sign the Act shortly. As a result, we anticipate the Advisory Council may consider making recommendations to DOL for implementing the exemption, and perhaps on whether DOL should provide broader exemptive relief in a prohibited transaction class exemption. The Advisory Council will hold a hearing on September 20, 2006 and the Institute will provide testimony at the hearing. Request for Information from Members

Because this hearing represents a promising new opportunity to make progress on cross-trading exemptive relief for actively-managed plans, the Institute would appreciate the assistance of members in making our strongest possible case. In particular, we would like members to provide information on the following topics:

- What benefits are received by mutual funds from the ability to cross-trade? Please try to provide concrete evidence, such as specific estimates of annual cost-savings. ¹ See Memorandum 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, and Pension Operations Advisory Committee No. 11- 02 [14453], dated February 12, 2002. 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. ²
- Do investment managers for non-ERISA pension plans (e.g., governmental plans) engage in active cross-trading? If so, how much money is saved by those plans from cross-trading?
- The Advisory Council identified parking illiquid securities, unfair allocation of favorable cross trade opportunities, and favoritism among accounts, as possible areas of abuse. The hearing notice asks for information about the evidence and seriousness of these practices. Under the cross-trading exemption in the Pension Protection Act, the investment manager must adopt and comply with written policies and procedures on cross-trading, including policies and procedures on pricing and allocating cross-trades objectively among the manager's accounts. The Act directs the Department of Labor to issue regulations on the content of the policies and procedures within 180 days after enactment. What procedures does your firm use to make sure managers do not park or dump securities, or otherwise favor one client over another?

(This could be within or outside the scope of a cross-trading program.) If possible, please provide copies of your firm's compliance policies and procedures on these matters (including Rule 17a-7 compliance policies and procedures). Also, any evidence that such abuses are rare would be helpful. Except as needed to further our purpose of obtaining a workable cross-trading exemption, the information provided in response to this request will be treated as confidential and will not be disclosed to persons outside the Institute. The Institute will not identify the source of any data or other information used in our written or oral testimony.

Request for Member Comments on Pension Protection Act Exemption

The Pension Protection Act contains a set of conditions (described below) designed to safeguard plans in connection with active cross-trading. We would appreciate member comments on whether any of these conditions should be relaxed or otherwise modified in an administrative exemption.

- The exemption is limited to plans with at least \$100 million in assets. This limitation prevents a large subset of plans from benefiting from cross-trading. According to the Department of Labor's February 2006 Private Pension Plan Bulletin, based on 2001 Form 5500s, only 3.9 percent of defined benefit plans have \$100 million or more in assets. Should we seek an administrative exemption with a lower plan asset requirement (such as \$50 million)?
- Only securities for which market quotations are readily available may be cross-traded and the transaction must be at the independent current market price (as defined in SEC Rule 17a-7).
- No brokerage commission, fee (except for customary transfer fees disclosed in advance to the plan fiduciary), or other remuneration may be paid in connection with the transaction.

3

- The investment manager must adopt and comply with written policies and procedures on cross-trading, including policies and procedures on pricing and allocating cross-trades objectively among the manager's accounts.
- The investment manager may not base its fee schedule or any other service (other than the investment opportunities and cost savings resulting from a cross-trade) on the plan's consent to cross-trading.
- A plan fiduciary (other than the investment manager or an affiliate) must authorize the cross-trading program in advance, after receiving certain disclosures from the investment manager about the conditions under which cross-trades may take place.
- The investment manager must provide a quarterly report to the authorizing plan fiduciary detailing the cross-trades for that quarter, including the identity of the security, the number of shares or units traded, the parties involved in the trade, and the trade price and method used to establish the price.
- The investment manager must designate an individual to be responsible for periodically reviewing cross-trades for compliance with the written policies and procedures. The individual named must issue an annual report to the plan fiduciary within 90 days following the end of the annual period, signed under penalty of perjury, describing the review process, the level of compliance, and any specific instances of non-compliance. The report also must notify the plan fiduciary of his right to terminate participation in the cross-trading program at any time.

Timing of Responses

We understand that obtaining answers to the questions outlined above and reviewing the aforementioned exemption conditions may take some time and require you to talk to other divisions within your respective firms. We ask that you provide as much information as possible to Mary Podesta or Elena Barone by Friday, September 1, 2006. Mary Podesta can be reached at 202-326-5826 or podesta@ici.org and Elena Barone can be reached at 202-326-5821 or ebarone@ici.org. Elena Barone Assistant Counsel