INVESTMENT COMPANY INSTITUTE

MEMO# 17677

June 15, 2004

DOL ADVISORY OPINION ON APPLICABILITY OF ERISA PROHIBITED TRANSACTION RULES TO ALTERNATIVE TRADING SYSTEMS

[17677] June 15, 2004 TO: PENSION MEMBERS No. 32-04 PENSION OPERATIONS ADVISORY COMMITTEE No. 41-04 EQUITY MARKETS ADVISORY COMMITTEE No. 28-04 COMPLIANCE ADVISORY COMMITTEE No. 62-04 RE: DOL ADVISORY OPINION ON APPLICABILITY OF ERISA PROHIBITED TRANSACTION RULES TO ALTERNATIVE TRADING SYSTEMS The Department of Labor has issued Advisory Opinion 2004-05A,1 which addresses whether the execution of a securities transaction between a pension plan and a "party in interest" through an alternative trading system would violate the prohibited transaction rules of the Employee Retirement Income Security Act of 1974 (ERISA).2 The advisory opinion was issued to Liquidnet, an alternative trading system under Rule 300(a) of Regulation ATS of the Securities Exchange Act of 1934. According to the advisory opinion, Liquidnet's subscribers, which are institutional investors not affiliated with Liquidnet, often act as fiduciaries or investment managers for purposes of ERISA and provide other services to employee benefit plans. Because the system executes trades on a "blind" basis and handles a large volume of trades, it is possible for a subscriber, in its capacity as a plan fiduciary, to unknowingly buy or sell a security on behalf of a plan from/to a subscriber that is a party in interest to the plan. In addition, the advisory opinion notes that it is possible for a plan fiduciary to direct a trade through Liquidnet where the counterparty is an affiliate of the fiduciary. The advisory opinion concludes that a "blind" transaction executed pursuant to Liquidnet's procedures would not, in itself, constitute a prohibited transaction under ERISA sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) or 406(b)(2). In reaching this determination, the Department cited the Conference Report accompanying ERISA, which provides that "a transaction [generally] will not be a prohibited transaction (under either the labor or tax provisions) if the transaction is an ordinary 'blind' purchase or sale of securities through an 1 Advisory Opinion 2004-05A is available on the Department of Labor's website at http://www.dol.gov/ebsa/regs/aos/ao2004-05a.html. 2 The prohibited transaction rules of ERISA prohibit plan fiduciaries (which includes investment managers and others that exercise discretionary control over plans and their assets) from causing plans to engage in certain transactions with "parties in interest" — a broad term that includes parties providing services to plans. 2 exchange where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved." Liquidnet's trading procedures, in the Department's view, operate in a manner similar to such an exchange. The advisory opinion, however, cautions that a transaction would not be considered "blind" if, prior to

the execution of such transaction, the plan fiduciary responsible for the plan's engagement in the transaction knew, or had reason to know, the identity of the counterparty to the transaction. Furthermore, such purchases and sales through an alternative trading system cannot have arisen in connection with any arrangement, agreement or understanding designed to benefit the fiduciary (or its affiliate) or any other party in interest to the plan. The advisory opinion also states that ERISA's general fiduciary standards3 apply to: (1) the determination to buy or sell a particular equity security (and the appropriate purchase or sale price for that security) and (2) the selection of the trading system through which to purchase or sell equity securities. Consequently, plan fiduciaries must consider "the costs associated with the use of alternative trading systems as well as the potential revenue returns, discounts, and other benefits that result from the continuing use of particular alternative trading systems over other similar services." Finally, the advisory opinion cautions that a plan fiduciary, prior to its decision to execute a securities transaction, should determine whether any existing or potential conflicts of interest or prohibited transactions would interfere with the fiduciary's duties under ERISA, including the duty to act solely on behalf of the plan. Thomas T. Kim Associate Counsel 3 Section 404(a)(1) of ERISA, among other things, requires plan fiduciaries to discharge their duties for the exclusive purpose of providing benefits to participants and their beneficiaries.
