

July 10, 2000

Mr. Ivan Strasfeld
Director of Exemption Determinations
Pension & Welfare Benefits Administration
Office of Exemption Determinations
U.S. Department of Labor
Room N-5649
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Re: Joint Submission in Support of Active Cross-Trading Exemption from Section 406(b)(2) of ERISA

Dear Mr. Strasfeld:

Earlier this year the Department of Labor (Department) held hearings on whether to allow actively managed funds to cross-trade pursuant to a general exemption from Section 406(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA) - Prohibited Transactions.¹ Such an exemption would apply only to actively managed pension funds that voluntarily agree through their independent plan fiduciaries to participate in cross-trading activities.

Representatives of each of the organizations signing this submission testified at the hearings in favor of an exemption for active cross-trades; that is, securities cross-traded for actively managed pension funds. These organizations are: the Association for Investment Management and Research (AIMR),² the Investment Company Institute (ICI),³ the Investment Counsel Association of America (ICAA),⁴ and the Securities Industry

¹ Hearing on Cross-Trades of Securities before the Department of Labor, Pension and Welfare Benefits Administration, February 10-11, 2000.

² The Association for Investment Management and Research (AIMR) is a global, not-for-profit organization of more than 42,000 investment professionals in 95 countries. Through its headquarters in Charlottesville, Virginia, and more than 94 Member Societies and Chapters throughout the world, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

³ The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,084 open-end investment companies ("mutual funds"), 479 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.879 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders.

⁴ The Investment Counsel Association of America (ICAA) is a not-for-profit association that exclusively represents the interests of SEC-registered investment advisers. Founded in 1937, the Association's membership today consists of more than 260 investment advisory firms that collectively

Association (SIA).⁵ Our collective membership represents a substantial portion of all investment and related services provided to ERISA plans.

During the course of the hearings, the Department panel members posed several common questions to those testifying on behalf of the organizations mentioned above. This letter supplements our respective hearing statements by addressing two of the issues posed by the panel: (1) the respective duties of plan fiduciaries versus investment company directors, and (2) what cross-trading information plan managers should disclose to plan fiduciaries under a class exemption.

COMPARISON OF DUTIES OF PLAN FIDUCIARIES AND INVESTMENT COMPANY DIRECTORS

At the hearing, the Department suggested that application of the U.S. Securities and Exchange Commission (SEC) disclosure rules for cross-trades might not be appropriate for ERISA accounts, because ERISA plan fiduciaries and investment company boards of directors (“directors”) are not similarly situated. Specifically, the Department suggested that directors have better resources or capabilities than plan fiduciaries with which to review cross-trading records provided to them.

Section (a) of this letter describes the legal standards applicable to directors and ERISA plan fiduciaries. Section (b) discusses and proposes a sophistication test for plan fiduciaries. In brief, both directors and plan fiduciaries are held to similar duties of care and loyalty with respect to actions taken on behalf of the investment company and its shareholders or the plan and its participants. We believe that the use of a sophistication test for plan sponsors wishing to enter into a cross-trade program could provide additional comfort that plan fiduciaries have the requisite sophistication, resources, and expertise to monitor cross-trade transactions executed on behalf of the plan.

A. Legal Standards for Investment Company Board of Directors and Plan Fiduciaries

1. Investment Company Board of Directors

In addition to certain specific obligations imposed by the Investment Company Act of 1940 (“1940 Act”), directors are held to legal standards under state corporation and business trust law. Although some of the responsibilities of a director may vary from state

manage in excess of \$2 trillion for a wide variety of institutional and individual clients. For additional information, please consult the ICAA web site at www.icaa.org.

⁵ The Securities Industry Association (SIA) brings together the shared interest of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift and pension plans. The industry generates in excess of \$300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals.

to state, or may vary because of the nature of the legal entity (for example, depending upon whether the investment company is organized as a corporation, business trust or limited partnership), state law generally imposes two fundamental responsibilities on each director: a duty of care and a duty of loyalty.

The duty of care requires that a director act with the degree of diligence, care and skill that a person of ordinary prudence would exercise under similar circumstances in a like position and in a manner that he or she reasonably believes is in the best interest of the investment company. The duty of care requires that a director obtain adequate information concerning matters he or she is called upon to decide and exercise his or her business judgment with respect to matters on which the board is expected to act. Under the “business judgment rule,” a director is protected from liability for his or her decisions, so long as the director (1) acted in good faith; (2) was reasonably informed; and (3) rationally believed the action taken was in the best interests of the company.

The duty of loyalty requires that a director act in good faith, avoid unfair dealing, and resolve conflicts of interest in favor of the investment company and its shareholders. The duty of loyalty prohibits a director from engaging in business competition with the investment company or from obtaining any unfair gain from the investment company’s operations. In addition, the duty of loyalty prohibits a director from converting to his or her own personal benefit opportunities that properly belong to the investment company.

In the context of cross-trading, Rule 17a-7 under the 1940 Act requires that investment company directors review a fund’s cross-trades at least quarterly. In conducting these reviews, the directors are bound by the duties described above.

2. ERISA Plan Fiduciaries

Under ERISA’s fiduciary duty rules, plan fiduciaries are subject to a prudence rule and an exclusive benefit rule. ERISA requires plan fiduciaries to perform all duties with the level of care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. ERISA defines a prudent fiduciary as one who: considers all available alternatives; evaluates all the facts on each potential course of action, investment or investment strategy; considers how the proposed action, investment or investment strategy fits into to overall goals of the plan; and obtains the best value for all services supplied to the plan. This requirement parallels the duty of care standard applicable to directors.

Under the exclusive benefit rule, plan fiduciaries must act solely in the interests of, and for the exclusive benefit of, the plan participants and beneficiaries. The exclusive benefit rule is a codification of the common law duty of loyalty. A plan fiduciary must avoid conflicts of interest that might affect its ability to make decisions on behalf of the plan and its participants and beneficiaries.

3. *Application to Cross-Trades*

In deciding whether to permit cross-trades, and in reviewing cross-trades involving a mutual fund or a pension plan, directors and plan fiduciaries would both be subject to the duty of care/prudence and the loyalty/exclusive benefit standards with respect to fiduciary activities. This would require directors and plan fiduciaries to, among other things, receive requisite information regarding the cross-trades and to review information solely on the basis of whether the cross-trades were in the best interests of the particular mutual fund or plan. In the past, the Department has provided exemptive relief for agency cross-transactions where the investment manager has discretion over only one side of the transaction. The Department conditioned this exemptive relief on regular disclosure of cross-trade information. In Prohibited Transaction Class Exemption 86-128 (PTE 86-128), the Department required the investment manager to provide the authorizing plan fiduciary with certain detailed reports regarding the cross-trade transactions either within 10 days of the transaction or quarterly.⁶ Thus, in PTE 86-128, the Department recognized that the authorizing plan fiduciary would be capable of reviewing this disclosure information to determine whether the transactions are in the best interests of the plan.

B. Sophistication

At the hearing, the Department voiced its concern that plan fiduciaries might be less sophisticated than mutual fund directors and, thus, less able to conduct an adequate review of information provided regarding cross-trades. As discussed above, plan fiduciaries and fund directors have substantially similar duties and are obligated to fulfill them using appropriate means. For example, plan fiduciaries often retain consultants to help them assess performance and trading activity for the plan portfolio. Nevertheless, in order to address the Department's potential concern, various witnesses at the hearing suggested that the Department impose a sophistication test for plans engaging in cross-trades. Historically, the Department has used assets under management as a proxy for sophistication.⁷ A cross-trade exemption could be limited to plans with greater than a certain amount in assets to ensure that the plan sponsor has the requisite sophistication and expertise to engage in a cross-trade program. These plan sponsors may also have more resources available to assist them in fulfilling their duties.

⁶ PTE 86-128 requires the investment manager to provide the authorizing plan fiduciary with either: (1) a confirmation slip for each cross-trade of securities within 10 business days of the securities transaction containing information described in Rule 10b-10(a)(1-7) under the Securities Exchange Act of 1934; or (2) at least once every three months, a report disclosing a compilation of the information that would have been provided to the plan if individual transaction confirmations had been delivered during the three-month period. In addition, the plan fiduciary must receive a summary at least annually that identifies the total number of cross-trades during the period and includes a description of the manager's brokerage placement practices if such practices have materially changed during the period.

⁷ See, e.g., PTE 84-14, 49 Fed. Reg. 9494 (Mar. 14, 1984); PTE 96-23, 60 Fed. Reg. 15597 (Mar. 24, 1995).

The prudence standard in ERISA section 404(a)(1)(b) requires fiduciaries to have the level of knowledge appropriate to the nature of the particular plan or its investments. In other contexts, the Department has recognized that certain types of plan investments may require a greater degree of sophistication on the part of plan fiduciaries. For example, in a letter describing fiduciary guidelines for the investment of plan assets in derivatives, the Department indicated that certain plan investments “may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments.”⁸

Therefore, ERISA’s prudence standard in conjunction with an asset-based sophistication test would help ensure that a plan fiduciary would have the level of sophistication necessary to monitor the cross-trade transactions executed on behalf of the plan. Moreover, as noted above, the Department recognized that certain plan fiduciaries have the requisite sophistication to review and monitor agency cross-trades in granting PTE 86-128.

PROPOSED DISCLOSURE TO CLIENTS REGARDING CROSS-TRADE TRANSACTIONS

This section sets forth proposed reporting and disclosure requirements that would enable plan fiduciaries to monitor active cross-trades. We provide below recommendations for (a) a prototype list of required quarterly disclosures for plan fiduciaries, (b) a list of disclosures to be provided upon the plan fiduciary’s request; and (c) record-keeping requirements. Appendix A contains a “mock-up” of a quarterly cross-trade report. This proposed disclosure would be in addition to, and would not replace, the information received by plan fiduciaries on confirmation slips for each transaction pursuant to Rule 10b-10. Rule 10b-10 information includes, but is not limited to, the date and time of transaction, the identity, price, and number of shares or units of the security, and other specific data in the case of transactions in certain debt securities.

⁸ Letter from Olena Berg, Assistant Secretary Pension and Welfare Benefits Administration, U.S. Department of Labor, to Eugene Ludwig, Comptroller of the Currency (March 21, 1996).

A. Required Quarterly Reporting and Disclosures

An investment manager engaging in cross-trades should be required to provide a quarterly report to the plan's fiduciary detailing cross-trades entered into on behalf of the account during the prior quarter. Such a report would enable plan fiduciaries to monitor whether the cross-trades were in the best interest of the plan and whether the trades show patterns indicative of possible abuse. Plan fiduciaries could request additional information (see part B below) should they have any concerns or questions. We suggest that each quarterly report include the following information:

- the trade date;
- the name of issuer/security;
- the type of transaction (sale or purchase);
- the principal amount;
- the number of shares;
- the price;
- the basis for the price;
- the high and low prices of the security on the date of the cross-trade; and
- a certification regarding compliance with the firm's procedures.

B. Disclosures Provided Upon Request

A plan fiduciary should be able to request additional information from its investment manager regarding any cross trade entered into on the plan's behalf. This information could include the following:

- the generic type of counter-party (such as individual, fund, or partnership);
- the percentage of the plan's trades that were cross-trades;
- the justification for the cross-trade;
- any other relevant information reasonably available on the cross-trade.

C. Record-Keeping

Managers participating in cross-trades should retain written records for each trade for six years from the end of the fiscal year in which the cross-trade occurred. Managers should be required to supply the information contained in the records if requested by the plan fiduciary or by an authorized Department representative.

SUMMARY AND CONCLUSION

We believe there is compelling evidence that there are adequate safeguards and remedies available to pension funds should they decide voluntarily to engage in active cross-trades. Section 404 of ERISA and numerous federal and state laws and regulations already offer effective deterrents and means of redressing fiduciary conflicts and abuses. The proposed fiduciary sophistication test and cross-trade disclosure requirements would help ensure that (1) the plan fiduciary's knowledge and expertise is adequate and (2) the fiduciary has the necessary information available to review each trade and to identify potential questionable trading patterns. Proscription is not an appropriate standard to apply to transactions when they clearly stand to benefit the vast majority of ERISA plans and when adequate means exist to detect and prosecute any malfeasance.

In light of all the information presented - here, at the hearings, and in prior written submissions - we urge the Department to adopt a class exemption for cross-trading by actively managed accounts. Thank you for your consideration of this important matter.

Very truly yours,

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Appendix A

Cross-Trade Disclosure Document

[Name of Pension Plan]

PTE __ Cross-Trade Transactions Report

For [date] to [date], [year]

<u>Trade Date</u>	<u>Name of Issuer/ security</u>	<u>Principal Amount</u>	<u>Transaction Type</u>	<u>Shares</u>	<u>Price</u>	<u>High/Low Price</u>	<u>Basis</u>
2/2/2002	IBM common stock	\$515,000	Sale	5000	\$103	\$(x)	last sale price reported in consolidated system
ETC							

[Manager certification regarding compliance with firm's procedures]