

February 14, 2000

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

Att: Class Exemption for Securities Cross-Traded by Index/Model-Driven  
Funds

Dear Sir or Madam:

The Securities Industry Association (“SIA”) appreciates the opportunity to comment on the Department’s proposed class exemption for cross-trading among passively managed accounts and certain large accounts in the restructuring context. The SIA is a trade association comprised of over 740 broker-dealers who provide services to the hundreds of thousands of plans covered by ERISA, holding over \$7 trillion in plan assets. The SIA’s members are parties in interest to every ERISA plan, through provision of brokerage services, investment advice and management or as plan sponsors, and as such, our members daily face the complicated web of ERISA rules governing their behavior and impacting the ways they can serve those plans.

The SIA’s members are very concerned with public trust and confidence and take very seriously their responsibility to act in the best interest of all investors, including retirement accounts. Our members believe that the ability to cross-trade is a positive benefit to investors and that the cost savings that have inured to mutual funds and non-ERISA accounts over the years should be extended to ERISA plans. However, our members also recognize that cross-trading should be done with appropriate, yet flexible protections. We appreciate the enormous effort that went into the proposed exemption for passive cross-trading and our specific comments in no way diminish our acknowledgement of the progress that the exemption represents.

We do want to note, however, that the time the Department has taken to propose this class relief is troublesome and we are concerned that the volume of enthusiastic comment on active cross-trading received by the Department in response to the Department's March 1998 Notice has not enabled the Department to propose class relief for active cross-trading at this time.

#### The Department's Request for Comments on Specific Questions

In the Department's proposal, as well as in its March 20, 1998 Notice, the Department refers repeatedly to its concern that by cross-trading, a manager is avoiding market impact, as if market impact can be manipulated and forecast by the manager and as if market impact is beneficial to plans. Whether market impact will be good or bad for a particular account is unpredictable. However, money managers generally believe that in most cases, market impact is to be avoided, if possible. Where a manager represents both parties to a trade, if there is good market impact for one, there will likely be adverse market impact for the other. Indeed, to the extent there is any positive impact from one party's trade, much of it often inures to external parties trading at the same time, rather than the party to the trade. In many cases, if a manager places buy and sell orders for different accounts in the market at or near the same time, both accounts will suffer market impact as other sophisticated traders take advantage of the trades. Cross-trades, however, avoid the uncertainty of market impact altogether, and avoid harm to one, if not both of a manager's clients when the manager has two or more clients trading in opposite directions. Cross-trades also eliminate transaction costs and custody costs.

The Department's assumptions about cross-trading are inconsistent with multiple clients of a common manager trading, for very legitimate reasons, in different directions on the same day. The potential conflicts presented by such situations are inherent in a multiple client world. The conferees on ERISA recognized that some transactions could be technically prohibited but should "nevertheless be allowed in order not to disrupt the established business practices of financial institutions which often perform fiduciary functions in connection with these plans consistent with adequate safeguards to protect employee benefit plans", H. Rep. No. 93-1280; 93<sup>rd</sup> Cong., 2<sup>nd</sup> Sess. at page 309. In this regard, for years, money managers have developed procedures, like reasonable allocation of investment opportunities and reasonable allocation of security fills at any given price, to insure fair treatment of clients. The ability to cross-trade under appropriate conditions would be another such procedure fostering fairness to clients. Indeed, for several reasons, we believe the Department should embrace cross-trading and encourage its use by managers in appropriate circumstances. First, in addition to eliminating detrimental market impact and other transaction costs noted above (e.g., commissions, mark-ups and mark-downs, custody fees and transfer taxes), to the extent a trade might impact the market, cross-trading also avoids the potential conflict a manager could face when deciding which trade to place first – if a manager puts in a sell order before the buy order, the seller could receive a lower price than if the trade sequence had been reversed. Second, cross-trading would be done under

prescribed conditions to ensure fair treatment and fair pricing. Finally, cross-trading is already an item covered in the examinations of the Securities and Exchange Commission and other regulators; its use for ERISA plans will only heighten the scrutiny and review of these transactions to ensure the absence of abuse.

The Department also seeks comment on cross-trading thinly traded securities. The SIA agrees that market impact in the trading of thinly traded securities may be more dramatic than with more actively traded securities. That is precisely why a manager would want to cross trade such securities, when two of the manager's accounts need to trade in different directions on the same day. Where large numbers of plans and other accounts share common investment managers, cross-trades present the fairest overall result to both accounts.

The Department requests comments on whether Index Funds and Model-Driven Funds should be able to cross securities where the fund holds a significant percentage of the total outstanding shares. While we are not certain that we understand the Department's concerns, it appears that the Department is worried that by cross-trading those shares, the manager keeps them out of the market. Cross-trading by ERISA accounts is a fraction of the cross-trading that occurs regularly among mutual funds and non-ERISA accounts that hold significant percentages of the total shares of a particular security. Where managers cannot cross-trade, they seek other methods of execution which are likely to avoid market impact. Avoiding adverse market impact when the buyer or seller has a large order is almost universally seen as a prudent act. Accordingly, we think that the size of an account's holdings of a given security should not affect whether it may cross-trade that security.

#### Triggering Events

The SIA objects to narrowing the timeframe in which to cross after a triggering event. We think this additional restriction is inconsistent with the stated premise of the proposed exemption – that cross-trading is a benefit to plans. Cross-trading is primarily a trading function. It involves a manager cross-trading between two accounts in lieu of sending both trades to a broker to be executed in separate agency transactions in the market. In 1975, in its investment advice regulation, the Department provided a safe harbor for trading decisions executed within 5 days. The Department is now taking the position in this proposed exemption that trading decisions must be effected within two days. Particularly in the case of Index and Model-Driven Funds -- where the investment management decision is nondiscretionary and model-driven -- we see no reason why the time limit for trading should be shorter than the 5 day period permitted for trade execution under the safe harbor provided in 29 CFR 2510.3-21(d).

The SIA also objects to the disclosure requirement relating to trigger events which would require a manager to disclose the dollar level of new funds or amounts to be liquidated, the appearance of which constitutes the precise triggering event. This disclosure requirement limits cross-trades for no valid reason that we can discern. Tying the manager's hands with respect to the best time to trade for both accounts limits the manager's ability to simultaneously and fairly serve two or more clients trading in the same security. The proposed exemption cuts off cross-trade opportunities after two days, even if there are cross-trade opportunities still available after that time and even if it would be in the plan's interest to cross-trade after such time.

#### The \$50 Million Test For Large Accounts

The exemption uses total assets of \$50 million as the test for a sophisticated account, applicable both to institutional investors and employee benefit plans. In recent exemptions, the Department has used a formulation in recent individual exemptions (see for example, PTE 99-50) that allows affiliated plans to be aggregated for purposes of meeting the \$50 million threshold. We believe that this definition is appropriate for the class exemption on cross-trading as well.

#### Disclosure and Authorization

The SIA objects to the level of the disclosure required under section II of the proposed class exemption. First, the proposed exemption requires the advance written authorization of plan fiduciaries. In the SIA's view, the benefits of cross-trading are so obvious to most plan sponsors (and indeed the reason they select large indexers to maximize crossing opportunities), that negative consent after disclosure should be sufficient. The proposed exemption requires that the disclosure detail the requirements of the exemption, which in the SIA's view, is burdensome and duplicative since the final exemption must also be provided to clients prior to authorization. In addition, the proposed exemption requires a statement to the effect that "the Manager will have a potentially conflicting division of loyalties and responsibilities to the parties to any cross-trade transaction." The statement must also explain how the Manager's cross-trading practices and procedures will mitigate such conflicts. In the context of model-driven trading decisions, given the pro rata allocation of opportunities, use of the closing price for all trades, and a maximum of two days in which to effect the cross-trade, the SIA is hard-pressed to understand what conflict of interest a manager will be able to cite. The Department claims to have crafted an exemption which eliminates, in its best judgment, enough of the discretion inherent in cross-trading to form a protection exemption in the interest of participants and beneficiaries. Nonetheless, it unnecessarily requires an additional warning and reminder to plan fiduciaries, as if the practice should not have been exempted at all.

Section II(m) requires that annually, each plan fiduciary be notified of any change in the triggering events for the funds in which its plan's assets are invested, any change in the triggering events for the funds in which its plan is **not** invested, and any triggering events and other disclosure items for new funds created since the last annual notice in which its plan is **not** invested. These latter two categories of disclosure are simply unnecessary and irrelevant disclosure to a plan fiduciary who has no real interest in the information, and will neither read the irrelevant information nor make the effort to pore over the disclosure to find the relevant information. A plan fiduciary should be provided only the information relevant to its plan's investments. We respectfully request that the exemption not require affirmative disclosure of this information but that it be provided on request.

We also feel strongly that the exemption should adopt a flexible approach for the required disclosure, permitting disclosure and authorization by e-mail or other electronic means, including posting information on the manager's web site, providing information by cd-rom or other electronic means, etc. As technology advances and we communicate more and more with our clients using electronic means, we believe that the continuing requirement for paper disclosure and written authorization is outdated and burdensome.

### Records

Section III(a)(3) of the proposed exemption requires that on a fund-by-fund basis, the manager must record the actual trades executed on a particular day, noting which of those trades resulted from triggering events. The requirement is not limited to cross-trades. The preamble suggests that the notation need not specify which triggering event caused the trade, provided that it is clear that some triggering event caused the trade. This requirement is unnecessary, in light of the fact that by definition, an index or model-driven fund can only trade as a result of a triggering event. It is hard to imagine a less illuminating recordkeeping requirement. Moreover, it is extremely burdensome. If, in fact, sections III(a)(2) and (3) require each purchase or sale to be tagged with a specific triggering event, we believe that the exemption will involve so much additional recordkeeping (millions of dollars worth per year per manager) that it defeats its usefulness. Marking each trade to indicate that the trade was caused by one trigger event or another is a waste of effort (and useless to a plan fiduciary).

The exemption also requires in section III(a) that the records required to be maintained must be "readily available to assure accessibility and maintained so that an independent fiduciary" may obtain them within a reasonable period of time. In an age of electronic recordkeeping and storage, a reasonable period of time must take into account archiving and formatting, processes which can take time. We believe that the Department should acknowledge that reasonable in this context may be thirty days.

Conclusion

The SIA appreciates the opportunity to comment on the proposed passive cross-trading exemption. We hope that the Department will consider and incorporate the comments we have provided. In addition, for many of the reasons set forth in this letter and the many comment letters submitted in response to the March 20, 1998 Notice, we strongly encourage the Department to propose an exemption to permit cross-trading in actively managed accounts.

In the event that you would like to discuss any of the comments in this letter, we would be happy to do so at your convenience.

Sincerely,

Maryanne Elias  
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