

TESTIMONY OF GERALD T. LINS

**ON BEHALF OF THE
SECURITIES INDUSTRY ASSOCIATION**

**BEFORE THE UNITED STATES DEPARTMENT OF LABOR
PENSION AND WELFARE BENEFIT ADMINISTRATION**

"CROSS-TRADING OF SECURITIES"

FEBRUARY 10, 2000

Ladies and Gentlemen, good morning. I am Gerald T. Lins, General Counsel, ING Furman Selz Asset Management, and I am here today on behalf of the Securities Industry Association ("The SIA"). The Securities Industry Association is a trade association comprised of nearly 800 securities firms throughout North America. Our members include brokers, dealers, banks, investment managers, and other financial institutions. As is more and more often the case now, many of our members are part of extensive financial institutions that provide a variety of financial services to the public and to each other, both domestically and globally. Given the recent financial services reform legislation, the interconnection among types of financial institutions and among our members will only increase.

Many of our members provide investment management services to the hundreds of thousands of plans covered by ERISA, plans that hold over \$7 trillion in assets. To the extent our members act as investment managers, they are deemed to be fiduciaries under ERISA, and must therefore conduct their activities within the confines of ERISA and the Internal Revenue Code. In addition, most of the SIA's members are also regulated by what may be thought of as the primary functional regulators: the Securities and Exchange Commission ("SEC") for investment advisors; the Federal Reserve Board and the Office of the Comptroller of the Currency for banks; the stock exchanges, the National Association of Securities Dealers and the SEC for broker-dealers; and state insurance commissioners for our affiliated insurance companies. All of these regulatory structures include two common themes: to act in the interest of one's clients and to avoid self-dealing. While regulators have sometimes differed in their respective approaches to various trading and management issues, we believe that clients generally benefit to the extent the applicable regulations of these agencies are coordinated and brought into sync. We believe it is important for all relevant regulators to recognize – and adapt their rules to reflect – that a given investment manager is usually managing assets for many different clients at one time: for ERISA-covered, as well as non-ERISA-covered entities, some with fairly similar investment guidelines and others with guidelines that require trading in a diametrically opposite direction. Indeed, even under one consistent style of investment management, some accounts on a given day will be receiving new assets to be invested, while others will be seeking partial or complete distributions, leading to one account selling an asset that another account will simultaneously be purchasing. A security which "grows out" of one account's guidelines (e.g., "small cap") may "grow into" another account's guidelines (e.g., "mid cap"). It is entirely appropriate for these trades to be in opposite directions. They are part and parcel of managing different accounts simultaneously, a fact of life for all financial institutions, and an attribute of successful,

experienced managers. Indeed, clients often choose managers based on the number of clients they serve and the variety of investment strategies they offer.

Cross-trading is the recognized practice of trading securities between two accounts managed by one investment manager. "Active" cross-trading occurs where the decision to trade is made by a manager and not mechanically or formulaically by a computer model. Cross-trades may be "direct," that is, the trade is executed in-house, without the intervention of a broker or payment of a commission, directly between the two accounts. Alternatively, cross-trades may also be external or "brokered," with the investment manager placing simultaneous buy and sell orders with an independent broker-dealer, who then effects both transactions at a reduced commission.

Under appropriate circumstances, cross-trades are in the best interest of both the buying and selling accounts, for example, where one plan needs to liquidate part of its account in order to make benefit payments and a second plan using the same manager and investment strategy receives a large amount of employer contributions necessitating a purchase of the securities being liquidated by the first plan. Rather than independently selling and purchasing those shares on the open market and incurring broker-dealer commissions (or price spreads) and market impact, both plans would be better off simply cross-trading the securities. Virtually all of the numerous comments received by the Department in response to its March 20, 1998 Notice agreed that cross-trading directly benefits the accounts involved. In "direct" cross-trades, aside from avoiding market impact there is also no independent broker-dealer charging a commission or a spread. With external or "brokered" cross-trades, commissions and spreads are typically reduced to minimal levels because the broker-dealer bears virtually no risk and suffers no delay in executing the trade. Commission and spread savings are particularly acute in the case of "block" trades, which involve large, institutional quantities of securities. Large blocks of securities are often more difficult for the broker-dealer to move simply due to the volume involved and may require the disassembling and subsequent reassembling of the block to meet the demands of independent buy and sell orders – complications that tend to precipitate higher commissions (and broader spreads) as well as unpredictable market impact.

Accounts also benefit from cross-trading through greater efficiencies. Cross-trading, for example, avoids the delay that arises when an independent broker-dealer cannot immediately satisfy the investment manager's order. Elimination of delays are particularly important in the context of trading institutional-sized blocks of securities because, again, these blocks must be disassembled for the seller and then reassembled for the buyer, actions that obviously take more time and effort than effecting a cross-trade.

Finally, cross-trading results in special saving when the securities at issue are traded in foreign markets. Foreign market transactions, absent the ability to cross-trade, typically involve additional costs such as settlement charges, registration fees, and taxes. In addition, often there are restrictions on the number of shares of a company that may be held by foreign entities – absent an ability to cross-trade, these restrictions could preclude a buying account from buying foreign shares because shares sold into the market by a manager's selling plans are purchased by other accounts.

In the context of trading, Section 406(b)(2)'s prohibition against a fiduciary acting on behalf of parties whose interests may be adverse to each other raises several issues. It is important to remember that the decision to *buy* or *sell* a security is distinct from the decision as to how best to *execute* the transaction. Once a decision has been made to purchase or sell a security for an account, the manager seeks to effect the transaction at the best overall price. This is true irrespective of whether one or many accounts are involved and irrespective of whether the trades are buys or sells. In almost all cases, the manager would like to have the trade done as close as possible to the then-current market price. As such, avoiding transaction costs and market impact to the maximum extent possible is critical. Cross-trading under appropriate safeguards not only reduces or eliminates attendant commissions (or mark-ups/mark-downs), but also avoids the unpredictable effects of market impact. Where a manager places buy and sell orders for different accounts in the market at or near the same time, both accounts often suffer market impact as other sophisticated traders take advantage of the trades. Cross-trades, however, can avoid the uncertainty of market impact altogether, and the potential harm to one, if not both, of a manager's clients when the manager has two or more clients trading in opposite directions.

Any time a manager deals with multiple clients, one could postulate a Section 406(b)(2) issue. However, managers generally address these situations by disclosing to customers the manner in which these "conflicts" will be dealt with, e.g., allocation of securities pro rata, allocation of securities purchased at different prices at an average price, etc. With appropriate safeguards, cross-trading for ERISA accounts can be dealt with in the same manner: disclosure in advance to customers that when another of a manager's customers seeks the opposite side of the trade, the orders will be crossed without resort to the market at the mid point of the current bid-asked spread, at the closing price for the day, at the last current reported price in the market, or at some other reasonable, objective valuation. The adherence to a disclosed trading practice eliminates any conflict inherent in the transaction.

Over the past ten years, as the Department's views on cross-trading have become more widely known, one of the examples raised by Department staff is the manager who "forces" a trade between a big, knowledgeable, high-profile plan paying fees on a performance basis and a smaller, flat-fee based, less sophisticated plan, to rid the former of a poorly performing security at an inflated price, which presumably the latter plan will not notice. Would disclosure of a client approved pricing practice ensure that an unscrupulous manager could never try to "dump" securities, in violation of Section 404's duty to act solely in the interest of one's clients, or Section 406's prohibition on acting in one's own interest or for one's own account, or Section 406's prohibition on acting on both sides of a transaction? Probably not. No more than disclosure on pricing or allocation of opportunities would prevent an unscrupulous manager with multiple clients from trying to favor one client over another. However, as the Department has said in other contexts, notably performance fees, this is a violation that could arise but is not a per se violation of the statute. We respectfully submit that the violation posed by these facts is more pointedly Section 406(b)(1), not Section 406(b)(2). In making an investment and trading decision to favor one client over another, the manager would be acting for its own account or in its own interest.

Simply put, cross-trading offers significant savings over typical transactions occurring in the open market – savings far outweigh the minimal risk of unscrupulous trades. Moreover, like a

number of other situations – such as use of affiliated brokers – any potential risk can be adequately dealt with through Section 404 and appropriate class exemption conditions. Accordingly, we appreciate the opportunity to appear before the Department to comment on the Department's approach and review what we believe would be appropriate and adequate standards and safeguards respecting the granting of exemptive relief from Section 406(b)(2).

As the Department knows from the comments received in response to its March 20, 1998 Notice, large investment management firms count the cost savings associated with cross-trading of their non-ERISA accounts in the hundreds of millions of dollars. Against these savings stands only the yet-to-be-seen possibility that a few rogue investment managers might improperly attempt to use cross-trading as a method to favor certain clients to the detriment of others. We submit that the number and quality of the trading standards and safeguards gleaned from the Investment Advisers Act of 1940, SEC Rule 17a-7 under the Investment Company Act of 1940, and certain requirements of the Department's Prohibited Transaction Class Exemption 86-128 more than adequately address the Department's concerns about the possible risks of active cross-trading. Also, it is important to remember that these standards and safeguards do not stand alone. Investment managers engaging in cross-trades will also be subject to ERISA's high fiduciary standards, as well as the other prohibited transaction provisions of ERISA Section 406(b), including Section 406(b)(1)'s prohibition on self-dealing.

The SIA's May 19, 1998 letter to the Department in response to the Department's March 20, 1998 Notice described what standards and safeguards we believe would fully protect the interests of plan participants and beneficiaries, yet also allow cross-trading when in the objective best interest of the plans involved. A brief review of those standards and safeguards at this time might be useful, however.

The first set of standards derives from the Investment Advisers Act of 1940, under which investment advisers owe their customers the highest duty of trust and fair dealing. The Advisers Act requires advisors to place the customers' interests above their own. Further, Section 206 of the Advisers Act specifically prohibits an investment adviser from engaging in any fraudulent, deceptive or manipulative conduct, including, according to SEC interpretation, a wide variety of unethical and fraudulent practices such as scalping, dumping, and misleading advertising.

Next is Rule 17a-7 under the Investment Company Act of 1940, a rule first developed in 1966 and amended several times since then. Rule 17a-7 sets forth the conditions under which the SEC will permit mutual funds and accounts under common management to engage in cross trades with each other. The conditions of the rule limit the exemption to those situations where there is no likelihood of overreaching by the investment companies participating in the transaction. In adopting Rule 17a-7, the SEC itself noted that "the interests of investors will be served by the rule in that it permits affiliated investment companies which heretofore may have chosen to avoid the application procedures of Section 17(b) of the Act by purchasing or selling securities on the open market, thereby incurring duplicate brokerage charges, to avoid the payment of brokerage by effecting the transactions with each other."

Rule 17a-7 allows cross-trading only in securities for which market quotations are readily available and at the current market price. Rule 17a-7 also requires that (a) purchases and sales

may not be for any consideration other than cash; (b) the transaction must be consistent with the policy of each investment company participating in the transaction as set forth in its registration statement and reports; (c) no brokerage commission, fee (except for customary transfer fees) or other remuneration may be paid in connection with the transaction; and (d) the board of directors of the investment company must adopt policies and procedures to ensure that the conditions of the rule are complied with, make and approve such changes to these policies and procedures as the board deems necessary, and review all transactions conducted in reliance on the rule on a quarterly basis. Moreover, the investment company must permanently maintain in an easily accessible place, a copy of the policies and procedures adopted by the board, including any changes made, and preserve for at least six years a written record of each transaction made in reliance on the rule. The requirements of Rule 17a-7 thus comprehensively address potential price and non-price conflicts presented by active cross trades between investment companies and between investment companies and other accounts with the same investment manager.

The third source of proposed standards and safeguards for active cross-trading is the Department's Prohibited Transaction Class Exemption 86-128. In PTE 86-128, the Department exempted agency cross-trades where the investment manager only has discretion on one side of a transaction. As stated in the SIA's May 19, 1998 comments, the following criteria contained in PTE 86-128 would be useful complements to the standards of Rule 17a-7 and the Advisers Act:

- (1) The transaction is performed under a written authorization executed in advance by a fiduciary of each plan involved in the transaction. This plan fiduciary must be independent of the manager directing the transaction.
- (2) The authorization is terminable at will by the plan, upon receipt by the manager of written notice of termination.
- (3) A form providing an election to terminate the authorization, along with instructions as to the use of the form, must be supplied to the authorizing plan fiduciary at least annually.
- (4) Within three months before an authorization is made, the authorizing fiduciary must be furnished with all available information that the manager seeking authorization reasonably believes to be necessary for the authorizing fiduciary to determine whether the authorization should be made, including the form for termination of authorization; a description of the manager's brokerage placement practices; and any other reasonably available information regarding the matter that the authorizing fiduciary requests.
- (5) The manager directing the cross-trades must furnish the authorizing fiduciary with either:
 - a confirmation slip for each cross-trade of securities within ten business days of the securities transaction; or
 - 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.

(6) The manager directing the cross-trades must furnish the authorizing fiduciary with 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.

The fact that the Department has provided exemptive relief in PTE 86-128 is most instructive and relevant to the issue at hand. Unlike cross-trading, where the likelihood of any direct or indirect benefit to an investment manager is generally non-existent, the use of affiliated brokers can provide some benefit to the ultimate owner of the investment manager. Nonetheless, the Department determined that, if done under appropriate safeguards, the use of affiliated brokers could offer major advantages to plans. The class exemption is now relied upon extensively, plans enjoy significant economies and cost savings and, to the best of our knowledge, there have not been any substantial abuses in managers' use of affiliated brokers since the adoption of PTE 86-128.

Although not proposed in the SIA's previous written comments, the SIA believes that at least initially, a sophisticated investor test at \$25 million in total plan assets may give the Department additional comfort that a more sophisticated fiduciary is reviewing the reports provided. Collective funds with smaller plans would also be permitted to cross-trade, so long as at least 50% of the collective fund assets were from plans with \$25 million in assets.

It is important to remember that not only do the conditions noted above provide extensive protections against possible abuse, but they also do not force any client to permit cross-trading for its account. Indeed, the procedures include an easy and effective "exit" if and whenever the client desires it. As such, to the extent a client decides it does not have the time and/or resources to review information about cross-trading, it could simply execute the termination form and send it to the manager. The client is never "locked in" to cross-trading.

The SIA respectfully submits that the foregoing procedures and conditions so minimize the speculative risks of improper cross-trading that such risks cannot justify forcing ERISA plans to incur the millions of dollars in unnecessary commissions, fees and price spreads that result from the inability to actively cross-trade. Moreover, even assuming that there may be a handful of unscrupulous managers who attempt to trade improperly, ERISA's other fiduciary and prohibited transaction provisions, including Sections 404 and 406(b)(1), would provide potent and ready remedies for such misconduct. Indeed, for several reasons, we believe the Department should embrace cross-trading and encourage its use by managers under appropriate conditions. First, in addition to eliminating the detrimental market impact and other transactions 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. Second, cross-trading would be done under prescribed conditions to ensure fair treatment and pricing. Finally, although cross-trading is already an item in the examinations by the SEC and other regulators, its use by ERISA plans would only heighten the scrutiny and review it receives.

In sum, we respectfully request that the Department reconsider its view that the prohibition of ERISA section 406(b)(2) is per se. If it is unwilling to do so, the SIA requests an exemption

permitting active cross-trades; in our view, those trades are objectively in the best interest of both plans and their participants and beneficiaries. We believe the Department should grant significant exemptive relief from this prohibition and allow investment managers to pursue more advantageous returns for all of their clients, particularly where all of the securities laws protections and additional protections drawn from the Department's own exemptions would be available as conditions to the relief. Given the availability of objective standards and safeguards, the enormous cost savings that cross-trading affords far outweighs the minimal risks that a very small handful of investment managers might ignore the harm to their overall performance measures and attempt to improperly favor one client over another. The Department has all of the remedies available under Section 404 and Sections 406(a)(1)(D) and (b)(1) to address those few cases, if they exist. Where cross-trading does not result in such improper favoritism, it should be permitted and the relief should be proposed promptly. Accordingly, the members of the SIA urge the Department to implement such standards and grant class exemptive relief from the prohibition of ERISA Section 406(b)(2).