The Asset Management Industry
SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

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Comment Letter with the Department of Labor on Cross Trades, May 1998

May 19, 1998

Pension and Welfare Benefits Administration
Office of Exemption Determinations
Room N-5649
200 Constitution Avenue, N.W.
Washington, DC 20210

Attention: "Cross-Trades of Securities"

Ladies and Gentlemen:

The Investment Company Institute[1] (the "Institute") respectfully submits the following comments in response to the notice entitled "Cross-Trades of Securities by Investment Managers."[2]

The Institute and its membership have been actively interested in cross-trading issues for many years, having first requested guidance from the Department of Labor (the "Department") on cross-trading in 1983. The Institute's consistent position has been that the Department's exemptions for cross-trading under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") should be harmonized with rules under the securities laws governing cross-trading, specifically Rule 17a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"), 17 C.F.R. § 270.17a-7.

The Institute continues to believe that this approach is the correct one, for several reasons. First, cross-trading can benefit clients by reducing costs. Second, the overly and unnecessarily restrictive conditions in the Department's past exemptions have harmed pension plan clients by denying them the opportunities that other clients enjoy. Third, Rule 17a-7 has proven to be an effective means of distinguishing between cross-trading that is in the best interests of clients, and cross-trading that is not. Contrary to the assertions set forth in the Notice, Rule 17a-7 is not simply a pricing rule; it is responsive to the very same concerns that the Notice discusses and that underlie Section 406(b)(2) of ERISA. Fourth, as the Institute recently stated in a letter to the Assistant Secretary for Pension and Welfare Benefits and the Director of the Division of Investment Management of the Securities and Exchange Commission (the "SEC"), having the two regulatory bodies adopt coordinated standards to govern the same conduct would be the embodiment of "good government" and is entirely consistent with what has been an important stated objective of this Administration.

Each of these points is discussed in detail below. We believe they provide a compelling reason for the Department to adopt a class exemption that closely parallels Rule 17a-7, and to do so expeditiously.

I. Cross-Trading Can Benefit Clients

A. Investment Management Decisions

Investment advisers frequently encounter situations where it is in the best interests of one client to sell a particular security while it is in the best interests of another client to buy that same security. This can occur when the client is an investment company, an employee benefit plan or any other type of investment account. Examples of such situations are set forth below:

Management of Cash Flow. The named fiduciary of one plan with an account managed by an investment adviser may need to make distributions to participants, necessitating that part of the account be liquidated to make cash available on the distribution date. At the same time, another plan with an account managed by the same investment adviser using the same investment strategy may have just received a large cash inflow due to employer or employee contributions. Because both accounts are using the same investment strategy, the securities to be bought and sold may be identical.

This situation arises both with accounts that are "passively" managed in accordance with an index or model,[3] as well as with

accounts that are "actively" managed.

Reclassifications of Securities. An investment adviser may change the classification of a security, making it more appropriate for certain accounts and less appropriate for others. For example, a security issued by a growing company that was formerly considered "small capitalization" might be determined to constitute a "mid capitalization" security, or a stock considered a "value" investment might be reclassified as a "growth stock" in response to an increase in the stock's price. The adviser may then determine that it is appropriate to adjust its clients' holdings of that security, in accordance with the investment objectives and policies of those clients. In the latter situation, accounts with a "value" focus may want to dispose of the "growth stock," while accounts with a "growth" strategy may seek to acquire it.

Accounts with Different Portfolio Managers. Even in the absence of a formal reclassification of a security, different clients may be following independent strategies because they have different portfolio managers or management teams. It is possible that the managers of one client will determine it is appropriate to sell a particular security, while another client's managers wish to buy that same security.[4]

The above are only examples. It should be noted that in each case, the investment decisions are made independent of the opportunity to cross-trade, and are based on the objectives and policies of the particular accounts.

B. Trading

In situations, such as those described above, where an investment adviser determines that it is appropriate for one client account to sell the same securities that another client account should purchase, it may be possible to match the sale and purchase orders so as to "cross" the trade between the two accounts, rather than having both transactions executed in the market. Crossing the trade saves commissions and other transaction costs for both the selling and purchasing accounts because no broker is involved; the manager, on its part, derives no separate fee or other benefit from executing trades in this manner.[5]

For these reasons, investment advisers, consistent with their fiduciary duties to their clients, often will seek to take advantage of opportunities to cross-trade.[6] Indeed, our members have informed us that many prospective clients view the ability to provide cross-trading as an important factor in selecting an investment manager. In the case of investment company clients, such cross-trades must be in conformity with the requirements of Rule 17a-7 under the 1940 Act. In addition, it is our understanding that many of that rule's provisions, such as the pricing provisions, are applied in connection with cross-trading involving clients other than investment companies.

Unfortunately, as discussed further below, one class of clients is, for the most part, currently not able to receive the benefits of cross-trading—pension plans subject to regulation by the Department of Labor under ERISA.

II. The Department's Overly Restrictive Conditions Are Harmful to Plan Clients

To date, investment advisers have generally been unable to offer their pension plan clients the benefits that can arise from cross-trading. This is the case even where the investment adviser strictly adheres to the broad fiduciary standards of ERISA and the cross-trade is prudent and in the best interests of the plan.

A portfolio manager at an investment advisory firm acting with discretion on behalf of an ERISA plan is a fiduciary under ERISA, and is obligated to make investment decisions on behalf of the plan in accordance with ERISA's fiduciary standards.[7] In addition, the firm is subject to these fiduciary duties when determining how the investment decisions can be best executed. Cross-trading is often a prudent trading alternative and in the interests of the plan because of the savings in transaction costs compared to other trading alternatives.

Cross-trading, however, may raise issues under ERISA Section 406(b)(2). Under that section, a fiduciary is prohibited from acting in any transaction involving a plan on behalf of a party whose interests are adverse to the interests of the plan. Merely representing both sides in a transaction, according to the Department, presents an adversity of interests in violation of Section 406(b)(2)—even in the absence of fiduciary misconduct or harm to a plan's beneficiaries. To date, the Department has offered only limited relief from this prohibition, in the form of individual exemptions for both index or model-driven portfolios and actively managed portfolios. Otherwise, cross-trading is generally prohibited.[8]

The exemptions that have been granted in the case of actively managed portfolios have been too restrictive to be of any practical use because, among other things, they require prior independent authorization of each cross-trade and impose price and volume limitations. As a result, investment managers who have obtained such exemptions have found it impractical to use the relief for actively managed accounts at all.

For a number of reasons, the requirement to obtain prior independent authorization of each cross-trading opportunity from an independent fiduciary imposes substantial impediments to conducting a cross-trade for an actively managed account. First, a cross-trade opportunity may disappear during the delay required to seek approval because the other side of the trade may need to go forward in the meantime. Second, given the fast-paced nature of the securities markets, these delays can affect the ability of the trading desk to effectuate the trade under the specific market conditions that led the manager to request the trade to begin with. Third, clients such as plan sponsors, having delegated investment management authority to the manager, do not want—nor have the time—to be involved in approving specific transactions on an ongoing basis. These problems are compounded where a pooled investment fund is involved, because there are many more fiduciaries from whom consent would be required. In brief, this restriction effectively prevents those who have obtained such exemptions from implementing a meaningful cross-trading program for their actively managed accounts.

The pricing condition imposed as a condition to exemptive relief for actively managed accounts also poses a significant problem. The condition imposed by the Department requires that the trading price remain within 10% of the closing price on the day before the manager receives authorization to engage in the cross-trade. Changes exceeding 10% of a security's market price, however, are not uncommon. In fact, such price changes may increase the need to execute the trade as soon as possible. This condition, however, imposes an additional delay in order to seek a new authorization.

Under the volume limitation imposed by the Department, the cross-trade must involve less than 5% of the aggregate average daily trading volume during the week preceding the trade, unless waived. This limitation can present compliance difficulties and prevent plans from participating in desirable cross-trade opportunities.

The Department should take a more flexible and workable approach. Under ERISA Section 408(a), the Department has broad authority to exempt classes of transactions from Section 406 prohibitions where such relief is (1) administratively feasible, (2) in the interests of the affected plans, and (3) protective of the rights of participants and beneficiaries. The Institute submits that the SEC's experience with Rule 17a-7, as discussed below, demonstrates that the adoption of a similar class exemption under ERISA would be fully in accord with the requirements of Section 408. Moreover, any such exemption would not relieve the fiduciary from its other duties under ERISA, including those under Sections 403, 404 and 406(b)(1). We further note that such an exemption would be consistent with the views of Congress. The ERISA Conference Report directed the Department to use the exemption procedure "in order not to disrupt the established business practices of financial institutions which performs [sic] fiduciary functions in connection with these plans consistent with adequate safeguards to protect employee benefit plans."[9] Clearly, cross-trading in accordance with Rule 17a-7 is precisely this type of "established business practice."

Thus, the Department has ample authority to grant the exemption we are proposing.[10] Such a step would benefit plan clients by permitting them to receive the same cost savings that are available to other clients. The remaining issue is whether these opportunities can be given to plan clients without subjecting them to the various forms of abuse discussed in the Notice, including dumping and cherry-picking. As is discussed below, the Institute believes that Rule 17a-7 has shown that it is possible to provide clients the benefits of cross-trading while minimizing their exposure to such abuses.

III. Rule 17a-7 Provides a Model for an Appropriate Class Exemption

As is discussed in the Notice, cross-trading by registered investment companies must be in accord with the requirements of Rule 17a-7 under the 1940 Act, which exempts certain cross-trades from the broad prohibitions of Section 17(a) of that statute. Rule 17a-7 requires that any cross-trade be effected at a current market price, and sets forth various requirements for how to determine the current market price for different types of securities. It also requires that the transaction be consistent with the investment objectives and policies of the fund in question, that the security have readily available market quotations, that no commission or other fee (other than customary transfer fees) be paid in connection with the transaction, and that the fund's board (including a majority of directors who are not "interested persons") adopt procedures to ensure that the requirements of the rule are followed and determine no less frequently than quarterly that the transactions during the preceding quarter were in fact effected in compliance with these procedures. The rule also requires funds to maintain detailed records on all cross-trading transactions for a minimum of six years.

The Notice asserts that "proponents advocating the adoption of a similar exemptive standard" under ERISA "assume[ ] that if both sides of a cross-trade transaction receive a fair and objectively determined price for a security, there should not be any concern about potential fiduciary abuses under ERISA in connection with the transaction." The Notice goes on to state that the Department is not convinced that "reliance upon an objective fair price alone" will ameliorate the potential for conflicts such as dumping and cherry-picking, or allocating investment opportunities in an improper manner.

These statements in the Notice are, at the very least, rather enigmatic. They ignore the fact that Rule 17a-7 does not simply govern how the price for a security in a cross-trade transaction is to be determined, but rather imposes additional conditions designed to ensure that the transaction is in the fund's interests. They further suggest that ERISA restricts abuses that are not addressed under

the 1940 Act. This is simply not true. In fact, the very same concerns about potential conflicts in dealing with affiliates underlie both Section 17(a) of the 1940 Act and Section 406 of ERISA.

Attached as an Addendum [ed. note: not included on this website] to this comment letter is an analysis of Rule 17a-7 prepared by counsel to the Institute. The Addendum demonstrates that abuses such as dumping and cherry-picking are precisely the ones that led to the enactment of Section 17(a), and that the SEC sought to ensure that their potential would be minimized in adopting (and subsequently amending) Rule 17a-7.

Set forth below is a more detailed discussion of some of the potential abuses identified in the Notice, and why the Institute believes that a class exemption based on Rule 17a-7 would adequately address them.

Dumping and Cherry-picking. The Notice discusses the potential for an investment manager to use ERISA accounts to buy or sell securities in order to serve the interests of other clients. If the ERISA account is purchasing the securities under such circumstances, this could constitute "dumping." (An example of this, discussed separately in the Notice, would be placing relatively illiquid securities in ERISA accounts or otherwise using them to provide "artificial liquidity" or "price stability.") If the ERISA account is selling the securities, this could constitute "cherry-picking."

Rule 17a-7, however, contains provisions expressly designed to guard against these abuses. First, the rule's pricing provisions are intended to ensure that the client will not be forced to pay an inflated price (when it is purchasing a security) or receive a reduced price (when it is selling a security) for the benefit of another client. Thus, the rule protects against one obvious way in which a cross-trade could work to the disadvantage of a client.[11] The rule also is conditioned upon the security having readily available market quotations; this provision is designed to ensure that the price will be an accurate one (as well as eliminating the potential for the transaction being done in order to remove illiquid securities from a favored account).

Second, the rule requires that the transaction be consistent with the investment objectives and policies of the client. Thus, a transaction entered into in order to benefit another client would not be appropriate under the rule. The rule also requires the fund's board to review all transactions conducted under the rule on at least a quarterly basis. This permits the board to see if, for example, attractive holdings were transferred to other accounts, or less attractive holdings were transferred from other accounts.[12]

Finally, dumping and cherry-picking still would constitute a violation of the securities laws (e.g., Section 206 of the Investment Advisers Act), as well as Section 404 and Section 406(b)(1) of ERISA. Thus, both the SEC under the securities laws, and the Department and plan fiduciaries and participants under ERISA, would be permitted to take enforcement action in response to any such transactions.[13] Recordkeeping requirements such as those in Rule 17a-7 facilitate the ability of independent parties and regulators to review the transactions for these abuses, should they occur in connection with cross-trades, and take appropriate action.[14]

Unfair allocations of cross-trading opportunities. The Notice raises the concern that cross-trading opportunities, and the savings associated with them, would be allocated to favored client accounts (such as those with performance-based fees).

As a preliminary matter, the Institute must note that, as a result of the Department's current position, all plan clients (with minor exceptions) are denied the savings from cross-trading, and the benefits are limited to other accounts. Thus, to the extent the Department were to adopt a broad class exemption in this area, this concern would be ameliorated, as more plan clients would be able to participate in cross-trading opportunities.

More generally, pursuant to their fiduciary duties under both ERISA and the federal securities laws, investment advisers would be required to treat their customers fairly in allocating cross-trading opportunities. While we believe such a duty is implicit, we would not object to it being included as a condition in any class exemption that the Department might issue. A similar requirement has been included in individual exemptions granted by the Department. The Institute does not believe, however, that it would be in the best interests of ERISA accounts or other clients to require that such allocations be done in accordance with a rigid or mechanistic formula (e.g., pro rata). Such an approach may not be optimal in many circumstances (e.g., in the case of a de minimis transaction that would result in the allocation of odd lots to certain accounts). The Department should instead require managers to develop proper procedures to ensure that securities are allocated in a fair and equitable manner and to document how allocation decisions among clients are made.

Improperly Influencing Portfolio Management Decisions. The Notice suggests that the ability to engage in cross-trading might cause an investment adviser to engage in a transaction for one of its clients that it might not otherwise do. For example, if one client wished to purchase a certain security, the adviser might be tempted to have another client sell that security directly to it, whereas, in the absence of cross-trading, the second client might have instead sold another security.

While, as set forth above, there are numerous circumstances in which two clients of the same adviser will legitimately engage in matching transactions, causing any client to engage in a transaction in order to benefit another would constitute a violation of both

ERISA and the federal securities laws. Requirements to disclose all cross-transactions, and to keep records of all such transactions, would serve as important safeguards against these type of abuses.

Precluding Clients from Benefiting from Market Impact Costs. The Notice suggests that cross-trading can be problematic because one account could fail to realize the benefits that would result from the market impact of the other account's trade in the open market.[15]

It is far from clear what conclusion one should draw from this assertion. In the cases described in this letter—where two clients engage in offsetting transactions for reasons independent of any cross-trading potential—the issue cannot be avoided simply by prohibiting cross-trading. For example, take the case where the trading desk of an investment adviser receives an order to sell 50,000 shares of Company X with respect to Client A, and an order to buy 50,000 shares of Company X with respect to Client B. Assume further that neither order must be executed immediately. Finally, assume that the entry of either a sell order or a buy order will have a market impact. Presumably, at least in many cases, the fairest thing to do in such a situation would be to cross the trades—thereby saving the transaction costs and avoiding disadvantaging either client.[16]

Concerns Over Pricing Methodology. The Notice also raises concerns with certain aspects of the methodologies employed under Rule 17a-7 to ascertain current market price. For example, it describes a scenario in which an investment adviser anticipates a drop in the price of a stock and causes a favored client to buy the stock from an ERISA account (presumably rather than buying it at a higher price in the open market).

As an initial matter, this scenario is a highly unlikely one. "Anticipated" price changes can turn out to be wrong; indeed, the 1940 Act generally follows a "forward pricing" rule precisely in order to minimize the potential for transactions that benefit insiders.[17] Moreover, an adviser that wished to ensure that a client received a specific price on a given day need not engage in a cross-trade to do so; it could simply enter a limit order specifying that price. Thus, we do not believe that the Department's concern is a realistic one. Furthermore, to the extent a trade is contrary to the interests of a client, the various ERISA and securities laws remedies described above would be available.

As for the time to determine the price, using the current price, as contemplated in Rule 17a-7, is the most equitable way to price a cross-trade. For example, if trading instructions that can be crossed are issued early in the day, then, consistent with the trader's duty to obtain best execution, the best course for executing the trades would often be to use the prevailing market price at that point during the day to avoid potential downside market risk.

To the extent, however, that the Department has concerns or questions about the specific methodologies employed under Rule 17a-7, we would urge the Department to conduct a joint request for comment on this subject with the SEC. As is discussed further below, an important objective for both the Department and the SEC should be to maximize consistency between their rules. For Rule 17a-7 and any class exemption promulgated by the Department to employ different pricing methodologies would be a compliance nightmare, and should be avoided at all costs.

In conclusion, we believe that the conditions imposed under Rule 17a-7 are fully responsive to the concerns raised by the Department in the Notice. This should come as no surprise—they are the same concerns that Rule 17a-7 was meant to protect against.

Of course, no regulatory regime can offer a complete guarantee against abuse. But a class exemption based on Rule 17a-7 would minimize the potential through its use of a rigorous pricing methodology, full disclosure to clients of each transaction, extensive recordkeeping requirements, limitations to readily marketable securities, and the general requirement that each transaction be consistent with the client's objectives and policies. And both the Department and the SEC, as well as independent fiduciaries and plan participants, would retain the ability to prosecute and punish abusive transactions, even if they otherwise complied with the exemption. Thus, we believe the Department was simply in error when it reached the conclusion announced in the Notice that Rule 17a-7 would not adequately protect employee benefit plans.

IV. Consistent Regulatory Requirements for Cross-Trades Would Be Consistent with Administration Policy

As discussed above, both the Department and the SEC share common fiduciary concerns with respect to cross-trades. Although the goals of the DOL's and SEC's regulations are the same, the standards they have adopted are different, and these differences have resulted in investment advisers being forced to forego cross-trades that would have been in the best interests of their pension plan clients.

The Administration has determined that, where possible, regulatory agencies should endeavor to impose consistent requirements for

similar activities or transactions. Therefore, consistent with the Administration's "Reinventing Government" initiative as implemented through Vice President Gore's National Partnership for Reinventing Government, investment advisers should be subject to a uniform standard when effecting cross-trades for ERISA-covered plans, mutual funds and other clients. Requiring investment advisers to adhere to conflicting regulatory requirements for similar transactions, but for the type of client involved, is an example of government acting at cross-purposes. Indeed, presumably this is exactly the type of regulatory inconsistency that the Administration has set out to abolish through its Reinventing Government initiative.

Under the Administration's standard of good government—where regulatory agencies with similar goals work together to ensure that parties engaging in similar transactions are subject to consistent rules and regulations—the rules for investment advisers engaging in cross-transactions should be consistent regardless of the type of client involved. Consistent rules make sense because the DOL and the SEC share the same underlying policy concerns regarding cross-trades. They both seek to ensure that a fiduciary fulfills its duties to its clients and that the interests of the investors are fully protected.

V. Conclusion and Recommendations

For all of the above-mentioned reasons, the Institute strongly urges the Department to adopt a class exemption modeled on Rule 17a-7 under the 1940 Act. Set forth below are specific suggestions for provisions that should be included in such an exemption.

Requirement that the transaction be consistent with the investment objectives and policies of the plan. This provision is necessary to ensure that the transaction is consistent with the plan's best interests, and is based on a similar provision of Rule 17a-7.

Requirement that any security that is the subject of a cross-trade transaction be one for which market quotations are readily available. This provision of Rule 17a-7 is intended to limit the scope of the rule to securities that are not illiquid, and facilitates compliance with the pricing requirements. The Department has imposed a similar condition in its exemptions.

Requirement that the transaction be effected at current market price in accordance with specified methodologies. The pricing requirements of Rule 17a-7 are an important feature—though not the only one—of the rule. As discussed above, if the Department believes that the methodologies should be revised, it should do so in the context of a joint effort with the SEC.

Requirement that no commission or fee be paid in connection with the transaction, other than customary transfer fees. This provision ensures that both parties benefit from the cost savings under a cross-trade, and that there is no direct benefit to the adviser. The Department has imposed a similar condition in its exemptions.[18]

Requirement that plans approve procedures governing cross-trades and receive detailed quarterly reports on all trades conducted in accordance with these procedures. As discussed above, this provision of Rule 17a-7 helps to minimize the potential for dumping, cherry-picking and other abusive transactions by requiring full disclosure to the client. As was also discussed above, we believe such a provision is no less effective, and indeed perhaps more effective, than a pre-approval requirement, which the Department currently imposes on actively managed plans. Not only is it far more useful and easy to comply with, but it is also a better mechanism for policing trades. Such reports would enable the client to discern specific patterns of cross-trading in the context of an entire portfolio, which may not be as easily discernible on a transaction-by-transaction basis. Thus, the Department should, in general, require the approval of procedures governing, and quarterly reporting of, cross-trades.

Quarterly reporting, however, may not be appropriate or necessary in the case of index or model-driven accounts. This is primarily due to the sheer volume of transactions that these accounts may engage in. We would encourage the Department to fashion alternative protections (such as initial disclosure and authorization) for these specialized strategies.

One open issue is whether these procedures and reports should be adopted and received by the plan sponsor, or a specially retained independent fiduciary. In general, the Institute believes that it should be sufficient for the plan sponsor to serve in this capacity (unless, of course, it chooses to employ an independent fiduciary for this purpose). Such an approach avoids unnecessary costs. Nevertheless, the Institute would not object if the Department required smaller plans to retain an independent fiduciary for these purposes, if it is concerned that sponsors of such plans may lack the expertise necessary to conduct an informed review of the cross-trades. The Department should be aware, however, that this may disadvantage smaller plans by imposing additional costs upon them. Larger plans, those with over $25 million in assets, which would have the requisite expertise, should not be required to utilize a specially retained independent fiduciary.[19]

Recordkeeping requirement. The class exemption should contain a recordkeeping requirement similar to Rule 17a-7. This will aid in inspections and enforcement under ERISA.

Requirement that advisers adopt proper procedures to ensure fair allocation of cross-trading opportunities. While such a provision is not included in Rule 17a-7, we would not object to the Department imposing such a requirement in a class exemption. A similar

requirement has been included in individual exemptions granted by the Department. As is discussed above, however, the Department should not require that these procedures employ rigid or mechanistic criteria.

Other conditions. The Department should not include other conditions that it has insisted on in previous individual exemptions it has granted for actively managed accounts. These include the pre-approval requirement (which would not be needed if the Department imposes the quarterly reporting requirement we recommend),[20] the volume limitations and the restriction on changes in the price of the security (which would be meaningless in the absence of pre-approval).

A class exemption along the lines set forth above would fully protect the interests of retirement plans, their participants and their beneficiaries. Indeed, it would enhance their interests, by permitting them to take advantage of opportunities that other clients enjoy.

The Institute appreciates the opportunity to express its views on this important matter. We would be happy to meet with the Department to discuss any of the issues raised in this submission. If you have any questions or would like to arrange such a meeting, please contact the undersigned.

Very truly yours,

Craig S. Tyle

cc: The Honorable E. Olena Berg
Ivan L. Strasfeld, Esq.
Louis J. Campagna, Esq.
E.F. Williams, Esq.
Michael Schloss, Esq.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients, including retirement plans. In addition, the Institute's membership includes 487 associate members which render investment management services exclusively to non-investment company clients. A substantial portion of the total assets managed by registered investment advisers are managed by these Institute members and associate members.

[2] See 63 Fed. Reg. 13696, March 20, 1998 (the "Notice").

[3] "Index" funds are accounts that are managed so as to track as closely as practicable the total rate of return of a stock or bond index, such as the Standard & Poor's 500 Index (large capitalization U.S. equities) or the Russell 2000 Index (small capitalization U.S. equities). "Model-Driven" funds are accounts whose investments are determined by a computer model that uses prescribed objective criteria, typically criteria that relate to the performance of a specific segment of the public securities market. The model looks at structural aspects of the securities markets rather than involving an active evaluation of the securities themselves, and thus is managed in a manner similar to an index fund.

[4] This can occur not only when both such accounts are actively managed, but also when one or both is following an index or model-driven strategy.

[5] Transaction costs can take the form of a commission, which is paid to a broker that is acting as an agent for a customer, or a spread, which represents the difference between the price a dealer is willing to pay for a security and the price at which the dealer is willing to sell the same security. In addition, especially for securities traded primarily in foreign markets, transaction costs may include settlement charges, registration fees and taxes.

[6] The Notice raises the question of whether the emergence of electronic proprietary trading systems, the growth of block trading or the move to decimalization of stock quotes would have any effect on cross-trading programs, presumably by reducing the available cost savings.

The emergence of electronic proprietary trading systems, such as Instinet and Posit, has not had any effect on cross-trading programs, nor would it be anticipated to have any effect. These systems, which match purchase and sale orders received from investors, impose transaction costs for their use, usually $.01-$.02 per share traded. While these costs may be less than the market transaction costs that would otherwise be incurred, they still make the use of these systems more costly for client accounts than cross-trading.

Similarly, block trading involves transaction costs as a means to compensate the brokers involved. Block trading describes the process used by investors to dispose of large blocks of securities. A broker-dealer who acts as a "block trader" will purchase the

block of securities for its own account, off the market, and then will either retain the securities or attempt to sell them over an extended period. In fact, firms that engage in block trading may charge higher commissions or spreads than other firms because they need to put their own capital at risk. Therefore, growth of block trading should not have any effect on cross-trading programs.

The same response also applies to the question of whether the move to decimalization of stock quote spreads would have any effect on cross-trading programs. While decimalization may decrease spreads between bid and ask quotations, there will still necessarily be spreads, because those spreads are the source of compensation for broker-dealers trading securities on a principal basis. Paying those spreads can be avoided only by avoiding transaction costs, such as through cross-trading.

[7] Investment managers that exercise investment discretion over the assets of a plan are fiduciaries subject to the fiduciary responsibility rules set forth in Title I, Part 4 of ERISA. ERISA Section 3(21)(A)(i). As such, they must act solely in the interests of the participants and beneficiaries of the plan, for the exclusive purpose of providing benefits to them and defraying reasonable expenses of administering the plan. They are also required to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man 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. Finally, managers are prohibited from dealing with plan assets in their own interest or for their own account. ERISA Sections 403(c)(1), 404(a)(1), 404(a)(1)(A), 404(a)(1)(B), 406(b)(1).

[8] A class exemption from Section 406(b) permits a fiduciary to act as agent in an "agency cross transaction," and to receive reasonable compensation for effecting or executing such a transaction. PTE 86-128, 51 Fed. Reg. 41686 (Nov. 18, 1986). However, for this class exemption to be available, the person effecting or executing the agency cross transaction may not have discretion on both sides of the transaction, but may act only for either the buy side or the sell side. As a result, a large number of potential cross-trading opportunities, such as those we discuss in this submission, are not covered by PTE 86-128 and are unavailable for ERISA plans.

[9] H.R. Conf. Rep. No. 1280, 93rd Cong., 2d Sess. 309 (1974).

[10] The statement in the Notice that a cross-trade that comports with the requirements of Rule 17a-7 may still result in a per se violation of Section 406(b)(2), even if the result is favorable to the plans involved, itself is the most compelling reason to adopt a class exemption for such transactions.

[11] Concerns that the Notice raises about the prices mandated under Rule 17a-7 are discussed infra.

[12] The very same rationale underlies the condition included in the Department’s individual exemptions for actively managed accounts that required prior approval of any cross-trade. For the reasons discussed above, such a condition is not feasible. Post-trade reporting accomplishes the same objective, in a manner that is much less burdensome and more consistent with client expectations. Furthermore, questionable transactions are more likely to be detected in a quarterly review, where they can be analyzed in the context of other portfolio transactions and in light of subsequent performance.

[13] In the case of a bank acting as an adviser, the Board of Governors of the Federal Reserve system, the office of the Comptroller of the Currency or state banking regulators could bring actions.

[14] The Notice also discusses front-running. Front-running occurs when an investment adviser trades (or causes a favored client to trade) ahead of a client, thereby avoiding any market impact costs caused by the client’s trade and/or profiting from such impact costs through a subsequent transaction. Front-running is a violation of the federal securities laws, as discussed in the Addendum. We do not believe that the ability to cross-trade in any way increases the potential for front-running.

[15] Market impact costs are a measure of the price adjustment that occurs as a result of a transaction. For example, a sell order may cause the price of the security in question to decline. All things being equal, market impact costs will be greater the larger the trade in question is, and where the market for the security is less liquid.

[16] Moreover, whether a trade will have market impact and, if so, the extent of such impact, will often be uncertain. In contrast, cross-trading will result in a definite savings from the avoidance of transaction costs that will benefit both clients.

[17] Rule 22c-1 under the 1940 Act requires that purchase and redemption orders for mutual fund shares be effected "at the current net asset value of such security which is next computed after receipt [of the order]."

[18] It should be made clear, however, that, as in Rule 17a-7, customary transfer fees (which are generally de minimis) would be permissible.

[19] See, e.g., Black Rock Financial Management L.P. (60 Fed. Reg. 39012, July 31, 1995), Capital Guardian Trust Company (54 Fed. Reg. 53397, December 28, 1989).

[20] Similarly, a quarterly reporting requirement obviates the need to confirm transactions within ten days.

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