Comment Letter on Cross Trades, February 2000

Via Hand Delivery

February 14, 2000

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

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

Ladies and Gentlemen:

The Investment Company Institute[1] (the "Institute") respectfully submits the following comments regarding the proposed class exemption for cross-trades of securities by Index and Model-Driven Funds.[2]

The Institute and its membership have been actively interested in cross-trading issues since first requesting guidance from the Department of Labor (the "Department") on these matters in 1983. Most recently, in May 1998, the Institute submitted comments in response to the Department's notice entitled "Cross-Trades of Securities by Investment Managers."[3]

As we discussed in our prior correspondence, cross-trading can provide significant tangible benefits to advisory clients, in the form of savings of commissions and other transaction costs. ERISA clients, however, have largely been denied these benefits because of concerns about potential violations of the ERISA prohibited transaction rules. While the Department has in the past granted individual prohibited transaction exemptions for cross-trading, it has granted only a limited number for passively-managed accounts, and those for actively-managed accounts contain a number of restrictive conditions that render them unusable. In recent years, no individual exemptions have been granted.

In limiting cross-trades in this manner, the Department has been concerned that an adviser might enter into a cross-trade transaction that is in the interests of the client on one side of the trade but not necessarily in the interests of the client on the other side. The Institute has said previously, and continues to believe, that such a risk – to the extent it exists – can be addressed through the adoption of a class exemption with appropriate conditions. Consistent with this view, we generally support the Department's proposal of a class exemption for passive cross-trades. The proposal recognizes that cross-trading by Index and Model-Driven Funds, and pursuant to Large Account portfolio restructuring transactions, relies on objective factors and data, and as such does not give rise to the types of risks that are of concern to the Department. We continue to believe, however, that there is no need to limit the exemptive relief to passively-managed accounts, and that the Department should adopt a class exemption that covers actively-managed accounts as well. We discussed this point in detail in our testimony presented at the Department's public hearing on February 10, 2000, a copy of which is attached.

Nevertheless, we appreciate the Department moving forward on this issue and hope that the proposed exemption, together with the hearing on active cross-trading, represent evidence of continued progress on cross-trading issues. The Department should grant the class exemption as soon as possible so that employee benefit plans may, at least to this limited extent, enjoy the benefits of cross-trading in the same manner as other managed accounts of registered investment advisers.

Notwithstanding our general support for the Department's proposal of a class exemption in this area, we believe that several of the conditions in the proposed class exemption go beyond what is necessary. In addition, there are aspects of the exemption that require clarification. These comments are discussed in detail below.

I. Requested Modifications

1. "Blackout" Period for Model-Driven Funds

Section II(c) of the proposed exemption would require that if the cross-trade involves a Model-Driven Fund, it may not take place within ten business days following any change made by the Manager to the model underlying the Fund. In connection with this condition, the Department has sought comments as to whether a 10-day blackout period would be an acceptable approach to address the Department's concerns regarding model changes that may be timed to create additional cross-trading opportunities, or whether there are other approaches that would be equally effective but less burdensome to the Manager's operation of the Fund.

The blackout period approach would be not only burdensome but also unnecessary. It is premised on the mistaken notion that Managers may manipulate computer models to create cross-trading opportunities. This is not the case. The models in question are based on a series of assumptions and calculations, incorporating such factors as economic indicators and weightings of different asset classes and industry sectors. The performance of these models is analyzed on an ongoing basis, and changes may be made to improve investment performance. We understand that such changes do not occur on a routine basis, but only after an internal review process. Current practice is to notify affected clients when a fund model is changed, providing independent oversight of such changes and their resulting effects on the fund.

Not only are changes to computer models subject to various controls, but the definition of a "Model-Driven Fund" in Section IV(b)(1) requires that the data used by the model be independent third-party data not within the control of the Manager. Consequently, the data--the key component that determines the trading prescribed by the model--is not subject to manipulation.

Furthermore, a model change can, depending on the nature of the change, result in significant trading activity by a Model-Driven Fund. Thus, the period immediately following a model change may be the period during which the Fund can best realize the benefits of cross-trading. As a result, the 10-day blackout period requirement would not be in the interests of the plan investors.

For these reasons, the 10-day blackout period condition should be deleted. Moreover, because there is no foundation to the concerns underlying the blackout period condition, given the objective nature of the operation of Model-Driven Funds, we see no need for an alternative approach to address those concerns.

2. Definition of Equity Securities

Section II(f)(1) of the proposed exemption would require that cross-trades of equity securities involve only securities that are "widely-held" and "actively-traded," in addition to the requirement that market quotations for the securities be readily available from independent sources. The terms "widely-held" and "actively-traded" are deemed to include any security listed in an "Index" (as that term is defined in the proposed exemption).

The requirements that an equity security be "widely-held" and "actively-traded" are not necessary for an exemption for cross-trading by Index and Model-Driven Funds. For such funds, security selection is driven solely by objective factors. Because the level of trading and diversity of holdings are not relevant to security selection, they should not serve as a constraint on the ability to cross-trade. To the extent that these requirements are designed to assure that there is sufficient trading in the securities so that a price can be objectively determined for cross-trades, the requirement that market quotations for the securities be readily available from independent sources should adequately meet that need.

Therefore, the condition requiring equity securities to be "widely-held" and "actively-traded" is not necessary to protect plan investors in Index and Model-Driven Funds and should be deleted from the proposed exemption.

3. Cross-Trading Between Large Accounts

The proposed class exemption would provide relief for cross-trading between Index and Model-Driven Funds, or between an Index or Model-Driven Fund and a Large Account. However, it would not provide relief for cross-trading between Large Accounts. Such transactions should be included in the exemption.

Under the terms of the exemption, a Large Account may participate in cross-trading only if an independent fiduciary has directed that the account be liquidated, or has authorized a "portfolio restructuring program" to produce a portfolio that will be an Index or Model-Driven Fund, and where the liquidation or restructuring must be completed within 30 days (subject to independently-approved extensions). These limitations significantly limit the discretion of a Large Account manager or trading adviser in deciding which securities to buy and sell and over what time period. Including cross-trades between Large Accounts in the exemption would not diminish the protections under the exemption.

4. Definition of Large Account

Section IV(e) defines a "Large Account" as an investment fund, account or portfolio that, among other things, may hold assets of a registered investment company other than an investment company advised or sponsored by the Manager.

We do not see any reason for this exclusion. The Large Account would not be participating in the Manager's cross-trading program unless it were advised by the Manager, and relief would not be necessary under the exemption unless that were the case. This definition thus excludes the very category of investment companies for which relief was intended. Therefore, the limitation excluding investment companies managed or sponsored by the Manager from the definition of a Large Account should be deleted.

5. Manager-Issued Securities Limitation

The proposed exemption would not permit cross-trades of any security issued by the Manager unless the Manager has obtained a separate prohibited transaction exemption.

In the context of an exemption for cross-trading by Index and Model-Driven Funds, it is not clear why such a restriction is necessary. Manager-issued securities could only be traded by such Funds if such securities were included in the relevant index or program model. In the case of Large Accounts, these securities could only be traded in connection with a portfolio restructuring, where the security is being liquidated from an existing portfolio or being bought or sold in order to restructure a portfolio into an Index or Model-Driven Fund. The decision to buy or sell the security is therefore based on objective factors. In light of this, there appears to be no reason for the class exemption to exclude cross-trading in such securities.

II. Requested Clarifications

1. Disclosure Requirement for "New" Funds

Section II(l) of the proposed exemption would require that "with respect to Funds that are added to the Manager's cross-trading program . . . the Manager shall provide a notice to each relevant independent plan fiduciary prior to, or within ten (10) days following such addition of Funds . . . which contains a description of such Fund(s)," along with a notice of the plan's right to terminate participation in the cross-trading program.

The Institute reads this provision to require disclosure regarding Funds new to the cross-trading program only to those independent plan fiduciaries whose plans have invested in those Funds. Under this view, disclosure would be provided to an independent fiduciary only when the "new" Fund is one in which the fiduciary's plan is currently invested.

The alternative interpretation would be to require disclosure to fiduciaries of plans managed by the Manager and engaging in cross-trading under the exemption of the identity of all of the Manager's accounts, ERISA and non-ERISA, that may engage in cross-trading under the exemption. This would include not only pooled funds but also separate accounts for large customers. Such a disclosure requirement would be a significant burden, requiring a notice to be sent out to all such fiduciaries each time the Manager is retained to manage a new Fund or Large Account. For large Managers, this can occur as often as weekly or even daily.

The disclosure of the identity of every potential cross-trading counterparty would be of no value to a plan fiduciary. The identity of the other accounts would reveal little about the cross-trading process or the Manager's cross-trading procedures.

Such a broad disclosure requirement also would raise significant privacy and confidentiality concerns. A Manager's clients often request that their identities not be disclosed to third parties, a requirement that may be imposed as part of the investment management agreement. Requiring disclosure of the identities of all eligible client accounts would be contrary to client requests for confidentiality and inconsistent with the agreements governing those relationships.

For these reasons, the Department should clarify that the scope of the "new Funds" disclosure requirement is limited to those Funds in which the particular plan has invested.

2. Manager-Sponsored Plans

The only provision of the proposed exemption dealing with plans maintained by the Manager is Section II(e), which requires that no more than 10% of the assets of a Fund or Large Account at the time of the cross-trade be comprised of the assets of plans maintained by the Manager for its own employees for which the Manager exercises investment discretion. The implication is that such Funds and Large Accounts may engage in cross-trades even though their investors include Manager-sponsored plans. However, there is no provision that addresses how the independent authorization conditions (Section II(i) through (n)) apply to such plans, given that the plan fiduciary responsible for such a plan's investment matters is unlikely to be independent of the Manager.

The Department should make clear that the independent fiduciary authorization conditions do not apply to plans maintained by the Manager. This position would be consistent with other exemptions that do not apply the independent authorization requirement to plans of the fiduciary for whom relief is provided. For example, the special rules for pooled funds in PTE 86-128 specifically provide

that the requirement that the authorizing fiduciary be independent of the fiduciary seeking relief does not apply in the case of a plan covering only employees of the fiduciary seeking relief. PTE 86-128, § IV(d)(1)(A). The Department should add a similar provision to the proposed exemption.

3. Scope of Disclosure and Authorization Requirements

Section II(i) makes clear that its independent authorization requirement applies only to an Index or Model-Driven Fund that holds plan assets. This is appropriate, since only such funds would be governed by ERISA's prohibited transaction provisions, and there would be no reason for the exemption to require authorizations in connection with funds that are outside the scope of ERISA and subject to other legal standards.

This distinction, however, is not clearly made in Section II(j), the provision requiring disclosures to independent fiduciaries of existing plan investors in Index and Model-Driven Funds. To be consistent with Section II(i) and the objectives of the exemption, Section II(j) also should be limited to those Index and Model-Driven Funds that hold plan assets.

This also is an issue with Large Accounts. As described in the definition of a Large Account in Section IV(e), a Large Account may be a non-ERISA institutional investor, such as a governmental plan, charitable foundation or registered investment company. The disclosure and authorization requirements for Large Account transactions in Section II(n) should apply only if the Large Account holds plan assets.

III. Conclusion

The Institute believes that the proposed class exemption represents a positive develop-ment in the continuing dialogue between the Department and the investment management industry on cross-trading issues. Therefore, the Institute urges the Department to grant the class exemption expeditiously, subject to the foregoing comments. In addition, we hope that this class exemption will serve as a first step towards the grant of a class exemption for cross-trading by actively-managed accounts.

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: 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. Its membership includes 8,018 open-end investment companies ("mutual funds"), 495 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.802 trillion, accounting for approximately 95% of total industry assets, and over 78.7 million individual shareholders. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 409 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 64 Fed. Reg. 70057, December 15, 1999.

[3] 63 Fed. Reg. 13696, March 20, 1998.