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DOL Issues Final Guidance on Cross-Trading Procedures

On October 6, 2008, the US Department of Labor (the "DOL") released its final regulation regarding the content of the policies and procedures that an investment manager must adopt if it seeks to effect cross trades under the statutory cross-trading exemption added by the Pension Protection Act of 2006 (the "PPA"). The final regulation replaces, with few changes, an interim final regulation that the DOL issued on the same subject in early 2007. Although the final regulation becomes effective on February 4, 2009, investment managers that obtained client consent to engage in cross trades based on compliance with the interim final regulation will not be required to obtain a re-authorization as a result of the final regulation. Despite the issuance of the final regulation, a number of interpretive issues concerning the statutory exemption remain—including regarding its application to private investment funds.

Background

The DOL has long been of the view that if an investment manager to an ERISA plan exercises its discretion on "both sides" of a cross trade, this will violate the provision of ERISA that prohibits a fiduciary from acting in any transaction on behalf of a party whose interests are adverse to the interests of the plan (ERISA § 406(b)(2)). Before the PPA, the DOL had issued a prohibited transaction class exemption permitting certain "passive" cross trades involving index and model driven funds (DOL PTCE 2002-12). However, the DOL had declined to expand the scope of this relief to cases where the manager has unrestricted discretion on both sides of a trade.

The PPA added a new statutory exemption for cross trades that meet a number of conditions outlined in the statute (ERISA § 408(b)(19)). In general, the exemption applies if:

- the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
- the trade is effected at the independent current market price of the security;
- no commissions or brokers fees are paid (other than disclosed, customary transfer fees);

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- a plan fiduciary other than the investment manager directing the trade authorizes the transaction in advance in a separate written agreement after the fiduciary receives a separate written disclosure regarding the investment manager's cross-trading policies and procedures; and
- each participating plan has assets of at least $100,000,000. (In the preamble to the final regulation, the DOL stated that each plan participating in a pooled investment vehicle that holds "plan assets" (other than a master trust) must meet this minimum threshold in order to take advantage of the exemption.)

In addition, the investment manager directing the trade must:

- provide the authorizing plan fiduciary with a quarterly report identifying all cross trades in which the plan participated;
- not base its fee schedule, nor condition the provision of any other service, on the plan's consent to cross trading;
- **adopt and conduct cross trades in accordance with written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program, and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program**; and
- designate an individual who will periodically review the compliance of purchases and sales with the manager's written policies and issue an annual written report, signed under penalty of perjury, within 90 days of the period to which it relates; the report must detail the steps performed during the periodic review, the manager's level of compliance and instances of non-compliance, as well as notify the plan fiduciary of the plan's right to terminate the cross-trading authorization at any time.

On February 12, 2007, pursuant to a directive in the PPA to issue guidance within six months of the PPA's enactment, the DOL issued an interim final regulation implementing content requirements for the written cross-trading policies and procedures (see bolded text above). The final regulation largely adopts the material provisions of the interim rule.

The Final Regulation

The final regulation requires that the cross-trading policies and procedures adopted by an investment manager and disclosed to a plan fiduciary be "clear and concise" and written with the aim of being understood by the plan fiduciary. At the same time, the policy must be detailed enough to facilitate a compliance officer's periodic review of the policy. Furthermore, the written policy must be fair and equitable to all accounts participating in the cross-trading program and

reasonably designed to ensure compliance with the statutory requirements summarized above. The policy must specifically include the criteria used to determine that a particular cross trade will benefit both parties and the methodology used to ensure cross trades are executed at the "current market price," along with any sources involved in determining such price.

Investment managers must apportion cross trades fairly among accounts and the policy must describe the method for this apportionment. The policy must note that any investment manager cross trading pursuant to the exemption is faced with conflicting duties to the parties involved and must further explain the investment manager's procedures for mitigating such conflicts.

The policy must also describe the procedure for ensuring that each participating plan has assets of at least $100,000,000. (The final regulation importantly notes that this minimum asset threshold must be satisfied upon a plan's initial participation in the cross-trading program and only on an annual basis thereafter—thereby limiting a manager's need to constantly monitor the size of a client's asset base.)

The policy must identify the name of the compliance officer responsible for ensuring compliance with the regulation (*i.e.*, identifying the individual by title is insufficient) and explain why such individual is qualified for the position. Additionally, the policy must describe the scope of an annual review to be performed by the compliance officer that results in a written evaluation of compliance with this rule.

Finally, the policy must explain that compliance with the final regulation (and the statutory subsection to which it relates) does not alone satisfy the requirements of the statutory cross-trading exemption because the exemption requires a number of other conditions to be met in addition to the written policies and procedures requirement.

Other Guidance in the Preamble

In addition to the text of the final regulation itself, the DOL made some important statements in the preamble to the final regulation. For example:

- The DOL noted that a manager's failure to comply with its own policy would result in a prohibited transaction in respect of any cross trade where the policy had not been followed. However, any such instance of non-compliance would not in itself render the statutory exemption inapplicable to other cross trades where the policy had been followed (and the other requirements of the statute met).
- The DOL stated its view that securities trades between an account managed by an investment manager and an account managed by the investment manager's affiliate would

not, in itself, violate ERISA. However, a violation of ERISA could occur in operation if, in fact, there is an agreement or understanding between the affiliated entities to favor one account at the expense of another. On the other hand, individual portfolio managers employed by the same investment management entity may not engage in a cross trade without exemptive relief. The DOL specifically noted that the relief of the statutory cross-trading exemption would be available in such a case.

- The DOL noted that nothing in the final rule would preclude a compliance officer from reviewing cross trade compliance using an appropriate sampling method, provided that the sampling methodology is disclosed in the manager's policy. The DOL also stated its expectation that auditors would ensure that the sample selected is representative of the total universe of relevant transactions.

Additional Guidance May Be Forthcoming

In adopting the final regulation, the DOL rejected a number of comments from various securities industry associations that were intended to make the exemption more "user friendly" by conforming many of the exemption's operational requirements to parallel requirements under the Investment Company Act of 1940. Nevertheless, the DOL did explicitly note that the enactment of the statutory exemption for cross trading did not foreclose the DOL's future consideration of administrative relief on the subject.

One unanswered question regarding the statutory exemption that would hopefully be addressed in any future guidance is how the exemption might apply in the case of a pooled investment vehicle. As noted above, the DOL has already stated that each plan participating in a pooled investment vehicle that holds "plan assets" (other than a master trust) must meet the $100,000,000 threshold—suggesting that managers of private funds may in fact use the exemption. However, for example, neither the statutory exemption nor the DOL guidance addresses how to apply the statutory requirement that the cross trading authorization be terminable "at any time" in the case of a pooled investment vehicle. (Presumably any guidance would incorporate the parallel provision under the DOL's guidance regarding agency cross trades, which grants plans a special right to withdraw from the fund, "within such time as may be necessary to effect the withdrawal in an orderly manner that is equitable to all withdrawing plans and to the nonwithdrawing plans.")

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