

Department of Labor Finalizes Regulations under ERISA Cross-Trading Exemption

The U.S. Department of Labor ("DOL") has finalized regulations under the statutory prohibited transaction exemption for cross-trades involving ERISA accounts¹. A "cross-trade," as defined in the final regulations, means the purchase and sale of a security between a plan and any other account managed by the same investment manager (as defined in ERISA). The final regulations are effective on February 4, 2009. The DOL issued "interim final" regulations on February 12, 2007 regarding the content of the written cross-trading policies and procedures that are required under the exemption, but at that time left open many other interpretive issues raised by the exemption. In the final regulations, the DOL addressed several of these. This update provides a summary of the exemption, including requirements related to the written cross-trading policies and procedures, as well as a summary of some of the DOL's clarifications in response to comments received on the interim regulations.

Summary of Statutory Cross-Trading Exemption

The cross-trading exemption in ERISA section 408(b)(19) allows cross-trades between accounts managed by the same investment manager if the following conditions are met:

- A fiduciary (other than the investment manager or any affiliate) for each account participating in the transaction

must authorize the manager in advance of any cross-trades to engage in cross-trades at the manager's discretion, after the fiduciary has received disclosure regarding the conditions under which cross-trades may take place (but only if such disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the manager (described below);

- The manager must adopt, and effect cross-trades in accordance with, policies and procedures (described below) that are fair and equitable to all accounts participating in the cross-trading program and that include certain required policies and procedures;
- The manager must designate an individual responsible for periodically reviewing such purchases and sales to ensure compliance with the written policies and procedures, which individual must issue an annual report;
- The manager must provide the fiduciary with quarterly reports detailing all cross-trades executed by the manager in which the account participated during the quarter, including the following information, as applicable:
 - Identity of each security bought or sold;
 - Number of shares or units trades;

¹ 29 C.F.R. 2550.408b-19, 73 FR 58,450 (October 7, 2008).

- Parties involved in the cross-trade; and
- Trade price and the method used to establish the trade price;
- Each plan participating in the transaction must have assets of at least \$100 million;
- Market quotations for the security must be readily available;
- The transaction must be effected at the independent current market price of the security;
- No brokerage commission fee (except for customary transfer fees, the fact of which is disclosed) or other remuneration may be paid in connection with the transaction; and
- The manager may not base its fee schedule on an account's consent to cross-trading, and no other service may be conditioned on such account's consent to cross-trading.
- a requirement that the manager allocate cross-trades among accounts in an objective and equitable manner and a description of the allocation method(s) that will be used by the manager;
- the identity of the compliance officer responsible for reviewing the manager's compliance with its cross-trading policies and procedures (and a statement of the compliance officer's qualifications);
- a statement that the cross-trading exemption requires satisfaction of several objective conditions in addition to the requirements that the manager adopt and effect cross-trades in accordance with written cross-trading policies and procedures; and
- a description of the scope of review to be conducted by the compliance officer, that is, whether the officer's review is limited to compliance with the manager's written policies and procedures or overall compliance with the cross-trading exemption.

Summary of Requirements Applicable to Manager's Cross-Trading Policies and Procedures

Under the final regulations, the manager's written cross-trading policies and procedure must include:

- a description of the criteria which will be applied by the manager in determining that the execution of the transaction as a cross-trade will be beneficial to both parties to the transaction;
- a description of how the manager will determine that the cross-trades are effected at the "independent current market price" of the security, within the meaning of SEC Rule 17a-7(b), including the identity of sources used to establish the prices;
- a description of the procedures for ensuring compliance with the requirement that each plan participating in the cross-trade have a minimum asset size of \$100 million (a plan or master trust will satisfy the \$100 million minimum asset size requirement as to a transaction if it satisfies the requirement upon its initial participation in the cross-trading program and on an annual basis thereafter);
- a description of how the manager will mitigate potential conflicts in its responsibilities to the parties involved in the cross-trade transaction;

Summary of DOL Response to Comments

In issuing the final regulations, the DOL provided guidance on many questions that were left unanswered in the "interim final" regulations, including the following:

- *Cross-Trades with Investment Manager's Affiliates.* The DOL declined to interpret the cross-trading exemption as covering trades executed between an account managed by an investment manager and an account managed by an affiliate of such a manager. However, the DOL indicated that such a trade between an account managed by an investment manager and an account managed by an affiliate of such a manager may nevertheless not be a prohibited transaction, unless in operation there were an agreement or understanding between the affiliated entities to favor one account at the expense of the other in connection with the transaction.
- *Application of the Exemption to Pooled Investment Vehicles.* The DOL clarified that an "account" includes a pooled fund or account; however, the preamble indicates that, in order for the cross-trading exemption to be available to a pooled fund or account, each plan in the pooled vehicle must have at least \$100 million in assets.
- *Minimum Asset Size Test.* The final regulations provide that a plan or master trust will satisfy the \$100 million minimum asset size requirement as

to a transaction if it satisfies the requirement upon its initial participation in the cross-trading program and on an annual basis thereafter.

- *Consequences of Non-Compliance with Policies and Procedures.* The DOL clarified that, in order for the cross-trading exemption to apply, the investment manager must adopt, and cross-trades must be effected in accordance with, written cross-trading policies and procedures. Accordingly, the DOL stated its view that the exemption would be unavailable for any transaction that was not effected in accordance with such cross-trading policies and procedures (though non-compliance with respect to any transaction would not, in itself, render the exemption inapplicable to the investment manager's entire cross-trading program).
- *Role and Responsibility of Compliance Officer.* The DOL noted in the preamble to the final regulations

that the final regulations do not specifically address whether the compliance officer must review each individual cross-trade. However, it stated that nothing in the final regulations would preclude cross-trades from being reviewed using an appropriate sampling methodology based upon the universe of cross-trades effected by the investment manager under the exemption, provided that the sampling methodology is disclosed in the investment managers policies and procedures.

- *Rule 17a-7.* The DOL declined to adopt several suggestions from commenters that would have made the final regulations consistent with, and comparable to, the Rule 17a-7 cross-trading provisions, due to the many differences between mutual funds and ERISA-covered employee benefit plans.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits.

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