The Investment Lawyer
Covering Legal and Regulatory Issues of Asset Management
VOL. 26, NO. 2 • FEBRUARY 2019

Cross Trading in Focus: Decoding the Regulatory Framework

By John V. O'Hanlon, Kaitlin McGrath, Steven W. Rabitz, and Andrew L. Oringer

"Cross trades," or trades between accounts with the same investment manager, continue to be an area of focus of both the Securities and Exchange Commission (SEC) and the Department of Labor (DOL). This article discusses the regulatory framework applicable to cross trades under the Investment Company Act of 1940, as amended (Investment Company Act), the Investment Advisers Act of 1940, as amended (Investment Advisers Act), and the Employee Retirement Income Security Act of 1974 (ERISA) and provides related compliance recommendations to investment managers.

Cross Trading under the Investment Company Act and the Investment Advisers Act

Regulatory Restrictions on Cross Trading

Section 17(a) of the Investment Company Act

Section 17(a) of the Investment Company Act provides, in relevant part, that it shall be unlawful for an affiliated person of a registered investment company (fund) or an affiliated person of such a person, acting as principal, to knowingly sell any security or other property to, or purchase any security or other property from, the fund.[1] Section 17(a) is designed to prevent insiders from engaging in "special transactions . . . of which shareholders may never be apprised."[2] The SEC has noted that Section 17(a) is intended primarily to proscribe "a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the [fund]."[3]

Accordingly, Section 17(a) generally prohibits cross trades between a fund and its affiliated persons unless the SEC grants an exemption (by order), or there is an available regulatory exemption. Rule 17a-7 under the Investment Company Act provides a regulatory exemption for cross trades among funds that are affiliated persons solely by reason of having a common investment manager, investment managers that are affiliated persons, common directors, and/or common officers.[4] The Rule requires, among other things: (1) that the trade be of a security with readily available market quotations; (2) that the trade be executed at the "independent current market price," as defined in the Rule; and (3) that no brokerage commissions or other remuneration be paid in connection with the trade.[5]

Section 206 of the Investment Advisers Act

The Investment Advisers Act does not contain an analogous prohibition on cross trades.[6] However, the SEC typically scrutinizes an investment manager's cross trading practices in light of the manager's

fiduciary duty under Section 206 of the Investment Advisers Act.[7] The SEC and its Staff have interpreted this fiduciary duty as encompassing both a duty of loyalty, which requires the manager to "to act in the best interests of [its] clients and…avoid or disclose conflicts"[8] and a duty to seek best execution on client securities transactions.[9]

The SEC has found that favoring certain clients when effecting trades, without adequate disclosure of the practice, would breach an investment manager's duty of loyalty.[10] In some cases, the SEC has also found that pricing cross trades in a manner that favors certain clients would breach an investment manager's duty to seek best execution on client securities transactions.[11]

Industry Approaches to Addressing Cross Trades

To facilitate compliance with the regulatory restrictions on cross trading, investment managers generally: (1) adopt and implement policies and procedures designed to prevent unlawful cross trades; (2) take reasonable steps to prevent inadvertent cross trades (that is, where accounts managed by the same investment manager inadvertently cross a security in the market); and (3) disclose conflicts of interest relating to cross trades.

Policies and Procedures

Rule 206(4)-7 under the Investment Advisers Act generally requires investment managers to adopt and implement policies and procedures reasonably designed to prevent unlawful trading practices, including unlawful cross trades.[12] In connection with this requirement, investment managers should take steps to train their portfolio management and trading personnel and familiarize them both with the manager's policies and procedures and with the underlying regulatory restrictions on cross trading.[13] In addition, investment managers should develop and implement monitoring processes to seek to ensure that their policies and procedures are working as intended and to determine whether unlawful cross trades have occurred.[14]

Preventing Inadvertent Cross Trades

Under Section 17(a) of the Investment Company Act, cross trades are prohibited only if they are effected "knowingly."[15] The legislative history of Section 17(a) suggests that the term "knowingly" should be understood to exclude inadvertent violations, so long as the person responsible for the violation was acting in good faith.[16] Although the SEC has not provided specific guidance on what "knowingly" means in the context of Section 17(a), the SEC Staff has issued a few no-action letters that touch on the "knowingly" standard. In a 1973 letter to Israel Development Corporation, the Staff declined to take a no-action position in the context of Section 17(a) because the intended trading activity had a near certain likelihood of resulting in a cross trade due to the fact that the number of shares being sold amounted to over twice the weekly trading volume of the relevant security.[17] However, in a 1989 letter to Delta Government Options, the Staff took a no-action position where a fund and its affiliate proposed to independently enter bona fide quotations into an options trading system through a blind broker with no prearrangement of a cross trade, suggesting that the circumstances of these trades were sufficiently "unknowing" under Section 17(a).[18]

The SEC's enforcement actions in this area suggest that, for purposes of determining whether a cross trade was effected "knowingly" in violation of Section 17(a), the SEC may consider whether the parties made reasonable efforts to avoid inadvertent cross trades.[19] Similarly, where reasonable steps are taken to avoid inadvertent cross trades, the SEC may view this as an indication that the parties acted in good faith.

When investigating whether cross trades were effected "knowingly," the SEC may look for: (1) efforts to coordinate opposing trades; (2) improper motive or purpose; and (3) shareholder harm. In addition, in the context of "inadvertent" cross trades,

the SEC may seek to understand whether the trades were reviewed by compliance on a pre-trade or post-trade basis and whether the manager's policies and procedures address concurrent opposing trades that do not fit within Rule 17a-7 or another exemption.

Disclosing Conflicts of Interest

Section 206 requires an investment manager to disclose to a potentially disfavored client any situation where one client account may be favored over another and how the manager would manage such a conflict in order to allow the client that would be disadvantaged to make an informed decision whether to continue the advisory relationship.[20] Investment managers typically disclose their cross trading practices in response to Item 11 of Part 2 of Form ADV.[21] Many investment managers also use this section to disclose conflicts of interest relating to cross trades, including the potential for one client to be favored over another. Investment managers may also use their management contracts as a means of obtaining client consent for cross trading generally and/or of specific practices relating to cross trades, such as a particular pricing methodology.

Recent SEC Enforcement Actions

During the third quarter of 2018, the SEC settled charges with three investment managers relating to impermissible cross trades. These actions follow similar actions brought in recent years.[22]

Hamlin Capital Management, LLC

In an order published on August 10, 2018, the SEC settled charges against Hamlin Capital Management, LLC (Hamlin) relating to Hamlin's pricing methods for dealer-interposed cross trades between its separately managed account and pooled-investment-vehicle clients during the period November 2011 through March 2016.[23] Most of the cross trades at issue were of non-rated, tax-exempt, and thinly traded municipal bonds in which Hamlin held a controlling position. By arranging cross trades of the bonds, rather than transacting in the open market, Hamlin was able to provide liquidity to its selling clients and retain its own controlling positions in the bonds.

The SEC scrutinized Hamlin's practices with respect to the trades in light of its fiduciary duty under Section 206 of the Investment Advisers Act. The SEC alleged that two aspects of Hamlin's pricing method caused Hamlin to violate Sections 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-8(a)(2) thereunder.[24]

- First, the SEC alleged that Hamlin's practice of executing the buy at the bid price and the sell at a slight discount from the bid resulted in undisclosed favorable treatment because it allocated the full benefit of the market savings to Hamlin's buying clients.[25]
- Second, Hamlin used allocations that it obtained from third-party brokers for month-end valuation purposes to determine bid prices and, in some cases, the brokers had adjusted the allocations upward or downward at Hamlin's request.[26] The SEC alleged that where the brokers had adjusted the allocations upward, Hamlin's buy side clients typically paid more than they would have paid on the secondary market. As a result, Hamlin breached its duty to seek best execution on these trades.

The SEC also charged Hamlin with violations of: (1) Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder for failing to adopt and implement reasonably designed policies and procedures regarding cross trading and securities valuation; and (2) Section 207 of the Investment Advisers Act for making misrepresentations about its cross trading practices in its Form ADV. Section 17(a) of the Investment Company Act was not implicated because none of the cross trades involved funds.

The SEC noted that Hamlin had remediated its affected clients and made enhancements to its "policies, procedures, controls and disclosures."

Nevertheless, Hamlin was ordered to cease and desist the violations and pay a $900,000 penalty.

Cushing Asset Management, LP

In an order published on September 14, 2018, the SEC settled charges against Cushing Asset Management, LP (Cushing) arising from two cross trades of approximately $33.5 million.[27] On December 20, 2012, Cushing made separate decisions to: (1) sell units of a publicly traded master limited partnership (MLP) on behalf of a hedge fund it managed; and (2) buy the same number of units of the MLP on behalf of two funds it also managed. Although certain Cushing personnel consulted with legal counsel about how to avoid a cross trade, the SEC charged Cushing with causing the hedge fund to knowingly violate Section 17(a) of the Investment Company Act. The SEC noted that the trades comprised 40 percent of the trading volume for units of the MLP on the trading day.[28] In addition, although the Cushing traders executed the trades through separate brokers, they told the buy-side broker about the sell order, which prompted the buy-side broker to reach out to the sell-side broker. As a result, Cushing's clients wrongfully incurred approximately $125,000 in brokerage fees. Cushing was ordered to cease and desist the violation and pay a $100,000 penalty.

Putnam Investment Management, LLC

In an order published on September 27, 2018, the SEC settled charges against Putnam Investment Management, LLC (Putnam) and Zachary Harrison, a former portfolio manager and trader in Putnam's Structured Credit Group.[29] During the period April 2011 through September 2015, Harrison prearranged numerous dealer-interposed cross trades of residential mortgage-backed securities (RMBS) between Putnam client accounts, most of which were funds.

According to the order, Harrison sought to prearrange cross trades in cases where a selling client was disposing of its position in an RMBS and Harrison believed that the RMBS was a desirable investment for another client. Harrison typically executed the sale at the bid price and the repurchase at a slight markup the next day.[30]

The SEC alleged that the cross trades did not comply with Rule 17a-7, Putnam's policies and procedures, and/or Putnam's Form ADV.[31] As a result, the SEC charged Harrison and Putnam with causing certain funds to violate Section 17(a) of the Investment Company Act. The SEC further alleged that, by crossing at the bid price, rather than at "the average of the highest current independent bid and the lowest current independent offer," Harrison caused Putnam to favor its buying clients over its selling clients, in violation of Section 206(2) of the Investment Advisers Act.

The SEC also charged Putnam with violations of: (1) Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder for failing to adopt and implement policies and procedures reasonably designed to ensure compliance with the cross trading prohibitions; (2) Section 207 of the Investment Advisers Act for making misrepresentations about its cross trading practices in its Form ADV; and (3) Section 203(e)(6) of the Investment Advisers Act for failing to supervise Harrison.[32]

The SEC noted that after Putnam learned of Harrison's conduct in mid-2016, Putnam terminated Harrison's employment, conducted an internal investigation and self-reported to the SEC. The SEC also noted that, among other remedial efforts, Putnam had placed money in escrow to compensate harmed clients and retained a compliance consultant to review its policies and procedures. Putnam and Harrison were ordered to cease and desist the violations and pay penalties of $1,000,000 and $50,000, respectively. Harrison was also suspended from working in the securities industry for nine months.

Related Observations

Both Hamlin and Putnam demonstrate that the SEC is continuing to focus on pricing methods that systematically disadvantage particular groups

of clients. Whereas Putnam used the same pricing method as Western Asset Management Company (Western) (that is, executing the sell at the bid price and the repurchase at a slight mark-up over the bid), Hamlin used a reverse approach (that is, executing the repurchase at the bid price and the sell at a slight discount from the bid).[33] Consistent with Western, the SEC concluded that Putnam's pricing method caused Putnam to favor its buying clients in violation of Section 206(2) of the Investment Advisers Act. In addition, the SEC concluded that Hamlin's reverse approach resulted in undisclosed favorable treatment of its buying clients, in violation of Section 206(2).

A key difference between Hamlin and Putnam, however, is that Hamlin's pricing method otherwise complies with the federal securities laws, whereas Putnam's does not. Prior to Hamlin, the SEC had charged an investment manager with pricing cross trades in violation of Section 206(2) only in the context of other violations that separately invalidated the manager's pricing method.[34]

Cross Trading under ERISA

Background

ERISA and Section 4975 of the Internal Revenue Code of 1986, as amended (the Code) impose, as applicable, fiduciary responsibility and prohibited transaction requirements on investment managers and other fiduciaries with respect to arrangements, such as US private-sector retirement arrangements and individual retirement accounts, and entities that are deemed to constitute the assets of such arrangements (collectively, Plans).[35] Under Section 404 of ERISA, a fiduciary (such as an investment manager) must act for the "exclusive" purpose of providing Plan benefits to participants and beneficiaries (and defraying reasonable expenses of administering the Plan).[36] In addition, under Section 406(b)(2) of ERISA's prohibited transaction rules, a fiduciary may not "in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries."[37]

The DOL has indicated that the fact that two parties are on opposite sides of a given transaction does not necessarily make them adverse and determining whether a violation of Section 406(b) of ERISA has occurred is inherently a factual question.[38] Nevertheless, as the DOL has stated:

> Where an investment *manager has investment discretion with respect to both sides* of a cross trade of securities and at least one side is a [Plan] . . . *a violation of Section 406(b)(2) would occur*. The [DOL] has also taken the position that by representing the buyer on one side and the seller on the other in a cross trade, a *fiduciary acts on behalf of parties that have adverse interests to each other*. Moreover, the prohibitions embodied in Section 406(b)(2) of ERISA are per se in nature. *Merely representing both sides of a transaction* presents an adversity of interests that *violates* Section 406(b)(2) even absent fiduciary misconduct reflecting harm to a plan's beneficiaries.[39]

As the foregoing statements would suggest, the DOL has traditionally been unsympathetic to the potential advantages of cross trading to Plans, including mitigating market impact on the price of the security and saving on transaction costs. Instead, the DOL has focused on both a technical read of Section 406(b)(2) and a host of other potential conflicts.[40] Indeed, while the DOL recognizes "the advantages of cross trading to plans,"[41] the DOL was "unable to conclude that reliance on Rule 17a-7 would adequately protect [Plans] in situations where an investment manager exercises discretion for both sides of a cross-trade."[42]

The consequences of violating Section 406(b)(2) or one of ERISA's other fiduciary requirements

may be substantial. In particular, a fiduciary may be "personally liable to make good to such [P]lan any losses to the [P]lan resulting from each such breach, and to restore to such [P]lan any profits of such fiduciary which have been made through use of assets of the [P]lan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate."[43] In addition, if a cross trade deals with a fiduciary's own interest or account, the fiduciary may also be required to pay a 15% excise tax on the "amount involved" in the trade.[44] As a result, it can be critical for managers of Plan assets to be sensitive to ERISA-related cross trading concerns.[45]

Scope of the Prohibited Transaction Rules

"Blind" Transactions

The breadth of the prohibited transaction rules taken to an extreme could make it all but impossible for a manager to trade any security unless the manager knows with certainty that another one of its accounts is not on the other side of the trade. In this regard, it is important to note that Section 406(b)(2) of ERISA only results in a violation if the manager knew or should have known it would be a violation. As a general matter, the legislative history of ERISA also indicates that a transaction involving the purchase or sale of securities is "blind" and not subject to the prohibited transaction rules if it is a "purchase or sale of securities through an exchange where neither [the] buyer nor [the] seller (nor the agent of either) knows the identity of the other party involved" because "[i]n this case, there is no reason to impose a sanction on a fiduciary (or party-in-interest) merely because, by chance, the other party turns out to be a party in interest (or [P]lan)."[46]

While that history is likely best read as applied to ERISA's "per se" prohibited transaction rules with parties in interest (or disqualified persons under the Code), the DOL has focused on the "blind" transaction concept in the context of Section 406(b)(2) as well.[47] Thus, a "blind" transaction may by its nature escape the Section 406(b)(2) prohibition. Conversely, however, transactions that are not truly "blind" could implicate Section 406(b)(2) concerns. An investment manager therefore needs to identify when it knows or should know that a given situation could result in an impermissible cross trade. Investment managers may consider a variety of factors and develop policies and procedures to guard against inadvertent cross trades

Trading Venues

Electronic crossing networks (ECNs), alternative trading systems (ATSs) and other trading venues may give rise to the potential for inadvertent cross trades. Facts and circumstances will dictate whether a particular transaction executed through an ECN, ATS, or other trading venue constituted an impermissible cross trade.[48] The DOL has granted relief to at least one ATS, Liquidnet, which was created to facilitate "block" trades among institutional investors.[49] In considering that venue, the DOL explained:

> Liquidnet matches purchase and sell orders from its clients and gives purchasers and sellers the opportunity to negotiate a trade based on price and volume. The number of subscribers and the trading procedures assure a party's anonymity, unless the party wishes to identify itself to the counter-party. In our view, transactions executed through Liquidnet's trading procedures…that are designed to permit anonymous negotiations without identifying the parties, function in a manner similar to the operation of an exchange. Accordingly, based on your representations, it is our further view that "blind" transactions executed pursuant to such procedures would not, in themselves, constitute prohibited transactions under [S]ection 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) or 406(b)(2) of ERISA.[50]

However, the DOL also indicated:

> [A] transaction effectuated through the Liquidnet System will not be considered "blind if, prior to the execution of such transaction, the [P]lan fiduciary responsible for the [P]lan's engagement in the transaction knew, or had reason to know, the identity of the counterparty to such transaction. Given the ability of parties to a transaction to disclose their identities to each other, persons trading on behalf of employee benefit plans should be particularly careful to make sure the transaction is truly blind. Moreover, these determinations assume that such purchase and sale transactions did not arise in connection with any arrangement, agreement, or understanding designed to benefit the fiduciary (including an affiliate thereof) or any other party in interest to the [P]lan.[51]

As to this last point, interestingly, the DOL acknowledged that "[t]he number of subscribers and the trading procedures assure a party's anonymity, unless the party wishes to identify itself to the counter-party" and in a footnote also acknowledged that it understood that "subscribers using the system to negotiate a securities transaction may 'chat' with each other." The DOL continued:

> In this regard, you state that although the Liquidnet System does not disclose the identities of negotiating subscribers to each other, two such subscribers may electronically correspond to each other, without restriction as to content, through the Liquidnet System as part of the negotiation. You note that this type of correspondence is reviewed and retained by Liquidnet.[52]

The facts of the relief appeared to have involved only "buy-side" institutional market participants that "individually manage[d], on average, approximately $31 billion of equity assets" and the trade sizes "that have averaged approximately 44,000 shares." The applicant also represented that all transactions are executed on a "blind basis" and that all physical transfers of equity securities and cash are made between an independent clearing firm . . . and the buyers and sellers respective custodians. Therefore, the identities of the parties to a trade will not be revealed to the parties during the clearing process.[53]

After the relief granted to Liquidnet, the Pension Protection Act of 2006 added a broad statutory exemption for transactions in securities or other property conducted on a trading venue that is subject to regulation or oversight by an applicable federal, or to the extent determined by the DOL, foreign regulating entity if:

1. neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of the transaction or the transaction is conducted on a basis designed to match purchases and sales at the best price available on the trading venue;
2. the price and compensation associated with the purchase and sale are not greater than in arm's-length transactions with an unrelated party; and
3. if the fiduciary or party in interest engaging in the transaction has an ownership interest in the trading venue, an independent plan fiduciary authorizes the use of the trading venue for transactions and written or electronic notice is given to the independent fiduciary not less than 30 days prior to the Plan's first transaction is executed through the venue.[54]

The "bluebook" for the Pension Protection Act released by the Joint Committee on Taxation indicates that transactions made through an electronic communications network "may be permitted if the parties are not known to one another (a 'blind' transaction.)"[55] Section 408(b)(16) of ERISA thus merely provides an exemption where there is concern that the transaction may not be

truly blind.[56] While the Liquidnet relief presumes that the venue involves "blind" transactions, the statutory relief requires either that: (1) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of the transaction; or (2) the transaction is conducted on a basis designed to match purchases and sales at the best price available on the trading venue.

That said, not all trading venues will fit the parameters of this statutory exemption. Some venues are not regulated by federal authorities; others may deal in currency or other financial instruments that are not securities. Investment managers will therefore need to consider the blind transaction doctrine in combination with these authorities to the extent that they direct Plan assets through ECNs, ATSs, or other similar trading venues.[57]

Other Prohibited Transaction Exemptions for Cross Trades

Several other prohibited transaction exemptions have been issued in connection with cross trades, including: (1) Section 408(b)(19) of ERISA; (2) Prohibited Transaction Class Exemption (PTCE) 2002-12; and (3) several individual exemptions which may only be relied upon by the party that requested the relief. Space considerations limit the ability to describe these exemptions in detail. However, a few key observations can be made in turn at least about Section 408(b)(19) and PTCE 2002-12.

Section 408(b)(19) of ERISA

Section 408(b)(19) provides an exemption for certain cross trades. Section 408(b)(19) requires, among other conditions: (1) that the trade be a purchase or sale for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available; (2) that the trade be effected at the independent current market price of the security; (3) that no commissions or brokers' fees be paid (other than customary custody transfer fees, if disclosed); (4) that a Plan fiduciary other than the investment manager directing the trade authorize the trade in advance in a separate written agreement after receiving separate written disclosure regarding the investment manager's cross trading policies and procedures; and (5) that the investment manager not base its fee schedule or any other provision of any other service on the Plan's consent to cross trading as permitted under the exemption.[58]

Many investment managers have concluded that there are substantial impediments to relying on this exemption. One of the additional conditions of the exemption is that each Plan in an investment manager's cross trading program must have assets in excess of $100 million. Arguably, this condition could require each Plan investor in a commingled Plan asset fund (that is, a hedge fund or bank collective fund) to meet this $100 million threshold. Subsequent regulations have clarified that the test need only be measured at the Plan's initial participation in the program and on an annual basis thereafter, thus limiting the possibility that an investment manager would need to monitor the test on a daily basis.[59] Still, the question as to commingled Plan asset funds remains.

In addition, the exemption requires that a responsible individual annually determine whether the exemption is met and issue a written report under penalty of perjury regarding the results of the compliance to the Plan clients' fiduciaries.[60] Further regulations indicate the individual must be specified by name (that is, title is insufficient) and must have written policies explaining why the individual is qualified for the position.[61]

The exemption also requires that the investment manager 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 program and that such policies and procedures describe how the investment manager would allocate the cross trades in an objective manner among the participating accounts.[62]

Regulations promulgated by the DOL with respect to this exemption require the disclosure to be "clear and concise" and require the inclusion of the criteria used to determine whether or not a cross trade will benefit both parties, the methodology used to ensure that a cross trade is executed at "current market price," and the method for apportionment across participating accounts.[63]

The exemption and regulations also require that the investment manager's policies and procedures contain a description of how the investment manager will mitigate any conflicting loyalties and responsibilities to the parties involved in the program.[64] Failure to comply with the investment manager's policies and procedures would apparently mean the trade could be prohibited.[65] In addition, the DOL rejected a comment that would have required that the policies and procedures be "reasonably designed" to ensure that the transactions be fair and equitable to all accounts participating in the program. Instead, taking a strict reading of the actual statutory language, the requirement is that the transactions in fact be fair and equitable to all accounts participating in the cross trading program.[66]

Interestingly, in the preamble to the regulation, the DOL noted that "securities trades executed between an investment manager and an account managed by an affiliate of such manager are beyond the scope of [the exemption]."[67] In this regard, the DOL further noted that:

> An investment manager's exercise of discretionary authority, on behalf of an account it manages, to effect a purchase or sale of a security with another account over which an affiliate of the manager exercises discretionary authority would not, in itself constitute a violation of Section 406(b) of ERISA. However, a violation of ERISA's prohibited transaction provisions could arise in operation, if, in fact, there was an agreement or understanding between the affiliated entities to favor one managed account at the expense of the other account in connection with the transaction.[68]

It would likely be unwise to assume that a prohibited transaction could not occur where the participating accounts are managed by different, but affiliated, investment managers. The fact that the DOL has excluded crosses involving accounts of affiliated managers can be viewed as both a potential shield and a potential sword. At a minimum, the DOL's exclusion of cross trades involving accounts of affiliated investment managers places greater importance on whether there could be a prohibited transaction requiring an exemption in the first place. In this regard, as with cross trades for accounts of the same investment manager, the analysis turns on the precise facts and circumstances involved and sensitivity to the DOL's long standing unsympathetic posture toward cross trades.

PTCE 2002-12 and Individual Exemptions

Separately, eight years prior to the promulgation of Section 408(b)(19) in 1998, following a 1998 Notice Requesting Information, the DOL proposed a class exemption for cross trades of securities where at least one of the parties to the trade is an index or model-driven fund.[69] Eventually, the DOL promulgated a final exemption for passive cross trades in the form of PTCE 2002-12.[70] For purposes of the exemption, an "index fund" is a fund designed to track the rate of return, risk profile and other characteristics of an independently maintained securities index, either by replicating the combination of securities compromising the index or sampling those securities based on objective criteria. The investment manager cannot use its discretion, or data within its control, to affect the identity or amount of the securities to be purchased or sold, and the index itself must be a securities index that represents the performance of a specific segment of the public market for equity or debt markets in the United States and/or foreign countries where the index is created and maintained by a financial news or information firm, a securities

firm, or a public stock exchange or association of securities dealers that is independent of the index fund's investment manager. The index must also be standardized, meaning that it cannot be specifically tailored for use by the investment manager. Similarly, a "model-driven fund" is a fund in which securities are selected by a computer model based on objective criteria using third party data not within the investment manager's control to transform the index.

Although at least one of the parties to the trade must be Plan assets, the Plan need not necessarily be the index or model-driven fund. In addition, PTCE 2002-12 only covers passive cross trades that result from certain "triggering events," such as: (1) a change in an index fund's underlying index by the independent organization that maintains the index; (2) a change in the composition of a model-driven fund's portfolio mandated solely by reason of the applicable computer model; (3) a material amount of net change in the overall level of fund assets resulting from third-party directed investments and withdrawals; (4) an accumulation of a material amount of cash or stock attributable to interest, dividends or tender offers for portfolio securities; and (5) changes to a model-driven fund's portfolio that arise solely as a result of an independent fiduciary's decision to exclude certain securities or types of securities from the fund.[71]

Cross trades where one of the parties is a "Large Account" (that is, a Plan or other institutional account with at least $50 million or assets or a registered investment company not sponsored by the investment manager) may also be effected pursuant to a "portfolio restructuring program."[72] Notably, the DOL did not adopt broader relief for cross trades where both of the parties are "Large Accounts." The DOL noted that it was concerned that broader relief could permit an investment manager to "time" specific cross trades in a way that would entail some discretion and also noted that such relief was beyond the intended scope of the exemption.

In proposing this exemption, the DOL recognized

> that its concerns [were] more apparent in situations involving actively-managed accounts or funds, where an investment manager has total investment discretion to choose particular securities for such accounts or funds at any time, subject only to general investment guidelines or objectives established by the client [P]lan fiduciar[y].[73]

There are numerous additional conditions to reliance on PTCE 2012-12, including: (1) required disclosures and authorizations by independent Plan fiduciaries; (2) specification of the methodology for determining trade price; (3) a description of the types of securities that may be transacted in a cross trade; and (4) additional recordkeeping requirements.[74] In addition, the investment manager may not collect any commissions or brokerage fees. There are also some interpretative and operational challenges associated with PTCE 2002-12, such as the fact that the exemption only covers equity securities that are "widely held" and "actively traded."

The DOL was clear that it was "not proposing relief for transactions involving actively-managed cross trading . . ." and has still not done so, to date.[75] Accordingly, PTCE 2002-12 is of limited utility to many active managers. Although the DOL has also granted a number of individual prohibited transaction exemptions, some of which preceded PTCE 2002-12, relief under these exemption is only available to the requesting party. Ironically, in some ways, the net effect of PTCE 2002-12 and the individual exemptions is to underscore that they are the exception, rather than the rule. Managers will therefore need to continue to be sensitive to ERISA-related concerns surrounding cross-trading.

Compliance Recommendations

As noted above, Rule 206(4)-7 under the Investment Advisers Act generally requires investment managers to adopt and implement compliance policies and procedures reasonably designed to prevent unlawful trading practices, including unlawful

cross trades.[76] SEC enforcement actions in this area emphasize training and monitoring as key components of an effective compliance program.[77] In light of the recent focus on cross trades, investment managers may wish to revisit their policies, procedures and practices to confirm that they remain reasonable to prevent and detect unlawful cross trades. Set forth below are recommendations for investment managers seeking to enhance the training and/or monitoring aspects of their programs.

Training Recommendations

Investment managers should seek to train their portfolio management and trading personnel not only on the content of their compliance policies and procedures, but also on the underlying regulatory restrictions. Investment managers should also seek to foster a culture of compliance where personnel ask questions and escalate their concerns up the applicable reporting chain.

Rule 17a-7 under the Investment Company Act requires funds that engage in cross trades pursuant to the Rule to maintain board-approved procedures governing trades effected in reliance on the Rule.[78] Training should cover the interaction between these policies and other policies and procedures governing cross trades. It is important for portfolio management and trading personnel to understand that Rule 17a-7 is a narrow exemption to Section 17(a)'s broad prohibition on cross trades involving funds. In this regard, it may be helpful to articulate a clear process for handling trades that do not fit within Rule 17a-7 or another exemption. For example, in the case of equity trades, the standard procedure could be to send concurrent opposing trades to different brokers.

Portfolio management and trading personnel may mistakenly believe that effecting a cross trade through a third-party broker effectively "breaks" the cross by causing the client accounts to transact with the broker rather than directly with each other.[79] Investment managers should seek to clarify this common misconception through training and/or the inclusion of an express statement in their policies and procedures that broker-interposed cross trades are prohibited. Investment managers should also talk with portfolio management and trading personnel about how the cross trading prohibitions intersect with their obligations to seek best execution.

Some investment managers, through their policies and procedures, impose limits on the amount of time a trader must wait after selling a security on behalf of one client account before purchasing the security again for another client account. Although these limits can be beneficial, particularly in the context of fixed income securities where trades effected on the same day through the same broker may have a likelihood of crossing, it is important that traders understand the underlying regulatory restrictions and not become overly reliant on these "rules." For example, investment managers that impose such limits should confirm that portfolio management and trading personnel understand that prearranging cross trades around waiting periods would violate Section 17(a) of the Investment Company Act (in the case of cross trades involving funds) and ERISA's prohibited transaction rules (in the case of cross trades involving Plans).

Monitoring Recommendations

Many investment managers utilize post-trade monitoring processes to seek to ensure that their cross trading policies and procedures are working as intended and to determine whether any unlawful cross trades have occurred. Typically, a designated group of individuals in trading or compliance is assigned to review trades overnight or on a T+1 basis and identify any potential cross trades using factors like execution time, spread and order size. Potential cross trades are then subject to further review and if violations are identified, corrective actions may be taken.

Some investment managers also monitor for potential cross trades throughout the trading day. This process is typically conducted by trading personnel. The advantage of monitoring for potential cross trades throughout the trading day is that

unlawful cross trades can be cancelled and rebooked before they are finalized. Pre-trade alert systems that use technology to flag opposite side trades for the same security may detect potential cross trades even earlier.

Approaches to preventing inadvertent cross trades tend to vary by security type as a strategy that works well for highly liquid securities may not be effective for illiquid securities (and vice versa). Investment advisers should develop processes that consider not only the liquidity of the securities in question and the opportunity for meaningful market exposure, but also the trading volume their transactions may occupy.

Some investment managers may require that concurrent opposing trades be executed through different brokers or on different trading desks. Investment managers may also consider using technology to enhance their processes for preventing unlawful cross trades. For example, algorithmic tools that use pre-determined criteria to randomly select brokers without trader input may help to ensure that an inadvertent cross is truly "unknowing."

As noted above, some investment managers may impose an intraday "time out" (for example, 15 minutes, one hour, three hours, 24-hours, etc.) between opposing trades. Other managers have considered using internal firewalls to prevent traders from accessing information about opposing trades. The effectiveness of a particular process may depend on an investment manager's organizational structure, operations and diversity of investment strategies. In addition, while processes like the ones described herein may help investment managers mitigate risk, there is no guarantee that any one process or combination of processes would be sufficient to fully address regulators' concerns.[80]

Finally, investment managers to ERISA-covered accounts may be confronted with unique challenges when they retain discretion in connection with "rebalancings" of accounts under their management or facilitate in-kind transfers of securities between accounts under their management. To avoid concerns arising from an investment manager's retention of discretion in connection with an in-kind transfer, a manager may insist that a client independently direct the manager to redeem the positions in-kind and direct that the redemption be followed with an immediate contribution in-kind to the destination fund. Additional disclosures are often made, and depending on the type of investments, an investment manager may not only provide a list of the actual positions and their recorded value, but also the valuation methodologies utilized.[81] Many managers facilitating these requests will require appropriate representations from an independent Plan fiduciary stating that the investment manager itself is not acting as a fiduciary in the process.[82]

Conclusion

Given the recent focus on cross trades, investment managers should continue to be mindful of the applicable regulatory restrictions. In addition, as noted above, investment managers may wish to revisit their policies, procedures and practices to confirm that they remain reasonable to prevent and detect unlawful cross trades.

John V. O'Hanlon is a partner and **Kaitlin McGrath** is an associate in Dechert LLP's financial services group. **Steven W. Rabitz** and **Andrew L. Oringer** are partners in Dechert LLP's employee benefits group.

NOTES

1 *See* 15 U.S.C. § 80a–17(a).

2 Alfred Jaretzki, "The Investment Company Act of 1940," 26 *Wash. U. L. Q.* 303, 321 (Apr. 1941).

3 *See Mergers and Consolidations Involving Registered Investment Companies*, SEC Rel. No. IC-10886 (Oct. 2, 1979), citing Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., at 256-59 (1940).

[4] 17 C.F.R § 270.17a-7. *See also Notice of Proposal to Adopt Rule 17a-7*, SEC Rel. No. IC-4604 (May 20, 1966) (explaining that the "conditions as to the availability of the exemption…are designed to limit the exemption to those situations where the [SEC], upon the basis of its experience, considers that there is no likelihood of overreaching of the [funds] participating in the transaction.)

[5] 17 C.F.R § 270.17a-7. For fixed income securities, the "independent current market price" is defined as "the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry."

[6] Section 206(3) of the Advisers Act restricts only: (1) "principal transactions," where an investment manager, acting as principal for its own account, buys securities from, or sells securities to, a client; and (2) "agency cross transactions" where an investment manager, acting as broker for another client, buys securities from, or sells securities to, a client. 15 U.S.C. § 80b-6(3). *See also* "Study on Investment Advisers and Broker-Dealers," SEC Staff (Jan. 2011), at 27 (*Study on Investment Advisers and Broker-Dealers*) ("[e]ffecting cross trades between clients (where a third-party broker is used) is not specifically addressed by the Advisers Act").

[7] Section 206 generally prohibits an investment manager from engaging in fraudulent, manipulative or deceptive conduct. 15 U.S.C. § 80b-6. While not explicitly stated in the Advisers Act, the US Supreme Court has held that the Advisers Act, through Section 206, imposes a fiduciary duty on investment managers by virtue of an investment manager's fiduciary relationship with its clients. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

[8] Winstead McGuire Sechrest & Trimble, SEC No-Action Letter (pub. avail. Feb. 21, 1975); *Study on Investment Advisers and Broker-Dealers* at 106. Because an investment manager's duty of loyalty "requires [the manager] to act in the best interests of each client," a scenario where the manager "could favor one client over another" could jeopardize the manager's ability to fulfill this obligation. *Study on Investment Advisers and Broker-Dealers* at 27.

[9] In a 2006 no-action letter to Federated Municipal Funds, the SEC Staff addressed an investment manager's duty to seek best execution in the context of cross trades between funds as follows: "if the [manager]…could obtain greater proceeds for the [selling] fund by selling the security in the market…the [manager] should sell the security in the market" and if the manager could obtain lesser costs for the buying fund by buying the security in the market, the manager should buy the security in the market. *See* Federated Municipal Funds, SEC No-Action Letter (pub. avail. Nov. 20, 2006).

[10] *See In the Matter of McKenzie Walker Investment Management, Inc.*, SEC Rel. No. IA-1571 (Jul. 16, 1996) (failure to disclose that performance fee accounts were favored over non-performance fee accounts in the allocation of equity trades and IPOs); *In the Matter of John McStay Investment Counsel, L.P.,* SEC Rel. No. IA-2153 (July 31, 2003) (failure to disclose change in IPO allocation methodologies and that the change in methodologies favored mutual fund accounts).

[11] *See, e.g., In the Matter of Renberg Capital Management, Inc.*, SEC Rel. No. IA-2064 (Oct. 1, 2002) (alleging that an investment manager "failed to seek best execution in securities transactions for certain advisory clients because of undisclosed trading practices involving cross trades between client accounts" that caused "the accounts on the purchasing side [to pay] higher execution costs for their shares).

[12] 17 C.F.R. § 275.206(4)-7(a) (requiring a registered investment manager to adopt and implement policies and procedures reasonably designed to prevent violations by the manager and its supervised persons of the Advisers Act and the rules thereunder).

[13] *See In the Matter of Back Bay Advisors, L.P.*, SEC Rel. No. IC-25787 (Oct. 25, 2002) (*Back Bay*). The SEC order discussed several weaknesses in Back Bay's compliance program, including Back Bay's failure to adequately train its personnel:

Back Bay never trained its CIO, compliance officer, portfolio managers or any of its other personnel about affiliated transactions. The closest the firm came to educating employees was its practice of periodically distributing a compliance guide to some of its investment staff. However, Back Bay took no efforts to ensure that its staff actually consulted the manual. Some personnel, including the CIO, could not recall ever referring to it. The firm incorrectly assumed that its personnel were familiar with the relevant rules.

14 *See id.* The SEC order also noted that Back Bay's monitoring processes were inadequate:

> [P]ortfolio managers who effected cross trades repeatedly indicated on the quarterly compliance questionnaires that no such transactions had occurred. Back Bay had no policies or procedures in place to test the accuracy of those responses. As a result, Back Bay never caught any of the errors and they persisted for years.

15 15 U.S.C. § 80a–17(a).

16 *See Investment Trusts and Investment Companies,* Hearings Before A Subcommittee of the Committee on Banking and Currency, US Senate 76th Congress, Third Session on S. 3580, Part I at 257 (Apr. 2,3,4,5,8,9 and 10, 1940) (statement of David Schenker, SEC Chief Counsel). This interpretation is also supported by the Seventh Circuit's decision in *SEC v. Advance Growth Capital Corp.*, which suggests that a transaction with an affiliated person would violate Section 17(a) if it is committed in a manner that is not "unknowing, inadvertent or unwilling."

17 *See* Israel Development Corporation, SEC No-Action Letter (pub. avail. Nov. 12, 1973).

18 *See* Delta Government Options, SEC No-Action Letter (pub. avail. Jul. 21, 1989). The Staff noted that, because the transactions were entered into without prearrangement and consummated on a blind broker basis, the affiliate would not know the identity of the other party to the transaction, and thus, would not be in a position to influence the actions of the fund.

19 *See In the Matter of Western Asset Management Co.*, SEC Rel. No. IC-30893 (Jan. 27, 2014) (Western) (alleging that Western had failed to adequately train and supervise its trading personnel to ensure compliance with cross trading prohibitions); *Back Bay* (stating that the manager's "violations occurred in part because of its poor compliance controls," noting that the manager's personnel "were ignorant of the applicable statutory requirements and instead followed their own practices for cross trading.").

20 *See also Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with respect to Investment Adviser Portfolio Trading Practices*, SEC Release No. 34-58264 (July 30, 2008) (emphasis added). To address the obligations arising under an investment manager's fiduciary duty, the SEC has stated that it is important for the manager to implement policies and procedures to identify potential conflicts of interest and practices that could result in one client account being favored over others. S*ee Compliance Programs of Investment Companies and Investment Advisers*, 68 Fed. Reg. 74714 n.15 (Dec. 24, 2003).

21 Item 11 of Part 2 of Form ADV addresses Codes of Ethics, Participation or Interest in Client Transactions and Personal Trading.

22 *See e.g., Western*; *In the Matter of Aviva Investors Americas*, *LLC et al.*, SEC Rel No. IC- 32280 (Sept. 24, 2016).

23 *In the Matter of Hamlin Capital Management, LLC*, SEC Rel. No. IA-4983 (Aug. 10, 2018) (*Hamlin*) (involving violations of Section 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder).

24 As noted above, Section 206 generally prohibits an investment manager from engaging in fraudulent, manipulative, or deceptive conduct. 15 U.S.C. § 80b-6. Rule 206(4)-8(a)(2) extends this prohibition to communications between an investment manager to a pooled investment vehicle and any investor or

prospective investor in the pooled investment vehicle. 17 C.F.R. § 275.206(4)-8(a)(2).

[25] The SEC also noted that this practice was prohibited under Hamlin's compliance manual.

[26] The brokers Hamlin had used for month-end valuation purposes were typically the underwriters of the bonds. Hamlin had extensive knowledge of the bonds and, on occasion, would "challenge" the allocations provided by the brokers. Hamlin did not formally document the rationale for these challenges.

[27] *In the Matter of Cushing Asset Management, LP*, SEC Rel. IC-33226 (Sept. 14, 2018) (*Cushing*) (involving a violation of Section 17(a) of the Investment Company Act).

[28] Although the SEC noted that the trades comprised 40 percent of the trading volume for units of the MLP on the trading day, the SEC did not state that any particular percentage of the trading volume would have been determinative of a cross trade violation.

[29] *In the Matter of Putnam Investment Management, LLC et al.*, SEC Rel. IC-33257 (Sept. 27, 2018) (*Putnam*) (involving violations of Section 17(a) of the Investment Company Act of 1940, as amended (Investment Company Act) and Sections 203(e)(6), 206(2), 206(4) and 206(7) of the Advisers Act and Rule 206(4)-7 thereunder).

[30] Most of the cross trades were done through one of two brokers with whom Harrison had established relationships. This enabled Harrison to use code words to indicate that he intended to repurchase a security he was selling at a slight markup the next day.

[31] Putnam's policies and procedures would have required Harrison to execute the trades at the midpoint of the higher of two bids and the lower of two offers obtained within the hour. Putnam's Form ADV represented that Putnam would conduct cross trades in accordance with Rule 17a-7, including Rule 17a-7's requirement to use "an independent current market price," as defined in the Rule.

[32] In support of (1) and (2), the SEC noted that the personnel in Putnam's Structured Credit Group did not receive adequate training on cross trades. The SEC also noted the Compliance Department tried to implement a monitoring process to detect prearranged cross trades occurring on a T+1 basis, but its implementation of this process was flawed.

[33] *Western* (involving violations of Section 17(a) of the Investment Company Act, Sections 203(e)(6), 206(3), 206(4) and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder).

[34] For example, in *Western*, the investment manager's practice of executing the sell at the bid price and the repurchase at a slight mark-up over the bid was invalid in the first place because the trades involved funds and, therefore, needed to comply with Rule 17a-7 to be exempt from Section 17(a) of the Investment Company Act. Because the trades involved fixed income securities, Rule 17a-7 would have required them to be executed at "the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry."

[35] 29 C.F.R § 2510.3-101, as modified by Section 3(42) of ERISA, contains certain rules pursuant to which a pooled investment vehicle, such as a hedge fund or a collective investment trust would be deemed to constitute the assets of Plan investors, subjecting the investment manager and other fiduciaries (and potentially counterparties) to ERISA and Section 4975 of the Code. ERISA only applies to the assets of private sector retirement Plans. In addition to governing arrangements such as individual retirement accounts, Section 4975 of the Code also contains the excise tax provisions applicable to Plans subject to ERISA and Section 4975 of the Code. 26 U.S.C. § 4975

[36] 29 U.S.C. § 1104(a)(1)(A). ERISA also requires that a fiduciary 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 exercise of a like character and with like aims." *Id.* § 1104(a)(1)(B).

This Article does not cover potential cross trade issues that may arise for governmental plans. Governmental plans are not subject to ERISA's fiduciary responsibility

and prohibited transaction rules, and each such plan is governed by local law. However, the rules governing most governmental plans contain at least some fiduciary responsibility and related provisions that may bear on the legality of potential cross trades. Such rules may contain provisions that are substantially similar to ERISA's prohibited transaction rules. Even if they do not, investment managers should still consider whether other provisions applicable under local law, such as a provision similar to ERISA's "exclusive benefit" provision could bear on the investment manager's ability to legally effect cross trades.

37 29 U.S.C. § 1106(b)(2). The DOL indicated that Section 406(b)(3) violations could also result from cross trades. Section 406(b)(3) prohibits a fiduciary from receiving any consideration for his own personal account from any party dealing with such Plan in connection with a transaction involving the assets of such Plan. *Id.* § 1106(b)(3); *Proposed Class Exemption for Cross Trades of Securities by Index and Model-Driven Funds*, 64 Fed. Reg. 70057, 70059 (Dec. 15, 1999) (1999 Proposal).

38 *See* Advisory Opinion 2003-15A (Nov. 17, 2003).

39 *Notice Requesting Information on Cross-Trades of Securities by Investment Managers*, 63. Fed. Reg. 13696 (Mar. 20. 1998) (emphasis added) (1998 Notice Requesting Information). *See also Reich v. Strong Capital Management Inc.*, No. 96-C-0069, USDC, E.D. Wis. (June 6, 1996); *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979). The DOL noted that " . . .[w]hen identical trustees of two employee benefit plans whose participants are not identical effect a loan between the plans without a [Section] 408 [of ERISA] exemption, a per se violation of ERISA exists." *Cuitair,* 590 F.2d at 529. *See* also the text of the quote cited in n.66, *infra*, and the text of the following paragraph.

40 Specifically, the DOL's concerns are illustrated by, among other things, the potential for an investment manager to:

(i) Place relatively illiquid securities into ERISA accounts in order to, among other reasons, shift anticipated losses away from, or provide artificial liquidity and price stability for, favored accounts;

(ii) Use ERISA accounts as buyers or sellers of securities at particular times in order to promote the interests of more favored client accounts;

(iii) Allocate favorable cross trade opportunities, and the transaction cost savings associated with such trades, to favored client accounts, such as those that have a performance-based fee arrangement with the manager in order to either increase the manager's fees or demonstrate superior investment performance;

(iv) Allow cross trade opportunities to affect the underlying investment management decision as to which securities to buy or sell for particular ERISA accounts; and

(v) Use cross trades to avoid the potential market impact of large trades on certain accounts where such trades may not be in the best interests of all accounts involved or may not result in the best execution for the acquisition or sale of such securities.

1998 Notice Requesting Information at 13697.

41 1999 Proposal at 70059.

42 1998 Notice Requesting Information at 13699.

43 29 U.S.C. § 1109.

44 *Id.* § 1106(b)(1). Section 406(b)(1) of ERISA provides an independent basis for prohibited transaction liability where a fiduciary "deal[s] with the assets of [a P]lan in his own interest or for his own account." For violations of Section 406(b)(1), the Code requires not only correction, but also the imposition of excise taxes on the "amount involved." *See* 26 U.S.C. § 4975. Whether a particular cross trade goes beyond merely a Section 406(b)(2) violation and involves an act of self-dealing with the clear intent to benefit the fiduciary depends on the facts and circumstances.

45 *See, e.g.*, the SEC's and DOL's 2014 enforcement actions against Western. According to the DOL's press release:

[The DOL's settlement] follows investigations, which revealed the purchase of prohibited

securities that resulted in losses to the accounts of nearly 100 employee benefit plans and investment funds holding plan assets. The settlement also resolves findings that the company engaged in prohibited cross-trading of securities in the accounts of other retirement plans and funds, which caused additional losses. The settlement was achieved in coordination with the [SEC]. The settlement and related SEC charges require Western…to restore a total of more than $17.4 million to employee benefit plans and other accounts and… pay more than $3.6 million in penalties.

"US Labor Department and Securities and Exchange Commission reach combined $21M in settlements with Western Asset Management," News Release (Jan. 27, 2014). The press release also noted that the DOL's investigation found that because the cross trades involved unfair pricing, certain ERISA-covered accounts suffered more than $6 million in losses. *Id.*

46 H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 306 (1974).

47 *See* Advisory Opinion 2004-05A: " . . . based on your representations, it is our further view that 'blind' transactions executed pursuant to such procedures would not, in themselves, constitute prohibited transactions under section 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) or 406(b)(2) of ERISA."

48 *See* Theda R. Haber, Steven W. Rabitz and Alan S. Wilmit, "ERISA Aspects of Cross-Trading and Electronic Crossing Networks," Practising Law Institute, *Pension Plan Investments 2000: Confronting Today's Issues* (May 2000).

49 Advisory Opinion 2004-05A (May 24, 2004).

50 *Id.*

51 *Id.*

52 *Id* at n.4.

53 *Id*. In particular, Liquidnet represented that "during the entire execution and settlement processes, subscribers interact with each other pursuant to policies and rules designed to ensure anonymity."

54 To date, no foreign regulated venues have been approved by DOL.

55 *Joint Committee on Taxation Report, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006,"as Passed by the House on July 28, 2006 and as Considered by the Senate on August 3, 2006.* JCX-38-06 (Aug. 3, 2006).

56 29 U.S.C. § 1108(b)(19). ERISA Section 408(b)(19) also provides relief from the self-dealing provisions of ERISA where a manager or its affiliate may have an ownership interest in the ECN, ATS or other trading venue. This relief is important because self-dealing concerns could independently arise where an investment manager uses a system that could affect its best judgment as a fiduciary.

57 The Pension Protection Act of 2006 also added a separate exemption for "block trades." *Id.* § 1108(b)(15) ERISA Section 408(b)(15) provides limited relief for certain block trade transactions. The exemption states that it available for parties in interest "other than a fiduciary."

58 *Id.* § 1108(b)(19).

59 17 C.F.R. § 2550.408b-19.

60 29 U.S.C. § 1108(b)(19). The exemption also requires significant advance disclosure to Plan clients' fiduciaries and quarterly reporting of all cross trades, including the identity of each security bought and sold, the number of shares or units traded, the parties involved, the trade price and the method used to price the trade.

61 17 C.F.R. § 2550.408b-19.

62 29 U.S.C. § 1108(b)(19).

63 *Id.*

64 Interestingly, the DOL requires an affirmative statement that the investment manager will have conflicting loyalties, and deleted an earlier reference to "potentially" conflicting loyalties. The DOL noted that it believes "that there is an inherent conflict of interests when there is a common investment manager for both sides of a transaction." Statutory Exemption for Cross-Trading of Securities, 73 Fed. Reg. 58450, 58452 (Oct. 7, 2008) (Release Adopting Statutory Exemption for Cross-Trading of Securities).

65 17 C.F.R. § 2550.408b-19.

66 Release Adopting Statutory Exemption for Cross-Trading of Securities at 58452.

67 *Id.*

68 *Id.*

69 1999 Proposal at 70059.

70 Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds, 67 Fed. Reg. 6614 (Feb. 12, 2002) (Release Adopting PTCE 2002-12).

71 *Id.*

72 *Id.* For purposes of PTCE 2002-12, a "portfolio restricting program" is defined as:

> Buying and selling the securities on behalf of a Large Account in order to produce a portfolio of securities which will be an Index Fund or a Model-Driven Fund managed by the Manager or another investment manager, or in order to produce a portfolio if securities the composition of which is designated by a party independent of the investment manager, or to carry out a liquidation of a specified portfolio of securities for the Large Account.

73 1999 Proposal at 70059.

74 Release Adopting PTCE 2002-12.

75 *Id.*

76 17 C.F.R. § 275.206(4)-7(a) (requiring a registered investment manager to adopt and implement policies and procedures reasonably designed to prevent violations by the manager and its supervised persons of the Advisers Act and the rules thereunder).

77 *See, e.g., Western*; *Back Bay*. The SEC's recent enforcement action against Putnam is no exception. *See Putnam*. Although the SEC did not identify anything in Putnam's written policies and procedures that was lacking, the SEC still concluded that Putnam had not fulfilled its obligations under Rule 206(4)-7. In this regard, the SEC noted that Putnam had failed to adequately train its personnel and undertake sufficient efforts to monitor for and detect cross trades.

78 17 C.F.R § 270.17a-7(e) and (f).

79 The SEC and the DOL both take the view that the cross trading prohibitions under their jurisdiction apply equally to "direct" cross trades (*i.e.*, cross trades effected by an investment manager without the use of a broker) and "broker-interposed" cross trades (*i.e.*, cross trades effected through a third-party broker, in some cases, pursuant to a reduced compensation arrangement).

80 The use of so-called "ethical screens" may or may not be viewed favorably, although there may be some informal indications that the DOL is skeptical about their utility as a catch-all approach. *See also Board of Trustees of the AFTRA Ret. Fund v. JPMorganChase Bank*, 09 Civ. 686 (SAS) (S.D.N.Y. Aug. 5, 2011).

81 Differing approaches may need to be considered where the positions are less liquid or hard to value.

82 In some instances, the use of an independent fiduciary expert may be indicated.