

Management Alert

Department of Labor Promulgates Interim Cross-Trading Rules

As part of the Pension Protection Act enacted in 2006 (PPA), Congress added to ERISA a statutory exemption for cross-trading. The Department of Labor (DOL) has traditionally taken a restrictive view of the circumstances under which an investment manager could initiate trades between its clients if one of those clients (or both) were ERISA-covered employee benefit plans. In 2002, the DOL issued a prohibited transaction class exemption that permitted cross trades, but only for certain computer-generated model strategies or index type accounts. As a result of the DOL's position, many investment managers have adopted a policy that prohibits cross trades involving ERISA clients.

As part of the PPA, Congress provided a much broader statutory exemption for cross trades involving ERISA plan clients that have at least \$100 million in assets, provided that the cross-trading is approved by an independent fiduciary and that the investment manager complies with various disclosure and reporting requirements. The exemption, contained in new section 408(b)(19) of ERISA, defines a cross trade as the purchase and sale of a security between an ERISA plan and another account managed by the same investment manager. The other account may be another ERISA plan client or other type of client of the investment manager.

One of the requirements of the new exemption is that the investment manager must have adopted written cross-trading policies and procedures (Policies). In addition, the investment manager must designate a compliance officer to periodically review cross trades to ensure compliance with the Policies. On February 12, 2007, the DOL issued interim final rules for implementing these requirements – DOL regulation section 2550.4086-19 (the Interim Rules). *The Interim Rules only provide guidance with respect to requirements regarding the investment manager's policies and procedures and written disclosure obligations.* They do not cover any of the other requirements of the new exemption.

Policy and Procedure Requirements

The Interim Rules require that the Policies be fair and equitable to all accounts participating in the manager's cross-trading program. In addition, the Policies must be written in a clear and concise manner calculated to be understood by the independent plan fiduciary authorizing cross-trading – a "plain English" requirement. Finally, the Policies must be sufficiently detailed to facilitate the required periodic review by the compliance officer.

The Interim Rules specifically require that the Policies contain:

- The criteria to be applied by the investment manager in determining that the cross trade will be beneficial to both parties to the transaction.
- A description of the manager's procedures for determining that cross trades are effected at the "independent current market price" (within the meaning of the securities laws), including identity of sources used to establish such price.
- A description of the manager's procedures for ensuring compliance with the \$100 million minimum client asset size requirement set forth in the exemption.
- A description of how the manager will mitigate potential conflicting divisions of loyalties and responsibilities.
- A statement that the manager will allocate cross trades among accounts in an objective and equitable manner and a description of the allocation methods available to and used by the manager. If more than one method may be used, the Policies must also include a description of what circumstances will dictate the use of a particular methodology.
- The identification of the compliance officer and a statement of that person's qualifications for the position.
- A statement describing the scope of the compliance officer's periodic review, including whether the review is limited to compliance with the cross trade Policies or whether it extends to an overall review of compliance with the cross trade exemption.
- A description of the manager's pricing policies and procedures.
- Any other appropriate policies or procedures.

Disclosure Requirements and Authorization

A manager's Policies must be disclosed to the plan's independent fiduciary in advance of his or her authorization for the plan to participate in cross trades. The authorization to participate in cross trades must be in a document *separate from the investment management agreement* or any other document containing disclosures about the plan's account, such as the investment manager's Form ADV or any information given to the independent fiduciary in connection with other DOL prohibited transaction exemptions (*i.e.*, in connection with the affiliated broker dealer exemption under Prohibited Transaction Class Exemption 86-128). In addition, the disclosure document must contain a statement that the manager may potentially have conflicting divisions of loyalty and responsibilities in connection with the cross trade program.

The exemption and the Interim Rules apply both to separate accounts and to commingled funds.

Conclusion

Managers of ERISA plan assets will want to review the new exemption's requirements and the requirements of the Interim Rules and determine whether to alter their current cross-trading policy. Some may determine that the requirements remain too onerous; others may wish to take advantage of this new opportunity.

If you are interested in discussing this matter further or would like to implement a new cross-trading policy for ERISA accounts, contact your Seyfarth Shaw attorney or any of the attorneys listed in the investment management practice area on our website, www.seyfarth.com.

ATLANTA

One Peachtree Pointe
1545 Peachtree Street, N.E.
Suite 700
Atlanta, GA 30309-2401
404-885-1500
404-892-7056 fax

BOSTON

World Trade Center East
Two Seaport Lane
Suite 300
Boston, MA 02210-2028
617-946-4800
617-946-4801 fax

CHICAGO

131 South Dearborn Street
Suite 2400
Chicago, IL 60603-5577
312-460-5000
312-460-7000 fax

HOUSTON

700 Louisiana Street
Suite 3700
Houston, TX 77002-2797
713-225-2300
713-225-2340 fax

LOS ANGELES

One Century Plaza, Suite 3300
2029 Century Park East
Los Angeles, CA 90067-3063
310-277-7200
310-201-5219 fax

NEW YORK

1270 Avenue of the Americas
Suite 2500
New York, NY 10020-1801
212-218-5500
212-218-5526 fax

SACRAMENTO

400 Capitol Mall
Suite 2350
Sacramento, CA 95814-4428
916-448-0159
916-558-4839 fax

SAN FRANCISCO

560 Mission Street
Suite 3100
San Francisco, CA 94105-2930
415-397-2823
415-397-8549 fax

WASHINGTON, D.C.

815 Connecticut Avenue, N.W.
Suite 500
Washington, D.C. 20006-4004
202-463-2400
202-828-5393 fax

BRUSSELS

Boulevard du Souverain 280
1160 Brussels, Belgium
(32) (2) 647 60 25
(32) (2) 640 70 71 fax



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