



THE COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS

February 21, 2003

Office of Exemption Determinations
Division of Exemptions
Room N-5649
U.S. Department of Labor
200 Constitution Ave., N.W.
Washington, DC 20210

Attn: Karen Lloyd

Re: Application #D-11024
CIEBA Request for Class Exemption Regarding Cross-Trading
by or under the Supervision of an In-house Asset Manager

Ladies and Gentlemen:

You asked that we review and respond to the July 2002 Report on Cross-Trading by ERISA Plan Managers, commissioned by the Department and prepared by Thomas H. McInish. Overall, we read the Report as cautiously supporting cross-trading by INHAMs, subject to certain conditions. (*See, e.g.*, Report pp. 26-27.) We also suggest that such conditions already have been fully incorporated into CIEBA's proposed exemption. We note in particular that the Report echoes our own observation to the Department that there are few incentives for abuse in the context of cross trading between in-house plans, particularly in the case of large plans managed by an INHAM.

Aside from the foregoing, we have three major reactions to the Report, as well as a number of specific observations and comments. First, as an academic exercise the Report provides a well-reasoned and thorough analysis of the economics of cross trading *in general*, but it offers little in the way of practical guidance and suggestions for applying the theories it advances to any specific plan. In this respect, perhaps the most important practical suggestion that it offers is to require the adoption of written cross-trading policies and procedures for each plan. CIEBA has already made this same suggestion. Each individual plan's fiduciaries can adopt such policies and procedures taking into account the Report's theoretical observations *as relevant* to that specific plan.



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Second, much of the Report's focus seems to be on equity securities that otherwise are traded frequently and in large volumes. Any attempt to address certain of these points (for example, the analysis regarding variances in daily trading volumes and prices) would have no clear relevance to fixed income securities or more thinly traded equities and might require line-drawing where none is warranted. Again, our response is that many of these more esoteric details of the economics of cross trading are best left to individual managers' cross-trading policies and procedures.

Third, to the extent that the principal conclusion drawn by the Report seems to be that some or all of the benefit of any "bargain" derived from cross trading should go to the "less motivated" party to the transaction, it is completely counter to all of the Department's efforts to impose objective standards on cross trading. In theory, Dr. McNish's conclusion may be valid for any individual transaction; in reality, it is so subjective as to be unworkable.¹ It assumes that the parties' relative motivations can be measured. Even if the "less motivated" party can be determined, it is not possible to determine the relative *difference* in the parties' motivations – does it justify giving the *entire* benefit of the bargain to one party, or 90%, or only 51%? We also pointed out in our last submission that the mere availability of a cross trade can *change* motivations because of the bargain element or because it presents an investment opportunity that otherwise cannot readily be duplicated in the open market. Nor does urgency to obtain liquidity necessarily translate to motivation to sell a *specific* security. Moreover, we have already pointed out that, in the case of fixed income securities, *both* parties benefit by splitting the spread that otherwise would go to the dealer in a market transaction.²

Except in unusual circumstances, most plans will be both buyers and sellers of securities over the long run, and will participate in cross trades both as the initiating (more motivated) and responding party (less motivated); any theoretical benefits of being on one side of the transaction will be offset over

¹ We also note that this conclusion assumes that all cross trades will be valued using the bid-asked spread; in fact, the default under Rule 17a-7 for exchange-traded securities is to use the last sale price for that day, if available.

² *See, also*, the last sentence on p. 23 for a similar conclusion with respect to certain equities.

time. We acknowledge that Rule 17a-7 pricing may not be an entirely accurate reflection of the market, but it provides both objectivity and symmetry (*i.e.*, to the extent that mutual funds using Rule 17a-7 may be counterparties).

We also wish to comment on certain specific statements made in the Report by Dr. McInish, to the extent that we believe such statements may be relevant to our more general points discussed above:

- Page 2: “By becoming a party to a cross trade, a plan foregoes the possibility of using patient trading strategies.” We suggest that this is not necessarily the case; in fact, cross trading may be fully compatible with a patient trading strategy. Several of the examples in our prior submission – such as opportunistic trading and “delaying” otherwise planned transactions in anticipation of a later cross-trading opportunity – could be consistent with a patient trading strategy.
- Page 3: “It is unlikely that SEC inspectors would note or comment on DOL regulations in their inspection reports if these differed from SEC requirements.” On the contrary, it has been our experience that, in general, auditors from the SEC regularly request information regarding investment managers’ policies and procedures for complying with ERISA, and sometimes follow-up by requesting written “opinions” of counsel or referring matters to the Department for further advice and further review.
- Pages 5-6: We agree with the general view that cross trading offers greater benefits to larger plans. We also note that, in item (3) on page 6, the reference to manager “disagreement” is an oversimplification. As pointed out in our prior submission, there are numerous other reasons for one plan to buy while another is selling. To the list on page 6 we would also add: (4) Larger funds tend to have greater flexibility to take advantage of cross-trading opportunities (as discussed in our prior submission); (5) Larger plans tend to have more in-house expertise and greater ability to perform day-to-day supervision of portfolio managers and investments; and (6) Larger investment size affords more capacity and, hence, greater ability, to take advantage of cross-trading opportunities.
- Page 10: As discussed above in connection with party “motivations,” it is an interesting theory that the average purchase has a slightly greater market impact than the average sale; however, it is not clear how this has any relevance to any specific purchase or sale transaction. Rather, as with

many of the other points raised in the Report,³ this is merely one factor that a prudent fiduciary may wish to take into account in developing cross-trading policies and/or executing specific cross trades, but it cannot otherwise be objectively built into an exemption.

- Page 15: We do not discount the merits of ECNs or other alternatives to cross trading. The proposed exemption does not relieve an INHAM or portfolio manager from the obligation to first determine that engaging in a cross trade in lieu of another trading methodology is prudent and in the interest of the plan(s).
- Pages 18-21: As noted above, intraday patterns may be relevant only to a relatively small subset of all securities, and for some securities may be relevant only on some trading days. Again, it is an interesting academic exercise that is difficult to translate to any readily applicable, objectively determinable approach. Moreover, to the extent that end-of-day prices are not as reflective of “true” market price as prices taken at other times, the effects on a plan generally cannot be predicted and, over time, are likely to balance out.⁴
- Page 24, item 1: This point is also repeated elsewhere, *i.e.*, that cross trades involve a significant price risk. However, this risk can be favorable or unfavorable, and generally cannot be predicted. Cross trading offers price predictability. In effect, there is a trade-off between pricing accuracy and pricing volatility.
- Page 25, item 2: We agree that some potential cross trades require sophistication to administer; hence, the rather substantial conditions we have recommended in the proposed exemption.
- Page 25, item 3: The proposed exemption includes various conditions and checks to ensure that cross trading occurs only when it is beneficial to both parties. With respect to the managers’ cross-trading policies and procedures, Portfolio Manager policies are subject to the review and

³ *E.g.*, the discussion of block trades at page 12.

⁴ Note also that Rule 17a-7 refers to the “last” sale price, which is not necessarily an “end of day” price; it could well be the opening price on that day.

approval of the INHAM as well as to SEC review; the INHAM's policies and procedures are subject to SEC review as well as to review and approval of an independent auditor. They are all subject to the Department's clear position (*e.g.*, expressed in the Department's "derivatives" letter to the OCC) that a fiduciary must have or obtain the expertise needed to engage in more complex investment strategies.

We hope that this proves helpful. Please contact Richard Matta of the Groom Law Group at (202) 861-5431 if you have further questions or comments.

Sincerely,



Gary A. Glynn
President
United States Steel and Carnegie Pension Fund
Chairman, CIEBA

cc: Alan Lebowitz, Deputy Assistant Secretary
Program Operations, Employee Benefits Security Administration

CIEBA Cross-Trading Task Force