

**DEPARTMENT OF LABOR****Pension and Welfare Benefits Administration**

[Prohibited Transaction Exemption 2002-12; Application No. D-10851]

**Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds**

**AGENCY:** Pension and Welfare Benefits Administration, Department of Labor.

**ACTION:** Grant of class exemption.

**SUMMARY:** This document contains a final exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act or ERISA), the Federal Employees' Retirement System Act (FERSA), and from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The exemption permits cross-trades of securities among Index and Model-Driven Funds (Funds) managed by investment managers, and among such Funds and certain large accounts which engage such managers to carry out a specific portfolio restructuring program or to otherwise act as a "trading adviser" for such a program. The exemption affects participants and beneficiaries of employee benefit plans whose assets are invested in Index or Model-Driven Funds, large pension plans and other large accounts involved in portfolio restructuring programs, as well as the Funds and their investment managers. This exemption does not address cross-trades of securities among "actively-managed" accounts. The Department is considering additional safeguards to protect participants in plans that engage in active cross-trading prior to publishing a proposal to permit such cross-trades.

**EFFECTIVE DATE:** The effective date of the exemption is April 15, 2002.

**FOR FURTHER INFORMATION CONTACT:**

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**Paperwork Reduction Act Analysis**

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520)(PRA 95), the Department submitted the information collection request (ICR) included in the Class

Exemption for Cross-Trades of Securities by Index and Model-Driven Funds to the Office of Management and Budget (OMB) for review and clearance at the time the Notice of proposed class exemption was published in the **Federal Register** (December 15, 1999, 64 FR 70057). OMB subsequently approved the ICR under OMB control number 1210-0115. The approval will expire on April 30, 2003. The public is not required to respond to an information collection request unless it displays a currently valid OMB control number.

As described in detail in the **SUPPLEMENTARY INFORMATION** section which follows, the Department of Labor (Department) has made certain modifications to the terms of the proposed class exemption in response to comments received from the public. Although the recordkeeping and information disclosure requirements which constitute the information collection provisions of the final class exemption have been clarified in certain respects, the information collection provisions have not been substantively or materially changed from the proposed exemption. The Department has, however, made certain adjustments to its burden estimates and underlying assumptions in response to comments on the proposal. These adjustments relate to the numbers of entities offering Index and Model-Driven Funds and their client plans, and the number of Large Accounts that may make use of the exemption, and the estimated burden of the record-keeping requirement.

The Department's original estimates of the number of users of the exemption were based on the number of individual exemptions granted and applications received, and information received from exemption applicants about the number of plans involved, resulting in estimates of 10 entities with an average of 20 client plans for each. One commenter expressed the view that at least 50 entities with an average of 40 client plans would make use of the exemption. Because the Department acknowledges that the grant of this final exemption may affect the number of entities that would consider implementing a program of cross trading involving index and model funds, the assumed numbers of entities and plans have been increased for purposes of burden estimates to 20 entities and 40 plans, respectively. Similarly, the number of Large Accounts assumed for purposes of estimating burden has been increased from 10 to 40. While the assumed number of Large Accounts is smaller than the 1,000 offered by the commenter, the Department believes

that a number approximating 18% of all plans with \$50 million in assets would substantially overstate the number likely to make use of the exemption in connection with a portfolio restructuring program in a given year.

The commenter also indicated that the Department's estimates of the time required to establish and maintain the record-keeping systems that would be needed to comply with the exemption were significantly low. The comment states that a significant investment of \$4 to \$5 million would be required for each user to establish the necessary record-keeping systems, and that substantial amounts of time would be required daily for ongoing record-keeping, and annually for ongoing disclosures. Upon consideration of the comment, the Department has concluded that its original estimates did omit the impact of the initial investment of resources that would be required to enhance existing software and systems to track cross-trades to triggering events. As a result, the Department has revised its estimates to include the hours, or costs as applicable, of 1,040 hours of systems analyst time at \$51 per hour (based on Occupational Employment Survey data and 1999 Employment Cost Index, adjusted for non-wage compensation and overhead.) This change adds approximately 12,500 hours and \$424,000 to the estimated burden of the final exemption. These totals are distributed over a three year period for purposes of the annual burden shown below.

Given that record-keeping systems for securities transactions are primarily electronic in nature, and that the Department's burden estimates now take into account the start-up cost of modifying automated record-keeping systems, the Department has decided not to revise the estimated time required to maintain the required records of trades and to prepare disclosure materials. In the Department's view, the original estimates are reasonable in light of the degree to which record-keeping is automated, the industry's existing record-keeping practices involving cross-trading, and the information provided by other commenters.

In addition, the final exemption clarifies that the annual disclosures are required to be made with respect to only those Funds that hold plan assets and in which a given plan invests. The commenter had indicated that eliminating the annual disclosure requirement with respect to Funds in which a plan had no investments would substantially reduce the burden. This clarification, therefore, further supports retention of the original assumptions.

Finally, the commenter expressed the view that certain of the information required to be disclosed by the terms of the proposed exemption was duplicative and unnecessary. As noted earlier, with the exception of certain clarifications, the information collection provisions of the final exemption are unchanged from the proposal. The Department's basis for its conclusions with respect to the need for the disclosure and record-keeping provisions of the final exemption are discussed in detail in the **SUPPLEMENTARY INFORMATION** section that follows.

The burden estimates that result from the revised assumptions are presented below:

*Title:* Prohibited Transaction Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds.

*Agency:* Department of Labor, Pension and Welfare Benefits Administration.

*Affected Entities:* Business or other for-profit.

*Respondents:* 60 (20 entities and 40 Large Accounts).

*Responses:* 840.

*Annual Hour Burden:* \$9,100.

*Annualized Capital/Start-up Cost:* \$141,000.

*Annual Cost (Operating and Maintenance):* \$280,000.

*Annual Cost Burden:* \$421,000.

#### **Executive Order 12866 Statement**

Under Executive Order 12866, the Department must determine whether a regulatory action is "significant" and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a "significant regulatory action" as an action that is likely to result in a rule (1) having an annual effect on the economy of \$100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as "economically significant"); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

Pursuant to the terms of the Executive Order, it was determined that this action

is "significant" under section 3(f)(1) of the Executive Order. Accordingly, this action has been reviewed by OMB.

#### **Economic Analysis**

Establishing a class exemption that permits plans to cross-trade can be expected to have a variety of positive economic effects that will considerably exceed the direct costs incurred by plans to comply with the record keeping and reporting requirements enumerated in the PRA section of the final class exemption. By removing existing barriers to these types of transactions, the exemption will significantly increase the utilization of cross-trading among index and model-driven portfolios. This will result in substantial savings to plans by lowering the transaction costs in a number of ways. Although there is currently no source of data that can be used to precisely estimate the level of these savings or the distribution of these effects among various parties, extrapolating from several sources can provide a reasonable estimate of their overall magnitude.

Limiting the exemption to index and model-driven portfolio management techniques should preclude any changes in the incidence of trading activity. In contrast to active management techniques, index and model funds will continue to execute trades at the same levels that they would in the absence of the exemption because their trading is motivated by the need to remain within their tracking parameters rather than in response to marginal changes in expected transaction costs. It is therefore reasonable to assume that the changes in costs will result solely from a decrease in the cost of executing many individual trades rather than from a change in the levels of trades.

Changes in the costs of individual trades will result from (1) the elimination of commission costs that would otherwise be associated with a trade, (2) the avoidance of bid-ask spreads that impose costs for transactions executed through dealers, (3) the absence of fees and taxes that might otherwise apply, and (4) the avoidance of the market impact of large trades which might otherwise require price concessions to execute or effect the trade which would directly impact the market value of the resulting holdings.

Only the first three of these effects are considered in the analysis. The last, market impact, is not included because it can reasonably be expected to have largely offsetting effects. ERISA plans are equally likely to be on either side of a cross trade and in most cases are likely to represent both parties to a

transaction. In some instances, they will be advantaged by avoiding the changes in an individual securities price that might otherwise have resulted from a trade executed through another venue. In other circumstances, they will be disadvantaged. An equal probability of either will result in essentially offsetting effects in the aggregate.

A similarly conservative approach is taken in regard to two other aspects of the analysis. These are a result of the limitations in the available data and the absence of any experience with the full scope of relief afforded by the exemption on which to base an estimate. Although some data on the amount of ERISA plan assets in index funds is available, there is no similar source of reliable information to estimate the size of ERISA model driven assets to which the exemption would apply. There is also no experience with more extensive opportunities for cross-trading that are available under the exemption resulting from increased flexibility in allocating cross-trading opportunities, the extension of relief to a broader range of entities, and the inclusion of debt securities in the allowable transactions. Consequently the analysis is limited to index funds and does not incorporate increases in savings resulting from the extension of relief to circumstances with which there is no prior experience. As such, it should be interpreted as an extremely conservative estimate that is likely to represent a lower bound of the level of savings that can be expected to accrue to plans.

Two large financial services firms currently operating under individual exemptions that permit cross-trading among ERISA plans provided estimates of the savings in commissions, spreads, and fees that they have experienced managing both ERISA and non-ERISA indexed assets. These two estimates represent a significant portion of the ERISA plan universe and are therefore likely to be representative of the cost savings likely to occur. One of the firms estimated the cost savings to be approximately \$275 million per year for a total indexed portfolio of \$400 billion. The other estimated a savings of \$207 million for \$441 billion of indexed assets under management. Both of these include ERISA and non-ERISA assets, however, the experience should be indicative of expected results because the nature of trading costs for indexed funds should be virtually identical. Averaging these figures yields an estimate that costs savings of .057% or 5.7 basis points for each dollar of affected ERISA plan assets can be expected.

A recent survey of pension funds indicates that among the largest private sector defined benefit pension funds, 14% of the total assets were held in index funds. Among defined contribution plans, index funds constituted 12% of total assets. Applying these percentages to the most recent estimates of the total value of private pension funds yields an estimate of approximately \$584 billion of ERISA pension funds that are currently managed as indexed funds.

Applying the estimate of \$.00057 of savings for each dollar of assets under management results in an estimated level of cost reductions of approximately \$332 million per year that will result from the class exemption. This total cost savings estimate overlaps, in part, current costs savings experienced by plans whose managers have cross-trading programs covered under existing individual exemptions. While certain large index fund managers are successfully operating cross-trading programs for ERISA plans at this time, the class exemption is expected to create additional cost savings for these plans by increasing the number and frequency of cross-trading opportunities among the managers' client accounts. In addition, new cross-trading opportunities will be made available for plans whose assets are managed by entities that currently do not have individual exemptions. Finally, the conservative nature of the total estimate is highlighted by the fact that cost savings associated with cross-trading by model-driven funds have not been factored into the estimate of total cost savings due to the absence of available data.

**SUPPLEMENTARY INFORMATION:** On December 15, 1999, the Department of Labor (the Department) published a notice in the *Federal Register* (64 FR 70057) of the pendency of a proposed class exemption from the restrictions of sections 406(a)(1)(A) and 406(b)(2) of the Act, section 8477(c)(2)(B) of FERSA,<sup>1</sup> and from the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) of the Code.

The Department proposed the class exemption on its own motion pursuant

<sup>1</sup> The Department has responsibility for the administration and enforcement of section 8477 of FERSA. Section 8477 establishes the standards of fiduciary responsibility and requirements relating to the activities of fiduciaries with respect to the Federal Thrift Savings Fund. All references herein to the fiduciary responsibility provisions of Part 4 of Title I of ERISA also apply to the corresponding provisions of FERSA. Accordingly, the relief provided under this class exemption applies to cross-trades of securities by the Federal Thrift Savings Fund.

to section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B, (55 FR 32836, August 10, 1990).<sup>2</sup> The Department's determination to proceed with the proposed class exemption was based, in part, on information received from interested persons in response to a notice (the Notice) published in the *Federal Register* on March 20, 1998 (63 FR 13696).

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. Fourteen (14) public comments were received by the Department. Upon consideration of all the comments received, the Department has determined to grant the proposed class exemption subject to certain modifications. These modifications and the major comments are discussed below.

#### Discussion of Comments Received

The comments received by the Department were generally supportive of the issuance of a separate class exemption for cross-trading of securities by Index and Model-Driven Funds. However, many of the commenters requested specific modifications to the proposal in the following areas:

1. *Accounts Permitted to Cross-Trade.* Several comments noted that section I(a) and (b) of the proposal does not explicitly permit cross-trades between two or more Large Accounts. These comments noted that when more than one Large Account is buying or selling a particular security as part of a manager's cross-trading program, that security could be traded between two Large Accounts, two Index or Model-Driven Funds, or any combination thereof. In the operation of a cross-trading program, the matching of the buyer and seller would be coincidental. The commenters believe that a manager should be permitted to submit trade lists from each Large Account to its cross-trade allocation system and allow trades submitted on behalf of one Large Account to be crossed with trades submitted on behalf of another Large Account.

The Department notes that section I(a) and (b) of the proposal does not provide relief for cross-trades exclusively

<sup>2</sup> Section 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996) generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

In the discussion of the exemption, references to specific provisions of the Act should be read to refer as well to the corresponding provisions of section 4975 of the Code.

between two or more Large Accounts. The Department is of the view that such cross-trading would be outside the scope of the exemption because, among other things, there would be no "triggering event" to limit the amount of discretion exercised by the manager where such transactions occurred solely between Large Accounts.

The Department does recognize, however, that a manager's cross-trading program that complies with the requirements of the proposal may produce cross-trade opportunities that result from both triggering events of particular Index and Model-Driven Funds as well as from the decision of an independent fiduciary to restructure all or a portion of a Large Account's portfolio. Under such circumstances, the Department anticipates that the allocation of buying and selling opportunities across all Funds and Accounts participating in the cross-trading program may result in some individual cross-trades between two Large Accounts. In such an event, the exemption would permit the "coincidental" matching of a buyer and seller of particular securities where both buyer and seller are Large Accounts since such cross trades would be part of a unified process-driven cross-trading program where the allocations of available securities (from all Funds and/or Large Accounts) resulted from an objective process which did not permit the exercise of discretion by the manager, as required under section II(d) of the exemption. The Department has revised section I of the exemption to clarify this point.

Another commenter noted that no specific relief for cross-trades between two Large Accounts may be necessary where the decision to liquidate or restructure is made by an independent fiduciary or independent Account representative, and, therefore, the manager would not be acting as a fiduciary for either side of the transaction. Thus, the commenter suggested that the Department may wish to clarify whether additional relief for cross-trades exclusively between two or more Large Accounts is necessary. Alternatively, the commenter suggested that section I(b) of the proposal be modified to explicitly permit cross-trades solely between Large Accounts.

In response to this comment, the Department notes that violations of section 406(b)(2) of the Act would occur if the manager used its discretionary authority to determine whether to cross-trade securities between two Large Accounts at least one of which holds plan assets, which securities to cross-trade, the timing of such cross-trades,

and the amount of securities to cross-trade notwithstanding that the overall determination to restructure the accounts was made by independent fiduciaries.

Accordingly, except as provided above, the Department has determined not to expand the relief provided under this exemption to include cross-trades solely between two or more Large Accounts. The Department notes that the final exemption provides a manager with a significant amount of time in which to conduct cross-trades for a Large Account in connection with a specific portfolio restructuring program. A manager's discretion to time specific cross-trades for two Large Accounts, absent the limitations provided by a process-driven cross-trading program involving "triggering events" for Index and Model-Driven Funds, would entail the type of discretion commonly exercised by managers for "actively-managed" accounts. In this regard, relief for cross-trades by "actively-managed" accounts and pooled funds containing "plan assets" will be considered by the Department in a separate proceeding.

2. *Use of closing prices.* One commenter suggested that the Department modify the requirement that all cross-trades occur at the closing prices for the securities on the relevant market in order to allow for alternate pricing methodologies (e.g., "volume weighted average price" or "VWAP"), after appropriate disclosure to the affected plans. Section II(a) of the proposal requires that the cross-trade be executed at the closing price, as defined in section IV(h). Section IV(h) of the proposal defines "closing price" as the price for a security on the date of the transaction, as determined by objective procedures disclosed to Fund investors in advance and consistently applied with respect to securities traded in the same market, which procedures shall indicate the independent pricing source used to establish the closing price and the time frame after the close of the market in which the closing price will be determined. The commenter does note that "closing prices" are the most appropriate prices currently in use for cross-trades of securities by Index and Model-Driven Funds, whose objective is to track the return of an index, since the calculation of an Index Fund's "tracking error" is based on closing prices for the securities listed in the relevant index. However, the commenter states that index providers may utilize alternative pricing methodologies in the future and suggests that the Department should consider broadening the exemption to include such pricing methodologies.

The Department notes that many commenters have indicated that the use of closing prices for cross-trades of securities by Index and Model-Driven Funds is common industry practice at the present time. The Department does not believe that it has sufficient information at this time to determine which types of alternative pricing methodologies may be used by managers in the future or how such pricing systems would enable Index and Model-Driven Funds to better achieve their investment goals and strategies. Therefore, the Department has determined not to modify the requirement that cross-trades be executed at the closing price. The Department would be prepared to consider additional relief at a later date upon proper demonstration that the appropriate findings can be made under section 408(a) of the Act with respect to other pricing methods for cross-traded securities.

3. *"Triggering Events" and Cross-Trade Executions.* Several of the comments objected to the requirement in section II(b) of the proposal that any cross-trade of securities by a Fund be executed no later than the close of the second business day following a "triggering event." These comments noted that previously issued individual exemptions for cross-trades by Index and Model-Driven Funds allowed cross-trades to be executed within three (3) business days of a "triggering event" and that the proposal's reduction of this requirement to two days is inconsistent with the stated premise of the proposal that cross-trading is beneficial to plans. Other comments noted that, once an investment decision is made, a manager should have 5 days to trade after a "triggering event"—the same period of time to execute the trade as is permitted under the safe harbor provided in the Department's regulations for determining whether a broker-dealer is a fiduciary when it executes a securities transaction on behalf of a plan (see 29 CFR 2510.3–21(d)). Another comment requested that section II(b) be revised to require that cross-trades be executed either within three (3) days of a "triggering event," or within such other period of time as the manager may disclose to the independent plan fiduciary pursuant to the disclosure requirements under section II(l) of the proposal.

In response to the comments, the Department has determined that it would be appropriate to modify section II(b) of the final exemption to require that all cross-trades by a Fund be executed no later than the close of the third business day following a Fund's

"triggering event." The Department notes that a three-day limit for cross-trades by a Fund following the relevant "triggering event(s)" has worked successfully in the past for managers who were granted individual exemptions.<sup>3</sup>

4. *Blackout Period for Cross-Trades by Model-Driven Funds.* Many of the comments objected to the requirement in section II(c) of the proposal that no cross-trades by a Model-Driven Fund may take place within ten (10) business days following any change made by the manager to the model underlying the Fund. The preamble to the proposal indicated that this restriction is intended to prevent model changes which might be made by managers, in part, to deliberately create additional cross-trading activity. The comments suggested that such a long delay on the ability of a manager to cross-trade after a change in the computer model was unnecessarily restrictive. According to the commenters, this condition would prevent cross-trading during the 10-day "blackout" period even though other "triggering events" were occurring in the Fund. Other commenters noted that there are already sufficient restrictions on a manager's discretion built into the proposal.

While most comments objected to the 10-day "blackout" period, several of the comments indicated that a 5-day period would be sufficient to safeguard against the Department's concerns regarding model changes that may be timed to create additional cross-trading opportunities. Other commenters suggested that, rather than imposing a "blackout" period for an arbitrary period of time (e.g., 5 or 10 days), a more flexible approach could be used where a Model-Driven Fund would be able to cross-trade following the period of time necessary to complete the first re-balancing of the Fund's portfolio after the change is made by the manager to the Fund's model. Thus, under this approach, the "blackout" period could be less than three (3) days. One comment suggested that any cross-trading "hiatus" for a Fund should not be more than three (3) days. Other comments simply requested that the condition for a "blackout" period after a model change be deleted. Still other comments noted that, in the absence of a "blackout" period, a requirement for 10-day prior notice of a model change to each relevant plan's independent fiduciary should suffice. Finally, some

<sup>3</sup> See, for example, Prohibited Transaction Exemption (PTE) 95–56, 60 FR 35933 (July 12, 1999), regarding Mellon Bank, N.A., and its Affiliates.

commenters requested clarification that model changes made either (i) at the direction of a client plan, or (ii) as a direct result of input changes furnished by a third party data vendor (e.g., BARRA or Vestek), would not invoke a "blackout" period because such model changes would not be the result of an exercise of discretion on the part of the manager.

The Department continues to believe that some "blackout" period is necessary to prevent managers from exercising their discretion over the criteria or data used for a model to generate specific cross-trade opportunities. However, in recognition that a 10-day restriction may be too long a period to prevent a Model-Driven Fund from cross-trading, the Department has decided to modify the final exemption to require that cross-trades not take place within three (3) business days following any change made by the manager to the model underlying the Fund.

In addition, with respect to the one commenter's concerns that model changes resulting from independent events should not invoke a "blackout" period for a Model-Driven Fund, the Department acknowledges that any change to a model which is not the result of an exercise of discretion by the manager (e.g., changes directed by an independent plan fiduciary or furnished by a third party data vendor whose model is being used by the manager) would not require a "blackout" period for cross-trades by such Fund.

5. *Restrictions on Cross-Trades by a Manager Plan.* One comment objected to, and requested the deletion of, the requirement in section II(e) of the proposal that no more than ten (10) percent of the assets of any Fund or Large Account engaging in a cross-trade may be comprised of assets of employee benefit plans maintained by the manager for its own employees (i.e., a Manager Plan), for which the manager exercises investment discretion. The comment stated that this condition would create a disincentive to in-house management and may cause investment managers to place assets of a Manager Plan with outside managers solely on the basis of the potential cost savings that the outside managers could derive from cross-trades.

The comment noted that for large plans, in-house management is frequently more cost-effective and keeps the asset management function closer to the people who have the most to gain from maximizing investment performance and minimizing investment risk. The comment further noted that larger in-house fiduciaries

also manage assets for unaffiliated plans and other institutional investors, often as a result of a corporate spin-off with an accompanying plan restructuring. The comment stated that it understood the Department's concern regarding a manager's potential ability, through cross-trades, to unduly benefit a Manager Plan at the expense of its outside clients. However, the commenter believes that the other conditions of the proposal, including "triggering events" for cross-trades, detailed disclosures of cross-trading procedures and reporting of cross-trades resulting from a portfolio restructuring, would serve as a check on the manager's ability to favor a Manager Plan. Moreover, the commenter notes that to the extent that a Manager Plan's assets are commingled with assets of outside clients that are held in an Index or Model-Driven Fund managed as a collective investment fund, it would not be possible for the manager to "favor" only the Manager Plan in that Fund, even if the Manager Plan's assets represented more than 10 percent of the Fund's total assets. In any event, the comment noted that the 10 percent limitation should not apply to cross-trades that are made solely between Manager Plans.

With respect to the commenter's request to delete the 10% limitation in section II(e) of the proposal, the Department notes that, without such a percentage limitation, a substantial majority of the investors in a Fund could be comprised of Manager Plans. The Department does not believe that deletion of this percentage requirement would ensure a sufficient level of independent investor oversight of the manager's cross-trading program.

However, in consideration of the arguments raised by the commenters, the Department believes that a 20% limitation would still ensure a sufficient level of independent investor oversight in a Fund and would not unduly restrict the investment opportunities available for a Manager Plan with respect to such Funds. Therefore, the Department has modified section II(e) to increase the percentage limitation to 20%.

Accordingly, this exemption does not provide relief for cross-trades of securities of Index and Model-Driven Funds maintained by a manager under circumstances where the assets of the Manager Plans comprise all or a high percentage of the assets of the Fund. As noted above, the Department believes that the presence of independent fiduciaries to approve of plan participation in cross-trading programs following receipt of meaningful disclosures and the ability of such

fiduciaries to periodically monitor the arrangements provide important protections under the exemption. However, in response to several comments, the Department wishes to take the opportunity to state that the granting of this exemption does not foreclose future consideration of additional relief for cross-trading transactions that do not fit within the framework developed by the Department for this exemption. For example, the Department is currently considering additional relief for transactions involving assets of plans managed by in-house managers, as well as for transactions involving discretionary asset managers.

With respect to the comments requesting that the exemption allow cross-trades to occur solely between two or more Manager Plans, the Department notes that relief for these transactions could involve the exercise of discretion on both sides to a transaction that is inconsistent with the underlying concept of the proposal—which is to provide relief for cross-trades made pursuant to "process-driven" investment strategies. For this reason, the Department has determined not to revise the exemption in this regard.

Another comment stated that section II(e) of the proposal does not adequately address how the independent authorization conditions in section II(i) through (n) of the proposal would apply to a Manager Plan, given that the plan fiduciary responsible for the plan's investment matters is unlikely to be independent of the manager. This comment suggested that the Department not require an independent fiduciary authorization for a Manager Plan's participation in the manager's cross-trading program. The commenter stated that the suggested modification would be consistent with other exemptions that do not apply an independent authorization requirement to plans of the fiduciary for whom relief is provided.<sup>4</sup> Accordingly, the commenter requests that the Department adopt a similar provision under the final exemption.

The Department concurs with the comments and has determined to modify section II(h) of the final exemption (formerly section II(i) of the proposal) to clarify that the requirement that the authorizing fiduciary be independent of the manager shall not apply in the case of a Manager Plan. Nevertheless, the appropriate fiduciary for the Manager Plan must still receive the proper disclosures and provide an

<sup>4</sup> In this regard, see section IV(d)(1)(A) of PTE 86-128 (51 FR at 41696, November 18, 1986).

authorization for the Manager Plan to participate in the manager's cross-trading program. This clarification modifies the disclosure and authorization requirements applicable to a plan's participation in a manager's cross-trading program, as described in section II(h) through (l) of the final exemption (formerly section II(i) through (m) of the proposal).

In addition, the Department has also determined to modify the requirements contained in section II(n) of the proposal, relating to disclosures to, and authorization by, a fiduciary of a Large Account who is independent of the manager for cross-trades in connection with a portfolio restructuring for the Large Account. To clarify this matter, the Department has revised section II(m) of the final exemption (formerly section II(n) of the proposal) by adding the parenthetical phrase “\* \* \* (other than in the case of any assets of a Manager Plan)” to the requirements for an independent fiduciary discussed in section II(m)(1) through (4). In this regard, the Department notes that the final exemption still requires that proper disclosures be made to, and written authorization be made by, a Manager Plan's fiduciary in order for the Manager Plan to participate in a specific portfolio restructuring program.

6. *Exclusion of Thinly-Traded Equity Securities.* A number of commenters objected to the condition contained in section II(f)(1) of the proposal that required that cross-trades of equity securities involve only securities that are widely-held, actively-traded, and for which market quotations are readily available from independent sources. In this regard, the terms “widely-held” and “actively-traded” are deemed to include any security listed in an “Index” (as that term is defined in section IV(c) of the proposal).

The comments stated that this requirement was not necessary for an exemption for cross-trading by Index and Model-Driven Funds. According to the comments, security selection for such Funds is driven solely by objective factors. The commenters argued that the level of trading and diversity of holdings for securities are not relevant to security selections made by Funds and that such factors should not serve as a constraint on the ability of such Funds to cross-trade. Generally, the comments noted that if market prices are readily available, the exclusion of “closely-held” and “thinly-traded” equity securities is unduly restrictive. They further argued that such limitations would prevent use of the exemption for many “small-cap” and foreign equity securities. Thus, the

commenters urged the Department to delete the requirement that cross-traded equity securities be “widely-held” and “actively-traded.”

As an alternative approach, one commenter suggested a limitation based on a comparison of the size of the cross-trade to the prior public trading volume in the security over a reasonable period of time prior to the date of the transaction. Such a volume limitation would prevent cross-trades of equity securities where the total volume of shares being cross-traded would exceed a certain percentage of the total number of shares publicly traded on the market during a particular period of time.

The Department is not persuaded by the arguments submitted in favor of deletion of the requirements contained in section II(f)(1) that equity securities that are cross-traded must be “widely-held” and “actively-traded.” The Department continues to believe that cross-trades of “thinly-traded” securities raise issues as to whether both sides of the cross-trade have benefitted equally from the avoidance of adverse market impact. The avoidance of market impact would be more dramatic with “thinly-traded” equity securities than with equity securities that are “widely-held” and “actively-traded.”<sup>5</sup> Similarly, the avoidance of liquidity restraints would be more dramatic with “thinly-traded” equity securities than with equity securities that are “widely-held” and “actively-traded.”

In order to address its concerns without unnecessarily restricting the scope of relief under the proposal, the Department determined to deem equity securities that are included in an Index (as defined in section IV(c) of the exemption) to be “widely-held” and “actively-traded” for purposes of the exemption. However, the Department notes that the exemption does not preclude a manager from cross-trading a particular equity security not included in an index if the manager otherwise determines that such security is “widely-held” and “actively-traded.”<sup>6</sup>

<sup>5</sup> The Department notes that these concerns would also arise with “thinly-traded” debt securities. However, since “thinly-traded” debt securities of different issuers with the same coupon rate, maturity, and credit rating are relatively fungible, the Department did not believe that it would be appropriate to apply these concepts to such securities for purposes of this exemption.

<sup>6</sup> With respect to the selection criteria for securities included in a Fund's portfolio which are not included in an Index, the Department assumes that any screening criteria and/or weighting procedures used to create the portfolio will be determined using purely mathematical computations based upon objective raw data. In addition, the Department assumes that the investment management agreement relating to each Fund, as approved by plan investors in the Fund,

With respect to the comment suggesting a trading volume limitation, the Department notes that other commenters have discouraged it from addressing its concerns about cross-trades of “thinly-traded” securities through volume limitations, based on arbitrary percentages of the average daily trading volume for the securities. These commenters noted that the systems used by managers to allocate cross-trades among various Funds would have difficulty monitoring and re-allocating cross-traded securities to conform to such volume limitations.

In consideration of the above, the Department has determined not to modify section II(f)(1) in the final exemption.

7. *Cross-Trades of Securities Issued By the Manager.* Several comments objected to the requirement in section II(h) of the proposal that cross-trades not involve securities issued by the manager, unless the manager has obtained a separate prohibited transaction exemption for the acquisition of such security. One commenter noted that, although some institutions have obtained individual exemptions to deal with issues relating to acquisitions and dispositions of the manager's own stock by its Index and Model-Driven Funds,<sup>7</sup> others have concluded that no exemptive relief is necessary based on the facts and circumstances surrounding their individual situations. The commenter noted that, with regard to certain Index Funds, the manager does not exercise discretion in choosing the individual stocks to buy or sell, but rather seeks to mechanically purchase stocks selected through objective criteria which is outside of the manager's control. For example, in an Index Fund that is designed to replicate the exact capitalization-weighted composition of the Standard & Poor's 500 Composite Stock Price Index (the S&P 500 Index), if the manager's stock is included in the index, that stock will be purchased in the proportion dictated by the index without the manager exercising any investment discretion. In such instances, the commenter stated that a manager's failure to acquire the stock would cause “tracking error,” thereby subverting the goal of plan investors in

would set forth the specific dates on which the Fund's portfolio will be re-balanced. In this regard, the Department notes that no relief would be provided under this exemption for violations of section 406(b)(1) of the Act which may occur as a result of a manager's exercise of fiduciary authority or discretion to affect the components of an Index.

<sup>7</sup> For example, see Prohibited Transaction Exemption (PTE) 2000-30, 65 FR 37166 (June 13, 2000), regarding Barclays Bank PLC and its Affiliates.

the Fund to replicate the performance of the index. Other comments stated that it was not clear why a restriction for cross-trades of a manager's own stock is necessary and that there appears to be no reason to exclude such securities from the exemption. The Department accepts these comments and has determined to delete section II(h) of the proposal from the final exemption.

However, the Department notes that the exemption does not provide relief for any discretionary changes in an Index or Model-Driven Fund made by a manager, or any other discretionary decisions by the manager, which are designed to result in cross-trades of the manager's own stock for the benefit of the manager. Only cross-trades generated by non-discretionary changes in a Fund (e.g., changes in the capitalization weighting of the manager's stock within an index, or the addition or removal of the manager's stock from an index) are covered by this exemption. Accordingly, no relief is provided for such discretionary changes regarding the manager's own stock.

As noted previously, all conditions in the final exemption have been redesignated to reflect the deletion of section II(h) of the proposal.

**8. Disclosure and Authorization Requirements.** Many comments raised concerns about the scope of the disclosure and authorization requirements contained in section II(j), (k), (l) and (m) of the proposal. In this regard, the comments noted that section II(i) of the proposal expressly states that the written authorization requirement for a plan's participation in a manager's cross-trading program only applies to plans investing in an Index or Model-Driven Fund that holds "plan assets" subject to the Act. The commenters urged the Department to clarify that the notice and disclosure requirements contained in section II(j), (k), (l) and (m) of the proposal similarly apply only to independent fiduciaries of employee benefit plans that invest in Funds holding plan assets.

The Department acknowledges the commenters' concerns regarding the intended scope of the disclosure and authorization requirements of the proposal and wishes to clarify that such requirements were meant to apply only to those Index and Model-Driven Funds which hold "plan assets," as defined under the Department's regulations (see 29 CFR 2510.3-101). Therefore, the Department has revised section II(i) and (l) of the final exemption (formerly section II(j) and (m) of the proposal) accordingly.

Other comments objected to the prior written authorization requirement

contained in section II(i) of the proposal, noting that prior individual exemptions granted by the Department for cross-trades by Index and Model-Driven Funds did not contain a similar requirement. These comments expressed the view that requiring prior written consent from an independent plan fiduciary as a condition for the plan to invest in a Fund that is part of a manager's cross-trading program serves no useful purpose. The comments noted that if a plan fiduciary were to develop any objections to cross-trading on philosophical grounds, then the plan would be free to withdraw from the Fund without penalty. The commenters believed that imposition of such a requirement will be perceived negatively by plan sponsors as an unnecessary obstacle to their ability to freely invest and reinvest plan assets in a manager's Funds.

The Department disagrees with the commenters' assertion that prior written consent from an independent plan fiduciary is unnecessary. The Department notes that part of the reason for proposing a class exemption for cross-trades of securities by Index and Model-Driven Funds was to address issues which had come to the Department's attention subsequent to its granting of a number of individual cross-trading exemptions.

As stated in the Notice published on March 20, 1998, the Department recognizes that it is important to retain the flexibility to periodically review its exemption policy in the context of changed circumstances or new facts that may be brought to its attention (see 63 FR at 13698, first paragraph of section entitled "Issues and Developments"). The Department became aware of new issues involving cross-trades, including cross-trades by certain "passive" investment managers, through enforcement proceedings that raised concerns about whether plan fiduciaries were being provided with adequate disclosures regarding a manager's cross-trading program.

The Department continues to believe that adequate disclosures are necessary in order to enable a plan fiduciary to understand a manager's cross-trading program and how that program may affect the investment goals and objectives of Funds in which the plan may invest. The Department notes that the written authorization required by section II(i) of the proposal will apply to all of the Funds which participate in a manager's cross-trading program. Thus, once an authorization is provided by an independent fiduciary, a plan will be able to invest in any of the Funds without any additional authorization.

The Department further notes that the authorizations required under the exemption for existing plan investors in any Funds may be obtained through a separate notice which describes the Funds' participation in the manager's cross-trading program. Under this requirement, failure to return the termination form by the date specified in the notice will be deemed to be an approval by the independent plan fiduciary of the plan's participation in the cross-trading program. Therefore, the Department has determined not to revise the authorization requirements in the final exemption.

With respect to the required content for the disclosures that must be furnished pursuant to sections II(l) and (m) of the proposal, the commenters were concerned that the initial and annual notices must identify all Index and Model-Driven Funds participating in the manager's cross-trading program, together with detailed information regarding the "triggering events" and other information relating to each Fund. The comments noted that requiring such disclosures would cause managers to violate confidentiality restrictions contained in many client agreements and would also raise privacy concerns for clients who do not wish their identity, or the fact that they maintain an investment account with the manager, to be disclosed. In this regard, the comments noted that managers are restricted from disclosing confidential information about clients, particularly the Funds in which clients invest. In addition, the comments stated that such detailed disclosure would be of little practical value to plan fiduciaries when deciding whether to authorize or maintain plan investments in a particular Fund. As an alternative, several comments suggested that the initial and annual notices should include only general descriptions of the types of Funds that participate in the manager's cross-trading program and of the "triggering events" that give rise to cross-trade opportunities.

The Department acknowledges the concerns expressed by the commenters regarding the confidentiality restrictions contained in client agreements and privacy concerns relating to the identity of such clients and the Funds in which they may invest. Nevertheless, the Department continues to believe that the required disclosures will be useful to a plan fiduciary in understanding the scope and operation of the manager's cross-trading program and whether participation in the program remains in the plan's best interests. However, the Department does not intend for the disclosures in section II(k) of the

exemption (relating to a manager's ongoing disclosures of information about the cross-trading program) or section II(l) of the exemption (relating to disclosures for an annual re-authorization of the cross-trading program by an independent plan fiduciary) to require that privileged or confidential information be revealed by the manager. For example, these provisions, as revised herein, do not require a manager to furnish to independent plan fiduciaries the identity of any clients of the manager that are invested in other Funds that are added to the cross-trading program. In addition, any information disclosed by the manager regarding new "triggering events" for existing Funds need only provide such information with respect to Funds in which the plans are invested. With respect to disclosures regarding new "triggering events" which must be provided to the relevant independent plan fiduciaries of the affected Funds (as discussed further below), the Department does not believe that the final exemption requires the disclosure of privileged or confidential information.

Other commenters requested that the Department clarify that portion of section II(l) of the proposal which requires that the manager notify each relevant independent plan fiduciary of the addition of Funds to the manager's cross-trading program, or changes to, or additions of, "triggering events" regarding Funds, following a plan's initial authorization of participation in the program. Specifically, the comments requested clarification as to whether the phrase "each relevant independent plan fiduciary" was intended by the Department to be limited to fiduciaries of plans invested in those specific Funds that are added to a manager's cross-trading program or whose "triggering events" have been modified. The comments noted that it would be burdensome to require managers to notify all plans regarding modifications to "triggering events" that may occur in all Funds, including Funds in which such plans are not invested, just because such Funds participate in the cross-trading program. In addition, it would be difficult to provide notice to all plans prior to, or within 10 days following, such events affecting any of the Funds.

In consideration of such comments, the Department has modified section II(k) of the final exemption (formerly section II(l) of the proposal) to provide that the ongoing notices of information that must be furnished to "each relevant independent plan fiduciary" are required to be made only to those fiduciaries whose plans are invested in

the affected Funds (*i.e.*, the Funds added to the program or whose "triggering events" have been changed).

Other commenters stated that certain of the disclosures are unnecessary. For example, several comments objected to the statement required by section II(k) of the proposal, relating to investment decisions for a Fund not being based on the availability of cross-trade opportunities. These comments noted that this statement would be duplicative of other information required in the proposal and would provide no added protection to plans, other than the manager's promise to follow the conditions of the exemption. Certain comments objected to the disclosures described in section II(l) of the proposal including the required statement that "\* \* \* the Manager will have a potentially conflicting division of loyalties and responsibilities to the parties to any cross-trade transaction \* \* \*." In addition, section II(l) of the proposal required that the Manager explain how its cross-trading practices and procedures will mitigate such conflicts. According to the comments, following the terms of the exemption should be viewed as precisely what is necessary to mitigate the conflicts. Thus, the commenters believed that it will be misleading to inform client plans that the operation of a manager's cross-trading program, even with adherence to the terms of the proposed exemption, will still create conflicts.

The Department believes that specific statements relating to the fact that investment decisions for a Fund will not be based on cross-trade opportunities (as described in section II(k) of the proposal), and that there are potential conflicts of interest in such cross-trades (as described in section II(l) of the proposal), are important to an independent plan fiduciary's understanding of the issues involved with cross-trades of securities. The Department notes that, in any cross-trading program, including cross-trading programs maintained by "passive" investment managers, there would be a potential for abuse if a manager were able to control cross-trade opportunities to favor the interests of particular clients. Therefore, the Department has determined not to revise the exemption as requested.

Section II(l) of the proposal requires that independent plan fiduciaries be furnished with detailed disclosure of the procedures to be implemented under the manager's cross-trading program (including the "triggering events" that will create cross-trading opportunities, the independent pricing services that will be used by the

manager to price the cross-traded securities, and the methods that will be used for determining closing price). The comments noted that the preamble to the proposal suggests with respect to foreign securities that the applicable independent pricing source should provide the price in local currency rates and, if that currency is other than U.S. dollars, also provide the U.S. dollar exchange rate (*see* first paragraph of Section IV.B. of the preamble, 64 FR at 70062). In this regard, the comments noted that most pricing services that price foreign securities do not provide currency conversion rates. These commenters suggested that managers be allowed to use another independent service to provide such conversion rates, so long as the service is disclosed to plan investors.

The Department acknowledges the commenter's concerns, based on the language contained in the preamble to the proposal. However, the Department did not intend to prevent a manager from using another independent service to provide the appropriate currency exchange rates for a foreign security. Thus, the Department notes that no modification to section II(k) of the final exemption (formerly section II(l) of the proposal) is necessary.

A number of the comments noted that Section II(m) of the proposal (relating to a plan's annual re-authorization of its participation in the manager's cross-trading program) appears to require, among other things, that each plan fiduciary be notified annually of: (i) Any change in the "triggering events" in the Funds in which their plans are invested; (ii) any change in the "triggering events" in the Funds in which their plans are not invested; and (iii) any "triggering events" and other disclosure items for new Funds added to the cross-trading program since the last annual notice. These comments stated that the latter two categories of disclosures noted above are irrelevant to a plan fiduciary who has no assets invested in those Funds. The commenters believe that such information in the annual disclosures will make it more difficult for plans to properly analyze data which is relevant to an annual re-authorization of the plan's participation in the manager's cross-trading program. The comments suggested that annual disclosures to a plan fiduciary should be limited to that material which is relevant to its plan's investments in the manager's Funds. If a plan fiduciary determines to invest in other Funds for which no annual disclosure information has been previously provided, the fiduciary would then be provided with

the material relevant to the new Funds in such annual disclosures.<sup>8</sup>

Upon consideration of these comments, the Department believes that some plan fiduciaries may still find information about other Funds to be useful and should be provided that information by the manager upon request. Therefore, in order to limit the scope of the annual disclosures required in section II(l) of the exemption (formerly section II(m) of the proposal), the Department has modified that section to read as follows:

“\* \* \* Such annual re-authorization must provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested as well as explicit notification that the plan fiduciary may upon request obtain disclosures regarding any new Funds in which the plan is not invested that are added to the cross-trading program, or any new triggering events that may have been added to existing Funds in which the plan is not invested, since the time of the initial authorization \* \* \* etc.” [emphasis added]

A commenter requested that the annual re-authorization requirement contained in section II(m) of the proposal be deleted in its entirety. The commenter stated that coordinating such a re-authorization would entail the same administrative burdens as a requirement for periodic notice of new Funds to all plan fiduciaries investing in Funds which participate in the manager's cross-trading program. According to the commenter, a plan could request that the plan's investment in any Fund that participates in the cross-trading program be terminated without penalty. Thus, the commenter maintained that a plan's participants and beneficiaries should be adequately protected without having to re-authorize participation in the cross-trading program every year.

In the event that the Department determined to retain the annual re-authorization requirement, the commenter requested two modifications to section II(m) of the proposal. First, the commenter believed that providing a plan fiduciary with a list of new Funds participating in the manager's cross-trading program would not provide the fiduciary with any useful information. Therefore, the commenter requested that the requirement in

section II(m) of the proposal for disclosure regarding new Funds added to the manager's cross-trading program or any new triggering events be modified to permit the manager to make such information available upon request. Second, the commenter noted that section II(m) of the proposal requires the use of a “special termination form” in the annual re-authorization. The commenter noted that there are other methods of communication which would be easier and more efficient for a plan fiduciary to use in the event that the fiduciary decides to terminate its prior authorization.

The Department has determined that it would not be appropriate to delete the requirement for plan fiduciaries of affected Funds to provide an annual re-authorization of their plan's participation in the manager's cross-trading program. The Department believes that annual re-authorization will help ensure effective monitoring of a cross-trading program by the affected plans. Therefore, the Department has retained this requirement in section II(l) of the exemption.

However, in response to the comments regarding the need for a special termination form to be sent to each plan fiduciary, the Department has modified section II(l) of the exemption (formerly section II(m) of the proposal) to permit other forms of written communication to be used to terminate an authorization. Thus, the following new sentence has been added to section II(l) of the final exemption:

“\* \* \* In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request.”

In response to the comments regarding the requirement in the proposal for the annual disclosures to include a list of any new Funds participating in the manager's cross-trading program in which the plan is not invested, or any new triggering events for a manager's Funds in which the plan is not invested, the Department has previously noted above that section II(l) of the exemption has been modified to require that such information need only be provided by a manager upon request.

9. *Authorizations for Large Account Restructures.* Under section II(n)(3) of the proposal, a portfolio restructuring program must be completed within the later of: (i) 30 days of the initial authorization by an independent

fiduciary of the Large Account; or (ii) 30 days of the manager's initial receipt of assets associated with the portfolio restructuring, unless such fiduciary agrees to extend this period for another 30-days. The comments requested a number of revisions and clarifications to this provision. First, the commenters noted that most portfolio restructuring programs are completed within a thirty (30) day period. However, very large portfolio restructurings may take considerably longer. In such instances, the commenters believe that it would be more efficient to allow the manager to obtain authorization to extend the 30-day restructure period at the time of the Large Account fiduciary's initial authorization. Second, one commenter questioned whether securities that cannot be cross-traded with the manager's Funds and, therefore, must be traded on the open market, are affected by the 30-day deadline. Third, another commenter suggested that the 30-day period should begin for each asset on the date on which the asset is included as part of the restructuring account. According to the comment, this change would be responsive to the fact that the manager or trading adviser for a Large Account may not receive all assets to be restructured at the same time.

In response to these comments, the Department has determined to modify section II(m)(3) of the exemption (formerly section II(n)(3) of the proposal) to allow the initial authorization by an independent fiduciary of the Large Account for a specific portfolio restructuring to be effective for 60 days. The 60-day restructure period can be extended for another 30 days if the independent fiduciary for the Large Account agrees to the extension. In addition, the Department wishes to clarify that only securities that are cross-traded are affected by the requirements of section II(m) of the final exemption.

Accordingly, the Department has revised section II(m)(3) of the exemption (formerly section II(n)(3) of the proposal) to provide that:

“\* \* \* All cross-trades made in connection with the portfolio restructuring program must be completed by the Manager within sixty (60) days of the initial authorization \* \* \*” [emphasis added]

In light of the Department's revision to section II(m)(3), the Department does not believe that any further relief is warranted.

10. *Record-keeping.* Several comments expressed concerns regarding the record-keeping requirements contained in section III(a) of the proposal. In this regard, section III(a)(2)

<sup>8</sup>With respect to such annual disclosures, it should be noted that all relevant independent plan fiduciaries of plans invested in a Fund that is added to a manager's cross-trading program, or has changed or added any “triggering events” for cross-trades by such Fund after the Fund is included in the program, will already have been provided a separate notice of such event(s) prior to, or within ten (10) days following, each event, as required by section II(k) of the exemption.

requires, among other things, that each manager retain, on a Fund by Fund basis, trade lists which specify the amounts of each security to be purchased or sold for a Fund. This information should be provided in sufficient detail to allow an independent plan fiduciary to verify that each of the investment decisions for the Fund were made in response to specific triggering events. Section III(a)(3) of the proposal requires that, on a Fund by Fund basis, the manager must record the actual trades executed on a particular day, noting which of those trades (including all cross-trades) resulted from triggering events. The comments noted that the preamble to the proposal does not seem to require that the notations necessary to meet the requirements of section III(a)(3) specify which specific triggering event caused each trade (or cross-trade), provided that it is clear that a triggering event(s) caused such trades.

Other commenters stated that the record-keeping requirements of section III(a) are unnecessary because, under the proposed exemption, an Index or Model-Driven Fund can only cross-trade as a result of a triggering event. In addition, these commenters suggested that such a record-keeping requirement would be extremely burdensome if it became necessary to "tag" each purchase or sale of a security to a specific triggering event. In such instances, the comments stated that the exemption would involve so much additional record-keeping and costs (*i.e.*, millions of dollars worth per year per manager) that no manager will be able to economically maintain or operate a cross-trading program for its client accounts. Conversely, the comments noted that if the Department believes that "tagging" is not required under the proposal, this record-keeping requirement should be deleted since all cross-trades by a manager's Funds will result from at least one "triggering event" in order to meet the conditions of the exemption. Other comments noted that records regarding specific triggering events should be retained only if the triggering event resulted in actual cross-trading.

In response to these comments, the Department notes that other commenters have indicated that the record-keeping requirements contained in section III of the proposal are consistent with their current record-keeping practices. In this regard, the Department understands that under the individual exemptions granted for cross-trades by Index and Model-Driven Funds, managers have established record-keeping and monitoring systems

designed to ensure compliance with the terms and conditions of those exemptions.

The Department notes that the record-keeping requirements contained in the proposal, while more specific than those of the individual exemptions, were designed to be consistent with the record-keeping systems of managers operating cross-trading programs under the individual exemptions. Thus, the Department is not persuaded by the arguments submitted in favor of deletion of this record-keeping requirement. The Department continues to believe that records must be maintained with sufficient specificity to permit an independent plan fiduciary to verify compliance with the conditions of the exemption.

In response to the commenter's request for clarification as to whether the record-keeping requirements contained in section III(a) of the proposal would mandate that a manager's records demonstrate that each cross-trade by a Fund resulted from a specific "triggering event," the Department believes that the following discussion will be helpful.

When more than one bona fide "triggering event" has occurred, the Department expects that a manager's record-keeping system will be able to demonstrate that the cross-trades by the Fund resulted from such "triggering events." For example, if a manager's record-keeping system enables the manager to "link" purchases and sales of specific amounts of securities in each cross-trade by a Fund to "triggering events" within the 3-day period, then such a system would satisfy the record-keeping requirements of the exemption.

As discussed by the Department in the preamble to the proposal, the record-keeping requirements are intended to assure that independent plan fiduciaries will be able to determine whether Funds and their underlying models or indexes operate consistently in following the input of triggering event information. This information should be kept in sufficient detail to enable a replication of specific historical events in order to satisfy an inquiry by interested persons (as described in section III(b)(1) of the exemption). The Department further notes that records regarding specific triggering events need only be maintained if such events resulted in cross-trades that are subject to the conditions of this exemption.

Another comment noted that section III(a) of the proposal requires that the records must be " \* \* \* readily available to assure accessibility and maintained so that an independent

fiduciary" may obtain them within a reasonable period of time. The comment noted that most of the required records would be maintained electronically and archived after a few months. The commenter maintained that, while such records are retrievable within a period of days or weeks, the exemption should recognize that the volume of trading and records involved would make faster retrieval impossible. Another comment requested that the Department acknowledge that a "reasonable period of time" in this context would be thirty (30) days. In this regard, the Department acknowledges that thirty (30) days may be a reasonable period of time for obtaining and assembling the required information for interested persons if the volume and complexity of the cross-trading records that must be assembled for such persons is significant.

Other comments noted that making records available to plan participants and beneficiaries would be unduly burdensome and would add no significant additional protections.

The Department has determined that it would be appropriate to modify section III(b)(1) to exclude plan participants and beneficiaries unless such persons are participants or beneficiaries in a Manager Plan.

11. *Definition of "Index Fund" and "Model-Driven Fund."* Several comments noted that, unlike prior individual exemptions for cross-trading, the definition of the term "Index Fund" in the proposal (*see* section IV(a) below) requires not only that a Fund be designed to track the rate of return, risk profile and other characteristics of an independently maintained securities index, but also that such tracking occur either by " \* \* \* replicating the same combination of securities which compose such index" or by " \* \* \* sampling the securities which compose such index based on objective criteria and data." The commenters urged the Department to clarify that this definition was not intended to preclude an Index Fund from holding cash, cash equivalents or other equitizing cash investments.

The Department concurs with this comment. The definition of the term "Index Fund" under section IV(a) of the exemption is not intended to prevent a Fund from holding cash, cash equivalents or other equitizing cash investments. For example, the Department notes that the definition of "triggering event" contained in section IV(d)(3) of the exemption specifically contemplates that a Fund may have an accumulation of cash which is attributable to interest or dividends on,

and/or tender offers for, portfolio securities.

In this regard, the Department recognizes that significant levels of cash or cash equivalents in an Index Fund generally will create "tracking error" vis-a-vis the independently maintained securities index which the Fund is designed to track. Therefore, assets other than securities which are included in the designated index will only be held by a Fund for a limited period of time.

However, the Department also understands that many managers use temporary cash investments to buy index futures contracts (e.g., S&P 500 futures) in order to more precisely replicate the rate of return and other characteristics of the index prior to investing in the actual securities. It is the view of the Department that the term "Index Fund" would allow the use of futures contracts by an Index Fund in order to reduce "tracking error" and to achieve the designated investment objectives of the Fund provided that such use is disclosed to plan investors. The disclosures should adequately describe the appropriate parameters and limitations on a manager's use of futures contracts for a Fund.

In this regard, the Department's conclusion is based upon its understanding that "passive" investment strategies employed by managers for Index Funds do not primarily rely on futures contracts to achieve a Fund's investment objectives, but rather rely on such contracts as a means for temporarily investing cash accumulations in the Fund prior to actually investing in and holding securities contained in the index. Conversely, the Department is unable to conclude that an Index Fund which invests primarily in index futures contracts as a means of achieving its investment objectives would meet the definition of "Index Fund" under section IV(a) of this exemption.

Several comments noted that the definition of the term "Model-Driven Fund" under the proposal (see section IV(b) below) requires that the identity and amount of a Fund's securities be "\* \* \* selected by a computer model that is based on prescribed objective criteria using independent third party data, not within the control of the Manager \* \* \*" These comments expressed concern that the definition does not appear to include separately managed Index Fund portfolios that exclude specific securities based on independent plan sponsor direction (as opposed to the determination of a computer model). In this regard, the comments noted that the Department

has recognized in the past that the composition of a Model-Driven Fund may be influenced by client-initiated instructions to delete certain securities (e.g., tobacco stocks) from an index that is otherwise being tracked. The comments suggested that the definition should be modified to include plan sponsor direction. According to the comments, this modification will not affect the intended purpose of the definition, which is to limit the amount of discretion a manager may exercise to affect the identity or amount of securities to be purchased or sold and to assure that such transactions are not part of an arrangement to benefit the manager.

In response to these comments, the Department notes that the definition of "Model-Driven Fund" in section IV(b)(1) of the exemption would include separately managed Fund portfolios which exclude specific securities based upon an independent plan fiduciary's (e.g., a plan sponsor's) direction. The Department understands that managers will often use computer models which are designed to "screen" certain securities that are listed in an index from the acquisitions that a Fund would otherwise make, in order to accommodate plan sponsor direction. The definition of "Model-Driven Fund," by allowing the identity of the securities which compose the Fund to be selected by a computer model, can accommodate Fund portfolios which are specifically designed to meet the guidelines dictated by plan sponsors. Thus, the Department does not believe that any further modification to this definition is necessary.

Another commenter noted that the definition of "Model-Driven Fund" in section IV(b) of the proposal is limited to Funds which use a computer model to "transform an Index." The commenter stated that many Model-Driven Funds do not seek merely to "transform an index" by limiting their investment universe to those securities contained in a single Index, but rather seek to apply quantitative techniques using various forms of publicly available data across a wide spectrum of securities. For example, the Fund may seek to design a portfolio based on the largest 2500 stocks in the United States, based on market capitalization. These stocks may be contained in various independently maintained indexes, but not all 2500 stocks will be contained in a single index. The commenter urged the Department to delete the phrase "\* \* \* to transform an Index" from section IV(b)(1) of the proposal and to substitute in its place the following "\* \* \* to achieve an investment return

that is either based upon or measured by an Index."

The Department does not believe that it would be appropriate in the context of a passive cross-trading exemption to permit managers to use indexes merely as a benchmark for the performance of a portfolio of a Model-Driven Fund. Accordingly, the Department has determined not to revise this definition.

Another comment related to both the definitions of "Index Fund" and "Model-Driven Fund." The commenter noted that sections IV(a)(3) and IV(b)(2) of the proposal provide that each definition includes any investment fund, account or portfolio which either contains "plan assets," is an investment company registered under the Investment Company Act of 1940, "\* \* \* or is an institutional investor." The comment noted that many index and model-driven funds are structured as common trust funds, limited liability companies, New Hampshire trusts or other forms of collective investment vehicles. Many of these funds do not contain "plan assets" subject to the Act, but are managed in the exact same manner as Funds that do contain "plan assets." The commenter is concerned that the definitions of "Index Fund" and "Model-Driven Fund" will not include such funds unless the phrase "\* \* \* or is an institutional investor" contained in sections IV(a)(3) and IV(b)(2) is modified to provide "\* \* \* or contains assets of one or more institutional investors."

The Department concurs with the commenter's suggestion and, accordingly, has modified sections IV(a)(3) and IV(b)(2) of the final exemption.

12. *Definition of "Triggering Event."* Section IV(d) of the proposal defines the term "triggering event" by listing four specific "events" that are included within the definition. In this regard, the comments noted that the preamble to the proposal states that if a computer model used to create a portfolio for a Model-Driven Fund is designed to exclude particular securities for reasons specified by a plan client or the plan's investment guidelines, such exclusions would not be considered a separate triggering event. However, the comments noted that some of the Department's prior individual exemptions for cross-trading included, as a separate triggering event, the following:

"\* \* \* a change in the composition or weighting of a portfolio used for a Model-Driven Fund which results from an independent fiduciary's decision to exclude certain stocks or types of stocks from the

Fund even though such stocks are part of the index used by the Fund.”<sup>9</sup>

The commenters requested that the Department modify the definition of “triggering event” to include a similar provision under the final exemption.

In response to the comments, the Department has added a fifth “triggering event” to section IV(d) of the exemption to incorporate the suggestion made by the commenters. Thus, section IV(d)(5) of the exemption includes within the definition of the term “triggering event” purchases and sales of securities made by Funds after changes to the portfolio of an Index or Model-Driven Fund solely as a result of an independent fiduciary’s decision to exclude certain securities from the Fund.

In this regard, the Department notes that with respect to a Model-Driven Fund, if the exclusion of certain securities is “built into” the original design of the model, the operation of that model by the manager should not create additional cross-trade opportunities for the Fund, since the Fund was not designed to buy the specific securities which are excluded. Similarly, if an “excluded security” is added to an index which has been used by the model to create a portfolio for a Model-Driven Fund, the model should have been already programmed to “screen” such securities from the acquisitions made by the Fund. Moreover, the additional triggering event would not apply with respect to any Index Fund or Model-Driven Fund that is a collective investment fund maintained by the manager, if the decision to exclude certain securities from the Fund’s portfolio was made by the manager.

Lastly, the Department notes that the “triggering event” contained in section IV(d) would be effective on the date that the independent fiduciary directed the manager to exclude the securities from the Index or Model-Driven Fund, and, accordingly, the cross-trades of such securities would have to occur within three (3) business days, pursuant to the requirements of section II(b) of the exemption.

Another comment suggested a further modification to the definition of “triggering event” in the proposal. The commenter objected to the requirement in section IV(d)(2) of the proposal that a triggering event include a “specific amount” of net change in the overall level of assets in a Fund, as a result of investments and withdrawals, and the requirement in section IV(d)(3) of a “specified amount” of accumulated cash or stock in a Fund. The commenter suggested that the references to “specific amount” and “specified amount” be changed to “material amount” in both section IV(d)(2) and (3). In connection with this modification, the commenter also requested that a manager be allowed to either (i) identify such material amount in advance as a specified amount of net change (or accumulated cash or

securities) relating to such Fund, or (ii) disclose, in the description of the manager’s cross-trading practices, pursuant to section II(l) of the proposal, the parameters for determining a material amount of net change (or accumulated cash or stock), including any amount of discretion retained by the manager that may affect such net change (or accumulated cash or securities), in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given.

The Department has considered the commenter’s suggestions for changes to the definition of “triggering event,” as contained in section IV(d)(2) and (3) of the proposal, and has determined that it would be appropriate to modify the final exemption. Thus, section IV(d)(2) and (3) of the exemption now reads as follows:

“(d) Triggering Event:

(2) A *material* amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that: (A) such *material* amount has either been *identified in advance as a specified amount of net change relating to such Fund* and disclosed in writing as a “triggering event” to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a “triggering event” for such Fund, *or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given; and \* \* \** [emphasis added]

(3) An accumulation in the Fund of a *material* amount of either:

(A) cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) stock attributable to dividends on portfolio securities; provided that such *material* amount has either been *identified in advance as a specified amount relating to such Fund* and disclosed in writing as a “triggering event” to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a “triggering event” for such Fund, *or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given \* \* \** [emphasis added]

In connection with the modification noted above, the Department cautions

managers that any parameters established for determining a material amount of net change (or accumulated cash or securities), and any discretion retained by the manager which may affect such amounts, must be sufficiently limited and described in enough detail to enable proper identification and monitoring of such triggering events by plan fiduciaries.

Further, with respect to the “triggering events” that must be disclosed to client plans, certain comments noted that section III(b)(2) of the proposal permits a manager, under certain circumstances, to refuse to disclose to clients any trade secrets, or commercial or financial information that is privileged or confidential, where such information is contained in the manager’s record-keeping system. However, these comments noted that the proposal does not include a similar protection for privileged or confidential information included within the mandated client disclosures for triggering events. For example, the triggering event contained in section IV(d)(4) of the proposal (*i.e.*, a change in the model-prescribed portfolio solely by operation of the formulae contained in the computer model underlying the Fund) can only be utilized if certain disclosures are made to an independent fiduciary of each of the plans participating in the Model-Driven Fund. The comments stated that certain of these disclosures may involve highly proprietary information that the investment manager is reluctant to disclose to clients, particularly through a written communication that a client could easily transmit to others. Thus, the comments requested that the Department allow a manager to refuse to disclose trade secrets, or commercial or financial information that is privileged or confidential, so long as the manager notes the reason for non-disclosure in its general disclosure to clients.

In this regard, the Department does not believe that the disclosure of basic factors for making changes in a portfolio for a Model-Driven Fund would require that privileged or confidential information be revealed by the manager to independent plan fiduciaries. Therefore, the Department has not modified the language of section IV(d)(4) in the final exemption.

13. *Definition of “Large Account.”*  
One comment noted that section IV(e) of the proposal excludes from the definition of “Large Account” any “

<sup>9</sup> See, for example, condition (c)(2) of PTE 94–36 (59 FR 19249, April 22, 1994) regarding The Northern Trust Company.

\* \* \* Index Fund or Model-Driven Fund sponsored, maintained, *trusteed* or managed by the Manager \* \* \* [emphasis added] The commenter noted that some banks act as a directed trustee for group trusts which are managed by third party investment managers. In these situations, the bank acts as a non-discretionary trustee and its primary role is to provide custody and record-keeping services for the group trust. The commenter stated that there is no reason that an independent investment manager should be precluded from retaining the bank as a trading adviser for the liquidation or restructuring of the Large Account since, in its capacity as a non-discretionary trustee, the bank will not be making the underlying investment decisions for the portfolio restructuring of the Large Account. Therefore, the commenter requested that the word "trusteed" be deleted from the definition of "Large Account" in section IV(e) of the proposal.

In this regard, the Department does not believe that it would be appropriate to include all investment funds trusteed by the manager in the definition of "Large Account" contained in the exemption. However, the Department has determined it would be appropriate to modify the language of section IV(e) of the final exemption to include an Index Fund or a Model-Driven Fund for which the manager is a nondiscretionary trustee. Consequently, the Department has added a definition of the term "nondiscretionary trustee" to the exemption under section IV(m).

Other comments suggested that the definition of "Large Account" in section IV(e) of the proposal should be modified by deleting entirely the phrase which provides that a Large Account " \* \* \* is not an Index Fund or a Model-Driven Fund sponsored, maintained, trusteed or managed by the Manager." These comments stated that, if the decision to liquidate a Fund's portfolio is made by an independent plan fiduciary, and such decision is entirely out of the manager's control, it should not matter whether the portfolio is an Index or Model-Driven Fund that is managed by the manager.

In response to these comments, the Department has determined that it would not be appropriate to make the requested modification to the definition of the term "Large Account" in section IV(e) of the exemption. The Department continues to believe that cross-trades by a manager's Index and Model-Driven Funds should be subject to the requirements and limitations applicable to Funds under the exemption, such as specified "triggering events" for cross-trade opportunities.

Another comment noted that section IV(e) of the proposal defines a "Large Account" as any investment fund, account or portfolio that, among other things, holds assets of a registered investment company other than an investment company advised or sponsored by the manager. The commenter believes that the limitation excluding investment companies advised or sponsored by the manager should be deleted. The commenter argued that the Large Account would not be participating in the manager's cross-trading program unless it were advised by the manager, and that the definition in the proposal excludes the very category of investment companies for which relief was intended.

The Department notes that the commenter's argument that a Large Account could be, and most likely would be, a registered investment company advised or sponsored by the manager is not consistent with the record upon which the exemption was developed by the Department. In this regard, the category of investment companies for which relief was intended under this exemption, as well as under prior individual exemptions, were those entities that are independent of the manager operating the cross-trading program, but who decide to hire the manager in order to carry out a specific portfolio restructuring program. In such instances, the restructured portfolio will often become an "Index Fund" or "Model-Driven Fund" (as defined herein) that will be managed by the manager.

However, the situation described by the commenter, which would permit the inclusion within a manager's cross-trading program for Large Accounts of "actively-managed" investment company portfolios advised by the manager, would expand the scope of the exemption beyond that intended by the Department. As discussed further below, the Department is not providing relief at this time for cross-trading programs involving "actively-managed" accounts or funds. Therefore, in response to this comment, the Department has determined not to modify section IV(e)(3) of the final exemption.

Other comments noted that the definition of "Large Account" in section IV(e) of the proposal requires that the plan or institutional investor whose assets are held by the Large Account have \$50 million or more in total assets. The commenter suggested that the definition be revised to permit assets of affiliated plans maintained by the same employer, or controlled group of

employers, to be aggregated for purposes of meeting the \$50 million threshold.

In consideration of the commenter's suggestion, the Department has modified the definition of "Large Account" in section IV(e)(1) of the exemption to permit the aggregation of assets of employee benefit plans maintained by the same employer, or controlled group of employers, provided that such assets are pooled for investment purposes in a single master trust.

14. *Definition of "Portfolio Restructuring Program."* Several comments noted that the term "portfolio restructuring program" is defined in section IV(f) of the proposal to include the buying and selling of 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 \* \* \*" In this regard, the comments noted that portfolio restructuring assignments occasionally contemplate that a manager will construct an Index Fund or Model-Driven Fund portfolio or some other type of portfolio which, once formed, will be managed on an ongoing basis by either the plan sponsor or an independent third party manager. In addition, the comments stated that since the terms "Index Fund" and "Model-Driven Fund" are already defined in the proposal, the phrase " \* \* \* managed by the Manager" in the definition of "portfolio restructuring program" is unnecessary. Accordingly, the commenters suggested that the phrase "managed by the Manager" be deleted from the definition in section IV(f) of the final exemption.

In response to the comments, the Department has modified the definition of the term "portfolio restructuring program" in section IV(f) of the exemption to read as follows:

"(f) Portfolio restructuring program— 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 by another investment manager, or in order to produce a portfolio of securities the composition of which is designated by a party independent of the Manager, without regard to the requirements of \* \* \* etc." [emphasis added]

15. *Volume Restrictions for Cross-Traded Securities.* A number of commenters responded to the Department's request for information on whether Index and Model-Driven Funds may hold a significant amount of the outstanding shares of a particular security, whether cross-trades of securities by a manager's Funds may represent a high percentage of the

outstanding daily trading volume for such securities, and whether some volume limitation for cross-traded securities would be appropriate. The commenters expressed the view that, even if a manager's Funds were cross-trading securities representing a high percentage of the average daily trading volume, there is no reason to impose a volume limitation in the exemption so long as the purchase or sale of such securities is mandated by a triggering event of an Index or Model-Driven Fund and the securities can be crossed at the closing market price, as established through an independent pricing source. These comments noted that such cross-trades are beneficial to plans regardless of whether the securities involved are thinly-traded, whether the Index and Model-Driven Funds hold significant amounts of the outstanding shares of the securities, or whether the manager's trading represents a high percentage of the trading volume for the securities. The commenters again noted the significant savings which are incurred by avoiding brokerage commissions and bid-ask spreads.

Thus, most commenters expressed the view that if a manager's Index and Model-Driven Funds have a bona fide need to buy or sell specific amounts of securities on any particular business day, in response to various triggering events, there should not be an arbitrary percentage limitation that would inhibit the manager from taking advantage of all cross-trade opportunities for such securities. However, another commenter expressed the view that the Department's exclusion of "thinly-traded" equity securities (by requiring in section II(f)(1) of the proposal that all cross-traded equity securities must be "widely-held" and "actively-traded") is unduly burdensome and unnecessary. As an alternative, this commenter recommended that the Department include "thinly-traded" equity securities, but impose some reasonable limitation on cross-trades of such securities, based on a comparison of the size of the cross-trade to the prior trading volume in the security over a reasonable period of time prior to the date of the transaction.

After considering the comments regarding the inclusion of "thinly-traded" equity securities in the exemption if an appropriate volume limitation is imposed, the Department has determined not to adopt this approach. The Department's decision is based, in part, on its understanding that, since a process-driven cross-trading program must allocate cross-trade opportunities in a mechanical fashion, it would not be economically feasible to

override such allocations whenever the equity securities involved exceeded a specified volume limitation. Therefore, the Department continues to believe that it is more appropriate to allow cross-trades of all equity securities that are listed in an independently maintained third party index (see definition of "Index" in section IV(c) of the exemption), without any volume limitations. Under the exemption, the Department deemed all equity securities listed in an index to be "widely-held" and "actively-traded" for purposes of this exemption in order to allow the largest possible universe of equity securities to be cross-traded within the parameters of the conditions of the exemption. In the Department's view, the inclusion of "thinly-traded" equity securities that are not listed in an index would require additional safeguards, such as volume information and limitations, which may not be economically feasible in connection with the operation of a manager's cross-trading program.

16. *Avoidance of Adverse Market Impact; Savings in Transaction Costs; A Computer Model's Consideration of Liquidity.* In response to specific questions posed by the Department in the preamble to the proposal on the avoidance of market impact through cross-trades (see Section IV.B. of the preamble, 64 FR at 70063), several commenters noted that, by cross-trading at the close of market price, both sides of the cross-trade benefit by avoiding the potential for adverse market impact. The comments stated that adverse market impact occurs each time an investor trades through the market as the market price moves away from the offered price, meaning that the price decreases when the investor wants to sell and increases when the investor wants to buy.

One commenter stated that the Department appears to have concerns about the fact that a manager's avoidance of market impact may not be beneficial to plans at certain times. These concerns originate from the assumption that a manager could benefit certain plans by using a particular trade's market impact as an opportunity for obtaining a better price for a security on the open market. In this regard, the commenter noted that market impact is unpredictable and cannot be forecast by the manager. The commenter stated that managers believe that in most cases market impact is to be avoided, if possible. Thus, the commenter expressed the view that cross-trading, by avoiding the uncertainty of market impact, enables a manager to avoid the possibility of harm to certain clients

which would result if trades were placed on the open market, and also eliminate transaction costs and custody costs.

Most commenters noted that a "passive" manager would have no incentive to use the limited amount of discretion allowed by its cross-trading program to favor one Fund or Account over another. One commenter stated that each manager would have the same trading goals for all Funds and Large Accounts—i.e., to maximize cross-trading and to minimize transaction costs for open market transactions.

Another commenter noted that Index and Model-Driven Funds are often buying and selling the same securities because there are many different Funds maintained by a manager that are tracking the same index (e.g., the S&P 500 Index). Many managers also design portfolios for Model-Driven Funds that are based on the same index. Moreover, many large capitalization stocks are listed in more than one index. The commenters noted that cross-trades of such stocks between Index and Model-Driven Funds, pursuant to triggering events that occur without a manager's exercise of any investment discretion, at an objectively determined "closing price" as reported from a reputable third party source, are an efficient and effective way of meeting the investment objectives of plans which invest in such Funds.

In response, the Department recognizes the merits of cross-trading to reduce or eliminate transaction costs in the context of "passively managed" assets. In such instances, a manager has limited investment discretion as a result of independently determined triggering events.

With respect to the Department's concerns that the avoidance of market impact through cross-trades may not equally benefit both sides of such transactions, the Department notes that the potential for abuse appears to be significantly less with "passively-managed" assets than with "actively-managed" assets. However, the Department does not believe that the commenters have demonstrated that cross-trading creates market impact savings, if any, for both sides to any given cross-trade. The Department has been provided with data by one commenter demonstrating some market impact savings for one side in cross-trades of significant amounts of securities (i.e. market impact savings were measured where the cross-trades involved a large capitalization security traded in amounts averaging one and a quarter days of the average public trading volume of the security). No data

was provided to the Department measuring market impact savings for smaller cross-trades, nor was data provided measuring the market impact savings, if any, for each side in a particular cross-trade. Even so, as noted below, certain commenters have concluded that there has been significant transaction cost savings with cross-trading "passively-managed" assets and that these savings are attributable solely to the reduction or elimination of brokerage commissions and bid-ask spreads.

Another commenter noted that the preamble to the proposal suggests that relief would not be available under the exemption if the computer model used for a Fund considered the liquidity or availability of securities that are in the cross-trading "network" of Funds managed by the manager (see the sixth paragraph of Section IV.A. of the preamble, 64 FR at 70062). This commenter expressed the view that such a restriction is harmful to plans and misapprehends the operation of some "passively-managed" Funds. The commenter stated that truly "passive" Index Funds track the relevant indices and attempt to reduce or eliminate "tracking error" between the value of the Fund's portfolio vis-a-vis the value of the index's portfolio. The more identical an Index Fund's portfolio looks when compared to the underlying index's portfolio, and the cheaper the acquisition and disposition costs of the securities in the index, the lower the "tracking error" becomes. Thus, a successful "passive" manager is one who has the least amount of tracking error in its Index Funds. The commenter noted that the model used for such an Index Fund will always start with the proposition that the portfolio wants each security in the index in its precise capitalization-weighting, as determined by the index. The more information the model has about the costs of acquisition of any security, the less the tracking error will be for the Fund's portfolio and the more successful the manager will be in meeting the plan's investment objectives.

The Department's concerns regarding a computer model's consideration of liquidity or availability of certain securities that are in the manager's cross-trading "network" are best illustrated by the following example:

A computer model for a Model-Driven Fund identifies three possible securities for acquisition by the Fund in an attempt to achieve the optimal portfolio for the Fund within the specified guidelines dictated by the Fund's investors. These securities are identified, for purposes of this example, as "A", "B", and "C". Security "A" is the most

liquid of the three securities, based on third party data, and security "C" is the least liquid. The model considers each security's liquidity factor, among other factors, and the estimated transaction costs which would be incurred to acquire the security, as part of its determination as to which security to buy and how much of the security to buy.

Assume that the model is programmed to make the selection of which security to buy, and the amount to buy, by considering only the liquidity information about each security that is available based on third party market data. Let's also assume that, based on such data, the model chooses security "A" and does not choose securities "B" or "C". The exemption would apply for acquisition of security "A" to be made by the Fund through cross-trades.

However, let's assume that the model is programmed to make the selection of which security to buy, and the amount to buy, by considering cross-trade opportunities that are available for each security, in addition to other liquidity information that is available based on third party data. Let's also assume that security "C" is available through a cross-trade and that the Fund can acquire all the securities it needs through cross-trades of that security. The model has been programmed to "view" security "C" as having "infinite liquidity" because the data within the control of the manager suggests that it can be acquired without incurring any transaction costs. However, this circumstance results from the fact that the necessary number of shares of security "C" which the model has determined that the Fund needs is available through cross-trades. Under this example, security "C" is considerably less liquid than security "A" based upon available third party data. The exemption would not apply for acquisitions of security "C" to be made by the Fund through cross-trades because the selection of security "C" was based upon the manager's own liquidity information at that time and not liquidity information based solely on third party data.

The Department believes that adoption of the commenter's liquidity approach could result in cross-trading opportunities within the control of the manager impacting upon the investment determinations of the Fund. In this regard, the Department notes that investment decisions made by a Fund may not be based in whole or in part by the manager on the availability of cross-trade opportunities and must be made prior to the identification and determination of any cross-trade opportunities, pursuant to the statement required under section II(j) of the exemption. Therefore, any model's consideration of information relating to cross-trade opportunities for particular securities, as part of the model's determination of which securities to buy or sell, how much of a security to buy or sell, or when to execute a sale or purchase of the securities for the Fund, would not be permitted under the exemption. The Department continues

to believe that liquidity considerations and other factors considered by a computer model must be based on independent third party data, not within the control of the manager, as described under section IV(b) of the exemption.

Other commenters noted that the transaction cost savings attributable to cross-trades, pursuant to cross-trading programs operating under the Department's existing individual exemptions, are significant. In response to the Department's questions about whether such cost savings are attributable to the avoidance of market impact or only commission savings, one commenter stated that its clients have saved over \$300 million annually through cross-trading and that this calculation is based entirely on the avoidance of brokerage commissions and bid-ask spreads. Another commenter stated that its clients saved approximately \$282 million in the calendar year 1999, based on the total number of shares that were cross-traded during the year, broken down by the market in which each share would have been traded if it went to the open market. This commenter also confirmed that these savings are attributable to savings in brokerage commissions, bid-ask spreads and taxes, as applicable in each market. Thus, in both instances, the commenters noted significant cost savings even without taking into consideration whatever measurable "savings" may have been attributable to the avoidance of market impact.

17. *Effect of Class Exemption on Individual Exemptions; Appropriate Scope of Relief for the Exemption.* The commenters expressed many different points of view in response to the Department's invitation for comments on the effect that the continuation of current individual exemptions, for cross-trades by Index and Model-Driven Funds, would have in offering an advantage to those investment managers granted such relief compared to those managers which would utilize this exemption (see Section IV.H. of the preamble to the proposal, 64 FR at 70066).

One comment noted that the proposal would expand the relief for cross-trading beyond the relief currently available under the individual exemptions, particularly by permitting cross-trades of debt securities and by expanding the definitions of Funds and Large Accounts that are permitted to cross-trade. However, the comment also noted that the proposal imposes a number of additional disclosure, authorization and operational requirements on cross-trading programs. Thus, the comment stated that it is not

clear whether managers who continue to utilize their individual exemptions would have an advantage over those utilizing the class exemption.

Another comment stated that some individual exemptions have been relied upon by managers for more than a decade and that such exemptions should remain in place after the class exemption is granted. This commenter noted that managers have invested substantial time and resources in the current cross-trading systems, and other programmatic features in such systems have been developed in reliance upon the conditions of the individual exemptions. Any revocation of the existing exemptions would mandate conformance with the new exemption's requirements and features, and the manager's cross-trading procedures and systems would have to be significantly revised. The commenter stated that such revisions would place an undue burden on the managers, would add significant costs to the operation of the existing cross-trading programs, and would not provide any added benefits to the managers' client plans.

However, other commenters stated that, by permitting firms to continue to rely on individual exemptions that have, in some respects, less stringent conditions than the proposal, the Department would create a competitive advantage for advisers who already have exemptions. Some commenters further stated that, by granting the class exemption, the Department is already creating a competitive advantage for firms that "passively manage" plan assets over those which "actively manage" such assets. These commenters urged the Department to hold all firms to the same standard, at least with respect to the class exemption, and eliminate the existing individual exemptions to ensure an "equal playing field" for all similarly situated managers that "passively-manage" assets.

In this regard, the Department has not made a determination at the present time whether to revoke any past individual exemptions for cross-trading programs involving Index and Model-Driven Funds. It is not clear whether managers who continue to utilize their individual exemptions will have an advantage over those utilizing the class exemption since cross-trades may only be performed if they conform with either all of the provisions of an individual exemption or all of the provisions of the class exemption (*i.e.*, managers who hold individual exemptions may not pick and choose selected provisions from their own exemptions and the class exemption). As noted in the preamble to the

proposal, prior to modifying or revoking any individual exemption, the Department must publish a notice of its proposed action in the **Federal Register** and provide interested persons with an opportunity to comment on any proposed revocation or modification of such exemptions.

Other commenters requested that the Department expand the proposal to permit cross-trades by "actively-managed" plan accounts of a manager. These commenters noted that the clear advantages of cross-trading should be available to both actively and passively managed funds, and that the Department's exclusion of "actively-managed" funds from the current exemption is unfair.

Other commenters stated that it was appropriate for the Department to handle cross-trades by "passively-managed" funds separately. Such commenters noted that "passive" managers have far less discretion than "active" managers. One comment stated that a class exemption attempting to address both "actively" and "passively" managed funds would be confusing and could lead to the application of unnecessarily burdensome conditions on "passively-managed" funds to address concerns applicable only to "actively-managed" funds.

The Department has determined to grant this exemption for cross-trading programs involving Index and Model-Driven Funds and to separately proceed with its consideration of relief for cross-trades by "actively-managed" plan accounts or pooled funds containing "plan assets" covered by the Act.<sup>10</sup> The Department acknowledges that appropriate cross-trades of securities by "actively-managed" accounts or funds would be beneficial to employee benefit plans in saving transaction costs and avoiding adverse market impact for both sides of the transactions. However, the Department believes that adequate safeguards must be developed in order to prevent abuses which could occur

<sup>10</sup> Interested persons may wish to review the information received by the Department in response to the Notice published in the **Federal Register** on March 20, 1998 (63 FR 13696) and in the testimony provided at the public hearing on cross-trades of securities by "actively-managed" plan accounts and pooled funds (the Hearing), which was held at the Department on February 10 and 11, 2000. Copies of the comments received by the Department in response to the Notice, and the testimony received at the Hearing, are available for public inspection in the Public Documents Room, Pension and Welfare Benefits Administration, U.S. Department of Labor, Room N-1513, 200 Constitution Avenue NW, Washington, DC 20210. For copies of the comments relating to the Notice, interested persons should request File No. M-9043. For copies of the testimony received at the Hearing, interested persons should request File No. D-10851 (Cross-Trades of Securities Hearing).

when an investment manager has significant investment discretion which could be used to benefit certain clients or the manager itself at the expense of its ERISA-covered accounts.

The Department is currently considering what conditions may be necessary to address potential abuses in cross-trading programs that would involve "actively-managed" plan accounts. The Department continues to receive and review additional information from various interested persons which will assist the Department in developing a separate class exemption for cross-trades by "actively-managed" plan accounts.

## Description of the Exemption

### A. Scope and General Rule

The exemption consists of four parts. Section I sets forth the general exemption and describes the transactions covered by the exemption. Sections II and III contain specific and general conditions applicable to transactions described in section I. Section IV contains definitions for certain terms used in the exemption.

The exemption set forth in section I provides relief from the restrictions of sections 406(a)(1)(A) and 406(b)(2) of ERISA and section 8477(c)(2)(B) of FERSA for: (a) The purchase and sale of securities between an Index or Model-Driven Fund and another such Fund, at least one of which holds "plan assets" subject to the Act; and (b) the purchase and sale of securities between such Funds and certain large accounts (Large Accounts) pursuant to portfolio restructuring programs of the Large Accounts. The exemption also would apply to cross-trades between two or more Large Accounts if such cross-trades occur as part of a single cross-trading program involving both Funds and Large Accounts pursuant to which securities are cross-traded solely as a result of the objective operation of the program.

The exemption under section I(a) applies to cross-trades of securities among Index or Model-Driven Funds managed by the same investment manager where both Funds contain plan assets. However, as stated above, a violation of section 406(b)(2) occurs when an investment manager has investment discretion with respect to both sides of a cross-trade of securities and at least one side is an entity which contains plan assets. As a result, the exemption is also applicable to situations where the investment manager has investment discretion for both Funds involved in a cross-trade but one Fund does not contain plan assets

because, for example, it is registered as an investment company under the Investment Company Act of 1940 (e.g., a mutual fund). Any mutual fund or other institutional investor covered by the exemption under section I(a) must meet the definition of an Index Fund or a Model-Driven Fund, contained in section IV(a) and (b). Institutional investors which meet the definitions contained in section IV(a) and (b) may include, but are not limited to, entities such as insurance company separate accounts or general accounts, governmental plans, university endowment funds, charitable foundation funds, trusts or other funds exempt from taxation under section 501(a) of the Code.

The exemption under section I(b) applies to the purchase and sale of securities between a Fund and a Large Account, at least one of which holds "plan assets" subject to ERISA or FERSA, pursuant to portfolio restructuring programs initiated on behalf of certain Large Accounts. The term "Large Account" is defined in section IV(e) to include certain large employee benefit plans or other large institutional investors with at least \$50 million in total assets, including certain insurance company separate and general accounts and registered investment companies. For purposes of the \$50 million requirement, the assets of one or more employee benefit plans maintained by the same employer, or controlled group of employers, may be aggregated, provided that such assets are pooled for investment purposes in a single master trust. A portfolio restructuring program, as defined in section IV(f), involves the buying and selling of securities on behalf of a Large Account in order to produce a portfolio of securities which either becomes an Index Fund or a Model-Driven Fund or resembles such a Fund, or to carry out a liquidation of a specified portfolio of securities for a Large Account. The Fund or other portfolio resulting from the restructuring program will be either managed by the manager of the Fund or by an investment manager that is independent of the Fund manager. The definition of a Large Account requires that an independent fiduciary authorize a Fund manager (i.e., a Manager, as defined in section IV(i)) to restructure all or part of the portfolio or to act as a "trading adviser" as defined in section IV(g) with respect to the restructuring of such portfolio. The trading adviser's role is limited under the exemption to the disposition within a stated period of time of a securities portfolio of a Large

Account and/or the creation of the required portfolio.

Under this definition, the manager may not have any discretionary authority for any asset allocation, restructuring or liquidation decisions or otherwise provide investment advice with respect to such transactions. In this regard, the Department notes that it expects the investment manager to comply with the applicable securities laws in connection with any portfolio restructuring program.

Section IV(a) and (b) require that the Index or Model-Driven Fund be based upon an index which represents the investment performance of a specific segment of the public market for equity or debt securities. Section IV(c) requires that the index be established and maintained by an independent organization which is: in the business of providing financial information or brokerage services to institutional clients; a publisher of financial news or information; or a public stock exchange or association of securities dealers. The index must be a standardized index of securities which is not specifically tailored for the use of the Fund manager.

Section IV(a) and (b) specifically define Index and Model-Driven Funds for purposes of the exemption. These definitions are designed to limit the amount of discretion the manager can exercise to affect the identity or amount of securities to be purchased or sold and to assure that the purchase or sale of any security is not part of an arrangement, agreement or understanding designed to benefit the manager. Under the definition of "Index Fund" contained in section IV(a), the investment manager must track the rate of return of an independently maintained securities index by either replicating the same combination of securities which compose such index or by investing in a representative sample of such portfolio based on objective criteria and data designed to recreate the projected return, risk profile and other characteristics of the index. Under the definition of "Model-Driven Fund" contained in section IV(b), trading decisions are passive or process-driven since the identity and the amount of the securities contained in the Fund must be selected by a computer model. Although the manager can use its discretion to design the computer model, the model must be based on prescribed objective criteria using third party data, not within the control of the manager, to transform an independently maintained index. Thus, for example, no exemptive relief would be available if the manager designed the computer

model to consider the liquidity or the availability of a security based on information that was solely within the control of the manager. In such instances, the computer model would be considering data that was not from a third party source, and that was within the control of the manager.

#### B. Price and Securities

Section II(a) of the exemption requires that each cross-trade be executed at the closing price for that security. In addition, section II(g) of the exemption requires that the manager may not receive any brokerage fees or commissions as a result of the cross-trades.

*Closing price* is defined in section IV(h) as the price for the security on the date of the transaction, as determined by objective procedures disclosed to Fund investors in advance and consistently applied with respect to securities traded in the same market. The procedures shall indicate the independent pricing source (and alternates, if the designated pricing source is unavailable) used to establish the closing price and the time frame after the close of the market in which the closing price will be determined. The pricing source must be independent of the manager and must be engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and must be widely recognized as an accurate and reliable source for such information. In this regard, some managers may use one pricing service for pricing domestic securities and another pricing service for pricing foreign securities. With respect to foreign securities, the applicable independent pricing source should provide the price in local currency rates and, if that currency is other than U.S. dollars, may also provide the U.S. dollar exchange rate. Thus, securities must be cross-traded in all cases at the closing prices received by the manager from the relevant independent pricing source.

The Department has adopted this definition of the term "closing price" in an effort to be consistent with the methods for determining the price of cross-traded securities currently utilized by Index and Model-Driven Fund investment managers, according to both the comments received in response to the proposal published on December 15, 1999 and the comments received in response to the Notice published on March 20, 1998. In addition, the Department believes that this pricing approach will ensure that the pricing procedures utilized are objective and not subject to the discretion or

manipulation of any of the involved parties.

Section II(f) of the exemption requires that cross-trades of either equity securities or fixed income securities involve only securities for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information. Section II(f)(1) further requires that cross-trades of equity securities only involve securities which are widely-held and actively-traded. In this regard, the Department notes that equity securities will be deemed to be "widely-held" and "actively-traded" under this exemption if such securities are included in an independently maintained index, as defined in section IV(c) herein. The Department expects that managers, in making their determinations regarding the types of securities included within the scope of this condition, would consider information about the average daily trading volume for equities traded on any recognized securities exchange or automated broker-dealer quotation system which would be readily available from independent pricing sources or other independent sources which publish financial news and information.

### C. Triggering Events

Section II(b) of the exemption requires that any purchase or sale of securities by a Fund in a cross-trade with another Fund or with a Large Account occur as a direct result of a "triggering event," as defined in section IV(d), and that such cross-trade be executed no later than the close of the third business day following such "triggering event." The Department believes that trading pursuant to triggering events limits the discretion of the manager to affect the identity or amount of securities to be purchased or sold. Triggering events, as defined in section IV(d), are outside the control of the manager and will "automatically" cause the buy or sell decision to occur.

Triggering events are defined in section IV(d) as:

(1) A change in the composition or weighting of the index underlying the Fund by the independent organization creating and maintaining the index;

(2) A material amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that:

(A) Such material amount has either been identified in advance as a specified amount of net change relating to such Fund and disclosed in writing as a "triggering event" to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a "triggering event" for such Fund or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given; and

(B) Investments or withdrawals as a result of the manager's discretion to invest or withdraw assets of a Manager Plan, other than a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options, including such Fund, will not be taken into account in determining the specified amount of net change;

(3) An accumulation in the Fund of a material amount of either:

(A) Cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) Stock attributable to dividends on portfolio securities;

provided that such material amount has either been identified in advance as a specified amount relating to such Fund and disclosed in writing as a "triggering event" to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a "triggering event" for such Fund, or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given;

(4) A change in the composition of the portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model underlying the Fund where the basic factors for making such changes (and any fixed frequency for operating the computer model) have been disclosed in writing to an independent

fiduciary of each plan having assets held in the Fund, prior to, or within ten (10) days after, its inclusion as a "triggering event" for such Fund; or

(5) A change in the composition or weighting of a portfolio for an Index Fund or a Model-Driven Fund which results from an independent fiduciary's direction to exclude certain securities or types of securities from the Fund, notwithstanding that such securities are part of the index used by the Fund.

The first three triggering events have been adopted based upon those triggering events utilized in prior individual exemptions, with an additional requirement in the second and third triggering events for the amounts involved, or the parameters for determining such amounts, to be specified and disclosed to independent fiduciaries of plans investing in the Funds. In addition, the fourth triggering event has been added in order to clarify that a triggering event also occurs as a result of a change in the composition of a Fund's portfolio mandated solely by operation of the computer model underlying the Fund. For example, if a model contained a formula for a Fund requiring only stocks with a certain price/earnings ratio and some of the originally prescribed stocks now were above the specified tolerances of the formula relating to that model, a triggering event would occur requiring that those stocks be sold by the Fund. The Department has included this triggering event under this exemption in order to clarify that Model-Driven Funds may need to buy or sell securities to conform to changes to the portfolio prescribed by the model that differ from changes to a portfolio necessitated as a result of changes to the underlying index. The exemption does not require that a computer model be operated according to any fixed frequency. However, the Department is of the view that the exemption would not be available unless the formulae contained in the computer model underlying a Fund were operated by the manager on an objective basis rather than being used for the purpose of creating cross-trade opportunities in response to the needs of other Funds or certain Large Accounts.

The Department further notes that under section II(k), disclosures must be made to independent plan fiduciaries of the affected Funds regarding the triggering events that would create cross-trading opportunities for such Funds under the manager's cross-trading program. Under the model-driven triggering event contained in the exemption, the basic factors for making changes in the composition of the

portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model must be included in these disclosures.

The Department notes that a fifth triggering event has been added to the final exemption, based on comments received, which permits plan sponsors to direct the manager to delete certain securities from an Index or Model-Driven Fund where the Fund otherwise would hold such securities based upon the particular index or computer model. The Department understands that this triggering event is consistent with practices utilized by certain managers in prior individual exemptions and will facilitate additional cross-trade opportunities.

#### *D. Modifications to the Computer Model*

Section II(c) requires that, if the model or the computer program used to generate the model underlying the Fund is changed by the manager, no cross-trades of any securities can be engaged in pursuant to the exemption for three (3) business days following the change. This restriction recognizes the authority of the manager to change assumptions involving computer models after the model's activation.

The Department notes that the three (3) business day "blackout" period for cross-trades by a Fund after any change made by the manager to the model underlying the Fund is intended to prevent model changes which might be made by managers, in part, to deliberately create additional cross-trading activity.

In addition, under section IV(b), a computer model for a Model-Driven Fund must use independent third party data, not within the control of the manager, to transform an index.

#### *E. Allocation of Cross-Trade Opportunities*

The Department notes that frequently the amount of a security which all of the Funds need to buy may be less than the amount of such security which all of the Funds will need to sell, or vice versa. Thus, section II(d) of the exemption requires that all cross-trade opportunities be allocated by the manager among potential buyers, or sellers, on an objective basis. Under section II(d), this basis for allocation must have been previously disclosed to independent fiduciaries on behalf of each plan investor, and must not permit the exercise of any discretion by the manager. In previous individual exemptions, applicants have relied on different systems (e.g. pro rata or queue) to objectively allocate cross-trade

opportunities. While it appears to the Department that a pro rata basis of allocation would be the method least subject to scrutiny, the Department recognizes the validity of other workable objective systems. However, the Department cautions that such systems may not permit the exercise of discretion by the manager.

#### *F. Requirements for Cross-Trades by a Manager Plan*

Section II(e) of the exemption requires that no more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade may be comprised of assets of employee benefit plans maintained by the Manager for its own employees (Manager Plans) for which the Manager exercises investment discretion. In this regard, the Department wishes to note that this percentage limitation would not apply to any Manager Plan(s) for which the Manager does not exercise investment discretion. For example, a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options would not be subject to the twenty (20) percent limit.

#### *G. Disclosures and Authorizations*

Section II(h) of the exemption requires that a plan's participation in a cross-trade program of a manager involving Index and Model-Driven Funds at least one of which holds "plan assets" subject to the Act will be subject to the prior written authorization of a plan fiduciary who is independent of the manager. However, for purposes of this exemption, the requirement that the authorizing fiduciary be independent of the manager shall not apply in the case of a Manager Plan. In this regard, section II(e) of the exemption requires that no more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade may be comprised of assets of a Manager Plan for which the Manager exercises investment discretion.

The authorization described in section II(h), once given, would apply to all Funds that comprise the manager's cross-trading program at the time of the authorization. Thus, a new authorization by an independent plan fiduciary for investment in a different Fund, in which the plan did not invest at the time of its initial written authorization, would not be necessary to the extent that such Fund was part of the program at the time of the original authorization. However, where a manager makes new Funds available for plan investors or changes triggering

events relating to Funds subject to the initial authorization, and such Funds or triggering events were not previously disclosed as being part of the manager's cross-trading program, section II(k) of the exemption requires that the manager furnish additional disclosures to an independent plan fiduciary. The Manager shall provide a notice to each relevant independent plan fiduciary of plans invested in the affected Funds prior to, or within ten (10) days following, such addition of Funds or change to, or addition of, triggering events, which contains a description of such Fund(s) or triggering event(s). Such notice will also include a statement that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner.

As noted below, section II(l) requires that disclosures be made to the relevant independent plan fiduciaries regarding each Fund in which the plan is invested as part of the notice required for a plan's annual re-authorization of its participation in the manager's cross-trading program. In addition, section II(l) requires that disclosures regarding any new Funds, or new triggering events in any existing Funds, in which a plan is not invested be made available, upon request, as part of the notice required for a plan's annual re-authorization of its participation in the manager's cross-trading program.

Section II(i) clarifies the meaning of Section II(h) with respect to existing plan investors in any of the Funds, which hold plan assets subject to the Act, prior to a manager's implementation of a cross-trading program. Under section II(i), the authorizing independent fiduciary must be furnished notice and an opportunity to object to that plan's participation in the program not less than forty-five (45) days prior to the implementation of the cross-trade program. Section II(i) further states that the failure of the authorizing fiduciary to return a special termination form provided in the notice by a specified date that is at least thirty (30) days from receipt shall be deemed to be approval of the plan's participation in the program. If the authorizing plan fiduciary objects to the plan's inclusion in the program, the plan will be given the opportunity to withdraw without penalty prior to the program's implementation.

Sections II(j) and II(k) describe the type of information that is required to be disclosed to a plan fiduciary prior to the authorization defined in sections II(h)

and II(i). Important among these disclosures is a statement describing the conflicts that will exist as a result of the manager's cross-trading activities. This statement must also detail and explain how the manager's practices and procedures will mitigate such conflicts. Such writing must include a statement that:

Investment decisions will not be based in whole or in part by the manager on the availability of cross-trade opportunities. These investment decisions include:

- Which securities to buy or sell;
- How much of each security to buy or sell; and,
- When to execute a sale or purchase of each security.

Investment decisions will be made prior to the identification and determination of any cross-trade opportunities. In addition, all cross-trades by a Fund will be based solely upon triggering events set forth in the exemption. Records documenting each cross-trade transaction will be retained by the manager.

Section II(l) further requires that notice be provided to the authorizing plan fiduciary at least annually of the plan's right to terminate its participation in the cross-trading program and its investment in any of the Funds without penalty. Such notice must be accompanied by a special termination form. Failure to return the form by a specified date that is at least thirty (30) days from the receipt will be deemed approval of the plan's continued participation in the cross-trading program. In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request. Such annual re-authorization will provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested, as well as explicit notification that the plan fiduciary may request and obtain disclosures regarding any new Funds in which the plan is not invested that are added to the cross-trading program, or any new "triggering events" (as defined in Section IV(d) below) that may have been added to existing Funds in which the plan is not invested, since the time of the initial authorization described in Section II(h), or the time of the notice described in Section II(i).

Section II(m) of the exemption details specific requirements for cross-trades of

securities which will occur in connection with a Large Account restructuring. In particular, section II(m)(2) requires that the authorization for such cross-trades must be made in writing prior to the cross-trade transactions by fiduciaries of the Large Account who are independent of the manager (except in the case of a Manager Plan). Such authorization must follow full written disclosure of information regarding the cross-trading program. Such authorization may be terminated at will upon receipt by the manager of written notice of termination. A termination form must be supplied to the Large Account fiduciary concurrent with the written description of the cross-trading program. Under section II(m)(3), the portfolio restructuring program must be completed within sixty (60) days of the initial authorization made by the Large Account's fiduciary (or initial receipt of assets associated with the restructuring, if later), unless the Large Account's fiduciary agrees in writing to extend this period for another thirty (30) days. Large Account fiduciaries may utilize the termination form or any other written instrument at any time within the 60-day period, or the additional 30-day period, to terminate their prior written authorization for cross-trading related to the portfolio restructuring program. Under section II(m)(4), within thirty (30) days of the completion of the restructuring program, the Large Account fiduciary must be fully apprised in writing of the results of the transactions. Such writing may include, upon request by the Large Account fiduciary, additional information sufficient to allow the independent fiduciary for the Large Account to verify the need for each cross-trade and the determination of the above decisions. However, pursuant to section III(b)(2) the manager may refuse to disclose to a Large Account fiduciary or other person any such information which is deemed confidential or privileged if the manager is otherwise permitted by law to withhold such information from such person, provided that by the close of the thirtieth (30th) day following the request, the manager gives a written notice to such person advising that person both the reasons for the refusal and that the Department may request such information.

#### H. Recordkeeping

Section III(a) requires that the manager maintain records necessary to allow a determination of whether the conditions of the exemption have been met. These records must be maintained for a period of six (6) years from the date

of the transactions. These records must include records which identify the following:

(1) On a Fund by Fund basis, the specific triggering events which result in the creation of the model prescribed output or trade list of specific securities to be cross-traded;

(2) On a Fund by Fund basis, the model prescribed output or trade list which describes: (A) which securities to buy or sell; (B) how much of each security to buy or sell; in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events; and

(3) On a Fund by Fund basis, the actual trades executed by the Fund on a particular day and which of those trades were associated with triggering events.

As explained to the Department, the triggering event relating to net investments in, or withdrawals from, a Fund results in new cash to invest in the Fund or the need to liquidate securities from a Fund. The model or index underlying the Fund determines which securities to purchase or sell based on the amount of net investments or withdrawals. This process results in the creation of a trade list or a model prescribed output of securities to be purchased or sold. The manager then applies its objective allocation system to the trade lists or model prescribed outputs used for other Funds participating in the cross-trade program to determine which particular cross-trades will occur between Funds. For those securities which cannot be cross-traded after application of the manager's allocation system, the necessary purchases and sales are made through other means.

In the view of the Department, records must be maintained of this cross-trading activity with enough specificity to allow an independent plan fiduciary to verify whether the safeguards of this exemption have been met. Section II(b) requires that any cross-trade of securities by a Fund occur as a direct result of a "triggering event" as defined in section IV(d) and is executed no later than the close of the third business day following such "triggering event."

Among the records needed to verify that this condition has been satisfied, section III(a)(1) requires that, on a Fund by Fund basis, the manager maintain a record of the specific triggering events which result in the creation of the list of specific securities for the manager's cross-trading system. Section III(a)(2) further requires that, on a Fund by Fund basis, the manager maintain records of

the model prescribed output or trade list, as well as the procedures utilized by the manager to determine which securities to buy or sell and how much of each security to buy or sell, in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events. As provided by section III(b)(2), if such material is viewed as a trade secret, or privileged or confidential, the manager may refuse to disclose such information if reasons for the refusal are given and the person is also notified that the Department of Labor may request such information.

This record-keeping requirement is intended to assure that independent plan fiduciaries will be able to determine whether Funds and their underlying models or indexes operate consistently in following the input of triggering event information. The Department does not intend to prescribe a detailed list of records that are necessary to enable a determination of compliance with the exemption because the necessary records will depend on the nature of the Index or Model-Driven Funds involved and other factors. This information, however, should be kept in sufficient detail to enable a replication of specific historical events in order to satisfy an inquiry by persons identified in section III(b)(1). Section III(a)(3) requires that, on a Fund by Fund basis, records be maintained of the actual trades executed by the Fund on a particular day and which of those trades resulted from triggering events.

Further, Section III(a) requires that the records must be readily available to assure accessibility and maintained so that an independent fiduciary, or other persons identified in section III(b)(1), may obtain them within a reasonable time. This requirement should permit the records to be retrieved and assembled quickly, regardless of the location in which they are maintained. For those records which are not maintained electronically, the records should be maintained in a central location to facilitate assembly and examination.

All records must be unconditionally available at their customary location for examination during normal business hours by the persons described in section III(b)(1). However, as noted with respect to information which may be disclosed to a Large Account fiduciary or other person, the manager may refuse to disclose to a person, other than a duly authorized employee or representative of the Department or the Internal Revenue Service, any such information which is deemed confidential or

privileged if the manager is otherwise permitted by law to withhold such information from such person. In such instances, the manager shall provide, by the close of the thirtieth (30th) day following the request, a written notice to such person advising that person of the reasons for the refusal and that the Department may request such information.

#### General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which require, among other things, that a fiduciary discharge his duties with respect to the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record, the Department finds that the exemption is administratively feasible, in the interests of the plans and their participants and beneficiaries and protective of the rights of participants and beneficiaries of such plans;

(3) The exemption is applicable to a particular transaction only if the conditions specified in the class exemption are met; and

(4) The exemption is supplemental to, and not in derogation of, any other provisions of the Code and the Act, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

#### Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990.)

#### Section I—Exemption for Cross-Trading of Securities by Index and/or Model-Driven Funds

Effective April 15, 2002, the restrictions of sections 406(a)(1)(A) and 406(b)(2) of the Act, section 8477(c)(2)(B) of FERSA, and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) of the Code, shall not apply to the transactions described below if the applicable conditions set forth in Sections II and III below are satisfied.

(a) The purchase and sale of securities between an Index Fund or a Model-Driven Fund (a "Fund"), as defined in Sections IV(a) and (b) below, and another Fund, at least one of which holds "plan assets" subject to the Act or FERSA; or

(b) The purchase and sale of securities between a Fund and a Large Account, as defined in Section IV(e) below, at least one of which holds "plan assets" subject to the Act or FERSA, pursuant to a portfolio restructuring program, as defined in Section IV(f) below, of the Large Account;

Notwithstanding the foregoing, this exemption shall apply to cross-trades between two or more Large Accounts pursuant to a portfolio restructuring program if such cross-trades occur as part of a single cross-trading program involving both Funds and Large Accounts for which securities are cross-traded solely as a result of the objective operation of the program.

#### Section II. Specific Conditions

(a) The cross-trade is executed at the closing price, as defined in Section IV(h) below.

(b) Any cross-trade of securities by a Fund occurs as a direct result of a "triggering event," as defined in Section IV(d) below, and is executed no later than the close of the third business day following such "triggering event."

(c) If the cross-trade involves a Model-Driven Fund, the cross-trade does not take place within three (3) business days following any change made by the Manager to the model underlying the Fund.

(d) The Manager has allocated the opportunity for all Funds or Large Accounts to engage in the cross-trade on an objective basis which has been previously disclosed to the authorizing fiduciaries of plan investors, and which does not permit the exercise of discretion by the Manager (e.g., a pro rata allocation system).

(e) No more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade is

comprised of assets of employee benefit plans maintained by the Manager for its own employees (Manager Plans) for which the Manager exercises investment discretion.

(f)(1) Cross-trades of equity securities involve only securities that are widely-held, actively-traded, and for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information. For purposes of this requirement, the terms "widely-held" and "actively-traded" shall be deemed to include any security listed in an Index, as defined in Section IV(c) below; and

(2) Cross-trades of fixed-income securities involve only securities for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information.

(g) The Manager receives no brokerage fees or commissions as a result of the cross-trade.

(h) As of the date this exemption is granted, a plan's participation in the Manager's cross-trading program as a result of investments made in any Index or Model-Driven Fund that holds plan assets is subject to a written authorization executed in advance of such investment by a fiduciary of the plan which is independent of the Manager engaging in the cross-trade transactions. For purposes of this exemption, the requirement that the authorizing fiduciary be independent of the Manager shall not apply in the case of a Manager Plan.

(i) With respect to existing plan investors in any Index or Model-Driven Fund that holds plan assets as of the date this exemption is granted, the independent fiduciary is furnished with a written notice, not less than forty-five (45) days prior to the implementation of the cross-trading program, that describes the Fund's participation in the Manager's cross-trading program, provided that:

(1) Such notice allows each plan an opportunity to object to the plan's participation in the cross-trading program as a Fund investor by providing the plan with a special termination form;

(2) The notice instructs the independent plan fiduciary that failure to return the termination form to the

Manager by a specified date (which shall be at least 30 days following the plan's receipt of the form) shall be deemed to be an approval by the plan of its participation in the Manager's cross-trading program as a Fund investor; and

(3) If the independent plan fiduciary objects to the plan's participation in the cross-trading program as a Fund investor by returning the termination form to the Manager by the specified date, the plan is given the opportunity to withdraw from each Index or Model-Driven Fund without penalty prior to the implementation of the cross-trading program, within such time as may be reasonably necessary to effectuate the withdrawal in an orderly manner.

(j) Prior to obtaining the authorization described in Section II(h), and in the notice described in Section II(i), the following statement must be provided by the Manager to the independent plan fiduciary:

Investment decisions for the Fund (including decisions regarding which securities to buy or sell, how much of a security to buy or sell, and when to execute a sale or purchase of securities for the Fund) will not be based in whole or in part by the Manager on the availability of cross-trade opportunities and will be made prior to the identification and determination of any cross-trade opportunities. In addition, all cross-trades by a Fund will be based solely upon a "triggering event" set forth in this exemption. Records documenting each cross-trade transaction will be retained by the Manager.

(k) Prior to any authorization set forth in Section II(h), and at the time of any notice described in Section II(i) above, the independent plan fiduciary must be furnished with any reasonably available information necessary for the fiduciary to determine whether the authorization should be given, including (but not limited to) a copy of this exemption, an explanation of how the authorization may be terminated, detailed disclosure of the procedures to be implemented under the Manager's cross-trading practices (including the "triggering events" that will create the cross-trading opportunities, the independent pricing services that will be used by the manager to price the cross-traded securities, and the methods that will be used for determining closing price), and any other reasonably available information regarding the matter that the authorizing fiduciary requests. The independent plan fiduciary must also be provided with a statement that the Manager will have a potentially conflicting division of loyalties and

responsibilities to the parties to any cross-trade transaction and must explain how the Manager's cross-trading practices and procedures will mitigate such conflicts.

With respect to Funds that are added to the Manager's cross-trading program or changes to, or additions of, triggering events regarding Funds, following the authorizations described in section II(h) or section II(i), the Manager shall provide a notice to each relevant independent plan fiduciary of each plan invested in the affected Funds prior to, or within ten (10) days following, such addition of Funds or change to, or addition of, triggering events, which contains a description of such Fund(s) or triggering event(s). Such notice will also include a statement that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner.

(l) At least annually, the Manager notifies the independent fiduciary for each plan that has previously authorized participation in the Manager's cross-trading program as a Fund investor, that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund that holds plan assets without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner. This notice shall also provide each independent plan fiduciary with a special termination form and instruct the fiduciary that failure to return the form to the Manager by a specified date (which shall be at least thirty (30) days following the plan's receipt of the form) shall be deemed an approval of the subject plan's continued participation in the cross-trading program as a Fund investor. In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request. Such annual re-authorization must provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested, as well as explicit notification that the plan fiduciary may request and obtain disclosures regarding any new Funds in which the plan is not invested that are added to the cross-trading program, or

any new triggering events (as defined in Section IV(d) below) that may have been added to any existing Funds in which the plan is not invested, since the time of the initial authorization described in Section II(h), or the time of the notice described in Section II(i).

(m) With respect to a cross-trade involving a Large Account:

(1) The cross-trade is executed in connection with a portfolio restructuring program, as defined in Section IV(f) below, with respect to all or a portion of the Large Account's investments which an independent fiduciary of the Large Account (other than in the case of any assets of a Manager Plan) has authorized the Manager to carry out or to act as a "trading adviser," as defined in Section IV(g) below, in carrying out a Large Account-initiated liquidation or restructuring of its portfolio;

(2) Prior to the cross-trade, a fiduciary of the Large Account who is independent of the Manager (other than in the case of any assets of a Manager Plan)<sup>11</sup> has been fully informed of the Manager's cross-trading program, has been provided with the information required in Section II(k), and has provided the Manager with advance written authorization to engage in cross-trading in connection with the restructuring, provided that—

(A) Such authorization may be terminated at will by the Large Account upon receipt by the Manager of written notice of termination.

(B) A form expressly providing an election to terminate the authorization, with instructions on the use of the form, is supplied to the authorizing Large Account fiduciary concurrent with the receipt of the written information describing the cross-trading program. The instructions for such form must specify that the authorization may be terminated at will by the Large Account, without penalty to the Large Account, upon receipt by the Manager of written notice from the authorizing Large Account fiduciary;

(3) All cross-trades made in connection with the portfolio restructuring program must be completed by the Manager within sixty (60) days of the initial authorization (or initial receipt of assets associated with the restructuring, if later) to engage in such restructuring by the Large Account's independent fiduciary, unless such fiduciary agrees in writing to

extend this period for another thirty (30) days; and,

(4) No later than thirty (30) days following the completion of the Large Account's portfolio restructuring program, the Large Account's independent fiduciary must be fully apprised in writing of all cross-trades executed in connection with the restructuring. Such writing shall include a notice that the Large Account's independent fiduciary may obtain, upon request, the information described in Section III(a), subject to the limitations described in Section III(b). However, if the program takes longer than sixty (60) days to complete, interim reports containing the transaction results must be provided to the Large Account fiduciary no later than fifteen (15) days following the end of the initial sixty (60) day period and the succeeding thirty (30) day period.

### Section III—General Conditions

(a) The Manager maintains or causes to be maintained for a period of six (6) years from the date of each cross-trade the records necessary to enable the persons described in paragraph (b) of this Section to determine whether the conditions of the exemption have been met, including records which identify:

(1) On a Fund by Fund basis, the specific triggering events which result in the creation of the model prescribed output or trade list of specific securities to be cross-traded;

(2) On a Fund by Fund basis, the model prescribed output or trade list which describes: (A) Which securities to buy or sell; and (B) how much of each security to buy or sell; in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events; and

(3) On a Fund by Fund basis, the actual trades executed by the Fund on a particular day and which of those trades resulted from triggering events.

Such records must be readily available to assure accessibility and maintained so that an independent fiduciary, or other persons identified below in paragraph (b) of this Section, may obtain them within a reasonable period of time. However, a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the control of the Manager, the records are lost or destroyed prior to the end of the six-year period, and no party in interest other than the Manager shall be subject to the civil penalty that may be assessed under section 502(i) of the Act or to the taxes imposed by sections 4975(a) and (b) of the Code if the

records are not maintained or are not available for examination as required by paragraph (b) below.

(b)(1) Except as provided in paragraph (b)(2) and notwithstanding any provisions of sections 504(a)(2) and (b) of the Act, the records referred to in paragraph (a) of this Section are unconditionally available at their customary location for examination during normal business hours by—

(A) Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service,

(B) Any fiduciary of a Plan participating in a cross-trading program who has the authority to acquire or dispose of the assets of the Plan, or any duly authorized employee or representative of such fiduciary,

(C) Any contributing employer with respect to any Plan participating in a cross-trading program or any duly authorized employee or representative of such employer, and

(D) Any participant or beneficiary of any Manager Plan participating in a cross-trading program, or any duly authorized employee or representative of such participant or beneficiary.

(2) If in the course of seeking to inspect records maintained by a Manager pursuant to this exemption, any person described in paragraph (b)(1)(B) through (D) seeks to examine trade secrets, or commercial or financial information of the Manager that is privileged or confidential, and the Manager is otherwise permitted by law to withhold such information from such person, the Manager may refuse to disclose such information provided that, by the close of the thirtieth (30th) day following the request, the Manager gives a written notice to such person advising the person of the reasons for the refusal and that the Department of Labor may request such information.

(3) The information required to be disclosed to persons described in paragraph (b)(1)(B) through (D) shall be limited to information that pertains to cross-trades involving a Fund or Large Account in which they have an interest.

### Section IV—Definitions

The following definitions apply for purposes of this exemption:

(a) *Index Fund*—Any investment fund, account or portfolio sponsored, maintained, trustee, or managed by the Manager or an Affiliate, in which one or more investors invest, and—

(1) Which is designed to track the rate of return, risk profile and other characteristics of an Index, as defined in Section IV(c) below, by either (i) replicating the same combination of securities which compose such Index or

<sup>11</sup> However, proper disclosures must be made to, and written authorization must be made by, an appropriate fiduciary for the Manager Plan in order for the Manager Plan to participate in a specific portfolio restructuring program as part of a Large Account.

(ii) sampling the securities which compose such Index based on objective criteria and data;

(2) For which the Manager does not use its discretion, or data within its control, to affect the identity or amount of securities to be purchased or sold;

(3) That either contains "plan assets" subject to the Act, is an investment company registered under the Investment Company Act of 1940, or contains assets of one or more institutional investors, which may include, but not be limited to, such entities as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund which is exempt from taxation under section 501(a) of the Code; and,

(4) That involves no agreement, arrangement, or understanding regarding the design or operation of the Fund which is intended to benefit the Manager, its Affiliates, or any party in which the Manager or an Affiliate may have an interest.

(b) *Model-Driven Fund*—Any investment fund, account or portfolio sponsored, maintained, trustee, or managed by the Manager or an Affiliate, in which one or more investors invest, and—

(1) Which is composed of securities the identity of which and the amount of which are selected by a computer model that is based on prescribed objective criteria using independent third party data, not within the control of the Manager, to transform an Index, as defined in Section IV(c) below;

(2) Which either contains "plan assets" subject to the Act, is an investment company registered under the Investment Company Act of 1940, or contains assets of one or more institutional investors, which may include, but not be limited to, such entities as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund which is exempt from taxation under section 501(a) of the Code; and

(3) That involves no agreement, arrangement, or understanding regarding the design or operation of the Fund or the utilization of any specific objective criteria which is intended to benefit the Manager, its Affiliates, or any party in which the Manager or an Affiliate may have an interest.

(c) *Index*—A securities index that represents the investment performance of a specific segment of the public market for equity or debt securities in

the United States and/or foreign countries, but only if—

(1) The organization creating and maintaining the index is—

(A) Engaged in the business of providing financial information, evaluation, advice or securities brokerage services to institutional clients,

(B) A publisher of financial news or information, or

(C) A public securities exchange or association of securities dealers; and,

(2) The index is created and maintained by an organization independent of the Manager, as defined in Section IV(i) below; and,

(3) The index is a generally accepted standardized index of securities which is not specifically tailored for the use of the Manager.

(d) *Triggering Event*:

(1) A change in the composition or weighting of the Index underlying a Fund by the independent organization creating and maintaining the Index;

(2) A material amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that: (A) Such material amount has either been identified in advance as a specified amount of net change relating to such Fund and disclosed in writing as a "triggering event" to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a "triggering event" for such Fund or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given; and

(B) Investments or withdrawals as a result of the Manager's discretion to invest or withdraw assets of a Manager Plan, other than a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options, including such Fund, will not be taken into account in determining the specified amount of net change;

(3) An accumulation in the Fund of a material amount of either:

(A) Cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) Stock attributable to dividends on portfolio securities; provided that such

material amount has either been identified in advance as a specified amount relating to such Fund and disclosed in writing as a "triggering event" to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a "triggering event" for such Fund, or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given;

(4) A change in the composition of the portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model underlying the Fund where the basic factors for making such changes (and any fixed frequency for operating the computer model) have been disclosed in writing to an independent fiduciary of each plan having assets held in the Fund, prior to, or within ten (10) days after, its inclusion as a "triggering event" for such Fund; or

(5) A change in the composition or weighting of a portfolio for an Index Fund or a Model-Driven Fund which results from an independent fiduciary's direction to exclude certain securities or types of securities from the Fund, notwithstanding that such securities are part of the index used by the Fund.

(e) *Large Account*—Any investment fund, account or portfolio that is not an Index Fund or a Model-Driven Fund sponsored, maintained, trustee (other than a Fund for which the Manager is a nondiscretionary trustee) or managed by the Manager, which holds assets of either:

(1) An employee benefit plan within the meaning of section 3(3) of the Act that has \$50 million or more in total assets (for purposes of this requirement, the assets of one or more employee benefit plans maintained by the same employer, or controlled group of employers, may be aggregated provided that such assets are pooled for investment purposes in a single master trust);

(2) An institutional investor that has total assets in excess of \$50 million, such as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund

which is exempt from taxation under section 501(a) of the Code; or

(3) An investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund) other than an investment company advised or sponsored by the Manager;

provided that the Manager has been authorized to restructure all or a portion of the portfolio for such Large Account or to act as a "trading adviser" (as defined in Section IV(g) below) in connection with a portfolio restructuring program (as defined in Section IV(f) for the Large Account.

(f) *Portfolio restructuring program*—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 by another investment manager, or in order to produce a portfolio of securities the composition of which is designated by a party independent of the Manager, without regard to the requirements of Section IV(a)(3) or (b)(2), or to carry out a liquidation of a specified portfolio of securities for the Large Account.

(g) *Trading adviser*—A person whose role is limited with respect to a Large Account to the disposition of a securities portfolio in connection with a portfolio restructuring program that is a Large Account-initiated liquidation or restructuring within a stated period of time in order to minimize transaction costs. The person does not have discretionary authority or control with respect to any underlying asset

allocation, restructuring or liquidation decisions for the account in connection with such transactions and does not render investment advice [within the meaning of 29 CFR 2510.3–21(c)] with respect to such transactions.

(h) *Closing price*—The price for a security on the date of the transaction, as determined by objective procedures disclosed to investors in advance and consistently applied with respect to securities traded in the same market, which procedures shall indicate the independent pricing source (and alternates, if the designated pricing source is unavailable) used to establish the closing price and the time frame after the close of the market in which the closing price will be determined.

(i) *Manager*—A person who is:

(1) A bank or trust company, or any Affiliate thereof, as defined in Section IV(j) below, which is supervised by a state or federal agency; or,

(2) An investment adviser or any Affiliate thereof, as defined in Section IV(j) below, which is registered under the Investment Advisers Act of 1940.

(j) *Affiliate*—An "affiliate" of a Manager includes:

(1) Any person, directly or indirectly, through one or more intermediaries, controlling, controlled by or under common control with the person;

(2) Any officer, director, employee or relative of such person, or partner of any such person; and

(3) Any corporation or partnership of which such person is an officer, director, partner or employee.

(k) *Control*—The power to exercise a controlling influence over the management or policies of a person other than an individual.

(l) *Relative*—A "relative" is a person that is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or a sister.

(m) *Nondiscretionary trustee*—A plan trustee whose powers and duties with respect to any assets of the plan are limited to (1) the provision of nondiscretionary trust services to the plan, and (2) duties imposed on the trustee by any provision or provisions of the Act or the Code. The term "nondiscretionary trust services" means custodial services and services ancillary to custodial services, none of which services are discretionary. For purposes of this exemption, a person who is otherwise a nondiscretionary trustee will not fail to be a nondiscretionary trustee solely by reason of having been delegated, by the sponsor of a master or prototype plan, the power to amend such plan.

Signed at Washington, DC, this 6th day of February, 2002.

**Alan D. Lebowitz,**

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