Bloomberg Tax

Tax Management Memorandum™



# If You Cross-Trade Securities, Make Sure Not to Cross ERISA

*By Michael Schloss*
The Wagner Law Group

*Employee benefit plan managers and fiduciaries who may trade assets between accounts under their control need to know how ERISA rules may apply, says The Wagner Law Group's Michael Schloss, a former ERISA enforcement advisor with the Labor Department.*

Securities trading between two accounts controlled by the same employee benefits plan manager or fiduciary may benefit both plans and other clients, but still may be prohibited due to ERISA's strict conflict of interest rules.

Section 406(b)(2) of the Employee Retirement Income Security Act of 1974 ("ERISA") prohibits a fiduciary from acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or its participants or beneficiaries. Generally, under §406(b)(2), "cross-trades" where at least one of the accounts is an ERISA-covered account, will be prohibited.

Cross-trading occurs when an investment manager causes an account under its control to buy or sell a security (or asset of any type) and another account under its control is the counterparty. There are basically two types of cross-trade transactions: *direct* cross-trades, directly between two accounts under the same investment manager's control; and *indirect* cross-trades, where the investment manager places a purchase order for one account and a sale order for another account with a broker or other intermediary with the understanding that the transaction will ultimately result in the transfer of the security or other asset between the two accounts.

Even where there is no self-dealing under §406(b)(1) or other ERISA provision, cross-trading by ERISA-covered plans or accounts will generally violate §406(b)(2) because each party to the cross-trade is managed by the same entity and, at the same time, each would ordinarily be considered "adverse" to the other party. In this case, the "same entity" means the "same entity." The Department of Labor has noted that trades between an account managed by an investment manager and an account managed by an affiliate would not, in and of itself, violate §406(b)(2) and would not qualify as a cross-trade. Thus, the DOL believes such transactions are also beyond the scope of the statutory exemption contained in ERISA §408(b)(19). "However," the DOL said in its preamble (hereinafter, "the Preamble") to its final cross-trade regulations, "a violation of ERISA's prohibited transaction provisions could arise in operation if, in fact, there was an agreement or understanding between the affiliated entities to favor one managed account at the expense of the other account in connection with the transaction" (73 Fed. Reg. 58,450 at 58,454 (Oct. 7, 2008)).

Generally, when an investment manager represents both parties to a cross-trade, it is on behalf of adverse parties — and "adverse" can be a default characterization. For example, in *Sandoval v. Simmons*, an Illinois district court held that parties with different interests in a transaction, even if such interests are not "antithetical," are still "adverse" within the meaning of 406(b)(2).

Ultimately, whether or not a transaction involves an adverse-interest party is a facts-and-circumstances question. For example, in Advisory Opinion 1981-45A, the DOL opined that "neither the situation in which a fiduciary of the Plan who is also a director of Blue Cross participates in a decision regarding the selection of the funding media or claims administrator of the Plan, nor the situation in which the same such individual participates in decisions of the Board of Directors of Blue Cross which directly or indirectly affect the Plan, would constitute a per se violation of section 406(b)(2)," but noted that "[c]ircumstances may arise … where the interests of Blue Cross are adverse to the interests of the Plan."

### *The Benefits and the Harms That Can Result From Securities Cross-Trading*

Assuming that the decisions to buy and sell particular securities on behalf of each ERISA-covered client are prudent and in the best interest of each party to the transaction, there may be significant advantages to performing a trade as a cross-trade. These benefits include the avoidance of market price uncertainties for both parties (specifically the market impact on the price of a security caused by an order being placed and fulfilled on a public market

— particularly when a very large transaction relative to market volume takes place) as well as the avoidance of market transaction costs that each party would incur if their individual purchase and sale orders were sent to the market.

Cross-trades may cause harm where a plan with significant economic leverage accepts a price for a security or asset in a cross-trade that does not reflect that plan's bargaining power. This can occur when one entity needs to liquidate an asset in relatively large amounts and the other entity has the option of buying any of a number of different securities and is in no rush to commit its cash to any particular investment. If the selling entity were to go to the market to liquidate its large position, that act will usually impact the market price negatively. An account that accepts an offer to immediately buy the security at the market price, rather than waiting for the selling entity to liquidate the security on the market and depress the price of the security on the market, therefore, gives up an opportunity to obtain the security for less.

The avoidance of market impact engendered by cross-trades can be used to facilitate harmful behavior in situations where a manager wishes to favor one client over another, or to maximize valuations for certain clients so as to directly increase the fees paid by those clients to the manager. This can happen, in the situation noted above, where one client wishes to liquidate large holdings of a security and that security happens to be held by many of the manager's other clients. The liquidation, if placed on the market, would depress the value of the other clients' holdings (and thus reduce the fees earned by the investment manager). In those situations, client accounts with significant cash (such as 401k plans) provide a ready source of liquidity for the securities that a manager could use to avoid the negative market impact that a public liquidation would create.

In the Preamble, the DOL provided examples of two additional, but similar, types of harmful cross-trading practices by investment managers with discretion on both sides of a transaction: (a) "Cherry picking … particular securities" and transferring them "from less favored accounts to promote the interests of more favored accounts"; and (b) "Dumping … particular securities to less favored accounts to promote the interests of more favored accounts" (at 58,452, nn. 5 and 6).

### *How Securities Cross-Trading May Violate ERISA*

In a 1998 notice, *Cross-Trades of Securities by Investment Managers* (hereinafter, "the Notice"), the DOL explained how cross-trading transactions could result in violations of one or more provisions of ERISA. For example, ERISA §406(b)(2) provides that an ERISA fiduciary may not act in any transaction involving a plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Where an investment manager has investment discretion with respect to both sides of a cross-trade and at least one side is an ERISA-covered account, the DOL has taken the position, in *Reich v. Strong Capital Management Inc.* (cited in the Notice at n. 3), that a §406(b)(2) violation occurs. Interestingly, Congress did not include within I.R.C. §4975(c) a parallel provision to ERISA §406(b)(2). The Tax Court, explaining this difference in *Rollins v. Commissioner*, quoted a parenthetical in the legislative history: "This prohibition is not included in the tax provisions, because of the difficulty in determining an appropriate measure for an excise tax" (T.C. Memo 2004-260 at 453). Even so, cross-trades might still result in excise taxes pursuant to I.R.C. §4975(c)(1)(E).

In the Notice, the DOL particularly noted the language of the Third Circuit Court of Appeals in *Cutaiar v. Marshall*, describing the duty of fiduciaries not just to balance — but to maximize — the economic leverage of each ERISA-covered client: "[E]ach plan deserves more than a balancing of interests. Each plan must be represented by trustees who are free to exert the maximum economic power manifested by their fund whenever they are negotiating a commercial transaction" (590 F.2d 523 (3d Cir. 1979) at 530).

#### *Merely Representing Both Sides May Constitute a Violation*

Further, according to the DOL, the prohibitions embodied in ERISA §406(b)(2) are *per se* in nature. Merely representing both sides of a transaction where there is an adversity of interests violates §406(b)(2) even absent fiduciary misconduct reflecting harm to a plan's beneficiaries. Reflecting that point, the Third Circuit noted in finding a violation of §406(b)(2) in *Cutaiar*:

"It is important to understand that this case involves no taint of scandal, no hint of self-dealing, no trace of bad faith. The violation was concededly a technical one, the result of a misunderstanding of the requirements of the newly enacted ERISA bolstered by the result of good faith submission of the dispute to impartial arbitration. Uncontradicted testimony before the district court established that the terms of the transaction were fair and reasonable with respect to both plans." (at 528).

Even so, despite acknowledging the "fair and reasonable" terms, the court concluded:

''We endorse without reservation the interpretation of the Secretary. When identical trustees of two employee benefit plans whose participants and beneficiaries are not identical effect a loan between the plans without a section 408 exemption, a per se violation of ERISA exists." (at 529).


Tax Management Memorandum

ISSN 0148-8295

Additionally, as the DOL made clear in the Notice, cross-trading may also involve violations of ERISA §406(b)(1) or (b)(3). Section 406(b)(1) prohibits a plan fiduciary from dealing with the assets of the plan in his own interest or for his own account. Section 406(b)(3) prohibits a plan fiduciary from receiving any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

Violations of §403 and 404 could arise as well, the DOL continued. ERISA §404(a)(1)(A) requires, in part, a plan fiduciary to discharge its duties solely in the interests of the participants and beneficiaries of that plan and "for the exclusive purpose" of providing benefits to participants and beneficiaries and defraying reasonable plan expenses. Similarly, §403(c)(1) requires, in part, that a plan's assets be "held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."

*Mutual Benefit Can Be Established but It's Difficult*

In its "Proposed Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds," the DOL stated:

"In the Department's view, conflicts of interest in cross-trading occur because a manager is exercising investment and trading discretion over both sides to the same transaction and making decisions as to: which securities to buy or sell; how much of each security to buy or sell; when to execute a sale or purchase of each security; where to conduct a trade (*i.e.,* on a market or through a cross-trade); and at what price to conduct a trade." (64 Fed. Reg. 70,057, 70,059 (Dec. 15, 1999))

And that makes sense. As a general matter, it is the very rare occasion where the particular investment that one client has chosen to sell (presumably because at that time and at the current market price that particular investment is the least desirable investment in the client's portfolio), will just happen to be the most desirable investment (out of the entire universe of possible investments) for another client in the same amount, at the exact same price and at the exact same time. While those occasions may occur, for example, in the context of rebalancing portfolios and client account liquidations, they remain relatively rare.

## DOL Enforcement Actions

Over the years, the DOL's Employee Benefits Security Administration (EBSA) has vigorously enforced its views relating to securities cross-trading in matters investigated alongside other government agencies such as the Securities and Exchange Commission (SEC) and the Special Inspector General for the Troubled Asset Relief Program (SIGTARP). Particularly notable are the above-mentioned *Reich v. Strong Capital Management Inc.* (No. 96-C-0669, USDC E.D. Wis. (June 6, 1996)); and, more recently, the joint DOL/SEC enforcement actions relating to Western Asset Management in 2014.

*Strong Capital Management*

In its *Strong* complaint, the DOL argued that by representing the buyer on one side and the seller on the other in a cross-trade, a fiduciary acts on behalf of parties that have adverse interests to each other. The Department alleged that Strong had engaged in 1,598 cross-trades involving employee benefit plan accounts, mutual fund accounts and other entities under Strong's discretionary control in a way that caused harm to its ERISA-covered accounts. The Department emphasized that the cross-trades were performed solely at Strong's discretion and not at the direction of independent fiduciaries for the plan accounts involved. The cross-trade transactions violated ERISA §§404(a)(1)(A) and (B) and 406(b)(2), the Department argued.

On the same day that the complaint was filed, the two parties also filed a consent judgment (which the court approved on July 16, 2014) indicating that Strong paid $5.9 million to resolve the matter. Settlement payments were made to about 155 accounts in amounts ranging from less than $20 to one account to more than $1 million to another account. While the settlement indicates that the amounts represented "Loss Amounts" and "Additional Recovery Amounts," the consent judgment does not provide detail about how those amounts were calculated.

Regarding Strong's payment, the Department stated that "$3.4 million … reimburses pension plans for any net losses from securities placed through cross trades [and a]nother $2.5 million is being paid to the pension plans in proportion to the amount of cross trades done in their accounts," according to a Wall Street Journal report the day after the consent judgment filing.

*Western Asset Management*

EBSA's second major public enforcement action regarding securities cross-trading has been described as "[o]ne of the most high-profile DOL-SEC collaborations," resulting in Western Asset Management Co. agreeing to pay $7.4 million to harmed clients plus more than $1.6 million in civil penalties to the SEC and DOL, as reflected in their respective press releases. According to SIGTARP, some of the cross-trades also violated a TARP contract between Western and the U.S. Treasury. "Western Asset was prohibited from engaging in cross trades involving RLJ Western, the PPIP fund it managed," SIGTARP said in a press release. "However, Western Asset violated this prohibition, illegally using the PPIP fund to defraud its clients out of $6.2 million."

The SEC published its factual findings, shedding light on the behavior at issue.



ISSN 0148-8295

As an initial matter, the SEC noted that ERISA prohibits cross-trades involving ERISA-covered accounts unless exemptive criteria are met. In particular, the SEC noted that ERISA §408(b)(19)(B)'s exemption for cross-trades requires such trades to be effected at current independent market prices within the meaning of SEC Rule 17a-7(b). Despite Western's own written internal policies and procedures prohibiting cross-trading between ERISA-covered accounts, beginning in 2007, Western engaged in unlawful cross-trades by entering into prearranged sale and repurchase transactions at non-market prices, the SEC disclosed:

"Specifically, prior to the sale transactions, Western and the dealers' representatives formed an agreement or understanding that the dealer would purchase securities from Western's selling client account and then sell the same securities to Western's purchasing client account. By interposing the dealer into prearranged sale and repurchase transactions involving [registered investment companies] and first or second-degree affiliates of a RIC, Western caused the affected client accounts to engage in cross trades … without having obtained an exemptive order or being able to rely on an exemptive rule. In the same manner, as described in a parallel proceeding announced by the Department of Labor, Western's cross trades involving client accounts governed by ERISA violated ERISA §406(b), and its cross trades involving the PPIF violated its agreement with the United States Treasury." *Id.*

"Western began engaging in prearranged cross transactions no later than January 2007, and it effected 88 cross transactions during 2007 with the dealers. Western executed the sale transactions at the highest current independent bid available for the securities, and executed the repurchase transactions at a small prearranged markup over the sale price. For example, in 2007, all but 1 of the 88 repurchases were effected at an identical markup over the sale price of just 0.03125% of the par value of the security, or, in bond parlance, a 1/2 "tick." In the eight-month period September 2009 through April 2010, Western caused its client accounts to engage in 108 prearranged sale and repurchase transactions, and 96% of these repurchases were effected at a 2 "tick" spread over the sale price. Western paid the markup to compensate the dealers for the administrative and other costs they incurred in connection with the transactions." *Id.*

Although it appeared that the cross-trades saved Western's clients market costs totaling approximately $12.4 million, because Western arranged to cross-trade securities at the bid price, it allocated the full benefit of these savings to its buying clients. "As a result," according to the SEC, "Western deprived its affected selling clients of their share of the market savings, an amount totaling approximately $6.2 million." *Id.*

### *Statutory Exemption Permitting Securities Cross-Trades: ERISA §408(b)(19)*

Section 408(b)(19) was added to ERISA by the Pension Protection Act of 2006 to permit discretionary cross-trades of securities subject to a number of conditions. Previously, securities cross-trades were permitted, if at all, only if they complied with the terms of an individual prohibited transaction exemption (examples of which are listed below) or the terms of two class exemptions: one relating to cross-trades involving index or model driven funds (PTE 2002-12) and the other relating to "agency" cross-trades (PTE 86-128).

By its terms, §408(b)(19) exempts, from ERISA §406(a)(1)(A) and (b)(2), cross-trading of securities that comply with a series of nine conditions:

(a) each cross-trade is of a security that is subject to market quotes, readily available and for no consideration other than cash;

(b) each cross-trade is conducted at the "independent current market price of the security" within the meaning of SEC Rule 17a-7(b);

(c) no brokerage commission, fee (except customary transfer fees disclosed in advance), or other remuneration is paid in connection with the cross-trade;

(d) a fiduciary (other than the investment manager) for each plan participating in the cross-trade received disclosures regarding the conditions under which cross-trades may be performed and authorized the investment manager to conduct cross trades in advance (both the disclosures and authorization must be separate from any other agreement or disclosure). Disclosures must include written policies and procedures of the investment manager regarding cross-trades and the authorization must be terminable by the plan at any time;

(e) each plan (or master trust containing the assets of plans maintained by employers in the same controlled group) has assets of at least $100,000,000;

(f) a quarterly report is provided to a plan fiduciary detailing all cross trades occurring such quarter providing: (i) the identity of each security bought or sold; (ii) the number of shares or units traded; (iii) the parties involved in the cross-trade; and (iv) trade price and the method used to establish the trade price;

(g) the investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;

(h) the investment manager has adopted and complies with written cross-trading policies and procedures that are "fair and equitable to all accounts participating in the cross-trading program," and include the manager's pricing policies and procedures, policies and procedures for


Tax Management Memorandum

ISSN 0148-8295

allocating cross trades in an objective manner among accounts participating in the cross-trading program; and

(i) the investment manager has designated an individual responsible for periodically reviewing the cross-trades to ensure compliance with the written policies and procedures who is responsible for issuing an annual written report, signed under penalty of perjury, no later than 90 days following the period to which it relates describing the steps performed during the review, the level of compliance, and any specific instances of non-compliance.

Pursuant to disclosures under (d), 29 C.F.R. §2550.408b-19 includes "Style and format" requirements, that the written policies and procedures be sufficiently detailed to be useful to a compliance officer but, at the same time, "clear and concise"; and "Content" requirements, that they include (among other things) the manager's criteria for ensuring that the cross-trades are "beneficial to both parties." Also to be included is a statement that the investment manager is conflicted when performing cross-trades, identification of the compliance officer responsible for reporting and the scope of the officer's review, a description of 408(b)(19) and other specified information.

*No Significant Rise in Cross-Trade Programs*

While the statutory exemption has helped some investment managers design cross-trade programs that comply with the exemption's detailed requirements and that are beneficial for clients, the exemption does not appear to have resulted in the broad adoption of cross-trading programs. Most entities continue to steer clear of cross-trading involving ERISA-covered accounts. Particularly impeding are the explanatory requirements and the $100 million account size threshold ((d) and (e) above).

*Individual PTEs*

Prohibited transaction exemptions granted to individual entities over the years include PTE 13-01 for Silchester Int'l Investors; PTE 95-83 for Mercury Asset Mgmt.; PTE 95-66 for BlackRock Fin. Mgmt. L.P.; PTE 95-56 for Mellon Bank, N.A.; PTE 94-61, for Batterymarch Fin. Mgmt.; PTE 94-47 for Bank of Am. Nat'l Trust and Sav. Ass'n; PTE 94- 43 for Fidelity Mgmt. Trust Co.; PTE 94-36 for the Northern Trust Co.; PTE 92-11 for Wells Fargo Bank, N.A.; PTE 89-116 for Capital Guardian Trust Co.; PTE 89-9 for State Street Bank and Trust Co.; and PTE 82-133 for Chase Manhattan Bank, N.A.

## Conclusion

Securities cross-trading under the right circumstances can provide tremendous value to impacted clients. The avoidance of market transaction costs (both with regard to fees and price uncertainties) can often result in a "win-win" situation for clients on both sides of a cross-transaction as well as the investment manager coordinating such transactions. However, because of ERISA's impediments to routine discretionary cross-trade transactions, the risk of harm to clients, the risk of abuse by investment managers, and the risk of incurring DOL enforcement action, parties should be extremely careful before they pursue the benefits cross-trading can create.

*This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.*

## Author Information

Michael Schloss, Of Counsel with The Wagner Law Group, specializes in employee benefit issues. Before joining the firm, Michael was the Director of the Office of Enforcement at EBSA, serving as its principal advisor regarding policy and program matters pertaining to civil and criminal enforcement of Title I of ERISA.



ISSN 0148-8295