THE BOND MARKET ASSOCIATION

Policy Brief

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Cross Trading Will Improve Returns for Private Pension Plan Participants

A proposal currently before Congress would amend the Employee Retirement Income Security Act (ERISA) to permit investment managers of private, defined benefit pension accounts to lower overall investment costs through a practice known as cross trading. Many public defined benefit plans—which are not governed by ERISA—already benefit from cross trading. The practice involves a securities transaction between separate pension accounts overseen by the same investment management firm without using an exchange or securities dealer. By conducting the transaction between accounts instead of on the open market, the investment manager virtually eliminates transaction costs—which ultimately increases financial returns for the pension plans.

In an example, an investment manager may have a portfolio of several accounts each with distinct investment goals. The investment manager might want to sell an amount of "security A" from one account to meet cash flow or investment strategy goals specific to that account. If, at the same time, another account in the portfolio has a need to acquire a certain amount of "security A," a cross trading opportunity exists. The investment manager can observe the bid and ask prices for "security A" in the open market and execute the transaction at the average of those prices. In other words, if the best bid to purchase "security A" was $100 and the best offer to sell the security was $101, the investment manager would conduct a transaction inside of this $1 spread at a price of $100.5. Such a price would benefit both accounts. At $100.5, the bid is $0.5 more than the best price bid in the market and $0.5 less than the best price at which the security was offered in the market. Both accounts—and the pension plan participants associated with both accounts—benefit from this transaction. In the case of transactions in equity securities, cross trading also helps investment managers minimize investment expenses by avoiding broker commissions.

It is important to note that in the asset management industry, investment managers play a fiduciary role. They are bound by law and contract to act in the best interest of the pension plans for which they provide investment management services. If, as in the example above, one account sought to sell an amount of "security A" but there was no corresponding need to purchase "security A" by another account in the investment manager's portfolio, a cross-trading opportunity would not exist. Bound by fiduciary duty, an investment manager could not use a second pension account to purchase the amount of "security A" the first account was seeking to sell. Instead of cross trading, the investment manager would sell "security A" on the open market.

The accounts investment managers oversee have varying investment objectives. The bulk of participants in one plan, for example, might be older workers closer to retirement age. Such a plan would have a shorter-term investment horizon than a plan dominated by younger workers. It is easy to envision, then, situations where cross trades would benefit both accounts. The plan for older workers may need to sell securities to pay benefits. The plan for younger workers, at the same time, may be seeking an asset similar to the security the plan for older workers wants to sell.

Safeguards in Legislative Proposal

Legislative language drafted to amend ERISA and permit cross trading includes a number of provisions intended to protect the assets for pension plan participants. The safeguards include:

- **Restricted Access to Cross Trading**

Cross trading would be available on an opt-in basis only under the proposed changes to ERISA's prohibited transaction rules. Plan sponsors could not be compelled to participate in cross trading programs. Cross trading agreements between investment managers and plan sponsors would be carefully designed contracts that make clear an investment manager's duties and obligations as well as the rights of the plan sponsor.

Further, only pension plans with an excess of $50 million in assets would be eligible to participate in cross trading programs under the legislative proposal. This will ensure that only those companies with the resources to employ personnel to provide sophisticated, professional oversight of plan asset management can engage in cross trading. This restriction would prohibit all but the largest six percent of ERISA defined benefit plans from using cross trading.

- **Disclosure**

Under the proposal, investment managers would be required to provide disclosure on a quarterly basis to the plan trustee detailing the cross trades in which the plan account participated. Information provided would include: trade date; name of security; range of price for security on day of trade; transaction type; transaction amount; type of counterparty; and other information the fiduciary may request.

While the legislative proposal leaves open the option for a plan trustee to request performance information on a specific trade, it does not mandate its disclosure. Trade-by-trade performance information is generally not viewed as useful to investors who focus on the investment manager's performance in the aggregate, or the return realized by the account as a whole. Making the performance of individual trades a requirement of disclosure would not provide plan trustees with meaningful information, but rather arbitrary snapshots of trading activity.

In addition, the legislative proposal would require investment managers to maintain written cross trading policies and procedures consistent with regulations promulgated as a result of this legislation. Investment managers would be required, on an annual basis, to certify that policies are adhered to by plan sponsors.

The legislative proposal would also prohibit the tying of an investment manager's fees to a plan sponsor's decision to participate in a cross trading program. No other services can be a condition of plan sponsor consent to participate in cross trading.

- **Trading**

Under the legislative proposal, cross trades must be conducted at independent current market prices. For bonds, cross trading prices would be determined by the average of the highest current independent bid and the lowest current independent offer. The cross trade can take place at a price inside of the market quotes because a trade between investment accounts presents no market risk and entails no significant trade processing expenses. On the open market, the securities would have to be sold through a broker-dealer. Brokers-dealers, by definition, are exposed to market risk—or the chance the security they are holding could decline in value. To compensate for the risk, they have higher offering prices and lower bids than would be achieved in a cross trade. This bid-offer spread—compensation to the dealer for its market-making function—is not a factor in a cross-trade and is the reason why transaction costs in cross-trades are virtually zero.

Critics of cross-trading claim that executing transactions outside of normal market mechanisms could affect the price of securities in large transactions. If an investment manager, for example, wanted to sell a large block of stock from a pension plan account in the open market, the large sell order could have the effect of reducing the market price for the stock in the short run. This analysis, however, fails to recognize the two-way nature of securities markets. If one pension plan account sends a large sell order to the market and another simultaneously sends a large buy order at the same limit price, the orders would match and the trade would be executed at the matching price. Despite the large transaction, the market price would not move. The same is true for a cross-trade. If one account wants to sell a security at a given price and another account under the same asset management firm wants to buy the same security at the same time at the same price—necessary conditions for a cross-trade to occur—the trade would take place without moving the market price. The transaction would achieve the same result as if both trades were sent simultaneously to the market, except both accounts would avoid transaction costs.

The current inability to conduct cross trades often hurts plans that may be seeking the specific security an affiliated plan is selling into the market. It is frequently the case with debt securities that the same asset cannot be repurchased at the quoted price, if at all.

For equities, cross trading also allows investment managers to avoid brokerage commissions and fees. What is more, under the proposed legislation, brokerage commission, fee or other compensation cannot be paid from one pension account to another or from either pension account to the asset manager. The only fees associated with cross trades are typical custodial fees charged by custodian banks, which amount to fractions of pennies on the dollar and are charged regardless of whether a trade is executed in the market or as a cross-trade.