April 11, 2021

Via Electronic Mail (IM-Rules@sec.gov)

Sarah ten Siethoff
Acting Director, Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Comments on Division of Investment Management Staff Statement on Investment Company Cross Trading Rule 17a-7

Dear Ms. ten Siethoff:

The Investment Adviser Association ("IAA")[1] appreciates the opportunity to comment on the Division of Investment Management's "Staff Statement on Investment Company Cross Trading."[2] Many IAA members act as investment advisers or sub-advisers to registered investment companies ("funds"). Today, funds may engage in securities transactions in both equity and fixed income securities with certain of their affiliates ("cross trades"), allowing funds and their shareholders to benefit from cost savings and efficiencies they would not obtain in the open market. The economic benefits from reducing transaction costs accrue directly to funds and shareholders – not to investment advisers. These cross trades must be effected in accordance with Rule 17a-7 (the "Cross Trading Rule") under the Investment Company Act of 1940 ("Investment Company Act"), which contains several conditions for cross trades that are designed to protect fund investors from conflicts of interest and other risks. In the absence of arms-length open-market negotiation that would otherwise determine execution price, a key goal of Rule 17a-7 is ensuring that pricing is fair to all funds and accounts involved. Among the conditions under the Cross Trading Rule are that the transactions must be in securities for which "market quotations are readily available," and must be effected at the "independent current market price" of the security.[3]

[1] The IAA is the leading organization dedicated to advancing the interests of investment advisers. For more than 80 years, the IAA has been advocating for advisers before Congress and U.S. and global regulators, promoting best practices and providing education and resources to empower advisers to effectively serve their clients, the capital markets, and the U.S. economy. The IAA's member firms manage more than $25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *Division of Investment Management Staff Statement on Investment Company Cross Trading* (Mar. 11, 2021) ("Staff Statement"), available at https://www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121.

[3] Rule 17a-7, Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof, available at https://www.ecfr.gov/cgi-bin/text-idx?node=17:4.0.1.1.19&rgn=div5#se17.5.270_117a_67.

As was noted in the June 2020 recommendation of the SEC's Fixed Income Market Structure Advisory Committee ("FIMSAC") to modernize the Cross Trading Rule, fund advisers face challenges in cross trading fixed income securities because it is difficult to meet all of the conditions under Rule 17a-7.[4] With the adoption of the SEC's new Valuation Rule 2a-5 under the Investment Company Act ("Valuation Rule") in December 2020, a new definition of "readily available market quotations" will include only investments that are Level 1 under the U.S. GAAP fair value classification hierarchy.[5] Although commenters on the Valuation Rule proposal urged the Commission to make clear that Rule 2a-5 will not infringe on funds' current cross-trading practices under Rule 17a-7,[6] the Valuation Release states that the new definition will apply "in all contexts under the Investment Company Act and the rules thereunder, including Rule 17a-7."[7] Unfortunately, application of the new definition to Rule 17a-7 will virtually prohibit advisers from engaging in fixed income cross trades. This will be the case even if such trades are in the best interests of the fund clients from a fiduciary perspective and even if the economics of cross trading would be to their benefit. The Staff Statement acknowledges that this new definition "may affect current investment company cross-trading practices," and asks for feedback to help it evaluate what, if any, recommendations it might make to the Commission to amend Rule 17a-7.

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[4] *See* FIMSAC's Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act ("FIMSAC Recommendation"), available at https://www.sec.gov/spotlight/fixed-income-advisory-committee/preliminary-recommendation-re17a-7.pdf.

[5] *See Good Faith Determinations of Fair Value*, 86 Fed. Reg. 748 (Jan. 6, 2021) ("Valuation Release"), available at https://www.govinfo.gov/content/pkg/FR-2021-01-06/pdf/2020-26971.pdf. Under new Rule 2a-5, for the first time, the SEC stated that "a security will be considered to have readily available market quotations if its value is determined solely by reference to [] level 1 inputs" as categorized by FASB Accounting Standard Codification Topic 820: Fair Value Measurement. *Id.* at 771. Therefore, investments valued using Level 2 and Level 3 inputs must be fair valued in good faith under the new rule. Funds will need to subject investments valued using Level 2 inputs to the fair value process, which could involve documenting the due diligence process of the pricing service provider(s). In comments on the valuation proposal, the IAA opposed excluding Level 2 securities from the definition of securities with readily available market quotations. *See* Letter from Gail C. Bernstein, IAA General Counsel, *Good Faith Determination of Fair Value* (File No. S7-07-20) (July 21, 2020), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/about/Comment_Letter_Compendiums/2020/July_21__2020_-_IAA_Comment_Letter_on_Fair_Valuation_Rule_Proposal_7_21_20_final.pdf. The SEC also noted in the Valuation Release that, in light of the new definition of readily available market quotations in Rule 2a-5, the SEC staff is reviewing no-action letters interpreting readily available market quotations (United Municipal Bond Fund, SEC Staff No-Action Letter (Jan. 27, 1995) and Federated Municipal Funds, SEC Staff No-Action Letter (Nov. 20, 2006)) to determine whether the letters or portions thereof should be withdrawn. Valuation Release at 773.

[6] *See, e.g.*, Letter from T. Rowe Price, *Good Faith Determination of Fair Value* (July 21, 2020), available at https://www.sec.gov/comments/s7-07-20/s70720-7455240-221012.pdf (recommending that the SEC clarify in any final fair value rulemaking that it is not intending to restrict current cross-trading practices).

[7] Valuation Release at 773 (noting also that "certain securities that had been previously viewed as having readily available market quotations and being available to cross trade under rule 17a-7 may not meet [the] new definition and thus would not be available for such trades").

Given the longstanding and beneficial practice of fixed income cross trading under Rule 17a-7, we support measures that would avoid or mitigate the adverse effects of application of the Valuation Rule definition. In addition, we commend the Commission for undertaking to modernize the Cross Trading Rule generally.[8] We strongly support prioritizing initiatives to modernize the applicable regulatory framework and increasing potential benefits to funds and fund shareholders. We urge the Commission to begin that review promptly and include an evaluation of the application of the new definition of "readily available market quotations" to cross trading.[9] We look forward to the opportunity to comment on a Commission proposal and write in the meantime to provide feedback on the Staff Statement. Our comments include several recommendations that we believe will modernize Rule 17a-7 to allow fund managers to engage appropriately in cross trading while protecting fund investors from conflicts and other risks, including that:

- The SEC recognize that an adviser's fiduciary duty and controls to address conflicts of interest create appropriate principles-based safeguards to protect fund shareholders with respect to cross trades.

- The SEC amend Rule 17a-7 to permit cross trades of Level 2 securities and modernize the methods by which a fund can obtain an "independent current market price," while continuing to protect fund shareholders.

- The SEC amend Rule 17a-7 to codify the 2018 no-action relief related to fund board oversight of cross trades.

Discussion

Rule 17a-7 is an important tool for fund management because cross trading provides several benefits for funds and their shareholders – many of which the Commission has recognized[10] – that would not necessarily be available in open market transactions. While cross

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[8] *See* SEC Agency Rule List – Long-Term Actions, Fall 2020, available at https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202010&RIN=3235-AM69.

[9] We appreciate that the staff has issued no-action relief stating that, if a fund chooses to comply with Rule 2a-5 before its September 8, 2022 compliance date, the staff would not object if the fund does not apply the new definition to its cross-trading practices until the September 8, 2022 compliance date. *See* Valuation Frequently Asked Questions, available at https://www.sec.gov/investment/valuation-faq. However, the Commission will need to propose and adopt amendments to Rule 17a-7 prior to that date or provide further no-action relief to funds until this issue can be resolved.

[10] *See, e.g.*, Valuation Release at 791; *Investment Company Liquidity Risk Management Programs*, 81 Fed. Reg. 82142, 82211 (Nov. 18, 2016) ("LRMP Release"), available at https://www.govinfo.gov/content/pkg/FR-2016-11-18/pdf/2016-25348.pdf. The volatile markets at the beginning of the COVID-19 pandemic in March 2020 demonstrate the value to fund shareholders of fund advisers cross trading among their funds, where each trade is in each fund's best interest, without having to expose each transaction to further price volatility.

trading may not be the primary means of trading for funds or even the most common means of trading, it can be a valuable tool when the underlying facts warrant. Cross trading reduces transaction costs in cases where instruments trade with a bid and offer spread and is thus cost effective for funds. It allows funds to engage in mutually beneficial securities transactions at fair and accurate prices that are consistent with funds' investment strategies either without incurring transaction costs or mitigating the transaction costs. Cross trades also benefit fund investors by limiting the market impact of the transactions. Funds also may engage in cross trading when a fund is liquidating in order to reduce transaction costs. In addition, cross trading is a "useful liquidity risk management tool" for a "fund facing liquidity constraints to avoid depressed or fire-sale prices when it is selling an asset for which market prices would otherwise be depressed."[11]

It is important not only to preserve, but to enhance, the ability of funds to continue to engage in cross trades in both equity and fixed income securities, consistent with investor protection and adviser fiduciary principles. Because the new definition of "readily available market quotations" raises significant challenges for fixed income cross trading, our recommendations focus primarily on these transactions.[12] As a general matter, we believe that the Commission should adopt a principles-based framework for fixed income cross trading grounded in an adviser's fiduciary duty, and resist as much as possible imposing prescriptive rules that do not evolve with changing markets. We also recommend specifically that the Commission update Rule 17a-7 to explicitly allow funds to rely on independent (unaffiliated) pricing service prices, with appropriate due diligence, as an alternative to obtaining broker quotes for a broad range of fixed income instruments when setting the transaction price for the cross trade. This would appropriately broaden the current framework and clarify that the use of independent pricing services is permitted beyond the context of municipal securities cross trades. We also support updating the obligations on fund boards under Rule 17a-7 to align with SEC staff no-action relief, which allows a fund's chief compliance officer ("CCO") to report on compliance with Rule 17a-7. We discuss each of these recommendations below.

1. An adviser's fiduciary duty and controls to address conflicts of interest create appropriate principles-based safeguards to protect fund shareholders.

Advisers have an equal fiduciary duty to both fund clients in a cross trade and must adopt and implement policies and procedures reasonably designed to ensure that cross trades are in the

[11] Valuation Release at 791.

[12] *See* FIMSAC Recommendation at 2 ("Rule 17a-7 requires that a fixed-income security be executed at the 'independent current market price' and then defines that term in part as 'the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry'. Obtaining multiple bids and offers for fixed income securities is difficult to impossible in most circumstances and is a requirement far more difficult than the one required for cross trades involving other clients (i.e., that the price is 'the most favorable under the circumstances').[Footnote omitted]").

best interest of both clients, including controls relating to pricing. An adviser's fiduciary duty requires that the terms of a cross trade are fair and reasonable to each participating client and do not involve overreaching or subsidization, either for the benefit of the adviser or either of the clients. Accordingly, advisers' controls must be designed to ensure that undesirable securities are not "dumped" on one of the clients in a cross trade, that the trade is consistent with the investment objectives, strategies, and risk profiles of both clients, that the price is both fair and reflective of the asset's current market price at the time of the transaction, that the transaction meets the adviser's duty to seek best execution for each client, and that conflicts and other material facts are fully and fairly disclosed to each of the clients.

Advisers and funds have policies and procedures for cross trades to comply with Rule 17a-7, as well as policies and procedures under compliance program Rules 38a-1 under the Investment Company Act and 206(4)-7 under the Investment Advisers Act of 1940 to determine that a particular investment and/or transaction is in the best interest of each fund client.[13] We urge the Commission to retain this principles-based approach to controls as it considers amendments to Rule 17a-7.

2. The Commission should amend Rule 17a-7 to permit cross trades of Level 2 securities and modernize the methods by which a fund can obtain an "independent current market price," while continuing to protect fund shareholders.

Being able to continue to engage in cross trading transactions in fixed income securities and variable rate demand notes (VRDNs)[14] is critical to many advisers' ability to manage their client portfolios in a cost-effective and efficient manner. However, these instruments will not satisfy the new definition of "readily available market quotations" because they do not involve Level 1 inputs. We recommend that the Commission explicitly permit funds to (a) cross trade Level 2 securities, and (b) determine an "independent" price for cross trades through use of: (i) broker quotes; (ii) an independent market price, as determined by an independent pricing service; or (iii) another method, such as par value, where there is no subjective opportunity for the adviser to change the original price paid by the purchasing fund and that price is thereafter used as the cross-trading price.

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[13] *See also*, Investment Company Institute, *Rule 17A-7 at the Cross Roads: The Right Path Forward* at 32 (April 2021) ("Funds should price qualifying transactions consistent with (i) applicable valuation and cross trading policies and procedures (including those adopted and implemented under Rule 38a-1 of the Investment Company Act),[footnote omitted] and (ii) the investment adviser's duty to seek best execution for each fund and its duty of loyalty to each fund."); *Compliance Programs of Investment Companies and Investment Advisers*, 68 Fed. Reg. 74714 (Dec. 24, 2003) ("Compliance Programs Release"), available at https://www.sec.gov/rules/final/ia-2204.pdf.

[14] Funds cross trade VRDNs, floating-rate municipal instruments, usually with long maturities (commonly 20 or 30 years), that carry a coupon that resets periodically and that have a put option that allows investors to put them back to a financial intermediary with specified notice, in reliance on SEC staff no-action relief. *See* Benham California Tax-Free and Municipal Funds, SEC No-Action Letter (June 30, 1995).

The Commission should permit cross trades of Level 2 securities, consistent with current practice and earlier Commission statements. When the Commission adopted the liquidity risk management rule in 2016, it agreed that an "assessment of an asset's liquidity, without more, would not determine whether the asset is eligible" to be cross traded under Rule 17a-7,[15] and allowed funds to cross trade "less liquid" securities and still satisfy the condition that the market quotation be readily available.[16] Specifically, the SEC stated that, "[i]n crafting policies and procedures reasonably designed to address the particular risks of *cross-trading less liquid assets*, a fund could consider specifying the sources of the readily available market quotations to be used to value the assets and establish specific criteria for determining whether market quotations are current and readily available, and include potential back-up sources if the primary sources are not available. Funds should consider including in their policies and procedures periodic reviews of the continuing appropriateness of those sources of readily available market quotations."[17] (Emphasis added). Consistent with this view, funds currently may rely on Rule 17a-7 and consider staff no-action letters when engaging in cross trades in fixed income securities and certain other assets that rely on Level 2 inputs.[18]

The Commission's extension of the new Rule 2a-5 definition of "readily available market quotations" to Rule 17a-7 represents a sharp reversal of the Commission's view of permissible cross trading in the LRMP Release without any explanation. We believe that the Commission should reconsider its 2020 statement in the Valuation Release and instead apply the LRMP Release and no-action relief rationale, *i.e.*, that funds are permitted to engage in Level 2 securities cross trades with appropriate controls, to the construction of "readily available market quotations" for purposes of Rule 17a-7.[19]

The Commission should permit independent current market prices to be determined through use of independent pricing services. The Commission should amend Rule 17a-7 to permit funds to rely on independent pricing service prices as an alternative to obtaining broker quotes for fixed income instruments when setting the transaction price for a cross trade. This is necessary not only because an adviser's ability to obtain multiple reliable broker quotes for a particular security in a particular quantity at a particular time can vary, but, as a matter of public policy, requiring advisers by regulation to obtain actionable quotes from brokers when there is no actual intention to execute as the only permitted mechanism is worthy of re-consideration.

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[15] LRMP Release at 82211.

[16] *Id.*

[17] LRMP Release at 82212.

[18] LRMP Release at 82211-2; *see also*, Valuation Release at 773 (citing United Municipal Bond Fund and Federated Municipal Funds no-action letters) and 780.

[19] *See* LRMP Release at 82211-12 ("Due to the particular risks associated with cross-trading less liquid assets, it may be prudent for advisers to subject less liquid assets to careful review (and potentially even a heightened review compared to other more liquid assets) before engaging in such transactions.").

This requirement imposes a cost on brokers, impacts the relationship between an adviser and a broker, and assumes that brokers are a cost-free utility that any adviser can access at any time. A negotiation process in arms-length trades is a key component of price discovery that has proved useful under Rule 17a-7, but a reimagined Rule 17a-7 has the opportunity to consider alternatives.

Looking to independent pricing services in an amended Rule 17a-7 as an appropriate source for an independent current market price for Level 2 securities is an appropriate and beneficial alternative, especially given the fact that fund advisers must satisfy themselves that the quotes or prices are reflective of a "current market price." As the Commission noted in the Valuation Release, pricing services provide advisers and funds with information such as evaluated prices, matrix prices, price opinions, or other information for a wide range of investments, including fixed-income securities (*e.g.*, corporate and municipal bonds), securitized assets, and bank loans. This information may be used as prices or as inputs in the fair value determination process.[20] Indeed, independent pricing services currently provide evaluated prices extensively to funds, many of which use these prices as fair values for the purposes of striking a fund's net asset value under the Investment Company Act[21] as well as in cross trades under Rule 17a-7. Pricing vendors can appropriately be used as sources of independent current market prices for cross trades as well as potential sources of observable pricing information that could inform the price of a security to be cross traded. With proper oversight, pricing services can provide an independent basis for determining that the terms of the transaction are fair and reasonable to each participating client.[22] Arguably, this framework of controls and oversight should give the Commission greater comfort than relying on quotes provided by individual brokers.

VRDNs should be allowed to be priced at par plus accrued interest. Today, funds cross trade VRDNs in reliance on a staff no-action letter,[23] but they would be excluded from cross trading under the new definition of "readily available market quotations." This is so even though these transactions trade at stable par pricing by virtue of their design. They are not traded at a bid and ask spread and their pricing is mechanical. They present none of the public policy pricing risks at the core of Rule 2a-5 and Rule 17a-7. Accordingly, in addition to allowing advisers to use independent pricing services to price fixed income securities, as discussed above, the Commission should also allow advisers to price VRDNs at par value plus accrued interest, the price at which they typically trade. Because VRDNs trade at par plus accrued interest, an adviser

[20] Valuation Release at 756, 777-8.

[21] *Id.* at 796.

[22] *See* LRMP Release at 82211 (citing one commenter to the LRMP proposal who stated that a less actively-traded security may be less liquid, but nonetheless have readily available market quotations, and a fund may determine that independent bid and offer prices are available in the market and argued that the relative illiquidity of the security itself will not alone be determinative of whether prices are available for Rule 17a-7 purposes.).

[23] *See* Benham California Tax-Free and Municipal Funds, *supra* n. 14.

does not have the discretion to change the price, removing the possibility of subjective influence over the pricing. Cross transactions in VRDNs or any other instrument with similar characteristics should thus remain permissible under any amendments to Rule 17a-7.

3. The Commission should amend Rule 17a-7 to codify the 2018 no-action relief related to fund board oversight of cross transactions.

The SEC staff has provided no-action relief under Rule 17a-7 allowing a fund's board to rely on a representation by the fund's CCO as to compliance with Rule 17a-7 rather than the board itself having to determine compliance.[24] This relief provides that the board may receive, at least quarterly, a written representation from the fund's CCO that the transactions effected in reliance on Rule 17a-7 during the covered period complied with the procedures adopted by the board pursuant to the rule. We recommend that the Commission codify this relief in amendments to Rule 17a-7.

Robust board oversight of funds is critical to ensuring that funds and their advisers that engage in cross trading comply with all applicable conditions. We believe this oversight may be satisfied by the CCO's written representation to the board that the transactions complied with Rule 17a-7 procedures adopted by the board. Funds and advisers maintain extensive documentation on their cross trading, allowing the CCO to evaluate the facts and circumstances around cross trades and allowing the board to investigate the CCO's representation, if warranted. In addition, where the fund adviser is acting as a sub-adviser, the fund CCO is independent from the sub-adviser's process and additive to any reviews that the sub-adviser imposes internally.

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[24] Independent Directors Council, SEC No-Action Letter (Oct. 12, 2018), available at https://www.sec.gov/divisions/investment/noaction/2018/independent-directors-council-101218.htm (a fund's board of directors may receive, at least quarterly, a written representation from the fund's CCO that transactions effected in reliance on Rule 17a-7 under the Investment Company Act complied with the procedures adopted by the board pursuant to the Rule, instead of the board itself determining compliance). In adopting Rule 38a-1, the Commission expressed a view that the proper role of the board with respect to compliance matters is to oversee the fund's compliance program without becoming involved in the day-to-day administration of the program. *See Compliance Programs Release, supra* n. 13.

We appreciate the staff's consideration of the IAA's comments on the Staff Statement and would be happy to provide any additional information that may be helpful. Please contact the undersigned or IAA Associate General Counsel Monique Botkin at (202) 293-4222 if we can be of further assistance.

Respectfully Submitted,

/s/ Gail C. Bernstein

Gail C. Bernstein
General Counsel

cc: Acting Chair Allison Herren Lee
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner