Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act

The Technology and Electronic Trading Subcommittee ("Subcommittee") of the Fixed Income Market Structure Advisory Committee ("FIMSAC") was formed to consider the impact of the growth of electronic trading platforms and the increased use of other electronic systems on the liquidity, efficiency and resiliency of the corporate and municipal bond markets. The Subcommittee is charged with considering the types of trading platforms and protocols used in the market as well as the role of price data and reference data providers. A mandate of FIMSAC is to consider policy recommendations to improve execution, access, and transparency of fixed income markets with a specific emphasis on the retail investor.

I. Background

One area of focus of the Subcommittee has been on the ability of an investment adviser registered under the Investment Advisers Act of 1940 (an "adviser") to sell a fixed-income security from the account of one of the adviser's clients to an account of a different client (a "cross trade"). An adviser generally may engage in a cross trade so long as the transaction is effected in a manner that is consistent with the adviser's fiduciary duty and obligation to achieve best execution. However, when a cross trade involves an investment company registered under the Investment Company Act of 1940 (a "fund" and the "1940 Act"), the adviser must abide by the conditions in Rule 17a-7 under the 1940 Act.[1] Advisers face significant challenges because, although Rule 17a-7 permits funds to participate in certain cross trades, the conditions as a general matter make it difficult to impossible to cross trade fixed income securities, as discussed in more detail below. The consequence is that retail investors, who generally obtain exposure to fixed income securities through funds, may not obtain the benefits associated with cross trades that other investors, investing through other vehicles or their own accounts, might obtain. The benefits of cross trades include the fact that neither account involved in the cross trade pays a bid-ask spread and thus, assuming that the transaction is executed at "mid", the price to both clients would be better than would be received in the market. In addition, if an adviser has a positive view of a fixed-income security, but is forced to sell it out of an account due to external factors, the adviser can move that fixed-income security to another account which otherwise might not be able to obtain it.[2]

II. The Legal Issues

Rule 17a-7 provides relief from the general prohibition on fund cross trades contained in Section 17(a), provided, as noted above, that certain conditions are met. In the context of cross trading fixed income securities, two conditions in Rule 17a-7, in particular, have created issues:

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[1] Rule 17a-7 provides an exemption, pursuant to certain stated conditions, to the prohibitions contained in section 17(a) of the Act, which would otherwise prohibit a cross trade between a fund on one side and one of its affiliates, or an affiliate of its affiliate, on the other.

[2] There are a variety of reasons an adviser might need to sell fixed income securities in such a situation, including to meet a large redemption, for liquidity reasons, or to comply with contractual or regulatory requirements.

- Rule 17a-7 states that no brokerage commission or fee or other remuneration can be paid for a cross trade except for "customary transfer fees". There is no definition of "customary transfer fees" in Rule 17a-7. As a result, it is unclear whether a custodial fee related to the transfer of a security from one client account to another client account, or a fee charged by an electronic trading platform or dealer to affect a cross trade for an asset manager client, would be considered a "customary transfer fee".
- 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").[3]

III. <u>Recommendations</u>:

First, the Subcommittee recommends that the SEC make it clear that custodial fees and the fees of electronic trading platforms or dealers can be paid in connection with effecting cross trades involving funds.

Second, the Subcommittee recommends that the SEC allow other methods of ensuring that a fair price is obtained in cross trades involving fixed income securities (beyond obtaining multiple bids and offers). Incorporating the standard used for institutional investors (the price used for the cross trade must be the most favorable under the circumstances) along with the interpretations thereunder, or incorporating the current standard in Rule 17a-7 (the price used for the cross trade is "the independent current market price"), without the further limitations contained in the Rule, would put retail investors on the same footing as other investors. In either case, it should be made clear that the standard is met if an adviser uses:

- an independent pricing source[4] to establish the fair value of the cross trade instead of obtaining multiple bids and offers, provided that the adviser is not relieved of its fiduciary duty and obligation to achieve best execution for both clients and the adviser can establish and maintain the oversight policies and procedures described below; or

[3] Dealers are increasingly unwilling to provide bids and offers when they believe an internal cross is likely to result and they will receive no compensation for their work. In the European Union, post-MiFID, many dealers no longer provide this support due to concerns over pre-trade transparency requirements, as well as general push-back on providing quotes that are used by others not directly for trading (*i.e.*, LIBOR panel issues).

[4] Such sources may include regulatory trade reports (e.g., TRACE, EMMA), aggregated dealer runs, electronic trading venue data services or other widely-used independent pricing services available to the adviser.

- an electronic trading platform that has functionality designed to achieve fair pricing of cross trades.

These two recommended methods for meeting the "independent current market price" standard are discussed in further detail below.

A. <u>Independent Pricing Sources</u>

In 1966, when Rule 17a-7 was adopted, there was no TRACE tape and independent pricing sources were not prevalent. Today, third-party pricing services are widely used and, in fact, are used by most funds to determine their NAV on a portfolio basis. We note that in the European Union it is an accepted practice to use pricing services for cross trades, though it is assumed that the pricing services levels are validated when necessary.

The SEC staff has issued no-action letters permitting funds to use an independent pricing service, rather than obtaining bids, to meet the cross trade requirement under Rule 17a-7 (the "Municipal Securities Letters").[5] However, the Municipal Securities Letters have limited use because the relief was only issued in the context of municipal securities and it is unclear whether a pricing service can be used when the cross trade involves other types of fixed income securities.

The Subcommittee believes that that use of an independent pricing source by the investment adviser to determine the price for the cross trade is not a safe harbor and cannot absolve the adviser of its fiduciary duty and obligation to achieve best execution for each of its clients. The Subcommittee expects that investment advisers should have robust oversight mechanisms over the independent pricing source, including annual reviews, back-testing and challenging prices that do not comport with the advisers' expectations of the current market price. To that end, the Subcommittee recommends that investments advisers adopt an "independent price plus" methodology whereby the adviser uses at least one other price confirmation input in order to triangulate the reasonableness of the independent price.[6]

The Subcommittee further believes that an adviser should be able to use any independent pricing source available to them as a price input, including independent pricing services, regulatory trade reports (e.g., TRACE, EMMA), aggregated dealer runs and electronic trading venue data services. These pricing sources may be made available directly to the adviser or through a crossing service provided by an electronic trading platform or a dealer. Each of these sources, if properly supervised and validated by the adviser as set forth below, could be used to

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[5] *See, e.g.*, Federated Municipal Funds, SEC Letter (Nov. 20, 2006); United Municipal Bond Fund, SEC Letter (Jan. 27, 1995).

[6] For illiquid securities or, in periods of high volatility, for fairly liquid securities, independent pricing sources may be inaccurate. For that reason, the Subcommittee believes that advisers must adopt policies and procedures to validate the reasonableness of any independent price used to establish the price for a cross trade.

establish "the independent current market price" more efficiently, and at least as accurately, as gathering multiple bids and offers from dealers on a disclosed basis.

Notably, each of these pricing sources is dependent on the existence of observable price inputs in the marketplace. As such, the Subcommittee believes that an adviser should not be permitted to use an independent pricing source to determine the cross price for any bond that is a "level 3 asset". The Subcommittee believes that advisers could not fully comply with the necessary safeguards for crossing such assets.

In light of these considerations and existing practices, the Subcommittee recommends that third party pricing services be permissible to cross Level 1 and 2 assets only, and further recommends that additional safeguards and best practices for advisers and participating funds, as applicable, are put in place to validate the suitability of the cross price for an individual bond. Specifically, the Subcommittee recommends that funds adopt policies and procedures that are reasonably designed to ensure that a vendor price is a reasonable reflection of "current market price" and that cross trades are executed for the benefit of the participating funds. Such procedures could include some or all of the following elements:

- Post-Trade Oversight: Post-trade forensic testing aimed at determining that the cross trades were in the interests of participating funds, such as:
  - tolerance checks on price (including executable prices sought and available at the time of the transaction);
  - Identification of any unusual trading patterns (e.g., investments outside the traditional investment thesis or significant short-term post-trade price moves), unusual or bespoke products on instrument, or unusual aggregate performance trends; and
  - Identification of any short-term/round-trip crossing.

- Board of Director Oversight: Oversight by the Board of Directors of each participating fund, such as:
  - maintaining policies and procedures to ensure regular reporting to the Board regarding compliance with Rule 17a-7;
  - making quarterly determinations that any cross trades were effected in compliance with such policies and procedures;
  - ensuring that any cross trades are consistent with the policies of each participating fund; and
  - ensuring that information sufficient for the Board to evaluate the benefits of any cross trades is retained and made available to the Board upon request, including:
    - The rationale for the transaction;
    - Records evidencing the pricing sources used to validate the suitability of the cross price, as well as any subsequent short-term price moves;

    - An analysis of cross trades relative to aggregate trade performance and trends; and
    - Best execution or cost savings analysis, as applicable, in relation to the cross transaction.

- Policies and Procedures for Independent Pricing Sources: Advisers must be responsible for, and adopt policies and procedures covering, the selection and use of independent pricing sources, which require that:
    - Pricing services meet objective independence standards that have been subject to due diligence and annual review and testing by the adviser;
    - The adviser utilizes other price confirmation inputs in order to confirm the reasonableness of the independent price ("independent price plus");
    - The adviser must back-test and validate the independent pricing data; and
    - Pricing sources are used in accordance with established policies designed to avoid cherry-picking prices.

In addition, the Subcommittee believes that requiring an adviser to report each cross trade to FINRA's Trade Reporting and Compliance Engine ("TRACE") or MSRB's Real-Time Transaction Reporting System ("RTRS"), as applicable, with a flag designating the trade as an internal cross, will assist in preventing advisers from favoring one client over the other. Currently, only internal crosses that are completed with the assistance of a broker-dealer are publicly reported. Widespread disclosure and identification of a cross trade will allow market participants to understand when a price has been determined by a single adviser and will assist the SEC's surveillance program.

B. Electronic Trading Platforms

Electronic trading platforms also did not exist when Rule 17a-7 was adopted in 1966, but are now widely used by advisers and, as noted by the SEC staff, can be an important tool for obtaining best execution.[7] In addition, many advisers need a third party to execute cross trades and they use electronic trading platforms to provide a cost-effective method of settling cross trades. Trading platforms also provide a complete audit trail that make it easier for the adviser and fund board of directors to exercise their cross trade oversight responsibilities.

Electronic trading platforms have developed functionality designed to achieve fair pricing of cross trades, including a competitive RFQ process whereby an adviser can initiate a bid wanted in competition ("BWIC") or an offer wanted in competition ("OWIC") on behalf of one fund and simultaneously respond to the request on behalf of the second fund with which the adviser

[7] The SEC has noted that "[p]rices superior to the public quote may at times be available in [Electronic Communications Networks (ECN(s))] . . . . Superior prices also may be available in systems not classified as ECNs . . . ." *See* Order Execution Obligations, Exchange Act Release No. 37619A (Sept. 12, 1996); *see also* NASD Notice to Members 01-22, Best Execution (April 2001).

wants to cross the bond. If the trading platform utilizes an "all-to-all" trading protocol, the BWIC or OWIC can be exposed to hundreds of market participants. In the case of a BWIC, for example, in the event that the adviser's bid is the high bid, the adviser may successfully bid back the bond. In the event that the adviser's bid is not the highest (or if there is less than the prescribed number of independent bids[8]), the bond will be sold to the highest independent bidder. Due to the competiveness of the RFQ process and the requirement that the adviser must enter the bid or offer, as applicable, on a blind basis (without the benefit of seeing the prices of other participants), it is easier for advisers to obtain best execution for both clients[9].

The Subcommittee also recommends that the SEC consider mandating that advisers and participating funds adopt policies and procedures for the selection and use of electronic trading platforms which require that:

- The adviser must periodically and systematically evaluate the execution it is receiving for funds through an electronic trading platform to ensure best execution for both clients is being achieved;
- The Board of Directors of each participating fund must have policies and procedures regarding compliance with Rule 17a-7 and make quarterly determinations that any cross trades were effected in compliance with such policies and procedures;
- Electronic trading platforms meet objective independence and regulatory oversight standards that have been subject to due diligence and annual review and testing by the adviser; and
- The adviser must seek to insure that each fund's total cost or proceeds in each transaction are the most favorable under the circumstances after considering the full range and quality of an electronic trading platform's services, including the value of research provided, as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser.

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[8] Technological safeguards could include preventing the cross trade unless there are at least two other unaffiliated bids and the adviser's bid provides better execution for the offer than the two unaffiliated bids.

[9] The Subcommittee believes that as these risk-based pricing protocols develop, they should be preferred to using independent pricing services if and where available.