MEMORANDUM

TO: U.S. Securities and Exchange Commission
Fixed Income Market Structure Advisory Committee

FROM: Stephen Keen

SUBJECT: File Number 265-30
Comments on Interfund Cross Trades

DATE: May 12, 2020

This memorandum is in regard to the panel on Internal Fund Crosses at the February 10, 2020, meeting of the Fixed Income Market Structure Advisory Committee. I believe I have information that may be of use to the Committee on this subject. My experience in this subject includes:

1. Representing Federated Investors in requesting the 2006 no-action letter (the "Federated Municipal Funds Letter") referred to during the Panel's presentation;

2. Helping supervise an independent investigation into the activities summarized in paragraphs 24 and 25 of In the Matter of Evergreen Investment Management Company, LLC, *et. al.*, Investment Company Act Release No. 28759 (June 8, 2009) (the "Evergreen Matter");

3. Drafting or reviewing Rule 17a-7 compliance procedures for several fund complexes; and

4. Nearly 30 years of counseling portfolio managers and traders from multiple advisors regarding agency cross trades between client accounts.

I will begin with some persnickety lawyer points, before considering factors in favor of amending Rule 17a-7 and raising some notes of caution.

I. ADDITIONAL LEGAL BACKGROUND

A. <u>Availability of Market Quotations</u>

Rule 17a-7 is supposed to be limited to "securit[ies] for which market quotations are readily available." This requirement was added by amendments to Rule 17a-7 adopted in 1981. At that time, the Commission rejected comments that the rule should be extended to securities for which market quotations were not readily available, as "the independent basis for determining the value of securities would be eliminated." 46 FR 17011, 17013 (1981). Nevertheless, the Commission thought that 17a-7 would permit cross trades "for many of the securities such as certain government securities,

certificates of deposit and bankers' acceptances held by investment companies because there is an active secondary market for these securities." *Id.*

The difficulty of obtaining market quotations for many fixed income securities is the root of the problem. Treasury securities, other sovereign debt, federal agency direct obligations and TBA agency mortgage-backed pass-throughs appear to have two-sided market quotations that are publicly available. It seems likely that certain large corporate bond issuers trade on a regular basis, but TRACE does not make historical bond trading information publicly available, and I do not have access to Bloomberg or a similar service that would provide this information. (I can report that, from a lay investor's perspective, it is easier to find detailed trading information on the most obscure cryptocurrency than on the bonds of a Fortune 500 company.)

In any event, I know from my clients that there are not continuous two-sided markets for all 2 million fixed income CUSIPs (or CDs and bankers' acceptances for that matter). Many of these securities can be readily traded, but the first step in trading is to request bids from the relevant dealer(s). Unless a dealer intends to take the security into inventory, the dealer must find buyer(s) to develop its bid. If the end result were a cross trade directly between two of the advisor's funds, the efforts of these dealer(s) and the potential buyer(s) would be for naught. Unsurprisingly, this is not the approach normally taken to establish the current market value for a 17a-7 transaction.

Instead, the advisor contacts dealers to ask for what the dealers believe would be their current bid and offer for the security. I believe that, generally, these dealers respond in good faith based on their experience in making a market for these types of securities. But, because there is no opportunity for price discovery, no one can be sure that the fund could execute a trade of the security at these levels.

B. The Federated Municipal Funds Letter

Although you would have to read the Incoming Letter to discover this, the Federated Municipal Funds did not interpret the United Municipal Bond Fund no-action letter as limited to the named pricing service. The United Municipal Bond Fund letter specifically represented that the pricing service would "hand price" the municipal securities, and Federated's pricing service did not use this methodology. The Federated Municipal Funds sought assurance that prices from any pricing service tested in the manner described in the United Municipal letter could be used as the "current market price" for a 17a-7 trade regardless of the pricing methodology employed by the pricing service.

You should also note that both the United and Federated Municipal Bond Fund letters apply only to securities for which *market quotations are not readily available*. Technically, the advisor must still go through the process of soliciting bids and offers from multiple dealers and only use the pricing service evaluation when there are not enough dealers willing to provide quotations or the quotations provided are so inconsistent as to be unreliable. A pricing service evaluation is to be used only as a last resort.

I would not regard the Federated Municipal Bond Fund Letter as ruling out use of a pricing service evaluation for non-municipal bonds. But funds may find it easier to obtain reliable indicative quotations for these securities than they do for municipal securities.

C. ERISA §408(b)(19)

This section of ERISA permits plans subject to ERISA to engage in cross trades with commonly managed accounts. Rule 408b-19 implements this statutory exemption. ERISA plans are the second most significant potential source of cross-trade opportunities after registered investment companies. If the Commission plans to propose reforms to Rule 17a-7, it would make sense to coordinate with the Department of Labor to see if it might propose parallel reforms to Rule 408b-19.

D. Duty of Loyalty

Professor Harris's observation that pricing is not the only fiduciary concern raised by cross trading is correct. The initial fiduciary question is whether the cross trade should occur at all. Even when the impetus for both funds to trade is self-evident—one needs to raise money and the other needs to invest it—the need to accomplish this by cross trading a particular security is not always so obvious. The selling fund could select any liquid security from its portfolio; the buyer's investment opportunities should be even less limited.

ERISA Rule 408b-19 addresses this concern explicitly, by requiring cross-trading procedures to include "A statement of policy which describes the criteria that will be applied by the investment manager in determining that execution of a securities transaction as a cross-trade will be beneficial to both parties to the transaction." The Commission's staff also took the opportunity to address this concern in the Federated Municipal Funds Letter. ("[C]onsistent with an investment adviser's duty of loyalty, we believe that an investment adviser should not cause funds to enter into a 17a-7 transaction unless doing so would be in the best interests of each fund participating in the transaction.")

E. Nasdaq Official Closing Price

The Commission's staff also used the Federated Municipal Bond Fund Letter (at footnote 9) to express their view that funds could use the Nasdaq Official Closing Price ("NOCP") as the market price for a Rule 17a-7 transaction. The Commission's staff further noted that the NOCP could be used on a forward basis, in other words, "that funds may agree, prior to the dissemination of an NOCP price, to engage in a 17a-7 transaction using that price," in which case, "the 17a-7 transaction would take place as if it were simultaneous with the dissemination of the NOCP price." In this circumstance, "funds that engage in 17a-7 transactions using NOCP prices should use the prices in calculating their NAVs as well."

The NOCP is based on actual trades and actionable quotations, so it is a "market quotation" for purposes of Rule 2a-4, while a pricing service evaluation is a "fair value." Nevertheless, the staff's position on using the NOCP provides a precedent for valuing a 17a-7 trade at the price of the traded security that will be used to calculate the trading funds' next NAV.

II. WHY EVALUATIONS FROM PRICING SERVICES MAY BE MORE FAIR THAN INDICATIVE QUOTES

Examining the dilutive effects of an exchange between funds can help illustrate the problem posed by using different prices for 17a-7 trades than are used to calculate the funds NAVs. Suppose a shareholder exchanges $1 million in shares from Fund A to Fund B. Both funds hold CUSIP 123, and the funds' portfolio managers decide it would be in the best interest of both funds to move $1 million worth of CUSIP 123 from Fund A to Fund B in a 17a-7 trade to effectuate the shareholder's exchange.

The portfolio managers solicit bids and offers from three dealers. Two dealers bid 99 ½ and offer 100 ½, which is consistent with the last reported trade of CUSIP 123 some number of weeks before. The third dealer believes that there is a chance that CUSIP 123 could be sold for a higher price of 101, so it bids 100 and offers 101. The average of the best bid (100) and best offer (100 ½) is 100 ¼, so Fund A sells Fund B CUSIP 123 for $1,002,500.

Suppose further that the funds' pricing service had provided a "mid" price evaluation for 100 for CUSIP 123 on the previous day, which is consistent with the indicative quotations provided by two of the dealers and the most recent trade. By selling for more than the last evaluated price, the 17a-7 trade for 100 ¼ will contribute a gain of $2,500 to Fund A's total return.

Finally, suppose that the pricing service continues to provide a price evaluation of 100 at the end of the day of the 17a-7 trade. The pricing service's research might make it aware of the one dealer's view that CUSIP 123 could be sold for 101, but the pricing service might find the opinion of the other two dealers and the prior trade more persuasive. Under the circumstances, the funds' managers determine that it is more reasonable to use the pricing service's evaluation than to rely on one dealer's higher quotes. If CUSIP 123 is valued at 100 for purposes of calculating Fund B's NAV, then Fund B's total return will be reduced by an unrealized $2,500 loss on the CUSIP 123 acquired from Fund A at a price of 100 ¼. The result of the 17a-7 trade would be to dilute Fund B by $2500 in favor of Fund A.

It can be argued that security prices move throughout a day and it is not necessarily dilutive to trade a security early in the day at a higher price than the end-of-day price used to calculate the funds' NAV. But my hypothetical facts belie this argument. The price used in the 17a-7 trade was not based on another trade of CUSIP 123 during the course of the day or on actual offers to purchase or sell CUSIP 123 at a particular time. All we have are different views of the security's value on that day and a rule that mechanically forces the funds to use an average of those values rather than what their managers may believe to be the fair value.

I find it helpful to think of the calculation of a fund's NAV as the fund buying a pro rata share of its portfolio from redeeming shareholders and selling a pro rata share of the portfolio to share purchasers. In other words, the fund is buying and selling each portfolio security for the price used to calculate its NAV. From this perspective, the question is why, if it is fair for a fund to purchase and sell a portfolio security from and to its shareholders at a pricing service's evaluated price, it should not also be fair for the fund to purchase or sell the portfolio security for the same evaluated price to or from an affiliated fund? Additionally, I would argue that an evaluated price from a pricing service,

the product of a regular and audited process based on extensive market research, is more likely to reflect the fair value of the security than an average of the views of three dealers with enough free time to accommodate the adviser's request for indicative quotations.

III. POTENTIAL RELEVANCE OF PROPOSED RULE 2a-5

As previously noted, except as provided in no-action letters, Rule 17a-7 only exempts interfund transactions involving "a security for which market quotations are readily available." The Commission has just proposed a new rule, 2a-5, that would define when market quotations are "readily available" for purposes of calculating a fund's NAV. Specifically:

> a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable.

The proposing release specifically notes that:

> "indications of interest" and "accommodation quotes," for example, would not be "readily available market quotations" for the purposes of proposed rule 2a-5.

I believe that this proposed definition is significantly narrower than the current interpretation of "readily available" for purposes of Rule 17a-7. The process described in Section I.A above does not yield a quoted price in an active market that could be accessed by the funds. In addition, although the proposed definition of "readily available" is nearly identical to the definition of Level 1 Inputs in ASC Topic 820, the funds managed by the Panelists and all other mutual funds I have reviewed classify their fixed income assets as valued using Level 2 Inputs. Under the hierarchy of Topic 820, the funds would have to use Level 1 Inputs ("readily available" market quotations) if they were available, which implies that market quotations for these securities would not be "readily available" as defined in Rule 2a-5.

The proposing release for Rule 2a-5 does not mention Rule 17a-7. I recommend that the Commission consider the interplay of the proposed definition of "readily available" and Rule 17a-7 before adopting Rule 2a-5. While the Commission would be within its authority to interpret "readily available" differently in the context of different rules, it should be worthwhile to explore amendments to Rule 17a-7 that would preserve its current scope while incorporating whatever definition is ultimately included in Rule 2a-5. In any event, the release adopting Rule 2a-5 should clearly indicate the Commission's views on the matter.

IV. SECOND ORDER EFFECTS OF RULE 17a-7

Although the Panel focused on the benefits of cross trades to their clients, I believe the Commission should also consider the impact of Rule 17a-7 on market efficiency and competition when developing proposed reforms to the rule.

A. Impact of Lost Trading Opportunities on the Market

As explained above, the difficulty of valuing fixed income securities stems from the lack of trading activity. When investors regard a fixed income security as a "buy and hold" investment, it may trade rarely, if at all, after its initial placement. This forces market participants, primarily pricing services, to extrapolate from a small number of trades the expected values of other fixed income securities with comparable ratings, tenors and terms. Lack of secondary market trading leaves few opportunities to test these extrapolations.

Rules 17a-7 and 408b-19 permit advisers to trade fixed income securities among their clients without exposing the trades to the market. The current system of asking for indicative quotes might provide an attenuated form of price discovery but, unless the adviser chooses to share the quotes with a pricing service, it will not affect the pricing service's evaluation of the security. If 17a-7 and 408b-19 are reformed to permit use of pricing service evaluations in all circumstances, then there would not be any possibility of price discovery from cross trading.

I realize this may not be a material concern; the Panelists indicated that interfund trades represent only a small part of their secondary market trading of fixed income securities. But it seems to me that the scarcity of trades makes the lost opportunities all the more precious. I would recommend the Commission explicitly weigh the trade-offs between market efficiency and savings to individual investors from interfund trading.

B. Competitive Effects on Smaller Advisers

The more fixed income accounts with similar investment programs managed by an investment adviser, the more opportunities the adviser will have to cross trade securities among the accounts. The reduction in trading costs will improve the investment results in these accounts and, consequently, improve the adviser's composite performance. This will give the adviser a competitive advantage over advisers with fewer opportunities for interfund trades due to managing fewer accounts.

In light of the Panelists statements, I expect these competitive effects would be small. But the Division of Investment Management now regularly requests comment on the impact of proposed reforms on smaller advisers, and this potential effect should be taken into consideration.

V. A DIFFERENT APPROACH FOR CONSIDERATION

I am hesitant to suggest any particular reforms. As the Committee members learned when they threw out ideas to the Panel, it is difficult to change any aspect of trading fixed income securities without creating a larger problem than you are trying to solve. Nevertheless, I would like to propose an approach that I think is more consistent with the usual trading process than the current requirements of Rule 17a-7, while also providing an opportunity for price discovery.

My approach would be to allow investment advisers to request bids or offers from dealers "subject to cross trade." The amount subject to cross trade would be specified and must leave at least a standard lot available for external sale or purchase, as the case may be. The request would also specify a commission to be paid on the cross-

traded amount. The winning dealer would be assured of the spread on whatever amount it sold externally and the commission on the balance that is cross traded.

The following example will illustrate my proposed approach.

1. Adviser has one fund that needs to sell up to $5 million of CUSIP 123 and other funds willing to buy $4 million of CUSIP 123 at current market value. Adviser sends a request for bids to several dealers. The request is for up to $5 million of CUSIP 123, subject to cross trades of $4 million, with a commission of 0.X% on the cross trades.

2. Dealer A submits an actionable bid of 100 ½ for $2 million of CUSIP 123. Dealer B submits an actionable bid of 100 ¼ for $1 million of CUSIP 123. Dealer C submits an actionable bid of 100 for $5 million of CUSIP 123.

3. Dealer A is the winning dealer with the best bid. Adviser executes a trade for $2 million of CUSIP 123 at 100 ½, which Dealer A presumably resells for a higher price to generate a spread. Adviser executes $3 million of trades from the selling fund to the buying funds, with Dealer A acting as broker and receiving the commission.

4. Dealer A reports the trades to TRACE, perhaps with an indication that $3 million were cross trades.

The objective of this approach is to give dealers sufficient incentive to engage in price discovery and find the other side for at least part of the trade, while preserving the adviser's ability to cross some of the position. This is not as advantageous for the adviser insofar as the approach requires the adviser to give up part of the position to the market. It also risks having only part of the cross trade filled ($3 million of the $4 million in the example), or not having it filled at all, but this is a standard risk of trading.

This approach would be advantageous to the selling fund because it can sell the entire $5 million at the best bid (100 ½) rather than an average price of 100 ¼ (assuming Dealer C will accept only $2 million rather than the $5 million for which it bid). While the buying funds will pay "top dollar," they are still buying at the bid rather than the asked price, and thus saving the spread. So long as the commission is less than the spread would be, the buying funds will reduce their trading costs.

This approach would allow cross trades to be executed through the standard trading process, with the dealer sending a confirmation for all $5 million of trades ($2 million principal, $3 million agency), the adviser sending trade tickets to the custodian and the trades clearing and settling through the applicable clearing agency. No special forms would need to be completed; the compliance department could verify acceptance of the best bid through its normal process of monitoring best execution.

While I'm sure that the Panelists could have pointed out at least a half dozen reasons this approach is impractical, it is possible that my suggestion might prompt them to explore approaches to cross trading that allow for genuine price discovery.

VI. CONCLUSION

Thank you for considering my comments. If any member of the Committee or Panelists wish to discuss these comments or have any questions, please respond by email and we can arrange a call.