

April 9, 2021

Ms. Sarah ten Siethoff
Acting Director, Division of Investment Management
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: *Staff Statement on Investment Company Cross Trading*

Dear Ms. ten Siethoff:

The Investment Company Institute¹ is writing to respond to the request for feedback from the SEC's Division of Investment Management on funds' cross trading practices under Rule 17a 7 of the Investment Company Act (the "cross trading rule").² We applaud the SEC's recent adoption of Rule 2a 5 (the "fair value rule"),³ a rulemaking that we believe will improve the regulatory status quo with respect to fair valuation.

¹ The [Investment Company Institute](#) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$29.1 trillion in the United States, serving more than 100 million US shareholders, and US\$9.6 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](#), with offices in London, Hong Kong, and Washington, DC.

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

³ *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128 (Dec. 3, 2020)(the "Fair Value Adopting Release"), available at www.sec.gov/rules/final/2020/ic-34128.pdf.

Unless the SEC takes further action, however, the Fair Value Adopting Release will have one very troubling effect—its guidance would severely limit cross trading in fixed-income securities.⁴

Shortly after the SEC published this new cross trading guidance, it became clear that this guidance would have a significant deleterious effect on funds' cross trading practices. Earlier this year ICI conducted a member survey to better understand and quantify funds' cross trading activity and its related benefits.⁵ Among other things, the results show that in 2020, respondents engaged in 44,976 cross trades of fixed income securities, totaling over \$204 billion. We then estimated cost savings by applying bid ask spread estimates for each asset class (we collected cross trading data across 11 fixed-income asset classes) to the total dollars cross traded in each asset class. We estimate that cross trading of fixed-income securities saved funds and their shareholders nearly \$329 million in 2020 and advisers' clients generally (i.e., funds, other pooled investment vehicles, and separately managed accounts) over \$390 million.

These and other findings from our survey are contained in the attached report—*Rule 17a-7 at the Crossroads: The Right Path Forward*. The report also describes why funds cross trade fixed income securities and how this benefits fund shareholders. Minimizing trading costs is one compelling reason, but cross trading also facilitates efficient portfolio management and compliance with investment policies.

The report concludes by recommending that the Commission modernize the cross trading regulatory framework by adding the following elements:

- A new scoping mechanism. Rather than require that a security have a “readily available market quotation” (as the SEC now defines the term) to be eligible for cross trading, the SEC should permit funds to cross trade securities that meet the definition of having Level 1 or 2 inputs under the GAAP fair value hierarchy. This would permit continued cross trading of fixed-income securities, subject to the rule's existing requirements and those recommended below.
- An updated pricing provision. 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), which would permit use of

⁴ To be eligible for cross trading under Rule 17a-7, a transaction must be a “purchase or sale...of a security for which market quotations are readily available.” But virtually no fixed-income-securities have “readily available market quotations” under the SEC's new definition (which applies for purposes of the fair value and cross trading rules), which means that funds' ability to cross trade fixed-income securities will be severely restricted. As we quantify in the attached report, even if the SEC staff retains existing no-action letters that permit cross trading of municipal securities—far from certain—this would permit only a minority of funds' existing cross trading of fixed-income securities.

⁵ Fifty-two ICI member firms responded, representing over \$23 trillion, or approximately 71 percent of US-registered fund assets, as of December 31, 2020.

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If you have any questions, please contact me at [REDACTED] Gregory Smith, Senior Director, Fund Accounting and Compliance at [REDACTED] Dorothy Donohue, Deputy General Counsel at [REDACTED] Matthew Thornton, Associate General Counsel at [REDACTED] Shelly Antoniewicz Senior Director, Industry and Financial Analysis, at [REDACTED] or Christof Stahel, Senior Economist at [REDACTED]

Sincerely,

/s/ Susan Olson

General Counsel
Investment Company Institute

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

Rule 17a-7 at the Crossroads: The Right Path Forward

APRIL 2021

The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

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Matthew Thornton, Associate General Counsel; Susan Olson, General Counsel; Dorothy Donohue, Deputy General Counsel; Gregory Smith, Senior Director, Fund Accounting and Compliance; Christof Stahel, Senior Economist; Irina Atamanchuk, Research Assistant; and Shelly Antoniewicz, Senior Director, Industry and Financial Analysis, prepared this report. Christina Saad provided research assistance.

Rule 17a-7 at the Crossroads: The Right Path Forward

I. Executive Summary

Section 17(a) of the Investment Company Act of 1940 (“Investment Company Act”) prohibits any affiliated person of a registered investment company (“fund”), or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. This broad statutory prohibition reflects the policy concern for potential abuses that may accompany affiliated transactions. For instance, one fund could “dump” unwanted securities into another fund, or the transaction could be priced in a way that clearly favors the buying or selling fund.

Under its rulemaking authority, the SEC has adopted several rules under Section 17(a) to exempt certain transactions from this prohibition, including Rule 17a-7 (the “cross trading rule”). This rule allows affiliated funds to “cross trade” with one another to avoid paying costs that each would otherwise incur if transacting on the open market.¹ To illustrate, suppose that a fund holds an investment grade corporate bond that it wishes to sell, and an affiliated fund wishes to buy that same bond. If the bond is trading on the open market with a “bid” of \$99.50 (i.e., the highest dealer offer to buy the security) and an “ask” of \$100.00 (i.e., the lowest dealer offer to sell the security), then the selling fund would receive \$99.50 for a sale of the bond on the open market, while the buying fund would pay \$100.00 for its open-market purchase. But if the two funds instead cross trade with each other for the bond at its mid-point price (\$99.75), each fund saves \$0.25.

The SEC has amended the cross trading rule several times since adopting it in 1966, generally to expand both the universe of securities eligible for cross trading and the conditions that funds must follow. SEC staff (“Staff”) no-action letters also have facilitated cross trading, with the most prominent letters allowing funds to cross trade municipal securities using evaluated prices (i.e., prices provided by an independent third-party pricing service).²

In December 2020, the SEC issued cross trading guidance in the adopting release for new Rule 2a-5 (the “fair value rule”).³ This guidance marked a sharp break from the Commission’s regulatory approach to cross trading. To be eligible for cross trading, a security must have a “readily available market quotation.” But under the SEC’s new definition of this term (which applies for purposes of both the fair value and cross trading rules), few fixed-income securities have “readily available market quotations” and therefore, funds’ ability to cross trade fixed-income securities would be severely restricted. The adopting release also noted that Rule 17a-7 reform was on the SEC’s rulemaking agenda,

¹ See *infra*, note 13 and accompanying text.

² See *infra*, notes 19 and 20 and accompanying text.

³ See *infra*, note 22 and accompanying text.

and the Staff in March requested “feedback...in evaluating what, if any, recommendations the Staff might make to the Commission in [regard to cross trading and Rule 17a-7].”⁴

We welcome this Staff request, and in this report we address the Staff’s questions and provide recommendations. Regulatory action is urgently needed—without it, funds must comply with this new cross trading guidance on September 8, 2022. Fixed-income securities represent a significant portion of fund assets. As of year-end 2020, approximately \$5.2 trillion in mutual fund assets, \$1.1 trillion in exchange-traded fund (ETF) assets, and \$173 billion in closed-end fund assets were classified as bond funds.⁵ As with any type of portfolio investment, funds seek to buy and sell their fixed-income portfolio securities in an efficient and cost-effective manner. If the new cross trading restrictions take effect, funds will lose the benefits that cross trading has provided to their shareholders, including cost savings and more efficient portfolio management. Moreover, to the extent that this guidance forces fund transactions to third-party securities dealers, the resulting transaction costs would be direct and ongoing wealth transfers from fund shareholders to those securities dealers.

In this report, we begin by discussing the history of the cross trading rule and the SEC’s and Staff’s related guidance in Section II. Section III describes why funds cross trade fixed-income securities and how this benefits fund shareholders. Minimizing trading costs is one compelling reason, but cross trading also facilitates efficient portfolio management and compliance with investment policies. We also discuss how cross trading fixed-income securities complements other means of trading in today’s complex fixed-income markets.

Following the SEC’s December 2020 cross trading guidance, ICI conducted a member survey to better understand and quantify funds’ cross trading activity and its related benefits. Fifty-two ICI member firms responded, representing more than \$23 trillion, or approximately 71 percent of US-registered fund assets, as of December 31, 2020. Section IV of the report describes the survey’s methodology. We present the survey’s key findings—responsive to many questions posed in the Staff Statement, particularly with respect to current cross trading practices—in Section V. Among other things, the results show that:

- » Respondents engaged in 44,976 cross trades of fixed-income securities, totaling more than \$204 billion in 2020.
- » This cross trading activity (in dollars) was concentrated heavily in relatively liquid, investment grade fixed-income securities: investment grade corporate securities (35 percent), US Treasury and agency securities (26 percent), and variable rate demand notes (VRDNs) (25 percent).

⁴ *Staff Statement on Investment Company Cross Trading*, SEC Division of Investment Management Staff (March 11, 2021) (“Staff Statement”), available at www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121.

⁵ Investment Company Institute. 2021, forthcoming. *2021 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*. Washington, DC: Investment Company Institute. Available May 2021 at www.icifactbook.org.

- » A large majority (71 percent) of respondents indicated that at least one of their funds cross traded a fixed-income security in 2020. In total, 2,266 of respondents' funds held more than a *de minimis* amount of fixed-income securities, and 965 of respondents' funds engaged in at least one fixed-income cross trade, or 43 percent of these funds.
- » Almost all (99.6 percent, in dollars) of the fixed-income securities that funds cross traded were classified as Level 2 securities under the US GAAP fair value hierarchy. Thus, virtually all of funds' 2020 fixed-income cross trading activity would be disallowed under the SEC's new definition of "readily available market quotation" as applied to Rule 17a-7. And if the Staff leaves in place its no-action letters, this would permit only a minority of cross trades currently being conducted—specifically, those in municipal securities (27.1 percent of the total dollars cross traded in 2020, which includes VRDNs).
- » Forty-two percent of the total dollars traded were priced using dealer quotes, meaning that the remaining 58 percent were priced using evaluated prices or in reliance upon the Staff no-action letter that permits cross trading of VRDNs at par plus accrued interest.⁶
- » A large majority of cross trades (83 percent, in dollars) involved two registered funds, as opposed to just one registered fund cross trading with other adviser client types (e.g., a nonregistered pooled investment vehicle or a separately managed account).
- » Most respondents' cross trading activity was either approximately the same (41 percent) or higher (46 percent) in March and April of 2020 as compared to the remainder of 2020.
- » We estimate that funds' fixed-income cross trading activity in their long-term mutual funds and ETFs represents about 3.7 percent of their total trading activity in fixed-income securities. While this level of cross trading provides significant benefits to funds and their shareholders, it is only a small portion of funds' overall trading activity (suggesting that funds and advisers are prudent and judicious in their use of cross trading, and mindful of their rule obligations and fiduciary duties of care and loyalty, respectively), and therefore an even smaller portion of trading activity in the fixed-income markets for all market participants.
- » More subjectively, 70 percent of respondents described cross trading of fixed-income securities as "very beneficial," with another 27 percent calling it "moderately beneficial."

⁶ See *infra*, note 46.

With this 2020 cross trading data, we estimated cost savings by applying bid-ask spread estimates (a proxy for transaction cost savings) for each asset class to the total dollars cross traded in each asset class.⁷ This analysis shows that:

- » Cross trading of fixed-income securities saved funds and their shareholders nearly \$329 million in 2020. It saved advisers' clients generally (i.e., funds, other pooled investment vehicles, and separately managed accounts) more than \$390 million.
- » The asset classes where fund savings were greatest were investment grade corporate securities (\$222 million), international fixed-income securities (\$35 million), and US Treasury and agency bonds (\$27 million). The differing savings by asset class generally were a function of larger volumes of trades (in dollars) and/or wider bid-ask spreads.
- » These numbers *understate* industrywide savings from cross trading because (i) our survey participation rate was high but less than 100 percent, (ii) bid-ask spreads are only one component of transaction costs, and (iii) overall, most respondents reported that their cross trading activity was the same or higher in March and April, the months during which bid-ask spreads were at their widest in 2020.
- » 2020 was an unusual year, and savings from cross trading will vary from year-to-year. Applying varying market condition assumptions to our 2020 data, we also calculated a potential range of savings (again, using bid-ask spreads as a proxy for transaction cost savings):
 - » To estimate savings in a "normal" year, we *excluded* the bid-ask spread figures from March and April for each asset class and applied only the spread figures from the remaining 10 months to the overall dollars cross traded. Under this scenario, cross trading would save funds approximately \$265 million (more than \$316 million for advisers' clients generally).
 - » To estimate savings in a year where market conditions are stressed throughout, we used *only* the bid-ask spread figures from March and April for each asset class, applying only those figures to the overall dollars cross traded. Under this scenario, cross trading would save funds approximately \$651 million (nearly \$759 million for advisers' clients generally).
- » If the SEC's new cross trading guidance takes effect and the Staff withdraws its cross trading no-action letters, virtually all of these \$329 million in fund savings would be lost. If the new guidance takes effect and the Staff retains the no-action letters, fund savings would drop from approximately \$329 million to \$12 million (i.e., the cross trading savings associated with investment grade and high-yield municipal securities), a 96 percent decline.

⁷ Because funds do not pay transaction costs to dispose of VRDNs (funds typically dispose of them by "putting" them back to a financial intermediary, without incurring transaction costs for doing so), we assumed no cost savings for the VRDN cross trades. See *infra*, notes 45 and 46.

Section VI describes our policy recommendations for modernizing and amending the cross trading regulatory framework. Specifically, we recommend that the SEC add the following key elements:

- » **A new scoping mechanism.** Rather than require that a security have a “readily available market quotation” (as the SEC now defines the term) to be eligible for cross trading, the SEC should permit funds to cross trade securities that meet the definition of having Level 1 or 2 inputs under the GAAP fair value hierarchy.
- » **An updated pricing provision.** 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), and (ii) the investment adviser’s duty to seek best execution for each fund and its duty of loyalty to each fund.
- » **Risk-based policies and procedures for evaluating and pricing cross trading opportunities.** The SEC could require funds and advisers to adopt policies and procedures that take a risk-based approach to evaluating, pricing, and approving potential cross trades, varying the level of scrutiny depending on the associated risks. Such an approach in the cross trading rule would permit cross trading with additional rigor as appropriate. The SEC could require that these policies and procedures explicitly address risk assessment and risk management.
- » **Provisions facilitating board oversight.** In addition to the quarterly compliance-related reporting that fund boards currently receive,⁸ the SEC could require funds to provide their boards with annual reports that include:
 - » summary information about cross trading activity for the year (e.g., reasons for engaging in cross trades, total dollars and total number of trades by asset class, parties to the transactions, how cross trading volumes compared to trading volumes generally, trend information, etc.);
 - » summary information related to any post-trade analysis that a fund may conduct, as described in Appendix C; and
 - » an assessment of the adequacy and effectiveness of cross trading procedures.
- » **Reporting of cross trading activity to the SEC and public transparency.** Amendments to Form N-PORT could require funds to report aggregated numbers of cross trades and dollars traded by asset type, similar to data we gathered through this survey. To provide additional transparency into funds’ cross trading practices, we would support making this information public on a delayed basis, in accordance with Form N-PORT’s current provisions.

The SEC’s December guidance places Rule 17a-7 at a crossroads, and the extent to which the rule will continue to benefit funds and their shareholders is very much in doubt. Recognizing that September 8, 2022, will quickly arrive, we urge the Commission to act promptly to propose and adopt amendments to Rule 17a-7 that will preserve funds’ ability to cross trade fixed-income securities for the benefit of their shareholders, subject to appropriate guardrails that recognize the SEC’s policy concerns and support the purposes of Section 17.

⁸ See *infra*, note 83 and accompanying text.

II. Background on Rule 17a-7

Section 17(a) of the Investment Company Act prohibits any affiliated person of a fund, or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund.⁹ Funds in the same complex may be deemed to be under common control, and therefore Section 17(a) prohibits Fund A in Complex X from selling portfolio securities to Fund B in Complex X. This statutory prohibition is designed to prevent affiliates from using a fund to benefit themselves to the detriment of the fund and its shareholders. The SEC has stated that “an unscrupulous investment adviser might ‘dump’ undesirable securities on a registered investment company or transfer desirable securities from a registered investment company to another more favored advisory client in the complex. Moreover, the transaction could be effected at a price which is disadvantageous to the registered investment company.”¹⁰

Importantly, Section 17(b) authorizes the SEC to exempt certain transactions from this prohibition where it finds, in part, that the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned. This exemptive provision recognizes, at least implicitly, that “[a]ny sweeping prohibition may involve hardship and unreasonable restraints and instead of protecting stockholders may, in specific cases, work to their disadvantage by preventing desirable transactions.”¹¹ And Section 6(c) of the Act provides that the SEC by rule, regulation, or order may exempt any person or transaction or any class of persons or transactions from any provision of the Act if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act.¹² The SEC has exercised this authority in numerous ways over the decades to prevent such harms to funds and shareholders that would otherwise result from overly broad restrictions on affiliated transactions.

Pursuant to this authority, the SEC adopted the cross trading rule in 1966.¹³ As stated in the adopting release, the rule’s purpose was to eliminate the filing and processing of exemptive applications “under circumstances where there appears to be no likelihood that the statutory finding for a specific exemption under Section 17(b) of the Act could not be made.” More specifically, the SEC stated that:

the interests of investors will be served by the rule in that it permits affiliated investment companies which heretofore may have chosen to avoid the application procedures of Section 17(b) of the Act by purchasing or selling securities on the

⁹ Section 2(a)(3)(C) of the Investment Company Act defines “affiliated person” to include “any person directly or indirectly controlling, controlled by, or under common control with, such other person....”

¹⁰ *Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof*, SEC Release No. IC-11136 (Apr. 21, 1980).

¹¹ Alfred Jaretzki Jr., *The Investment Company Act of 1940*, 26 Wash. U. L. Q. 303, 321 (1941).

¹² Also, Section 38(a) of the Investment Company Act authorizes the SEC to issue such rules as are necessary or appropriate to the exercise of the powers conferred upon the Commission in the Act.

¹³ *Adoption of Rule 17a-7 to Provide an Exemption from the Provisions of Section 17(a) of the Investment Company Act of 1940*, SEC Release No. IC-4697 (Sept. 8, 1966).

open market, thereby incurring duplicate brokerage charges, to avoid the payment of brokerage by effecting such transactions with each other.

The 1966 rule was narrower than the current version in two key respects: it permitted cross trades only of “securit[ies] traded upon a national securities exchange” and limited cross trading parties to affiliated registered funds (or separate series thereof). The rule also had fewer conditions (e.g., the rule imposed no obligations on fund boards and no recordkeeping obligations on funds).

In 1974, the SEC amended the rule to permit cross trading of “securit[ies] traded in the over-the-counter market” (provided that the security was entered in a specified inter-dealer quotation system).¹⁴ In 1981, with more experience with the rule and cross trading, the SEC amended the rule to further expand the scope of eligible securities and the rule’s conditions.¹⁵ In proposing these amendments, the SEC stated:

The Commission recognizes that a significant portion of the securities held by many registered investment companies—such as municipal securities, Government securities and money market instruments—presently may not qualify to be traded under Rule 17a-7 because they are not traded [on a national securities exchange or the over-the-counter market]. The Commission believes that it is appropriate to include, as eligible for exemption under the rule, any transaction in a security for which market quotations are readily available.¹⁶

The Commission thus recognized that a current market price could be determined for many securities held by funds and therefore proposed (and ultimately adopted) amendments expanding the rule’s scope beyond the narrow two-market construct of the 1974 rule.¹⁷

The rule currently permits cross trading of securities between funds and certain of their affiliated persons (e.g., other funds in the same fund complex), subject to numerous conditions. Most notably, funds may enter into cross trades only if the “transaction is a

¹⁴ *Adoption of an Amendment of Rule 17a-7 under the Investment Company Act of 1940 to Qualify for the Rule’s Exemptive Relief the Purchase or Sale of Securities Principally Traded in the Over-the-Counter Market Subject to Specified Criteria and of an Amendment of Item 2.07 of Form N-1R and of the EDP Attachment to Form N-1R under the Act to Obtain Better Information Concerning Rule 17a-7 Transactions under the Act*, SEC Release No. IC-8494 (Sept. 13, 1974).

¹⁵ *Exemption of Certain Purchase of Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof*, SEC Release No. IC-11676 (Mar. 10, 1981). The SEC (i) amended paragraph (a) to permit cross trading of “securit[ies] for which market quotations are readily available;” (ii) amended paragraph (b) to provide a means for pricing fixed-income securities (“For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry; ...”); and (iii) expanded the types of parties eligible to cross trade. Previously, only affiliated registered investment companies (or separate series thereof) could trade with one another. The amendment expanded permissible parties to include trades between a registered investment company (or a separate series thereof) and a person who is an affiliated person of such registered investment company (or affiliated person of such person) solely by reason of their having a common investment adviser or investment advisers which are affiliated persons of each other, common directors, and/or common officers (e.g., this could include nonregistered pooled vehicles or separate accounts). These amendments also assigned certain responsibilities to the fund board and introduced recordkeeping requirements.

¹⁶ See *supra*, note 10.

¹⁷ In the 1981 adopting release, the SEC further stated that “since a ‘current market price’ can be determined 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, the amendment to rule 17a-7 should assist in the execution of intra-complex securities transactions.”

Since 1981, the SEC has amended the rule further, but in ways generally not germane to this paper’s focus.

purchase or sale...of a security for which market quotations are readily available.” Further, the transaction must be effected at the “independent current market price” of the security, and for fixed-income securities this is “the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.”¹⁸ Additional conditions include or relate to:

- » ensuring that the transaction is consistent with the fund’s investment policies;
- » a general prohibition on commissions, fees, and remuneration paid in connection with the transaction (except for customary transfer fees);
- » board adoption of cross trading policies and procedures, approval of necessary changes, and quarterly determinations that transactions complied with the procedures;
- » satisfying board governance requirements (with respect to board independence); and
- » maintaining certain records.

The Staff also has addressed certain transactions under Section 17(a) and the cross trading rule. In the United Funds no-action letters from the 1990s,¹⁹ the Staff agreed not to recommend that the SEC take any enforcement action under Section 17(a) of the 1940 Act if the funds bought and sold municipal securities under Rule 17a-7 using prices provided by an independent pricing service, subject to certain conditions. The United Funds stated that their proposed pricing methodology was “consistent with the rule’s fundamental principle that the subject securities be priced on an independent basis.” In 2006, the Staff returned to the subject, clarifying that its relief in the United Funds Letters was not contingent upon using the specified pricing service and adding that an investment adviser that cross trades in reliance on Rule 17a-7 should consider its duty to seek best execution for each fund and its duty of loyalty to each fund.²⁰

Since then, the Commission has provided additional guidance on cross trading in the adopting releases for Rule 22e-4 (the “liquidity rule”)²¹ and the fair value rule²² under the Investment Company Act. The Liquidity Rule Adopting Release addressed how asset liquidity should be considered in connection with cross trading. It noted the risks associated with cross trading less-liquid assets, while suggesting that it may be prudent for

¹⁸ Rule 17a-7(b)(4).

¹⁹ *United Municipal Bond Fund; United Municipal High Income Fund, Inc.* SEC Staff No-Action Letter (pub. avail. July 30, 1992), as further modified in *United Municipal Bond Fund*, SEC Staff No-Action Letter (pub. avail. Jan. 27, 1995) (collectively, the “United Funds Letters”). The Staff granted this relief, notwithstanding the absence of “readily available market quotations” for those securities (a paragraph (a) rule requirement) or the funds’ inability to determine a “current market price” for them (a paragraph (b) rule requirement).

²⁰ *Federated Municipal Funds*, SEC Staff No-Action Letter (pub. avail. Nov. 20, 2006) (the “Federated Letter”).

²¹ *Investment Company Risk Management Programs*, SEC Release No. IC- 32315 (Oct. 13, 2016) (“Liquidity Rule Adopting Release”), at 243–248, available at www.sec.gov/rules/final/2016/33-10233.pdf.

²² *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128 (Dec. 3, 2020) (the “Fair Value Adopting Release,” or the “Adopting Release”), at 88-95, available at www.sec.gov/rules/final/2020/ic-34128.pdf.

advisers to subject such assets to careful review (and potentially even a heightened review) before engaging in such transactions.²³

The newly adopted fair value rule states that “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....” This definition is consistent with the definition of a Level 1 input in the fair value hierarchy outlined in US GAAP. Any portfolio investment *without* a readily available market quotation is within the fair value rule’s scope. Consequently, most fixed-income securities—generally classified as Level 2 securities under the GAAP fair value hierarchy—will be within the rule’s scope.

The Fair Value Adopting Release discusses the implications of the rule’s definition of “readily available market quotation” for the cross trading rule, stating that this new definition “will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7.” Further, “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 our new definition and thus would not be available for such trades.” The Adopting Release acknowledges that funds enter into cross trades in reliance on certain Staff no-action letters, and states that “[t]he staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn.” However, the SEC also notes that potential revisions to Rule 17a-7 are on the SEC’s rulemaking agenda and invites input from the public on this subject. The March 2021 Staff Statement reiterates these points, poses numerous cross trading-related questions, and requests public comment.

This latest cross trading guidance would significantly disrupt existing cross trading activities that have been benefitting fund shareholders for decades. If the SEC takes no further action prior to the compliance date for this guidance (September 8, 2022), funds’ ability to cross trade fixed-income securities will be severely restricted, as will the associated benefits for funds and their shareholders. This, coupled with the possible withdrawal of the cross trading no-action letters, would essentially eliminate funds’ ability to cross trade fixed-income securities.

²³ See *infra*, note 81 and accompanying text. This guidance did not assume that “less-liquid assets”—a term with a very specific meaning under Rule 22e-4, with examples including certain foreign securities and US bank loan participations (Liquidity Rule Adopting Release at 119)—could not have “readily available market quotations.”

III. Reasons for Cross Trading Fixed-Income Securities

A. Cross Trading Reduces Funds' Transaction Costs

Cross trading can benefit two funds in a complex when one wishes to sell a security, while another fund in that complex contemporaneously wishes to buy that same security.²⁴ Each fund may individually transact with a third party to sell (or buy) the security, but each would incur transaction costs in the process, which would negatively affect fund shareholders.²⁵ Thus, assuming the trade is appropriate for, and desired by, both sides, a cross trade at a fair and accurate price creates benefits for each fund, as each avoids costs that would otherwise be incurred through a transaction with an unaffiliated third party. In addition, cross trades reduce the “search” costs often associated with executing fixed-income trades with dealers, thereby facilitating more timely execution.²⁶

In explaining how index funds “can protect and even increase their returns,” authors Gregory Baer and Gary Gensler recognized the benefits of cross trading, stating that “index funds can match or ‘cross’ trades with other members of their fund families, thereby decreasing costs.”²⁷ Of course, these benefits are not limited to index funds.

B. Cross Trading Facilitates Efficient Portfolio Management and Compliance with Investment Policies

The Staff Statement asks about the circumstances under which funds engage in cross trading and the purposes for cross trading different types of securities. Ordinary portfolio management and compliance with investment objectives, strategies, and policies create many of funds' mutually beneficial cross trading opportunities. An adviser may decide to sell a fixed-income security (no matter to whom) for a variety of reasons having nothing to do with any change in its views of the security's merits or appropriateness for client accounts.

Certain sales of fixed-income securities may be explained by how changes in a bond's characteristics intersect with a fund's investment objective, policies, and strategies. For instance, a fund investing primarily in long-term bonds *must* periodically sell some of its bonds.²⁸ A bond gradually moves toward its maturity date over time. A “long-term” bond does not remain so forever—it becomes an “intermediate-term” bond, then a “short-term” bond, before maturing. For a fund complex with both a “long-term” bond fund and an “intermediate-term” bond fund, the former will be a reliable periodic seller of bonds, and

²⁴ Rule 17a-7 also permits funds to cross trade with certain affiliated persons other than funds, but for simplicity and unless indicated otherwise, we assume fund-to-fund transactions throughout this report.

²⁵ Rule 17a-7(d) prohibits the payment of brokerage commissions, fees, or other remuneration in connection with a cross trade.

²⁶ See *infra*, note 53.

²⁷ *The Great Mutual Fund Trap*, Gregory Baer and Gary Gensler, at 301 (paperback version) (2002).

²⁸ See *Frequently Asked Questions about Rule 35d-1 (Investment Company Names)*, SEC Division of Investment Management Staff, Question 11 (expressing the Staff's position that a “short-term,” “intermediate-term,” or “long-term” bond fund should have a dollar-weighted average maturity of, respectively, no more than 3 years, more than 3 years but less than 10 years, or more than 10 years), available at www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm#P72_9874.

the latter will be a natural buyer of those same bonds, as they move closer to maturity.²⁹ Moreover, this basic dynamic exists for both actively and passively managed funds with maturity or duration parameters. The impetus giving rise to a sale may differ somewhat between these fund types—in the case of an index fund, it is likely the index’s removal of a bond as part of a periodic rebalancing, due to *its* maturity or duration criteria—but the outcome is essentially the same.

Changes to a bond’s credit rating also may lead eventually to sales or purchases of that bond, depending on the fund’s investment policies. Many fixed-income funds have policies restricting what they may purchase (or creating minimum or maximum percentages of fixed-income securities) based on credit ratings. For instance, an investment grade bond fund’s investment policies may prohibit the fund from purchasing bonds that do not have an investment grade rating from one or more credit rating agencies, or the fund may otherwise realign its holdings following downgrades.³⁰ Similar to the example above, if a fund complex has both an investment grade bond fund and a high-yield bond fund, the two funds may be natural trading partners when bonds are downgraded or upgraded.

More generally, investment advisers typically have numerous clients (e.g., funds, other pooled investment vehicles, and separately managed accounts), and those clients pursue varying investment objectives as guided by varying investment strategies and policies. Consequently, their portfolios—and what they may be seeking to buy or sell at any time—may differ. These differences, together with changing market dynamics and changes to certain characteristics of bonds themselves (e.g., time to maturity or credit ratings) may prompt portfolio transactions for reasons unrelated to any change in the adviser’s views of the security. A security may no longer be a permissible holding, or may otherwise be a less-than-ideal holding *for a specific fund* (e.g., for an actively managed fund, the adviser may wish to shorten or lengthen the fund’s duration, or may wish to increase or decrease its exposure to an issuer or sector; for an index fund, a holding may be removed from the underlying index), and yet represent an appropriate investment for another. The more diverse an adviser’s client base, the more likely it is to be presented with mutually beneficial cross trading opportunities.

Transitional events affecting an investment adviser or fund also may generate cross trading opportunities. Changes in an investment adviser’s mandate are one example. When a client (e.g., a fund or a separately managed account) terminates an investment adviser or otherwise reduces its assets under management, control of those assets must be transferred, either back to the client or to a new adviser. Such terminations or reallocations of fund assets are not uncommon for funds using “manager of manager” arrangements, under which one or more subadvisers manage a fund’s assets subject to the supervision

²⁹ The same is also true of a fund complex with both “intermediate-term” and “short-term” bond funds, or any collection of funds with differing maturity or duration policies.

³⁰ Cf. Rule 35d-1(b) under the Investment Company Act (requiring that a fund investing at least 80 percent of its assets based on its name satisfy this threshold at the time the fund invests its assets). The SEC noted in this rule’s adopting release that “[t]he rule would require an investment company that no longer meets the 80% investment requirement (e.g., as a result of changes in the value of its portfolio holdings or other circumstances beyond its control) to make future investments in a manner that would bring the company into compliance with the 80% requirement.” *Investment Company Names*, SEC Release No. IC-24828 (Jan. 17, 2001), at n.32, available at www.sec.gov/rules/final/ic-24828.htm.

of a primary investment adviser.³¹ If the client does not wish to transfer all of its portfolio securities, those securities must be liquidated, which may create attractive purchase opportunities for the adviser's other clients. For example, within an active strategy, the adviser may have thoroughly researched the security and may continue to believe that it is a strong investment for another fund or account. Within a passive strategy, the adviser may wish to acquire the security if it is a component of an index that a fund is tracking.

A fund liquidation is another example. A fund may no longer be economically viable, but it may hold securities that the adviser continues to view favorably. To the extent that the liquidating fund's securities can be disposed of via cross trades, final liquidating distributions (or shareholder redemptions, if they precede final liquidation) are enhanced.

Finally, cross trading may be a liquidity management tool.³² Advisers manage funds and accounts with different liquidity needs and profiles. Flows into and out of those funds and accounts often are not uniform, or even directionally similar. One fund may be experiencing modest outflows in the ordinary course of its operations, while another has excess cash, or is experiencing inflows. In such cases, cross trading is a way of efficiently "matching" fund flows, allowing each fund to remain more fully invested in pursuit of its investment objective.

This tool also may be relevant in stressed markets as well, subject to appropriate policies and procedures. In stressed markets, the potential risks and conflicts associated with cross trading may be elevated, but so too are their benefits, as transaction costs (e.g., bid-ask spreads) tend to increase.³³ Indeed, in March 2020 the SEC³⁴ and Staff³⁵ permitted a greater array of affiliated transactions in stressed market conditions through various forms of liquidity-related relief, subject to additional specified conditions.³⁶

³¹ The SEC provides "manager of managers" exemptive relief to fund complexes, which conditionally permits a complex with an order to enter into, and materially amend, subadvisory agreements without shareholder approval.

³² See Liquidity Rule Adopting Release at 243.

³³ See, *U.S. Credit Markets, Interconnectedness and the Effects of the COVID-19 Economic Shock*, SEC Division of Economic and Risk Analysis (October 2020) ("DERA Report") (finding, among other things, that transaction costs for corporate bonds, as measured by effective bid-ask spreads, spiked to historically high levels in March 2020 in response to the COVID-19 shock), available at www.sec.gov/files/US-Credit-Markets_COVID-19_Report.pdf.

³⁴ See *Order Under Sections 6(c), 12(d)(1)(J), 17(b), 17(d) and 38(a) of the Investment Company Act of 1940 and Rule 17d-1 Thereunder Granting Exemptions from Specified Provisions of the Investment Company Act and Certain Rules Thereunder*, SEC Release No. IC-33821 (March 23, 2020), available at www.sec.gov/rules/other/2020/ic-33821.pdf. This order: (i) permitted an open-end fund or separate account to borrow from certain affiliates; (ii) relaxed certain conditions of interfund lending exemptive relief, for those registered investment companies that already had it; (iii) permitted a registered management investment company that did not already have interfund lending exemptive relief to establish and participate in a lending facility as set forth in an exemptive order that the SEC had issued within the past twelve months of the order; and (iv) permitted an open-end fund to enter into lending or borrowing arrangements that deviate from any relevant policy recited in its registration statement without prior shareholder approval.

³⁵ See *Investment Company Institute*, SEC Staff No-Action Letter (pub. avail. Mar. 26, 2020) ("ICI No-Action Letter") (stating that the Staff would not recommend enforcement action against any registered long-term mutual fund, or any affiliated person of the fund (or any affiliated person of such person) that is not a fund that purchases a debt security from a fund, if a purchaser purchases debt securities from a fund, under the specified circumstances and conditions); see also *Investment Company Institute*, SEC Staff No-Action Letter (pub. avail. Mar. 19, 2020) (stating that the Staff would not recommend enforcement action against any registered open-end money market fund, or any affiliated person of the fund (or any affiliated person of such person) that is subject to Sections 23A and 23B of the Federal Reserve Act and that purchases a security from a fund, if the purchaser purchases securities from a fund subject to the specified circumstances and conditions).

³⁶ We also would note that for those concerned about the impact of open-end funds' sales of fixed-income securities in stressed market conditions, cross trading lessens funds' demands on liquidity in the secondary market.

C. Cross Trading Is Especially Useful in Light of Existing Fixed-Income Market Structure

In some ways, cross trading fixed-income securities is more necessary and beneficial to funds than cross trading equities, due to the fundamental and long-standing differences in fixed-income and equity market structure. Unlike equities, buy-side market participants (e.g., funds) traditionally trade fixed-income securities in the dealer-to-customer market through manual means by which they bilaterally negotiate with dealers or other intermediaries (over the phone or through other means of communication). Trading fixed-income securities in this way is commonplace, and often requires funds to reach out to more than one dealer to execute a trade.

More recently, electronic trading platforms that include request-for-quote protocols and similar functionality allow funds to efficiently request and obtain competitive quotes from a selected number of liquidity providers. Further, electronification has led to more sophisticated execution and order management systems that can centralize multiple trade execution protocols, aggregate and assess liquidity across different data feeds for multiple instruments, and allow users to bilaterally communicate and negotiate with different liquidity providers. Electronification has provided greater trading and operational efficiencies for funds, which benefit fund shareholders through improved execution and lower costs. ICI supports these developments, along with a regulatory framework that will foster continued growth and innovation in the fixed-income markets.³⁷

Despite these recent positive developments, the fixed-income markets remain fragmented. Funds often need multiple avenues for successfully carrying out different trading strategies—one means of trading, or even a few, may not suffice. This is due in part to the number, variety, and complexity of fixed-income issues, which in turn affects tradability. Corporate bond liquidity, for example, varies from bond to bond due to the sheer number of different issues and the diverse nature of these instruments.³⁸ That liquidity may shift even more during periods of market stress, which requires the ability for funds and other buy-side market participants to select among these different protocols or rely on traditional over-the-counter trading methods, as necessary, to source interest.³⁹

Certain developments and trends affecting fixed-income trading over the past decade or so have contributed to additional challenges in trading fixed-income securities. Dealer

³⁷ See generally Letter from Sarah Bessin, Associate General Counsel, and Nhan Nguyen, Counsel, ICI, to Vanessa Countryman, Secretary, SEC (Mar. 1, 2021), available at www.ici.org/pdf/33146a.pdf. See also Keynote Address, 2021 Mutual Funds and Investment Management Conference, Eric J. Pan, President and CEO of ICI (March 15, 2021) (stating that policymakers and regulators should be considering ways to improve the fixed-income markets themselves), available at www.ici.org/pressroom/speeches/21_ejp_mfimc.

³⁸ A single company may have several bond issues outstanding, each with unique coupons, times remaining to maturity, or other features. And the time to maturity and liquidity of these issues change as they age. Also, many bond issues are small in size and not widely held and, as a result, may trade rarely.

³⁹ During periods of high market volatility such as March and April of 2020, market participants used both electronic and non-electronic means of trading. For example, anecdotal evidence suggests that buy-side market participants sought liquidity through electronic trading platforms after dealers stopped quoting prices over the phone. Some ICI members, however, reported that they resorted to traditional voice trading methods because dealers limited auto-streaming of quotes over electronic protocols. Some ICI members also report that during the period of volatility in the US Treasury markets in March 2020 and more recently in February 2021, liquidity on dealer-to-customer platforms decreased due in part to pricing challenges that liquidity providers such as dealers faced when trading in the interdealer market.

inventories of fixed-income securities (particularly corporate bonds) have significantly decreased, thereby affecting how funds and other buy-side participants to source liquidity. Citing work by the Federal Reserve Bank of New York, the SEC's Division of Economic and Risk Analysis (DERA) recently noted that "dealer [corporate bond] balance sheets have declined from approximately \$225 billion around the time of the 2008 [Global Financial Crisis (GFC)] to about \$50 billion today and generally are focused on more liquid aspects of the market."⁴⁰ DERA explained that following 2008, dealers moved toward an agency model (helping to match buyers and sellers), while no longer committing a large portion of their balance sheets to holding inventory, which has reduced the liquidity they provide.

Moreover, dealers' ability or willingness to commit their balance sheets to providing fixed-income market liquidity appears to be adversely affected by market conditions. Citing the work of the Federal Reserve Bank of Philadelphia on dealer inventory, DERA posited that dealer inventories in corporate bonds began declining in early March, and dealers only began accommodating customer demand again (by absorbing more inventory) after the Federal Reserve provided certain capital relief to regulated banks and introduced the Primary and Secondary Market Corporate Credit Facilities later in the month.⁴¹ Similarly, ICI's analysis of the impact of COVID-19 on financial markets found that, since late 2018, dealers' inventories of Treasury bonds and mortgage-backed securities (MBS) had been rising; in late February and March 2020, as dealers tried to intermediate the increased sales of Treasury bonds and MBS, their net inventories of Treasury bonds and agency pass-through residential mortgage-backed securities (RMBS) spiked; and dealers' increased holdings of Treasury and MBS likely limited their ability to intermediate trades in other fixed-income assets.⁴²

Funds avail themselves of multiple means of trading fixed-income securities. This includes cross trading, a valuable complement to other traditional and evolving trading functionalities and protocols. Given the need for buy-side market participants (including funds) to have flexibility when trading in the fixed-income markets, we welcomed the 2020 recommendation by the Technology and Electronic Trading Subcommittee of the SEC's Fixed-Income Market Structure Advisory Committee (FIMSAC) that the SEC amend Rule 17a-7 to facilitate funds' ability to cross trade fixed-income securities.⁴³

⁴⁰ DERA Report at 33.

⁴¹ *Id.* at 37.

⁴² *Report of the ICI COVID-19 Market Impact Working Group, The Impact of COVID-19 on Economies and Financial Markets* (October 2020), at 30–32, available at www.ici.org/pdf/20_rpt_covid1.pdf.

⁴³ See *infra*, Section VI, for a description of this FIMSAC recommendation. The SEC's FIMSAC is tasked to consider policy recommendations to improve execution, access, and transparency of fixed-income markets with a specific emphasis on the retail investor.

IV. ICI's Cross Trading Survey

Beginning in January, we surveyed members to better understand their fixed-income cross trading practices. Fifty-two ICI member firms responded, representing more than \$23 trillion, or approximately 71 percent of US-registered fund assets, as of December 31, 2020.

The survey focused on fixed-income cross trading activity during calendar year 2020.⁴⁴ Recognizing the breadth and variety of the fixed-income market (including variations in trading activity and transactions costs), we collected this cross trading information for the following 11 categories:

- » US Treasury and agency securities (including Treasury bills)
- » Investment grade municipal securities (excluding VRDNs)
- » VRDNs,⁴⁵ a subset of municipal securities
- » High-yield municipal securities
- » Investment grade corporate securities
- » High-yield corporate securities
- » Other mortgage-related securities (e.g., private MBS and collateralized mortgage obligations [CMOs])
- » Other asset-backed securities (e.g., collateralized loan obligations)
- » International fixed-income securities
- » Bank loans
- » Commercial paper and certificates of deposit (CDs)

⁴⁴ We asked each respondent to: (i) complete the survey for its fund complex only, and avoid reporting as a subadviser (if applicable), to avoid the possibility of double-counting data for certain questions; (ii) report information for fixed-income securities only (excluding preferred stocks); and (iii) include only transactions conducted pursuant to Rule 17a-7 and the related SEC and Staff guidance (responses included transactions where only one party was a registered fund, and did not include transactions facilitated by investment advisers where *neither* party to the transaction was a registered fund).

⁴⁵ VRDNs are floating-rate municipal instruments, usually with long maturities (commonly 20 or 30 years), that carry a coupon that resets periodically. VRDNs typically have either a one- or seven-day put option that allows investors to put the security back to a financial intermediary (usually a bank) at par with a one- or seven-day notice, respectively. It is this put feature at par that allows these securities to be considered liquid investments under Rule 2a-7 and therefore eligible for purchase by US money market funds.

For each of these categories, we asked respondents to provide data regarding:

- a) total number of cross trades;
- b) total dollars cross traded;
- c) of the total reported in subitem (b), the amount traded (in dollars) based on dealer quotes;⁴⁶
- d) of the total reported in subitem (b), the amount traded (in dollars) in securities classified as Level 2 in the US GAAP fair value hierarchy;⁴⁷ and
- e) of the total reported in subitem (b), the amount traded (in dollars) where both parties to the trade were 1940 Act-registered funds.⁴⁸

We also gathered information about the relative sizes of these trades for six of the categories.⁴⁹

With that information, we estimated the cost savings that cross trading provided to funds and their shareholders in 2020. Specifically, we estimated the cost savings for all cross trades during 2020, categorized by each of our 10 asset classes (we excluded VRDNs).⁵⁰ To compute estimated savings for an asset class, we multiplied the aggregate cross trade dollar volume by an estimate for the transaction cost for every dollar traded. The transaction cost estimates (i.e., bid-ask spread data, which served as a proxy) for each asset class were obtained from ICE Data Pricing & Reference Data, LLC (“ICE”) and Bloomberg and reflect the difference in the price paid or received over the value of the security per dollar traded.

We include a more detailed description of how we estimated these savings in Appendix A. In Appendix B, we present survey findings by asset class.

The estimated transaction costs are subject to a few important caveats:

- » “Transaction costs” are multifaceted, and may be broadly understood to include commissions, spreads, market impact costs, and opportunity costs.⁵¹ The SEC has acknowledged the difficulties of quantifying spreads, market impacts, and

⁴⁶ Generally speaking, we assume that cross trades *not* priced based on dealer quotes instead used evaluated prices. Also, VRDNs are commonly priced at par plus accrued interest in reliance on the *Benham California Tax- Free Trust*, SEC Staff No-Action Letter (pub. avail. Aug. 6, 1986).

⁴⁷ We assume that any transactions in securities that are not classified as Level 2 in the GAAP fair value hierarchy are therefore classified as either Level 1 or Level 3. We did not ask respondents to classify any non-Level 2 securities as either Level 1 or Level 3 securities.

⁴⁸ We asked this question to ascertain to what extent this cross trading activity involves registered funds on both sides. Also, this information allowed us to estimate not only the transaction cost savings realized by advisers’ clients generally, but also those savings realized by funds specifically.

⁴⁹ Specifically, we asked for the total amount (in dollars) of individual cross trades of \$1 million or greater for investment grade corporate, high-yield corporate, and international fixed-income securities bonds; for investment grade and high-yield municipal securities and VRDNs, we asked for the same information for individual cross trades of \$500,000 or greater.

⁵⁰ See *supra*, note 7.

⁵¹ See, e.g., *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, SEC Release No. 33-8349 (Dec. 18, 2003).

opportunity costs in particular.⁵² Here, we focus on bid-ask spreads because they are more easily calculable (commissions are not a common feature of fixed-income trading). This represents a more conservative approach, which results in an understatement of overall transaction costs.

- » For assets that are traded in a continuous market based on a limit order book, the best bid and best ask prices are observable at any point in time. For fixed-income securities that generally do not trade in such markets, such information is not continuously observable. Furthermore, bid and ask prices displayed in a limit order book are valid only for certain trade sizes. Therefore, the bid and ask prices, the bid-ask spread, and any total transaction cost for a given trade can only be estimated.
- » Securities within an asset class have divergent spreads, and a specific security's spread changes over time, particularly in stressed market conditions. To account for this, we collected data from respondents by asset class over the course of a year, aware that variance exists within those asset classes and over the course of the year (e.g., bid-ask spreads were generally higher—sometimes significantly so—for these asset classes in March and April).

Consequently, even if we had collected transaction-specific data from each respondent (e.g., with specific CUSIPs and trade dates), any attempted quantification of dollars saved from cross trading still would be only an estimate.

Even with those caveats, we believe our results represent a reasonable—and indeed, a conservative—estimate of transaction cost savings from cross trading. Our results quantify funds' cross trading activity, estimate its savings-related benefits, and go well beyond the SEC's limited cost-benefit analysis of cross trading in the Fair Value Adopting Release.⁵³

⁵² *Id.* See also *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, SEC Release No. 33-8998 (Jan. 13, 2009) (concluding that there was no “adequate basis for prescribing a specific and accurate methodology for reflecting transaction costs in a fund’s expense ratio” and instead requiring disclosure of a fund’s portfolio turnover rate, which “though imperfect, is an appropriate indicator of transaction costs for purposes of the summary section [of the prospectus].”).

⁵³ The SEC’s economic analysis of the effects of the new cross trading guidance on funds is mostly qualitative. The SEC’s quantitative assessment is essentially limited to observing that: (i) “approximately 28% of funds reported relying on 17a-7 for cross trades, but we cannot determine to what extent reliance on 17a-7 is limited to investments meeting the definition under the final rule of having readily available market quotations” (Fair Value Adopting Release at 127); and (ii) “approximately 33% of fund assets are fair valued with level 2 or level 3 inputs. However, we lack detailed data on funds’ engagement in cross trading in such securities to estimate what fraction of this subset will be affected by the definition of readily available market quotation. Likewise, we lack detailed data to estimate the transactions and other costs that a fund might incur if forced to go to the market for transactions that otherwise would have been executed with a cross trade.” (Fair Value Adopting Release at 160).

The SEC then qualitatively identifies as costs to funds of this new guidance: (i) funds’ having a more restricted set of securities available for cross trades; (ii) reductions in beneficial cross trading activity, which “allows both trading funds to avoid commissions or other transaction costs that would otherwise be borne in a market transaction” and “can allow 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;” and (iii) funds’ going to market for trades that otherwise would have been implemented via a cross trade, which includes searching for hard-to-find securities. On the other hand, the SEC posits that: (i) the new cross trading guidance “further mitigates the risk that one fund will ‘subsidize’ another fund through cross trading of assets with more subjective values;” and (ii) “any reduction in the extent of cross trades, to the extent that such trades are executed in the market, may affect market efficiency by contributing to price discovery....” Fair Value Adopting Release at 159–160 and 171.

V. Summary of Key Findings from ICI's Cross Trading Survey

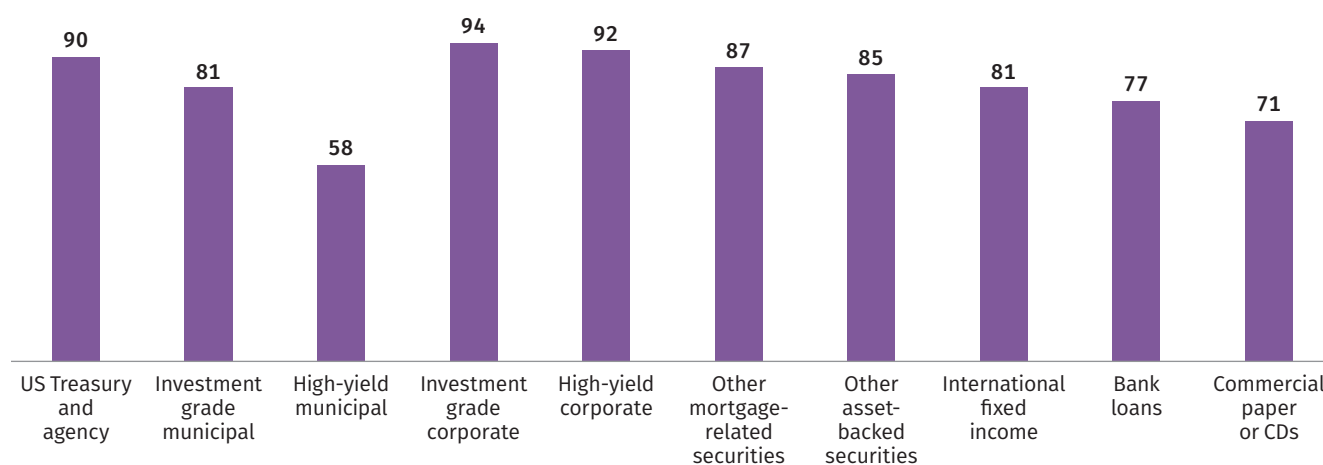
A. Cross Trading Is an Important Practice for Funds with Fixed-Income Securities

Almost all respondents indicated that they manage fixed-income investments. Generally speaking, most manage across a broad array of fixed-income security types, as indicated in Figure 1 below. Thus, the respondents generally represented fund complexes that could cross trade fixed-income securities.

FIGURE 1

Types of Fixed-Income Securities Held in at Least One of Respondent's Funds

Percentage of fund complexes, annual



Source: Investment Company Institute survey of cross trading activity

A large majority (71 percent) of respondents indicated that at least one of their funds cross traded a fixed-income security pursuant to Rule 17a-7 in 2020. To quantify this further, we asked each respondent:

- » How many of its registered funds typically hold more than a *de minimis* amount (i.e., greater than 5 percent) in fixed-income securities (we asked this to determine how many funds within a complex were potential candidates to cross trade fixed-income securities).
- » How many of its registered funds engaged in at least one cross trade of a fixed-income security in 2020.

In total, 2,266 of respondents' funds had more than a *de minimis* amount of fixed-income securities, and 965 of respondents' funds engaged in at least one fixed-income cross trade in 2020, or 43 percent of these funds.

B. Funds' Aggregated Fixed-Income Cross Trading Is Significant and Concentrated in Securities That Are Relatively Liquid, Investment Grade, and Level 2 Under GAAP

In 2020, fund complexes cross traded more than \$204 billion in fixed-income securities. To provide some context for this figure, those fund complexes that completed the survey had purchases and sales of fixed-income securities in their long-term mutual funds and gross redemptions and gross creations in their ETFs totaling approximately \$6.46 trillion and \$802 billion, respectively, according to ICI data.⁵⁴ Thus, based on our data, we estimate that funds' fixed-income cross trading activity in their long-term mutual funds and ETFs represents about 3.7 percent of their total trading activity in fixed-income securities.⁵⁵

As discussed above, it is critical that funds continue to have available all means of transacting in fixed-income securities for the benefit of their shareholders, and as we show below, the savings from cross trading are significant. Still, this relatively small percentage suggests that funds and advisers are prudent and judicious in their use of cross trading, and mindful of their rule obligations and fiduciary duties of care and loyalty, respectively. And because cross trading makes up only a small portion of funds' overall trading activity,

⁵⁴ The mutual fund figure represents total purchases and sales of municipal, government, and corporate securities by long-term mutual funds. Because we do not have comparable data on purchases and sales of securities by ETFs, we use gross issuance and gross redemptions of bond ETFs (domestic government, domestic corporate, domestic high yield, international/global bond, and domestic municipal bond ETFs) as a proxy.

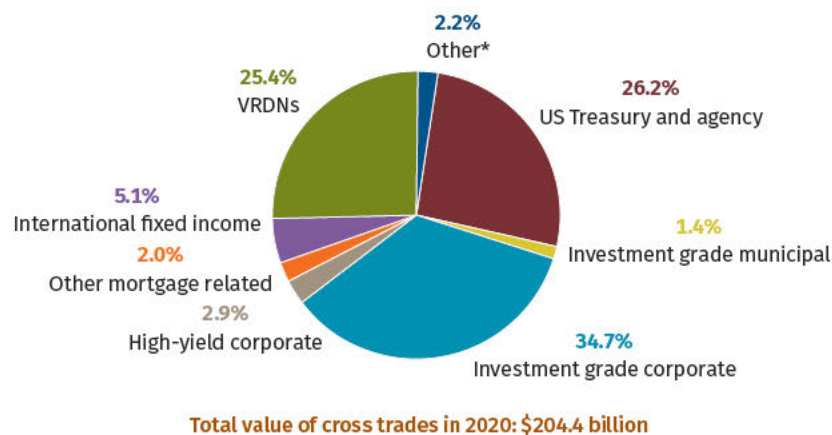
⁵⁵ In 2020, respondents' long-term funds (i.e., mutual funds and ETFs) traded in total approximately \$7.3 trillion dollars in fixed-income assets. Double counting the cross trades where funds were on both sides (to capture both purchases *and* sales) and counting only once those trades where a fund was only on one side (to capture purchases *or* sales), the total cross trading activity of respondents' funds during 2020 was \$374.5 billion ((2 × \$170.2 billion) + \$34.2 billion). To estimate and remove money market funds' cross trades, we assume that all reported cross trading activity in VRDNs (approximately \$103.4 billion ((2 × \$51.4 billion) + \$0.6 billion)) and commercial paper and CDs (approximately \$2.8 billion ((2 × \$1.0 billion) + \$0.9 billion)) occurred within money market funds. (See Appendix B for this asset class-specific survey data.) The resulting cross trading activity (purchases and sales) during 2020 within respondents' long-term funds was therefore \$268.4 billion (\$374.5 billion – \$103.4 billion – \$2.8 billion), or 3.7 percent of the \$7.3 trillion dollars traded in fixed-income assets by respondents' long-term funds.

it is an even smaller portion of trading activity in the fixed-income markets for all market participants.⁵⁶

As indicated in Figure 2 below, this cross trading activity (in dollars) was concentrated heavily in relatively liquid, investment grade fixed-income securities: investment grade corporate securities (35 percent), US Treasury and agency securities (26 percent), and VRDNs (25 percent). Cross trading activity in the remaining eight categories was modest in comparison.

FIGURE 2
Total Fixed-Income Dollars Cross Traded in 2020 by Asset Class

Percent, annual



* *Other* includes commercial paper, certificates of deposit, bank loans, high-yield municipal securities, and other asset-backed securities.

Source: Investment Company Institute survey of cross trading activity

Respondents reported 44,976 individual cross trades. Figure 3 shows the breakout of these individual trade numbers by asset class. Once again, the data show a high degree of concentration, with large percentages of these transactions in VRDNs (35 percent) and investment grade corporate securities (27 percent). Respondents reported more than 27,000 trades in these two categories (15,525 and 12,025, respectively), along with a relatively large number of high-yield corporate securities trades (10,169). By contrast, the fourth-highest category (international fixed-income securities) totaled 2,887 trades.

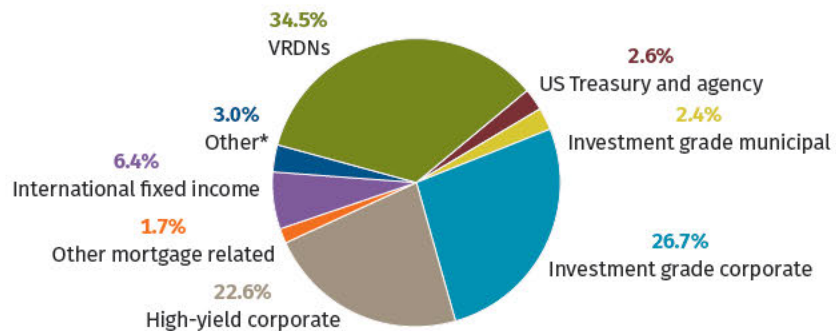
⁵⁶ The Staff Statement asks, “To what extent might cross-trades affect market efficiency because they are not publicly reported?” Because cross trading represents a small percentage of funds’ overall trading activity, and funds’ overall trading in the fixed-income markets represents only a portion of overall trading among market participants, we do not believe that fund cross trading materially affects market efficiency. And as discussed below in Section VI under our fifth recommendation, we would support making publicly available aggregated cross trading data reported by funds to the SEC on Form N-PORT.

The number of US Treasury and agency security cross trades were low (1,185) relative to the dollars traded (\$53.6 billion), while the number of high-yield corporate security cross trades were high (10,169) relative to the dollars traded (\$5.9 billion). This suggests that the average dollars per trade for the former were significantly higher than the average dollars per trade of the latter.

FIGURE 3

Total Number of Fixed-Income Cross Trades in 2020 by Asset Class

Percent, annual



Total number of cross trades in 2020: 44,976

* *Other* includes commercial paper, certificates of deposit, bank loans, high-yield municipal securities, and other asset-backed securities.

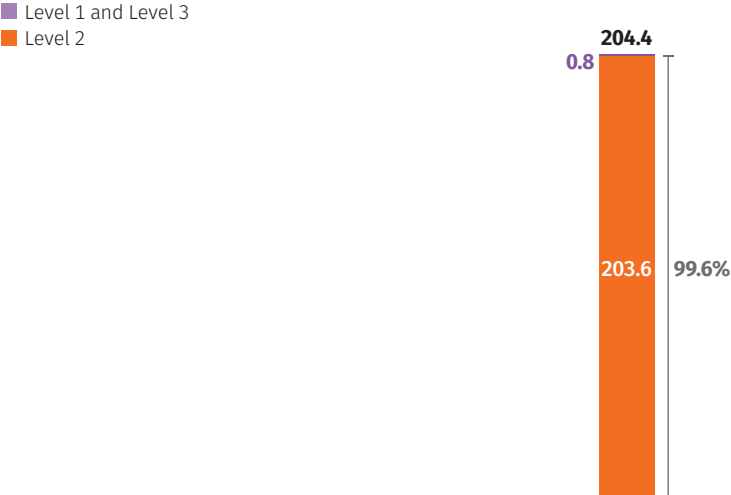
Source: Investment Company Institute survey of cross trading activity

Finally, and especially important given the December 2020 guidance, almost all (99.6 percent, in dollars) of the fixed-income securities that funds cross traded in 2020 were classified as Level 2 securities under the US GAAP fair value hierarchy.

FIGURE 4

Almost All Fixed-Income Cross Trades in 2020 Were of GAAP Level 2 Securities

Billions of dollars, annual



Source: Investment Company Institute survey of cross trading activity

This means that the guidance in the Fair Value Adopting Release would disallow almost all of funds’ 2020 fixed-income cross trading as of September 8, 2022. However, the existing Staff no-action letters that permit cross trading of municipal securities based on evaluated prices remain in effect—for now. But as indicated above, total cross trading of municipal securities (investment grade, high yield, and VRDNs) represents a minority of the industry’s overall fixed-income cross trading—27.1 percent (in dollars). Even assuming these letters remain in effect indefinitely, approximately 73 percent of funds’ cross trading activity would be eliminated, based on the 2020 data.

The Fair Value Adopting Release raises questions as to the continued status of those no-action letters: “The staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn.”⁵⁷ The Staff Statement reiterated that the letters “are being reviewed....” These statements hang over the letters, rendering funds’ continued reliance on them highly precarious. Because of the benefits they provide, these letters should be retained until the SEC has adopted rule amendments that obviate their need, similar to how the SEC rescinded prior SEC and Staff guidance related to fair valuation upon adopting the new fair value rule. But retention of the letters alone is at best a partial and insufficient solution.

For additional context, the SEC estimated in the Fair Value Adopting Release that about 35 percent of open-end fund assets are valued using Level 2 inputs (the figure was 53 percent for closed-end funds).⁵⁸ This smaller percentage for open-end funds can be explained by their larger total holdings in equities, which often are valued using Level 1 inputs. But if one looks instead at total fund *holdings* rather than total fund *assets*, the picture changes dramatically. One member informed us that as of December 31, 2020, it held approximately 94,000 separate fixed-income CUSIPS across its funds, compared to 4,400 equity CUSIPS. For this fund complex, more than 95 percent of its fund holdings would be ineligible for cross trading under the new guidance.

C. Funds Price Cross Trades Using Dealer Quotes and Evaluated Prices

For each asset class, we asked respondents to indicate the amount traded (in dollars) based on dealer quotes. In complying with paragraph (b)(4) to price fixed-income cross trades, funds may receive multiple bids (i.e., offers to buy the security) and offers (i.e., offers to sell the security) from third-party dealers, and use the midpoint of the highest bid and the lowest offer to price the cross trade. Our implicit assumption is that any fixed-income cross trading *not* based on dealer quotes must be done using evaluated prices (or, in the case of VRDNs, par plus accrued interest).⁵⁹

As indicated in Figure 5 below, 42 percent of the total dollars traded in 2020 were priced using dealer quotes as contemplated by paragraph (b)(4) of the rule, meaning that the remaining 58 percent were priced using evaluated prices or in reliance with the VRDN-specific no-action letter.

⁵⁷ Fair Value Adopting Release at 95.

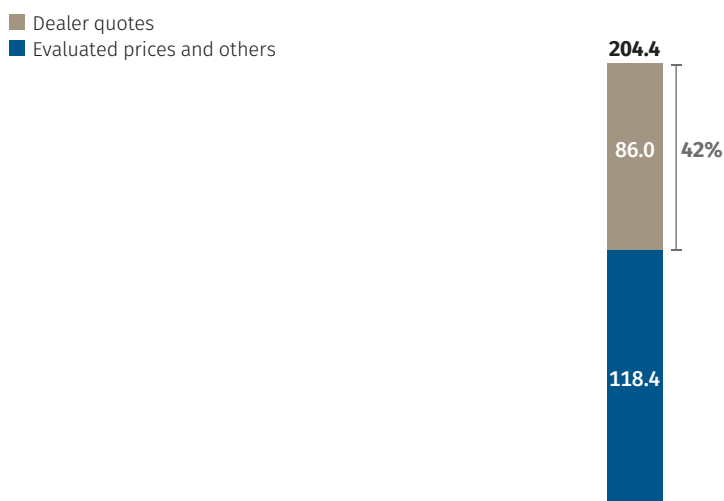
⁵⁸ *Id.* at 124–125.

⁵⁹ See *supra*, note 46.

FIGURE 5

Forty-Two Percent of the Total Value of Cross Trades in 2020 Was Based on Dealer Quotes

Billions of dollars, annual



Source: Investment Company Institute survey of cross trading activity

As is clear from both these aggregated figures and the asset class-specific data in Appendix B, some funds are using evaluated prices for securities other than municipal securities.⁶⁰ The SEC too noted in the Fair Value Adopting Release that some funds currently consider some or all investments valued with Level 2 inputs as having readily available market quotations.⁶¹ We surmise that this view and the practice of pricing cross trades using evaluated prices developed due to the historical lack of clarity (prior to December 2020) surrounding the definition of “readily available market quotation,” along with funds’ view that cross trading other fixed-income securities using evaluated prices poses risks not fundamentally different from, or greater than, those related to municipal bonds—a practice that the Staff has explicitly permitted.

⁶⁰ See *supra*, notes 19 and 20 and accompanying text.

⁶¹ Fair Value Adopting Release at 158.

D. Cross Trading Provides Significant Transaction Cost Savings to Funds and Their Shareholders

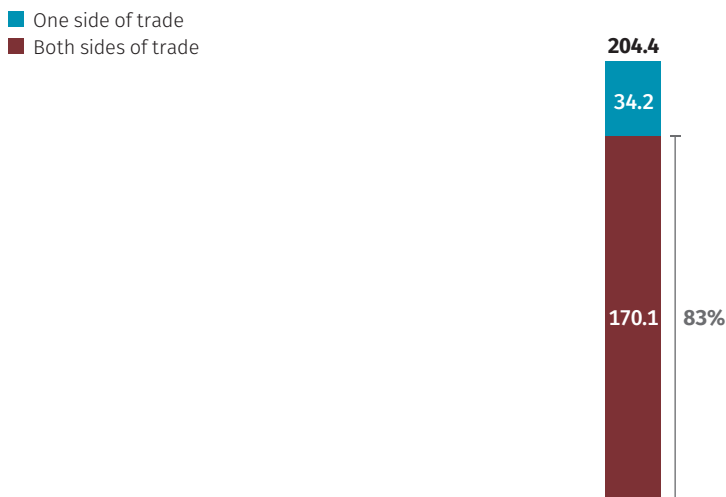
Each Rule 17a-7 cross trade involves two separate clients of an investment adviser, with at least one being a registered fund. To determine the typical cross trading parties (i.e., the prevalence of cross trades involving two registered funds) and to better estimate the transaction cost savings to funds specifically, we asked respondents to indicate the amounts traded (in dollars) for each asset class where both parties to the trade were registered funds (all other trades were assumed to involve only one fund).

As indicated in Figure 6 below, a large majority of cross trades (in dollars) involved two registered funds.

FIGURE 6

Eighty-Three Percent of Fixed-Income Cross Trades in 2020 Had Registered Funds on Both Sides

Billions of dollars, annual



Note: Components may not add to the total because of rounding.

Source: Investment Company Institute survey of cross trading activity

For any cross trade, the amount of the security's bid-ask spread (as expressed in basis points), multiplied by the total dollars traded, represents a useful measure of transaction cost savings for both parties. Using this approach, we applied an estimated average yearly bid-ask spread figure for each asset class to respondents' total reported cross trades (in dollars) for each asset class.⁶² See Appendix A for more details about the figures used and our methodology.

We estimate that cross trading fixed-income securities saved funds nearly \$329 million in 2020. Cross trading saved investment advisers' clients, in the aggregate (i.e., funds, other pooled investment vehicles, and separately managed accounts), more than \$390 million.

⁶² Based on how funds dispose of them, we assumed no transaction cost savings for VRDN cross trades. See *supra*, note 7.

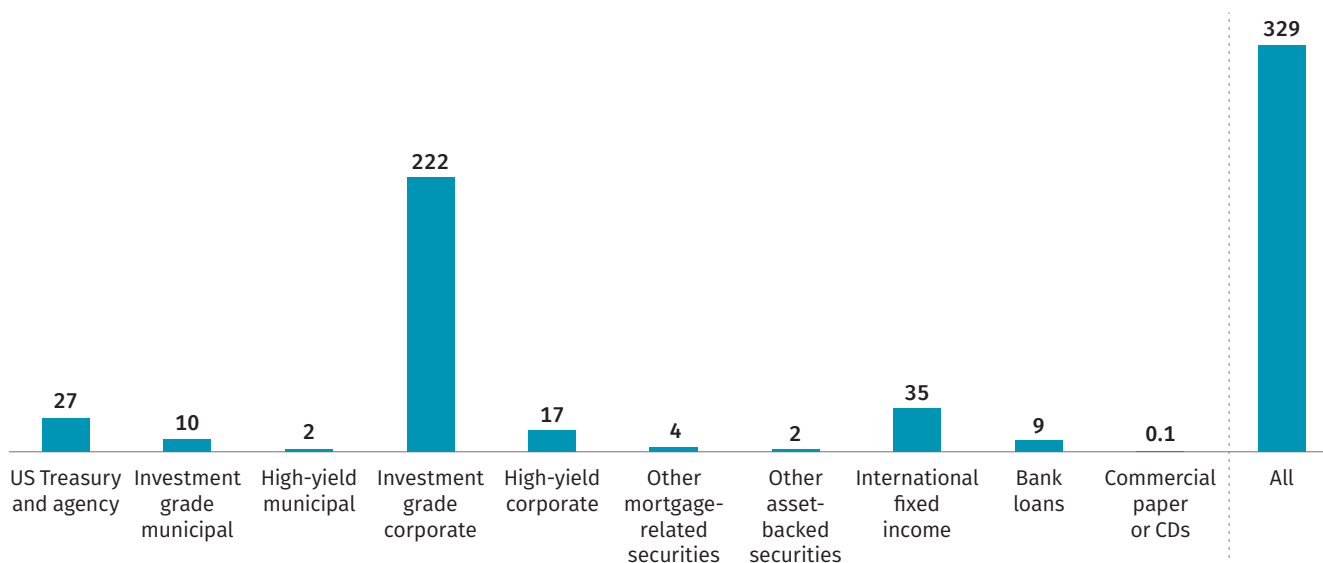
Loss of these savings—should it occur—would result in direct and ongoing wealth transfers from fund shareholders to third-party securities dealers, to the extent that this latest cross trading guidance forces fund trading activity to those dealers.

In Figure 7 below, we present funds’ total dollar savings by asset class and in the aggregate.

FIGURE 7

Funds’ Transaction Cost Savings by Asset Class and in the Aggregate

Millions of dollars, annual, 2020



Note: Transaction cost savings are calculated based on the monthly estimates of bid-ask spreads and total dollars cross traded for each asset class in 2020. See Appendix A for details.

Source: ICI calculations based on ICE data, Bloomberg data, and survey information of annual cross trading activity

We recognize that the savings from cross trading will vary from year-to-year. To get a better sense of the range of savings funds might realize in future years (and again, using bid-ask spreads as a proxy for transaction cost savings), we used our 2020 data (i.e., we held constant the total dollars cross traded across the asset classes) to calculate potential savings under two different sets of market conditions:

- » To estimate savings in a “normal” year, we *excluded* the bid-ask spread figures from March and April for each asset class (during these months, bid-ask spreads were abnormally high, and we treat them as outliers), and applied only the average spread figures from the remaining 10 months to the overall dollars cross traded. Under this scenario, cross trading would save funds approximately \$265 million (more than \$316 million for advisers’ clients generally).

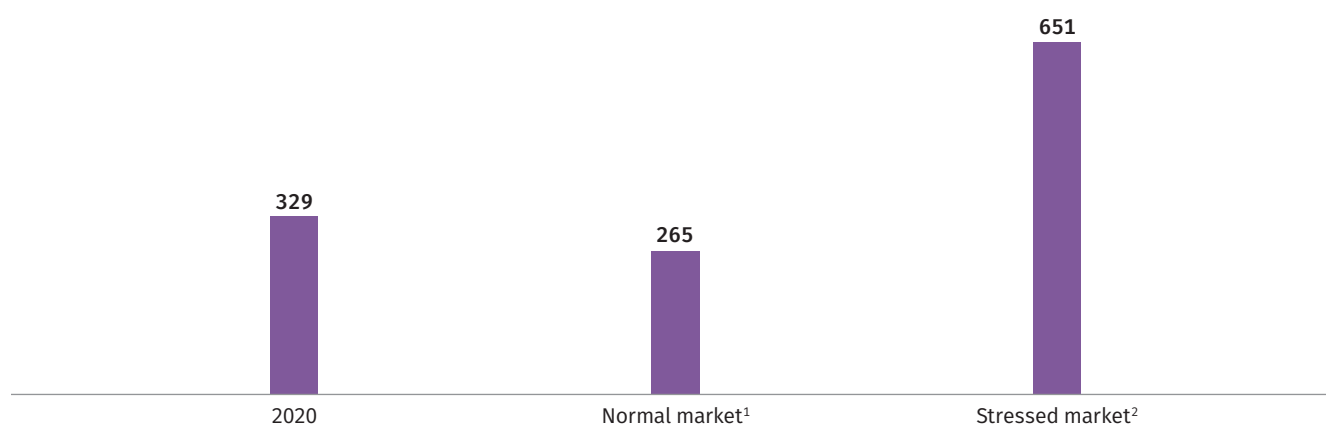
- » To estimate savings in a year where market conditions are stressed throughout, we used *only* the average bid-ask spread figures from March and April for each asset class, applying those figures to the overall dollars cross traded. Under this scenario, cross trading would save funds approximately \$651 million (nearly \$759 million for advisers' clients generally).

We show this in Figure 8 below.

FIGURE 8

Funds' Transaction Cost Savings from Cross Trading Will Vary by Market Conditions

Millions of dollars, annual



¹ "Normal market" conditions calculations are based on the simple average of transaction costs, excluding the estimated figures for March and April 2020.

² "Stressed market" conditions calculations are based only on the simple average of transaction costs in March and April 2020, and exclude the cost estimates for the remaining 10 months of 2020.

Note: Transaction cost savings are calculated based on the monthly estimates of bid-ask spreads and total dollars cross traded in 2020. See Appendix A for details. Based on the same methodology, investment advisers' nonregistered fund clients realized additional transaction cost savings of \$61 million in 2020 (i.e., our baseline estimate), and would realize additional savings of \$51.6 million under the "normal market" scenario, and \$108.9 million under the "stressed market" scenario.

Source: ICI calculations based on ICE data, Bloomberg data, and survey information of annual cross trading activity

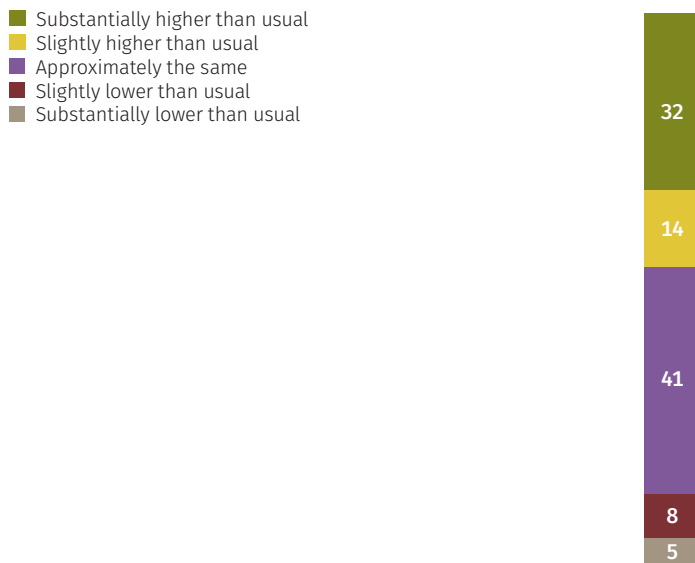
We believe our baseline estimate of \$329 million saved for funds in 2020 understates industrywide transaction cost savings. First, while we had very broad industrywide survey participation, it was not universal. Second, we requested transaction data for all of 2020 and did not ask for more specific quantitative information related to timing of trading activity. Due to the effects of COVID-19, 2020 was far from a normal year, and bid-ask spreads for fixed-income securities varied dramatically during 2020, spiking in March and April before settling back into more typical ranges. To the extent that funds' cross trading activity was disproportionately high in March and April, the related cost savings would also be higher.

To better understand potential variation in activity during 2020, our survey asked how fixed-income cross trading activity during March and April of 2020 compared to the fund complex’s normal level of fixed-income cross trading activity. Figure 9 below shows the responses. This suggests that industrywide cross trading activity was elevated during these months, and that the actual cross trading savings were almost certainly higher than the aggregated numbers presented above.

FIGURE 9

Cross Trading Activity During March/April 2020 Was the Same or Higher for Most Complexes

Percentage of fund complexes*



* Data include 71 percent of fund complexes that responded to the question.
Source: Investment Company Institute survey of cross trading activity

Finally, we note that our survey did *not* try to quantify the extent to which funds were forgoing potentially beneficial cross trades due to real or perceived rule restrictions—our estimate is based only on actual cross trades. Some fund complexes cross trade using dealer quotes, and others use evaluated prices. Some are frequent cross traders, and others do so sparingly. Still others cross trade only as laid out in the existing no-action letters. We are aware of one member that does not cross trade fixed-income securities at all due to legal uncertainty, notwithstanding the significant benefits that this member believes it would provide to its funds. Thus, differences in complex-by-complex cross trading activity appear to be based in part on the rule’s inherent ambiguities (existing prior to the December guidance) and differences in legal analysis and risk appetite, which is one reason why we have advocated for reform of Rule 17a-7.⁶³

⁶³ See *infra*, note 64 and accompanying text.

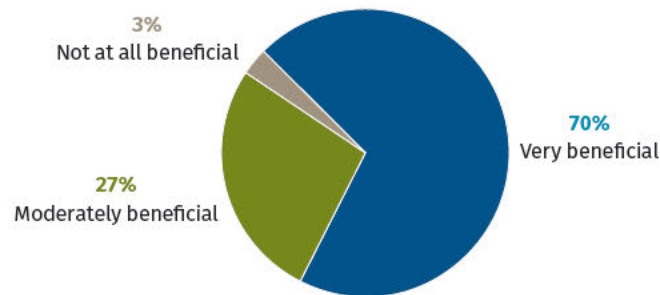
E. Respondents View Cross Trading of Fixed Income as Beneficial to Their Fund Complexes

Finally, we asked respondents to provide more subjective feedback on the importance to their fund complexes of cross trading fixed-income securities. Seventy percent of respondents described it as “very beneficial,” with another 27 percent calling it “moderately beneficial,” as indicated in Figure 10 below.

FIGURE 10

Cross Trading Fixed-Income Securities Is Very Beneficial for 70 Percent of Fund Complexes

Percentage of fund complexes*



* Data include 71 percent of fund complexes that responded to the question.

Source: Investment Company Institute survey of cross trading activity

VI. ICI's Policy Recommendations

The SEC's views on cross trading reflect two underlying policy considerations that sometimes conflict and compete with one another: concern with potential abuses of affiliated transactions generally, along with recognition that cross trading generates transaction cost savings for funds. Unduly focusing on potential abuses and narrowing Rule 17a-7 (whether by rule amendment or interpretation) invariably means that funds will forgo mutually beneficial cross trading opportunities and incur added costs.

In our comment letter on the SEC's fair value proposal, we observed that the cross trading rule was ripe for modernization and that the rule's terms have precluded fund complexes from entering into cross trades (particularly for fixed-income securities) that would be mutually beneficial.⁶⁴ Moreover, we recommended that the SEC "ensure that Rule 2a-5 does not interfere with existing cross-trading activity."

Far from preserving the current cross trading regime, the SEC's guidance in the Fair Value Adopting Release will significantly restrict funds' ability to cross trade fixed-income securities. Starting in September 2022, funds will be permitted to cross trade only those fixed-income securities that: (i) are municipal securities, in reliance on existing Staff no-action letters, for so long as those letters remain in place; or (ii) have "readily available market quotations," as that term is now defined. Largely proscribing fixed-income cross trading would be a significant step backward for funds and their shareholders. The ironic result of this guidance is that the cross trading rule will continue to work for those portfolio securities where its benefits are relatively modest (equities, for which trading is relatively easy and transaction costs are low) while being largely unavailable for those securities where it is most beneficial (various types of fixed-income securities, for which transaction costs are generally higher).

It is imperative that the SEC move expeditiously to amend Rule 17a-7. Otherwise, the significant fund and shareholder benefits detailed above will be lost as of September 8, 2022.

Fortunately, there is sufficient time for the SEC to propose and adopt rule amendments that preserve funds' ability to cross trade fixed-income securities, within appropriate guardrails. As importantly, the SEC need not start from scratch—last June the SEC's FIMSAC put forward credible ideas for amending Rule 17a-7 to facilitate funds' ability to cross trade fixed-income securities, which are deserving of consideration.⁶⁵

⁶⁴ Letter from Susan Olson, General Counsel, ICI, to Vanessa Countryman, Secretary, SEC, dated July 16, 2020, available at www.sec.gov/comments/s7-07-20/s70720-7433367-220249.pdf.

⁶⁵ *Preliminary Recommendation Regarding Modernizing Rule 17a-7 under the 1940 Act* (June 1, 2020)(the "FIMSAC recommendation"), available at www.sec.gov/spotlight/fix-income-advisory-committee/preliminary-recommendation-re17a-7.pdf. Unlike FIMSAC's recommendation (which it issued prior to the SEC's adoption of the fair value rule and its related guidance), however, our recommendations below account for and respond to these latest developments.

In a similar vein, we offer additional recommendations below. We believe that a well-designed rule can address the potential concerns with cross trades, while preserving their important benefits. A modernized cross trading regulatory framework would “facilitate fixed income trading in ways that benefit investors and our markets”⁶⁶ and have the following key elements:⁶⁷

- 1) **A new scoping mechanism.** The Staff Statement asks about the advantages and disadvantages of the rule’s threshold requirement that a security have a “readily available market quotation” as defined in the fair value rule. Limiting cross trading in this way is no longer tenable because it would significantly restrict cross trading of fixed-income securities and reduce its benefits. Assuming that the SEC decides to apply its new definition of “readily available market quotation” in all contexts under the Investment Company Act, we recommend that the SEC amend paragraph (a) of Rule 17a-7, so that securities *without* readily available market quotations (i.e., almost all fixed-income securities) are not excluded from cross trading.

Consistent with the thrust of FIMSAC’s recommendation,⁶⁸ we recommend amending paragraph (a) to permit cross trading of those securities that meet the definition of having Level 1 or 2 inputs under the GAAP fair value hierarchy.⁶⁹ The December 2020 guidance would effectively incorporate the concepts of the GAAP fair value hierarchy into the cross trading rule, albeit in a highly limiting way. Permitting cross trading of securities having Level 2 inputs as well would build on the regulatory approach taken in the fair value rule and still permit cross trading of fixed-income securities.

Of course, we recognize that this scoping provision is only part of the rule, and that other rule provisions (along with funds’ related policies and procedures and investment advisers’ fiduciary duties) play an important role in ensuring that cross trades are mutually beneficial. Securities having Level 1 or 2 inputs should facially qualify for cross trading, but all *transactions* in such securities would be subject to the rule’s existing conditions and those recommended below.

⁶⁶ See *Statement on Fixed-Income Trading and Investment Company Act Rule 17a-7*, Commissioner Elad L. Roisman (Mar. 11, 2021), available at www.sec.gov/news/public-statement/roisman-statement-rule-17a7-031121.

⁶⁷ The items below are not meant to be exhaustive, and this report focuses on those changes that are most critical. Other provisions of the rule are also worth reconsidering, provided that doing so would not jeopardize timely adoption of the most critical changes. See, e.g., FIMSAC recommendation at 2 (noting the ambiguity in the term “customary transfer fees” found in paragraph (d) of the rule). For instance, the SEC should permit the entities participating in a cross trade to pay unaffiliated third-party service providers *de minimis* amounts for any services provided in connection with the clearing, settlement, reporting, or facilitation of a trade.

⁶⁸ See FIMSAC recommendation at 4 (recommending that third-party pricing services be permissible to cross Level 1 and 2 assets only). As noted above, FIMSAC issued its recommendation prior to the adoption of the fair value rule, and its recommendation appeared to presume that it was *not* paragraph (a) of Rule 17a-7 that was impeding funds’ ability to cross trade fixed-income securities (specifically, the requirement that a security have a readily available market quotation), but rather the pricing requirements of paragraph (b).

⁶⁹ Under the GAAP fair value hierarchy, Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

2) **An updated pricing provision.** The degree of detail of paragraph (b) of Rule 17a-7 has necessitated rule amendments and could require more in the future.⁷⁰ At the same time, ambiguity in some of its key terms (e.g., what constitutes an “independent current market price” and how to satisfy the “reasonable inquiry” requirement under paragraph (b)(4) when cross trading fixed-income securities based on current bids and offers) had limited funds’ cross trading activity even before the SEC’s December guidance.⁷¹

As part of any package of rule amendments, we recommend streamlining this paragraph. 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),⁷² and (ii) the investment adviser’s duty to seek best execution for each fund and its duty of loyalty to each fund. As with fund valuation practices generally, funds should be permitted to price cross trades using multiple inputs and sources of data, including evaluated prices from independent third parties and independent dealer quotes,⁷³ provided they have a reasonable belief that the prices derived from those sources are accurate. The Staff’s policy positions in the United Funds and Federated Letters were sound,⁷⁴ and there is no compelling reason to limit that relief to municipal bonds.⁷⁵ Amending the cross trading rule would provide the opportunity to incorporate and expand upon the Staff’s long-standing position on permitting the use of evaluated prices for cross trades.

The case for such an approach is particularly strong in light of the SEC’s adoption of the fair value rule, which will establish “a certain minimum, consistent framework for fair value and standard of baseline practices across funds.”⁷⁶ Among other things, the fair value rule requires assessing and managing material valuation risks; establishing and applying fair value methodologies; testing fair value methodologies; and evaluating pricing services. All of these requirements could be incorporated into the Rule 17a-7 framework (or simply cross-referenced). Also, the SEC could expressly emphasize investment advisers’ specific duties of best execution and loyalty⁷⁷

⁷⁰ See, e.g., *Regulation NMS*, SEC Release No. 34-51808 (June 9, 2005)(amending Rule 17a-7 to incorporate provisions specific to NMS stocks).

⁷¹ Cf. FIMSAC recommendation at 2.

⁷² Valuation policies and procedures notwithstanding (which are normally directed toward pricing portfolio investments as of 4:00 p.m. eastern time for purposes of calculating a fund’s net asset value), funds should be permitted to engage in and price cross trades intraday, provided the funds’ policies and procedures address how this would be done.

⁷³ See Liquidity Rule Adopting Release at 248 (noting that “[i]ndications of interest’ and ‘accommodation quotes’ may not necessarily reflect the current market values of the securities and thus are not ‘market quotations’ or ‘market values’ for the purposes of Rule 17a-7”).

⁷⁴ See *supra*, notes 19 and 20 and accompanying text.

⁷⁵ See also ICI No-Action Letter, *supra* note 35. One of the conditions of that relief was that the price of the purchased debt security had to be “its fair market value under Section 2(a)(41) of the [Investment Company Act], provided that this price is not materially different from the fair market value of the security indicated by a reliable third-party pricing service.”

⁷⁶ Fair Value Adopting Release at 8.

⁷⁷ See generally *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, SEC Release No. IA-5248 (June 5, 2019)(providing guidance to investment advisers on their fiduciary duty, which includes the duty to seek best execution [included within the duty of care] and the duty of loyalty).

first articulated in the cross trading context in the Federated Letter⁷⁸ and its expectations with respect to determining a fair price.⁷⁹ Finally, this recommended approach would be a more “evergreen” rule provision that would not require revision as trading practices and regulation continue to evolve.

- 3) **Risk-based policies and procedures for evaluating and pricing cross trading opportunities.** Currently, Rule 17a-7 prohibits cross trades of securities without readily available market quotations (paragraph (a)) and requires different pricing conventions depending on the type of security (paragraph (b)). Otherwise, the rule does not apply different conditions by security type.

We would not favor a highly prescriptive cross trading rule with specific requirements applied to various asset types. But we also recognize that the risks associated with cross trading vary to some degree by asset type, fund, market conditions, and organizational structure. For instance, determining the appropriateness (including price) for a cross trade of a security with a readily available market quotation will generally require less scrutiny than a potential cross trade of a Level 2 security.

Accordingly, the SEC could require funds and advisers to adopt policies and procedures that take a risk-based approach to evaluating, pricing, and approving potential cross trades, varying the level of scrutiny depending on the associated risks. The fair value rule and its related guidance provide a useful model of how this could work. The rule’s requirements cover a large number of investment types that vary in their valuation risks (e.g., ranging from US Treasury bonds to pre-IPO stocks), while recognizing that the practical application of those requirements may differ.⁸⁰ Such an approach in the cross trading rule would still permit cross trading of a broader range of assets, but with additional rigor as appropriate. This also would be consistent with the SEC’s cross trading guidance in the Liquidity Rule Adopting Release, which stated:

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.⁸¹

⁷⁸ See *supra*, note 20 and accompanying text.

⁷⁹ See, e.g., *In the Matter of Western Asset Management Co.*, SEC Release No. IA-3762 (Jan. 27, 2014) and *In the Matter of Putnam Investment Management, LLC and Zachary Harrison*, SEC Release No. IA-5050 (Sept. 27, 2018) (finding, in each case, that by crossing at the bid [rather than the average of the bid and the ask prices], respondent(s) favored the buyers in the transactions over the sellers in violation of Investment Company Act Section 17(a) and Investment Advisers Act Sections 206(2), 206(4) and 207).

⁸⁰ See Fair Value Adopting Release at 14 (“different frequencies for the re-assessment of valuation risks may be appropriate for different funds or risks.”); at 29 (“We expect the frequency and nature of testing would vary depending on the type and amount of investments held by the fund.”); and at 87 (“We expect that the records kept may vary based on a variety of factors, including the subjectivity of the inputs used in determining fair value (e.g., Level 2 or Level 3).”).

⁸¹ Liquidity Rule Adopting Release at 246.

More specifically, the SEC could require that such policies and procedures address the following:

- » **Risk assessment.** Cross trading risks and potential conflicts will vary and may be asset-specific (e.g., different assets have different valuation- and liquidity-related risks) and fund-specific (e.g., varying depending on the breadth of the fund's investment objective, strategies, and policies). These risks also may be affected by market conditions (e.g., greater volatility and pricing uncertainty for an asset may increase the risk of cross trading that asset); the fund complex's organizational or personnel-related arrangements (e.g., whether the transacting funds share portfolio managers, or whether persons or functions outside portfolio management have independent decisionmaking authority with respect to cross trades); and use of third parties (e.g., pricing services and dealers providing quotes). Risk assessment is an important element of the SEC's liquidity, fair value, and derivatives rules,⁸² and those assessments (particularly with respect to valuation and liquidity) would inform risk management related to cross trading.
- » **Risk management.** A fund's specific risk assessment should guide the risk management mitigants and policies that the fund puts in place. For a fund that cross trades Level 1 equity securities only, its policies and procedures may look very different from those of a fund that may cross trade a broad array of fixed-income securities.

The Staff Statement asks about the kinds of controls advisers have in place to govern cross trading. In addition to those described in this section, we describe in Appendix C certain practices that funds and advisers use to comply with the cross trading rule and mitigate related risks. We do not recommend that they be incorporated into rule text. Rather, we provide them as examples of risk mitigants that a fund could adopt under a risk-based compliance framework.

A framework of this kind would avoid the narrow and binary approach to cross trading that the current rule and the SEC's latest guidance would otherwise create and allow diverse funds and fund complexes to manage their cross trading activity in a manner commensurate with its risks.

- 4) **Provisions facilitating board oversight.** Paragraph (e) of Rule 17a-7 requires a fund board to (i) adopt procedures reasonably designed to provide that relevant rule conditions have been complied with; (ii) make and approve such changes as the board deems necessary; and (iii) determine no less frequently than quarterly that all transactions were effected in compliance with such procedures. However, in a 2018 no-action letter to the Independent Directors Council, the Staff stated that it would not recommend enforcement action to the SEC if a fund board receives from the fund's chief compliance officer (CCO) written quarterly representations that transactions entered into in reliance on Rule 17a-7 were effected in compliance

⁸² See Rule 22e-4(b)(1)(i), Rule 2a-5(a)(1), and Rule 18f-4(c)(1).

with the board-adopted procedures, instead of the board itself determining compliance.⁸³

Amending the cross trading rule would allow the SEC to codify this commonsense Staff position. Consistent with the IDC Letter, we do not believe that boards should be required to receive and review transaction-specific cross trading information (of course, boards could still request such information).

But we believe the SEC should go further and adopt rule provisions that would strengthen board oversight of cross trading. A modernized board reporting framework should “facilitate the directors’ ability to focus on conflict of interest concerns raised by affiliated transactions, including whether a fund engaging in the types of affiliated transactions permitted by the Exemptive Rules [including Rule 17a-7] is in the best interest of that fund and its shareholders.”⁸⁴

To that end, the SEC could adopt cross trading-related enhancements to the current fair value and/or liquidity annual reports that fund boards receive (or will receive),⁸⁵ or require funds to provide their boards with a separate annual report under the cross trading rule.⁸⁶ Possible contents could include:

- » summary information about cross trading activity for the year (e.g., reasons for engaging in cross trades, total dollars and total number of trades by asset class, parties to the transactions, how cross trading volumes compared to trading volumes generally, trend information, etc.);
- » summary information related to any post-trade analysis that a fund may conduct, as described in Appendix C; and
- » an assessment of the adequacy and effectiveness of the cross trading procedures.

We believe that reporting of this nature would permit fund boards to “see the forest for the trees” and provide meaningful oversight of this fund activity. And to be clear, these board reporting recommendations would in no way limit what a board could request from an adviser in order to maintain oversight of funds’ cross trading activity. Rather, these items would be baseline reporting requirements, and boards and advisers would be free to add others as they deem necessary or appropriate.

⁸³ *Independent Directors Council*, SEC Staff No-Action Letter (pub. avail. Oct. 12, 2018)(“IDC Letter”).

⁸⁴ *Id.*

⁸⁵ See Rule 22e-4(b)(2)(iii) and Rule 2a-5(b)(1)(i)(B).

⁸⁶ This would complement the quarterly compliance-related board reporting that the IDC Letter permits. If a new reporting requirement of this nature were included in the cross trading rule, we would not favor mandating that a specific individual prepare the report (e.g., the fund CCO) because (i) the report’s subject matter could be multi-disciplinary, and (ii) fund complexes of all sizes should have the needed flexibility to comply. As with the fair value rule, we believe that a fund’s investment adviser should be permitted to prepare reports of this kind.

5) **Reporting of cross trading activity to the SEC and public transparency.** The SEC currently receives limited information on funds' cross trading practices.⁸⁷ Item C.7(e) of Form N-CEN asks whether the fund relied on Rule 17a-7 during the reporting period, but this annual report does not otherwise ask about the nature or extent of this activity. And funds also may report the dollar values of their cross trades in their financial statements,⁸⁸ but such reporting is required only if the activity is material, and the information is not reported in a format that permits the SEC (or others) to easily search, aggregate, and analyze it.

As part of an overhaul of Rule 17a-7, we would support enhancing the current SEC reporting framework to provide the SEC with greater visibility into funds' cross trading practices. Amendments to Form N-PORT could require funds to report aggregated numbers of cross trades and dollars traded by asset type, similar to what we have gathered through this survey. To provide additional transparency into funds' cross trading practices, we also would support making this information public, subject to Form N-PORT's existing provisions related to the timing of filings and public availability of that information.⁸⁹ This new reporting could be used by the SEC to spot notable trends in cross trading activity (by fund, fund complex, or industrywide) and follow up with funds as appropriate.

Finally, we would note that Rule 17a-7 is just part of a comprehensive regulatory framework. All fund trading activity, including cross trading, is subject to a battery of existing pre- and post-trade compliance checks and legal and regulatory obligations. For instance, funds are limited in what they may acquire (and in some cases, sell) by their investment objectives, strategies, and policies, as well as applicable restrictions of the Investment Company Act and its rules.⁹⁰ Investment advisers too owe all of their clients (including funds) fiduciary duties of care and loyalty, which applies to their trading activity for clients. These are robust restrictions and protections, to which the cross trading rule provides a further and more tailored layer of protection to funds and their shareholders. As the SEC considers rule amendments, it should do so in a way that complements and builds upon this existing framework.

⁸⁷ See *supra*, note 53.

⁸⁸ FASB ASC Topic 850-10-50-1.

⁸⁹ Reports on Form N-PORT for each month in each fiscal quarter of a fund generally must be filed with the SEC no later than 60 days after the end of such fiscal quarter. Information reported on Form N-PORT for the third month of each fund's fiscal quarter is made publicly available upon filing.

⁹⁰ In this regard, we would also note that paragraph (c) of the cross trading rule—which requires that the transaction be consistent with the policy of each fund, as recited in its registration statement and reports—imposes a more exacting limitation on these funds with less discretion or latitude in what they may buy and sell.

Appendix A: Estimating Transaction Cost Savings from Funds' 2020 Cross Trading Activity

To reallocate portfolio assets, invest new proceeds from the sale of fund shares, or meet redemptions, funds buy and sell portfolio assets in the underlying markets. For every market transaction, the fund pays a trading cost. In addition to commissions, market impact costs, and opportunity costs, that cost includes the cost of purchasing a security at the “ask” price (i.e., the lowest offer to sell the security) instead of the actual value of the security, or for receiving the “bid” price (i.e., the highest offer to buy the security) upon a sale of a security instead of the actual value of the security. The difference between what the fund pays or receives and the actual value of the security—the transaction cost—is the compensation to the counterparty for taking the other side of the trade. The difference between the bid price and the ask price is usually referred to as the bid-ask spread. We based our estimated trading cost savings on this difference.

If two funds instead engage in a “cross trade”—a trade at the actual value of the security between two affiliated funds—both funds benefit by avoiding the transaction costs. Conceptually, to estimate the cost savings for one fund for a given trade, we simply multiply the transaction cost per dollar traded that would have been paid by the fund had it transacted in the market with the dollar size of the cross trade:

$$CS = TC \times S,$$

where **CS** is the cost saving for the cross trade of size **S** that would have incurred the transaction cost of **TC**. The total cost savings for the industry during a given period is then the sum of these trade-by-trade cost savings across all cross trades during that period:

$$TCS = \sum_{\text{cross trades}} CS.$$

The transaction cost for a trade—that is, the difference between the traded price and the actual value of the security—is not directly observable and must be estimated. To compute the industrywide cost savings, we make a series of assumptions about the transaction cost estimates. We assume that within any of 10 asset classes surveyed, transactions costs:

- 1) are equal across assets within that class,
- 2) are the same across funds,
- 3) are symmetric—the cost for the buyer is equal to the cost for the seller—and equal to half the bid-ask spread, and
- 4) are linear in trade size—a trade of 10 times the size of another trade would be 10 times more expensive.⁹¹

⁹¹ The symmetry assumption does not affect the savings for cross trades where both parties are funds, but it is relevant for “one-sided” trades, where this assumption means that the transaction cost is half the bid-ask spread.

Then, under these assumptions, industrywide cost savings for funds are the sum across asset classes of the product of the transaction cost for an asset class—or half the bid-ask spread—and the dollar size of the aggregate cross trades in that asset class:

$$TCS = \sum_{\text{asset class}} [TCS_c] = \sum_{\text{asset class}} [TC_c \sum_{\text{cross trades in asset class } c} S].$$

We first obtained for each asset class and month in 2020 an estimate of the transaction cost per dollar traded. We used three general approaches, depending on the asset class:

- » For US Treasury and agency securities (including Treasury bills), we estimated the transaction cost as the monthly average of half the daily bid-ask spreads for the off-the-run 10-year US Treasury note.⁹²
- » For corporate and municipal bonds, we obtained from ICE the daily averages of half the price differences for all “traded pairs” (i.e., a purchase and sale of the same bond relatively close in time) in that asset class on that day based on FINRA’s TRACE and MSRB’s EMMA high-frequency data.⁹³ The price difference of a traded pair is the difference in prices of two adjacent trades of a given security, where the first trade is a dealer purchase from a customer and the second is a dealer sale to a customer. For efficiency, we computed the daily averages only for one day in the middle of each month.⁹⁴
- » For all other asset classes, we obtained from ICE the daily averages of half the bid-ask spreads of representative samples taken from ICE’s pricing universe files.⁹⁵ The bid-ask spreads also were computed only for one day in the middle of each month.

In the first column of Figure 11 below, we present the annual average of the monthly transaction cost estimates TC_c during 2020 for each asset class. For most asset classes, the transaction cost estimates for March and April were significantly larger than during the other months of 2020. In the second and third columns, we report the averages computed over all months *except* March and April and then for March and April *only*, respectively.

⁹² We obtained the end of day bid-ask spreads for the off-the-run 10-year US Treasury note from Bloomberg.

⁹³ Only trades larger than \$500,000 were captured, and the two paired trades must have occurred at least 5 minutes but less than 120 minutes apart in order to be captured. The trade size restriction is to exclude retail trades, and the window for the trade pairs is meant to ensure that the price differences neither reflect agency trades nor market movements.

⁹⁴ The mid-month days were 1/15, 2/18, 3/18, 4/15, 5/15, 6/15 or 18, 7/14, 8/14, 9/15, 10/15, 11/18, and 12/15. We also received from ICE for US investment grade corporate bonds (the asset class in our data set with the most cross trading activity (in dollars) and the largest amount of transaction cost savings by far) and for high-yield corporate bonds monthly averages of price differences for all “traded pairs” during the month. The resulting total cost savings were similar in magnitude under both approaches.

⁹⁵ For most asset classes, to reduce a duration effect on the bid-ask spreads, bonds were filtered to 2–10 year securities only. No maturity filtering was done for money market securities or bank loans.

FIGURE 11

Average Bid-Ask Spreads by Asset Class and Market Condition

Bid-ask spreads in basis point per dollar traded

Asset category	2020	Normal market ¹	Stressed market ²
US Treasury and agency	0.052	0.033	0.146
Investment grade municipal	0.390	0.369	0.498
High-yield municipal	0.365	0.355	0.413
Investment grade corporate	0.359	0.280	0.757
High-yield corporate	0.392	0.326	0.725
Other mortgage-related securities	0.118	0.101	0.200
Other asset-backed securities	0.197	0.184	0.259
International fixed income	0.467	0.460	0.499
Bank loans	1.578	1.455	2.193
Commercial paper or CDs	0.009	0.009	0.009

¹ "Normal market" conditions calculations are based on the simple average of transaction costs, excluding the estimated figures for March and April 2020.

² "Stressed market" conditions calculations are based only on the simple average of transaction costs in March and April 2020, and exclude the cost estimates for the remaining 10 months of 2020.

Note: Transactions cost savings are calculated based on the monthly estimates of bid-ask spreads and total dollars cross traded in 2020.

Source: ICI calculations based on ICE and Bloomberg data

From the survey responses, we obtained for each asset class the aggregate dollar amount of cross trades in 2020. The survey distinguished whether funds were on both sides of a trade or only on one side. With that information and following the above procedure, we estimated the aggregate cost savings for all of respondents' funds. Since VRDNs are generally disposed of at par plus accrued interest without incurring a transaction cost, we excluded all VRDN cross trades when estimating cost savings for traded pairs of investment grade municipal securities.⁹⁶

⁹⁶ See *supra*, note 7.

While we received only the annual amount of cross trading by asset class from the respondents, we have monthly estimates of the transaction costs. This allows us to estimate a range of total industry cost savings depending on market conditions. For the main result, we compute **TCS** using the annual average of the monthly transaction cost estimates during 2020—the first column in Figure 11. Figure 7 reports the cost savings by asset class **TCS_c** and as aggregated across all classes **TCS**. For most asset classes, the transaction cost estimates for March and April were significantly higher than those of the other months of 2020. To address this variation, we also computed **TCS** separately for normal and stressed market conditions. The former used the average transaction cost estimates for all months *excluding* March and April, and the latter computed the average transaction cost using *only* the March and April figures. Figure 8 presents the cost savings aggregated across all asset classes **TCS** based on the three differing sets of market conditions.⁹⁷

⁹⁷ If a fund is only on one side of a cross trade and the other side is taken by another pooled vehicle or account managed by the investment adviser, additional savings occur for the advisers' non-fund clients. Following the same approach as for computing the savings for funds in such "one-side" trades, investment advisers' non-fund clients realized additional transaction cost savings of \$61 million for 2020 (i.e., our baseline estimate), and would realize additional savings of \$51.6 million under the "normal market" scenario, and \$108.9 million under the "stressed market" scenario.

Appendix B: Cross Trading Survey Results by Asset Class

US Treasury and Agency Securities

Seventeen percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 1,185 distinct cross trades, totaling \$53.6 billion.

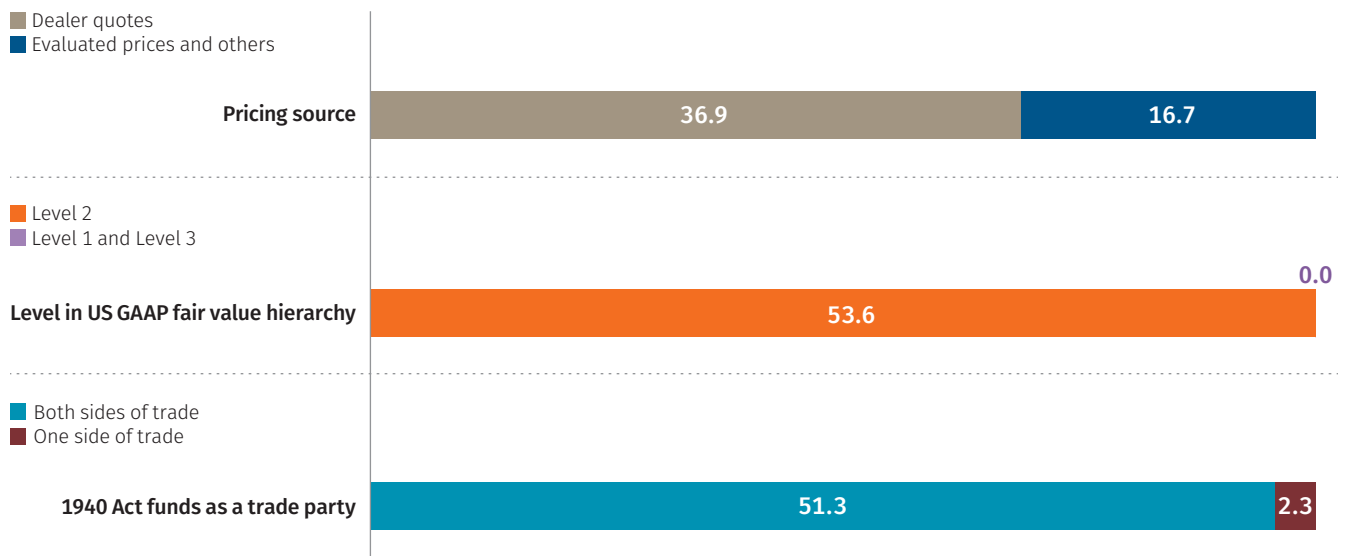
We estimate that these trades saved funds \$27 million and investment advisers' clients generally \$28 million.

Figure 12 below provides additional details about the funds' cross trading of this asset class.

FIGURE 12

\$53.6 Billion in US Treasury and Agency Securities Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

Investment Grade Municipal Securities (Excluding Variable Rate Demand Notes)

Thirty-one percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 1,067 distinct cross trades, totaling \$2.8 billion.

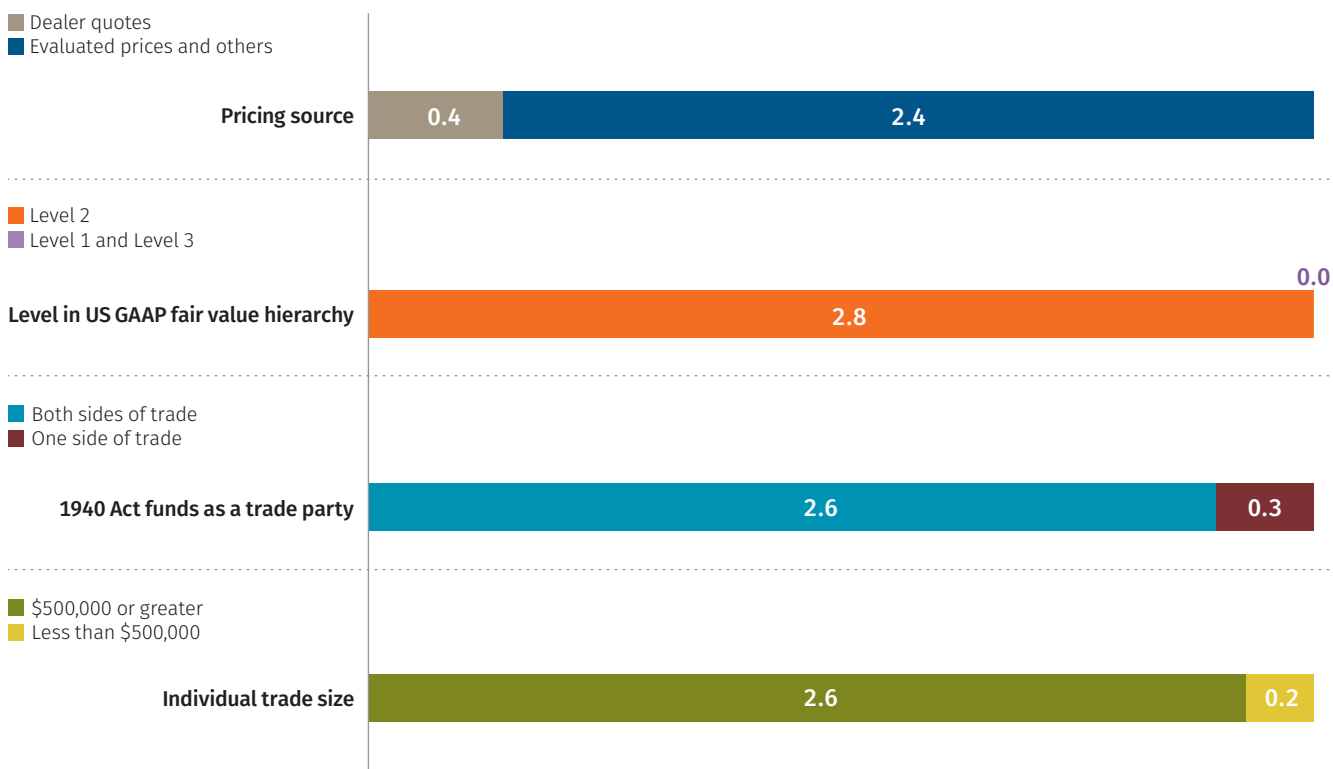
We estimate that these trades saved funds \$10 million, and investment advisers' clients generally \$11 million.

Figure 13 below provides additional details about the funds' cross trading of this asset class.

FIGURE 13

\$2.8 Billion in Investment Grade Municipal Securities Was Cross Traded

Billions of dollars, annual, 2020



Note: Components may not add to the totals because of rounding.

Source: Investment Company Institute survey of cross trading activity

Variable Rate Demand Notes (VRDNs)

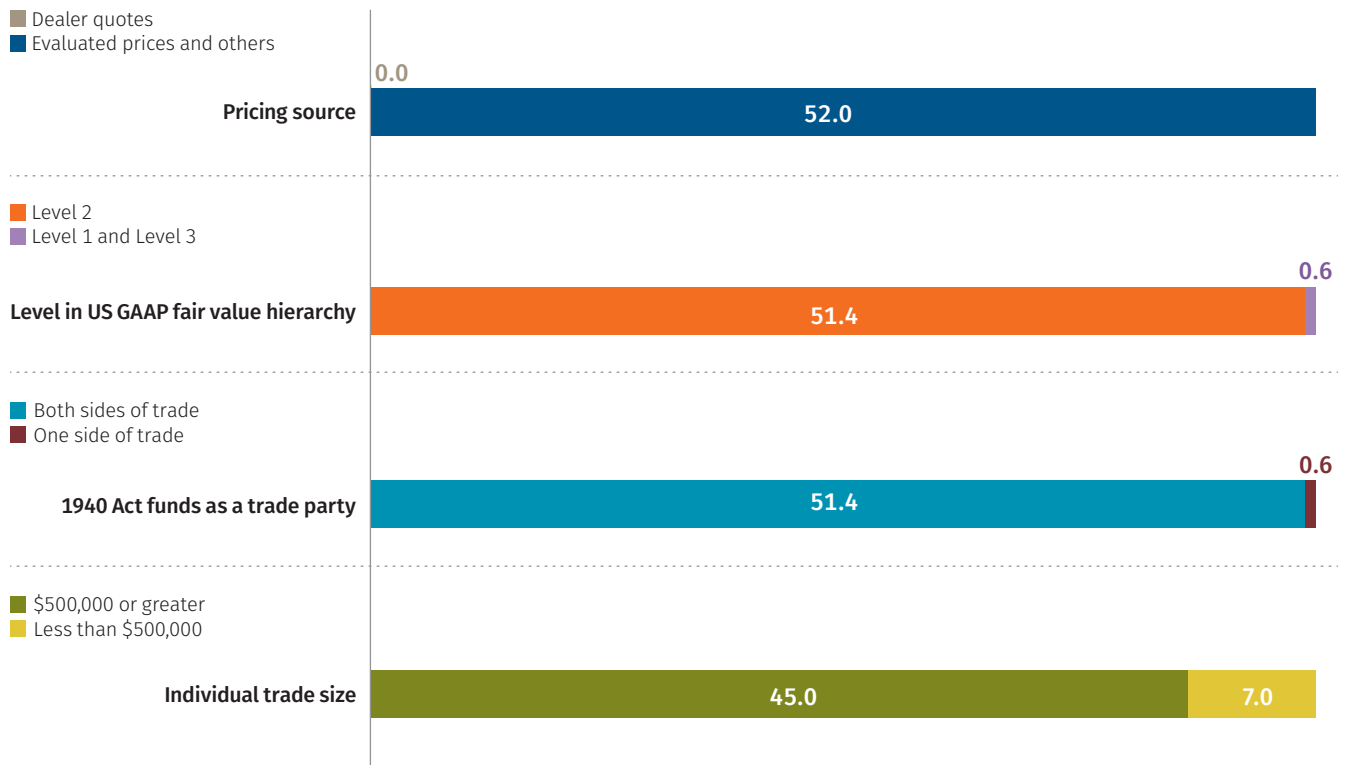
Thirty-one percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 15,525 distinct cross trades, totaling \$52.0 billion.

Figure 14 below provides additional details about the funds' cross trading of this asset class.

FIGURE 14

\$52.0 Billion in VRDNs Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

High-Yield Municipal Securities

Fifteen percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 361 distinct cross trades, totaling \$0.58 billion.

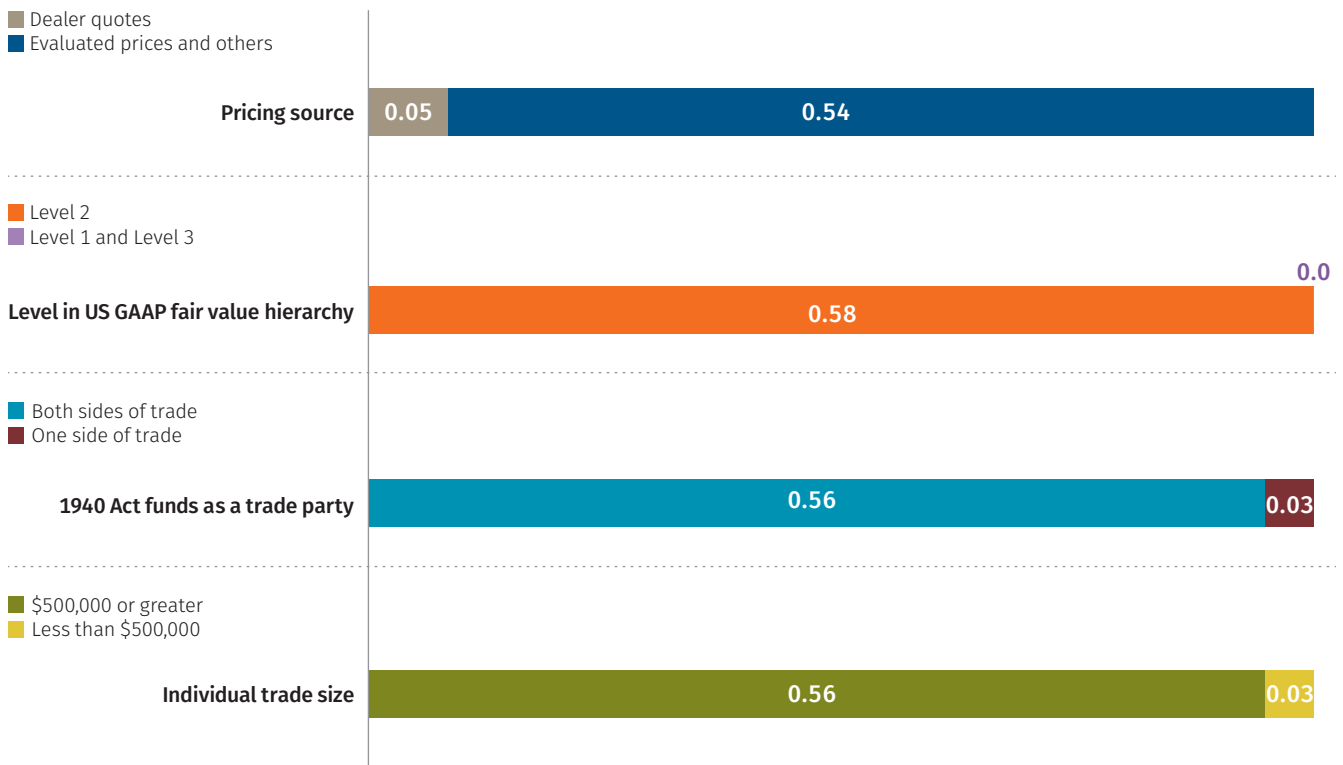
We estimate that these trades saved funds \$2 million, and investment advisers' clients generally \$2 million.

Figure 15 below provides additional details about the funds' cross trading of this asset class.

FIGURE 15

\$0.58 Billion in High-Yield Municipal Securities Was Cross Traded

Billions of dollars, annual, 2020



Note: Components may not add to the totals because of rounding.

Source: Investment Company Institute survey of cross trading activity

Investment Grade Corporate Securities

Thirty-three percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 12,025 distinct cross trades, totaling \$71.0 billion.

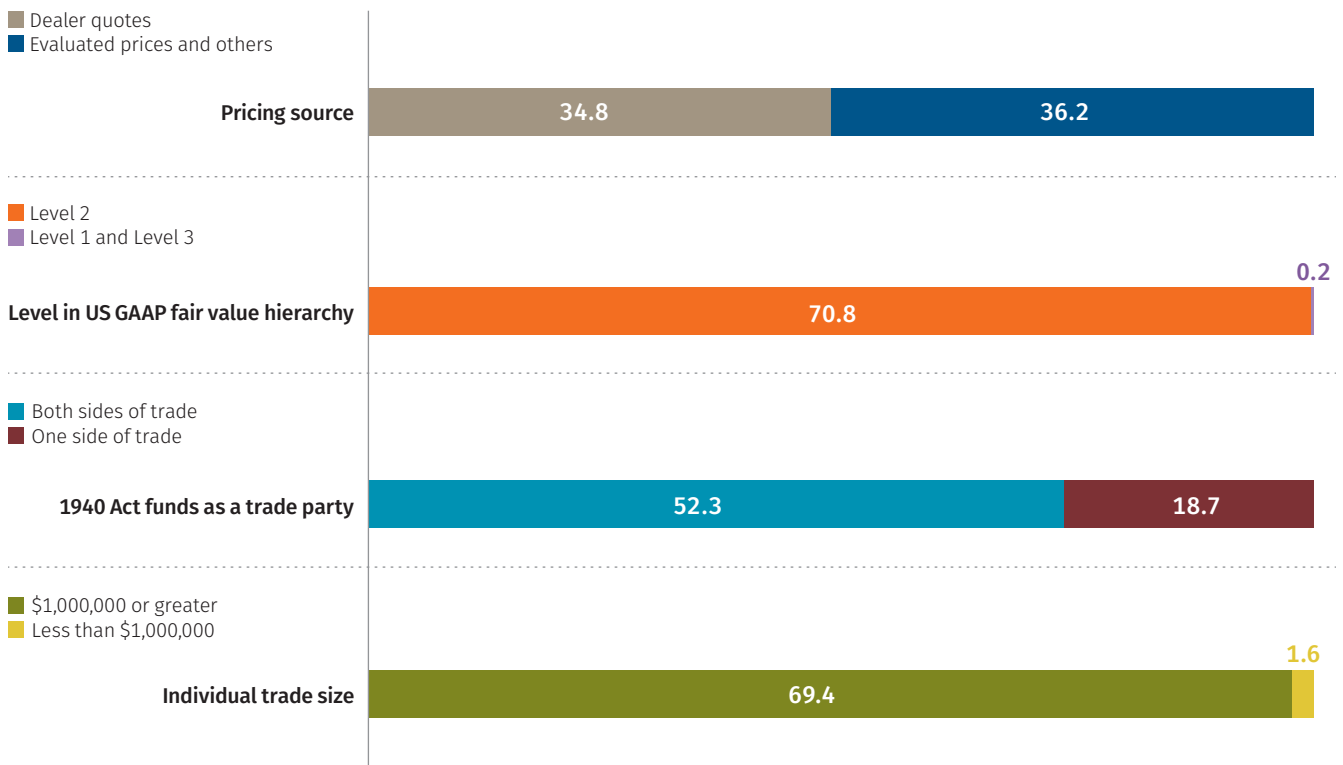
We estimate that these trades saved funds \$222 million, and investment advisers' clients generally \$255 million.

Figure 16 below provides additional details about the funds' cross trading of this asset class.

FIGURE 16

\$71 Billion in Investment Grade Corporate Securities Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

High-Yield Corporate Securities

Twenty-nine percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 10,169 distinct cross trades, totaling \$5.9 billion.

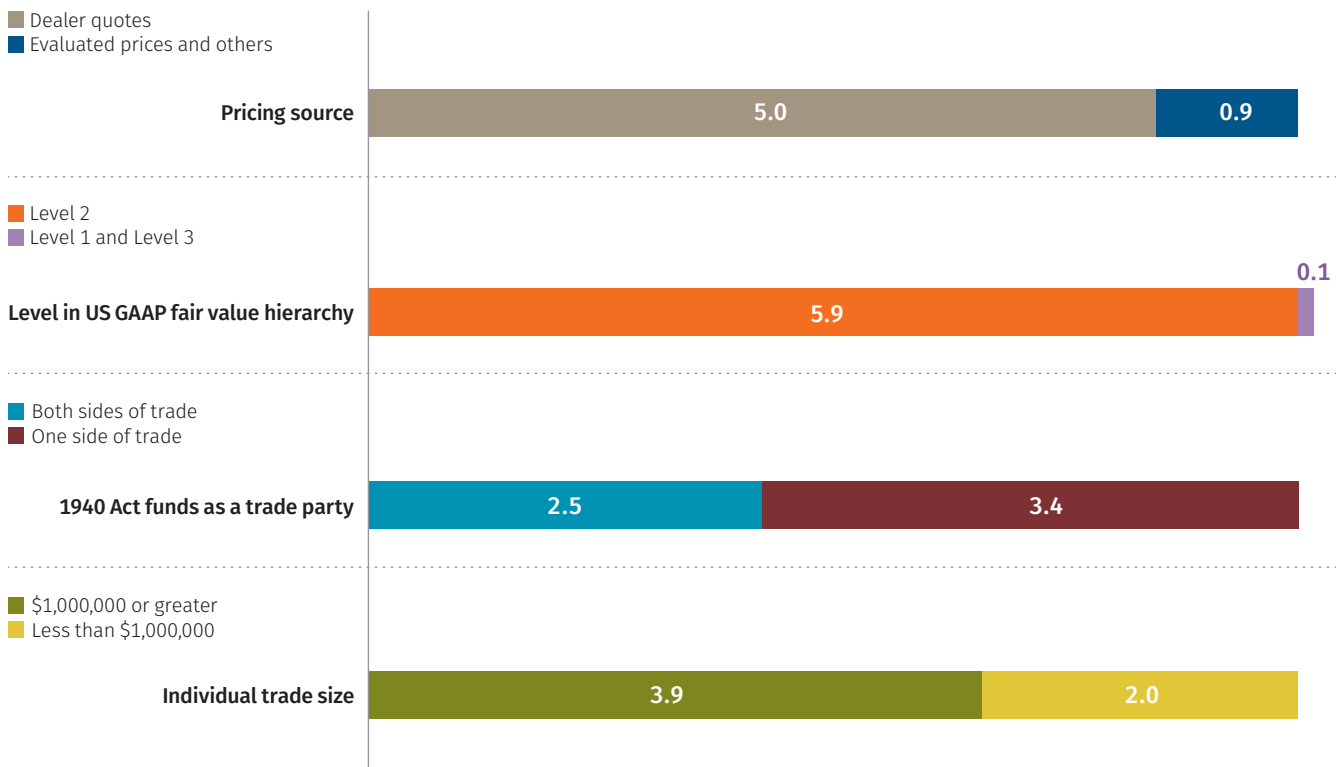
We estimate that these trades saved funds \$17 million, and investment advisers' clients generally \$23 million.

Figure 17 below provides additional details about the funds' cross trading of this asset class.

FIGURE 17

\$5.9 Billion in High-Yield Corporate Securities Was Cross Traded

Billions of dollars, annual, 2020



Note: Components may not add to the totals because of rounding.

Source: Investment Company Institute survey of cross trading activity

Other Mortgage-Related Securities (e.g., Private Mortgage-Backed Securities and Collateralized Mortgage Obligations)

Twenty-three percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 775 distinct cross trades, totaling \$4.1 billion.

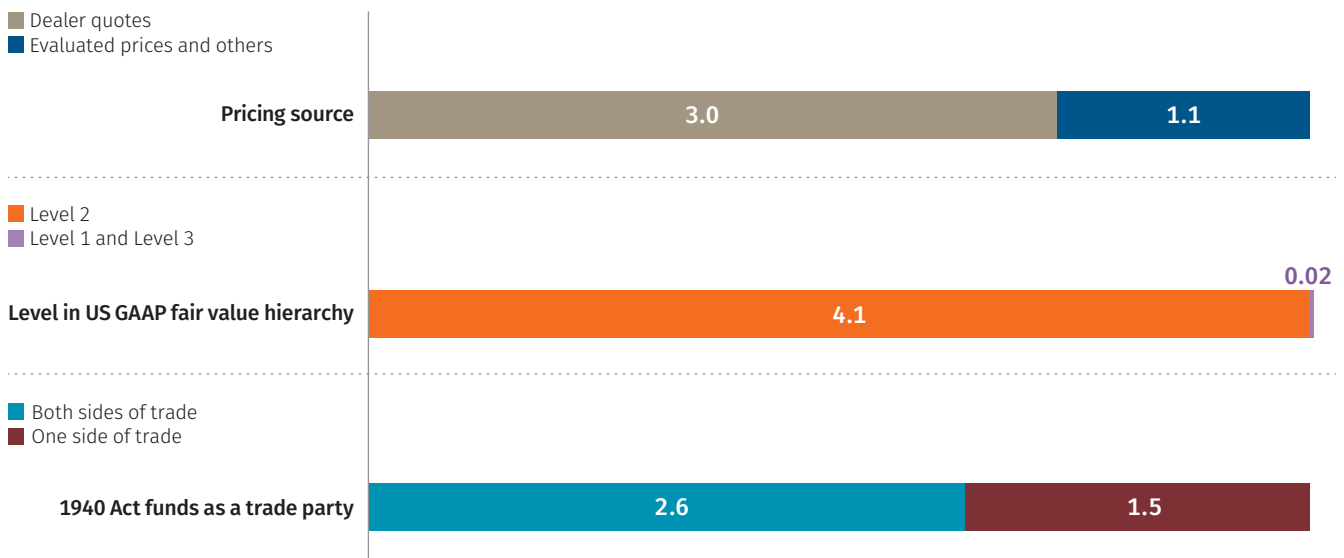
We estimate that these trades saved funds \$4 million, and investment advisers' clients generally \$5 million.

Figure 18 below provides additional details about the funds' cross trading of this asset class.

FIGURE 18

\$4.1 Billion in Other Mortgage-Related Securities Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

Other Asset-Backed Securities (e.g., Collateralized Loan Obligations)

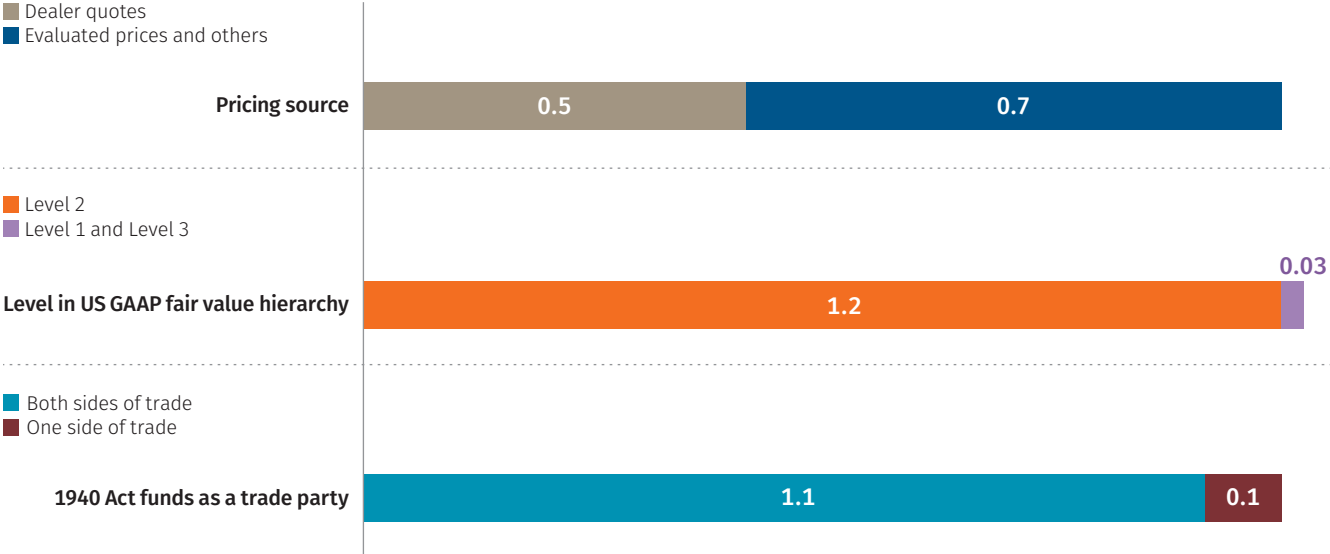
Twenty-one percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 302 distinct cross trades, totaling \$1.2 billion.

We estimate that these trades saved funds \$2 million, and investment advisers’ clients generally \$2 million.

Figure 19 below provides additional details about the funds’ cross trading of this asset class.

FIGURE 19
\$1.2 Billion in Other Asset-Backed Securities Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

International Fixed-Income Securities

Twenty-nine percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 2,887 distinct cross trades, totaling \$10.4 billion.

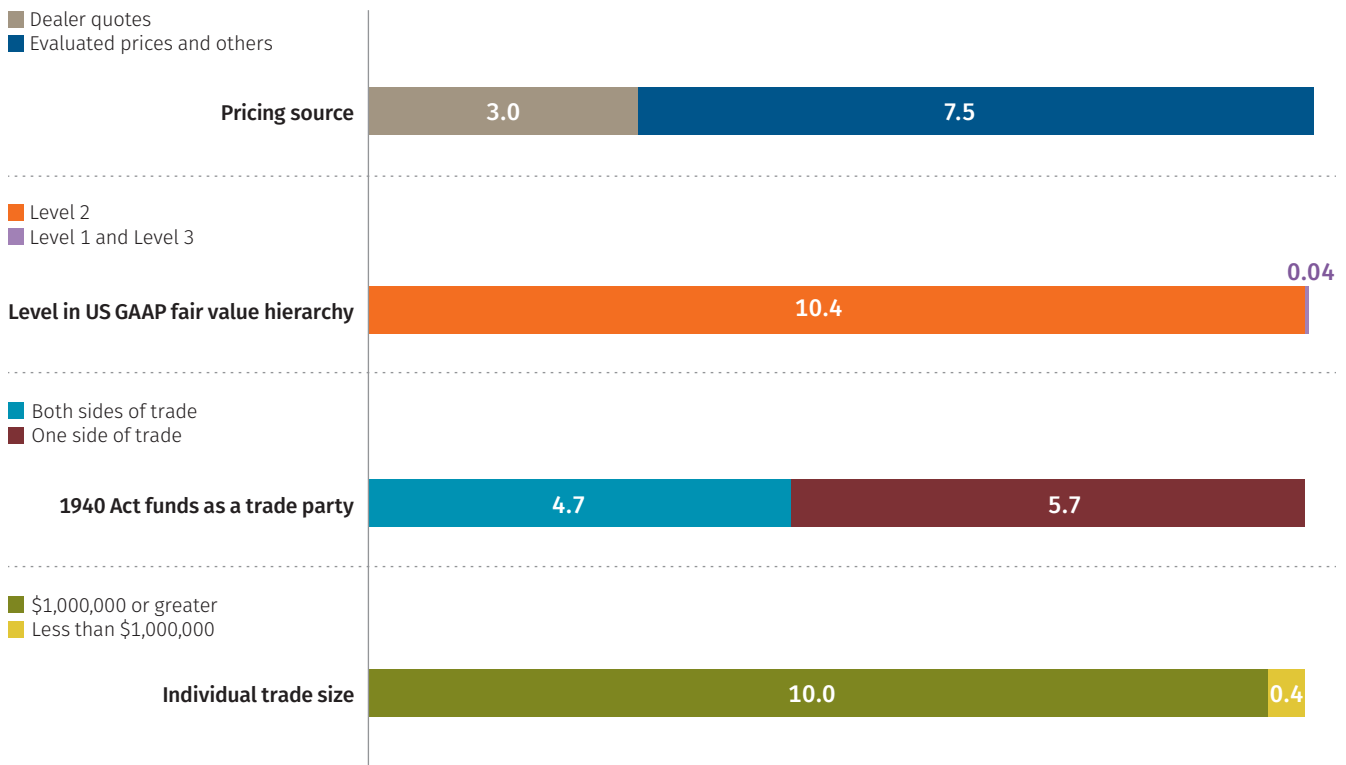
We estimate that these trades saved funds \$35 million, and investment advisers' clients generally \$49 million.

Figure 20 below provides additional details about the funds' cross trading of this asset class.

FIGURE 20

\$10.4 Billion in International Fixed-Income Securities Was Cross Traded

Billions of dollars, annual, 2020



Note: Components may not add to the totals because of rounding.

Source: Investment Company Institute survey of cross trading activity

Bank Loans

Twelve percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 624 distinct cross trades, totaling \$0.92 billion.

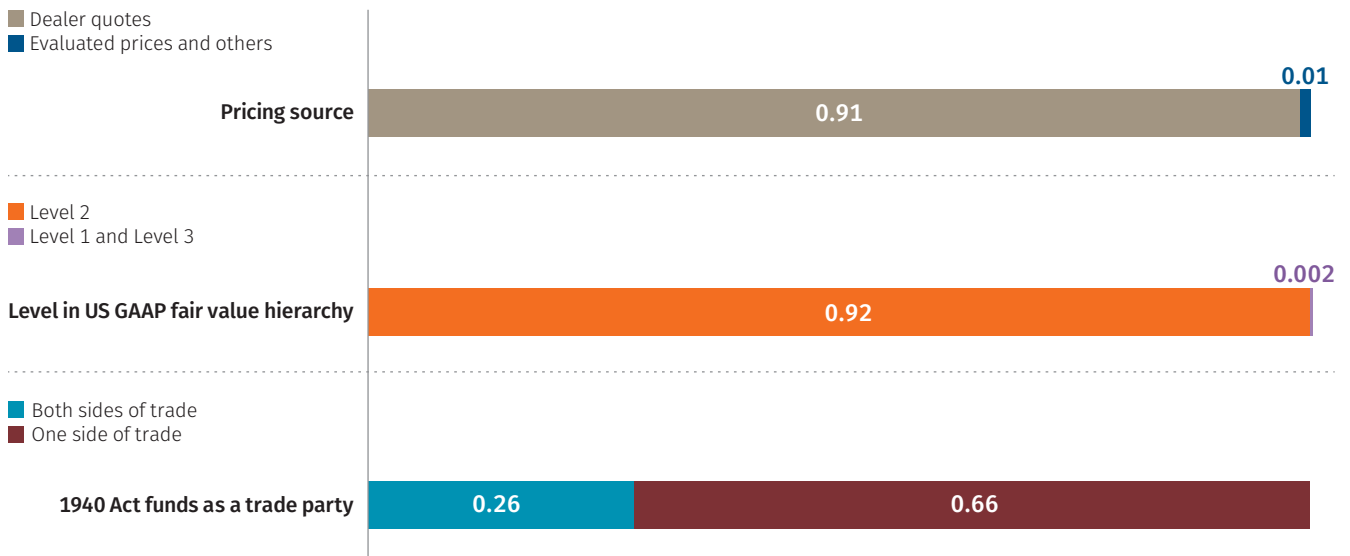
We estimate that these trades saved funds \$9 million, and investment advisers' clients generally \$15 million.

Figure 21 below provides additional details about the funds' cross trading of this asset class.

FIGURE 21

\$0.92 Billion in Bank Loans Was Cross Traded

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of cross trading activity

Commercial Paper and Certificates of Deposit

Twelve percent of respondents reported cross trading activity in this asset class in 2020. Those that cross traded securities in this asset class reported 56 distinct cross trades, totaling \$1.8 billion.

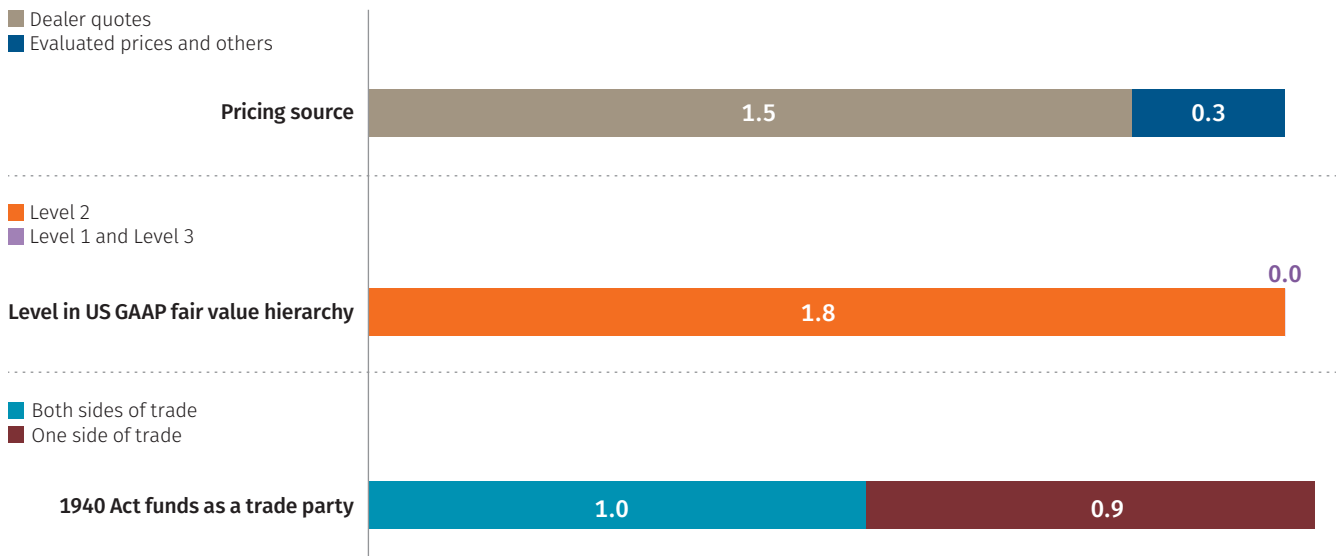
We estimate that these trades saved funds \$0.1 million, and investment advisers' clients generally \$0.2 million.

Figure 22 below provides additional details about the funds' cross trading of this asset class.

FIGURE 22

\$1.8 Billion in Commercial Paper or Certificates of Deposit Was Cross Traded

Billions of dollars, annual, 2020



Note: Components may not add to the totals because of rounding.

Source: Investment Company Institute survey of cross trading activity

Appendix C: Funds' Current Cross Trading Practices

In Section VI, we offer several recommendations for a reimagined cross trading rule, including requiring risk-based policies and procedures for evaluating and pricing cross trading opportunities.

Below we describe certain practices that funds and advisers use to comply with the cross trading rule and mitigate related risks. These are *not* meant to be grist for rule requirements, and we do not suggest that they are “best practices.” Again, the risks associated with cross trading vary by asset class, fund, market conditions, and organizational structure. And to a considerable extent, these mitigants may overlap. Consequently, we do not believe any single “right” set of risk mitigants exists for any fund complex, fund, or transaction, and each mitigant would not be appropriate under all circumstances.

Even so, we wish to highlight some well-developed practices, which some funds would use if the SEC were to require risk-based policies and procedures, as appropriately tailored to a fund’s or a transaction’s specific risks.

Generally speaking, evaluation of cross trading opportunities and oversight of cross trading generally may have useful and complementary *ex ante* and *ex post* elements, as described below.

- » **Pre-trade practices.** Some funds adopt practices for all security types and transactions, even if relatively low-risk. For instance, each person or party responsible for initiating the trade on each side could identify on a pre-trade basis the reason for the trade.⁹⁸

Building on this, a fund may also wish to require additional pre-trade actions (e.g., review and approval by a specified person or entity reasonably segregated from the person initiating the trade request),⁹⁹ as the risk associated with certain classes of transactions warrants (e.g., for securities that may be more difficult to value, or during stressed market conditions).

With respect to pricing a fixed-income cross trade, funds using evaluated prices could first ensure that such prices are backed by sufficient data to support the reliability of the price (e.g., recent actual trade data or accurate dealer quotes), or compare the evaluated prices to other independent sources of information; funds using dealer quotes could first ensure that the dealer(s) supplying the quotes have

⁹⁸ This practice—which could include use of preset “reason codes,” narrative descriptions, or a combination of the two—goes beyond Rule 17a-7(c)’s requirement that a cross trade be consistent with a fund’s investment policies.

⁹⁹ Cf. Rule 2a-5(b)(2) (requiring the valuation designee to specify the titles of the persons responsible for determining the fair value of the designated investments [including their functions], and reasonably segregate fair value determinations from the portfolio management of the fund) and Rule 22e-4(a)(13) (defining the liquidity program administrator as “the fund or In-Kind ETF’s investment adviser, officer, or officers [which may not be solely portfolio managers of the fund or In-Kind ETF] responsible for administering the program and its policies and procedures...”).

In this respect, we note that fund complexes differ in their organizational structures. While independent verification of certain aspects of cross trades can be very beneficial, we would not favor this being done in any one way, because this could disadvantage smaller fund complexes in particular (e.g., some fund complexes do not have multiple portfolio managers overseeing distinct funds and accounts, or separate portfolio management and trading functions).

sufficient experience with the given security, and that the quoted price represents an actionable and accurate transaction price. Either way, the fund should have a methodology in place so that it does not have unfettered discretion in choosing pricing sources.

The practices that funds use now to determine an accurate price for a cross trade are not dissimilar to those that they use to determine an asset's value each day, for purposes of calculating the fund's NAV. If anything, we expect funds to enhance these practices, following adoption of the fair value rule.

- » **Post-trade practices.** Whether a fund will be favored or disadvantaged by a potential cross trade may not be obvious by evaluating the trade in advance (this is true of many prospective fund transactions, irrespective of how they are executed), and spotting patterns of funds being systemically favored or disadvantaged may not be possible by evaluating individual trades in isolation.

Therefore, post-trade analytics and assessment can be an important means of ensuring that cross trades are fair and appropriate for the transacting funds. Such risk-based measures may include:

- » price testing specific to Rule 17a-7 trades (if available);
- » assessing cross trading execution quality;
- » evaluating holding period information for the securities traded (e.g., to help assess whether purchases have become long-term holdings); and
- » assessing how cross trading activity affected the liquidity profiles of the purchasing funds.



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