May 6, 2021

Sarah tenSiethoff, Esq.
Acting Director
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Staff Statement on Investment Company Cross Trading

Dear Ms. tenSiethoff:

I appreciate the opportunity to provide the Staff of the Division of Investment Management ("Staff") with feedback in response to the Staff Statement on Investment Company Cross Trading dated March 11, 2021, as published on the Commission's website.

For the past three years, I have served as an Adjunct Professor of Securities Law at the Catholic University of America, Columbus School of Law, teaching Securities Regulation: Compliance, a "transition to practice" class that focuses on compliance issues of registered investment advisers, registered investment companies ("funds") and registered broker-dealers. Prior to 2018, I practiced law in the investment management field for 33 years, both as a regulator and as a private attorney representing funds, independent directors and investment advisers.

Over the course of my career, I had extensive exposure to issues relating to cross trading between funds. Having represented all sides on these issues, I believe that my experience and perspective may be helpful to the Staff as you consider possible changes to Rule 17a-7 under the Investment Company Act of 1940 (the "Act"). I am respectfully submitting this letter on my own behalf, based on my experience with the relevant law and industry practices. The comments and observations herein are my own views and are not intended to reflect the views of my former colleagues or clients.

I have chosen to limit my recommendations with respect to paragraphs (a) and (b) of the rule to changes that would allow cross trades in municipal securities to continue in appropriate circumstances.

Summary of Recommendations.

For the reasons discussed below, I believe that the Staff should recommend that the Commission update Rule 17a-7 by:

1) Amending Paragraph (a) of the rule to provide that municipal securities for which market quotations may not be readily available may nonetheless be eligible for cross-trading if the securities

a. are classified by each fund participating in the transaction as either a "Highly Liquid Instrument" or a "Moderately Liquid Instrument," as those terms are defined in Rule 22e-4 under the Act, and

b. Each participating fund and/or its adviser has never classified the securities as a "Less Liquid Investment" or as an "Illiquid Investment".

2) Amending Paragraph (b) of the rule to add a provision allowing a cross-trade in municipal securities that are fair valued by reference to an evaluated price provided by an independent pricing service to be effected at that evaluated price if it fair value would be used to calculate the selling fund's current NAV per share that is next computed if the independent pricing service has been approved, monitored and evaluated by the selling fund in accordance with Rule 2a-5 under the Act;

3) Amending Paragraph (d) of the rule by adding "or custodial" after the word transfer, thereby clarifying that customary custodial fees can be paid in connection with a cross trade; and

4) Adding new paragraph (f) to the rule, which would require the Chief Compliance Officer of each participating fund:

a. To monitor whether cross trades effected by the company are effected in compliance with rule 17a-7;

b. To report to the fund's board on the results of that monitoring no less frequently than quarterly; and

c. To promptly report any material instances of non-compliance to the company's board of directors.

The rationale and proposed application of each of these recommendations are discussed below. Proposed rule text accomplishing each of these amendments is attached to this submission.

A. **Defining Securities Eligible for Cross-Trading Without Referencing Securities for Which Market Quotations are Readily Available.**

1) Rule 2a-5 and Municipal Bonds.

As discussed by the Commission in the release adopting Rule 2a-5 under the Act, a number of the commenters on proposed rule 2a-5 raised concerns that the proposed definition of "readily available market quotations" may affect current practices on cross trades under rule 17a-7.[1] The proposed definition was adopted without change in paragraph (c) of the final rule, which provides that:

[1] *See* *Good Faith Determinations of Fair Value*, Investment Company Act Release No. 34128 (December 3, 2020)(adopting Rule 2a-5 under the Act) at text accompanying notes 356 to 363 (hereafter, "Valuation Release").

> "For purposes of section 2(a)(41) of the Act (15 U.S.C. 80a-2(a)(41)), a market quotation is readily available only when that quotation is a quoted price (unadjusted) in active markets for identical investments that the fund can access at the measurement date, provided that a quotation will not be readily available if it is not reliable."

The new definition in Rule 2a-5 raises questions about whether municipal securities can continue to be treated as securities for which market quotations are readily available. Unlike equity securities, municipal bonds trade on a decentralized over-the-counter ("OTC") market, with investors placing their orders directly with dealers. Dealers execute orders by (i) committing their own capital; (ii) in the case of a buy order, identifying a holder of the security who is willing to sell the security; or (iii) in the case of a sell order, identifying a buyer for the security.[2] Dealers receive compensation for their role through a mark-up or a commission charged on the trade.

The secondary market for municipal bonds is further complicated by the fact that municipal bonds tend to be "buy-and-hold" investments that trade infrequently.[3] Accordingly, municipal bonds typically do ***not*** trade on a daily basis, which may prevent a bond from meeting the 2a-5 definition of a security for which market quotations are readily available. However, due to the high level of investor demand for municipal bonds, many of these bonds are quite liquid and can be readily sold on the secondary market.

2) Eligibility for Cross-Trading Under Rule 17a-7.

When adopting and amending Rule 17a-7 the Commission included requirements that were intended to ensure that a cross trade transaction effected in reliance on the rule would satisfy the standard set forth in Section 17(b) of the Act for an exemption from the prohibitions of Section 17(a), namely that:

(i) the terms of the 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;

(ii) the transaction is consistent with the policy of each fund involved, as recited in the fund's registration statement and reports filed with the Commission; and

(iii) the transaction is consistent with the general purposes of the Act.

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[2] See Wu, Simon Z. and Vieira, Marcelo, *Mark-Up Disclosure and Trading in the Municipal Bond Market*, Research Paper, Municipal Securities Rulemaking Board, (July 2019) at page 3.

[3] The "buy and hold" nature of municipal bonds has been attributed to the fact that such bonds have generally presented a historically low default risk, as well as the fact that almost half of outstanding municipal bonds are held by individuals, with another 20% or so held by mutual funds. See Brancaccio,Giulia. Li, Dan and Schurhoff, Norman, *Learning by Trading: The Case of the U.S, Market for Municipal Bonds*, (Nov. 2017) at pp. 6-7, available at https://economics.yale.edu/sites/default/files/brancaccio_jmp.pdf .

Accordingly, the Commission required both that there be an active secondary market for securities being cross traded and that the cross-trade be effected at an independent current market price.

The readily available market quotations test for whether a particular security is eligible for cross-trading under Rule 17a-7 was not a part of the original rule, but was added to the rule as part of the 1981 amendments.[4] Prior to that time, Rule 17a-7 had been available only for transactions in securities that had as their principal market either (i) a national securities exchange or (ii) the OTC market if the security was entered in an inter-dealer quotation system sponsored and governed by the rules of a national securities association registered under Section 15A of the Securities Exchange Act of 1934 (the "1934 Act). Each of these categories of eligible securities, by definition, traded on an active secondary market.[5]

The Commission amended Rule 17a-7 in 1981 to make the exemption available to "any transaction in a security for which market quotations are readily available" as long as the transaction was effected at the current market price as defined in the rule and the other conditions of the rule were met.

The rationale for using the phrase "security for which market quotations are readily available" to describe securities that qualify for cross-trading was described by the Commission as follows:

> "By limiting the purchases or sales authorized under rule 17a-7 to securities for which market quotations are readily available and requiring the transactions to be affected (sic) at the independent current market price for such security, the Commission believes the potential for abuse would be remote. Reliance upon such market quotations provides an independent basis for determining that the terms of the transaction are fair and reasonable to each participating investment company and do not involve overreaching."[6]

The Commission went on to state its belief that it would not be appropriate to allow cross trades in securities for which market quotations are not readily available, noting that

> "[S]ince 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 amendments to rule 17a-7 should assist in the execution of intra-complex securities transactions."

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[4] *See* *Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof*, Investment Company Act Release IC-11676 (March 10, 1981)(adopting amendments to 17a-7) ("Release 11676").

[5] In fact, when adding the category for securities traded on an over-the-counter market, the Commission specified that, in addition to the security being entered in an inter-dealer quotation system, on the day of the cross-trade the quotation system had to carry at least two independent bids and offers for the securities furnished by at least two broker-dealers, thereby ensuring both the existence of an active secondary market and the availability of an independent current market price. See *Over-The-Counter Securities*, Investment Company Act Release IC-8199 (January 8, 1974)(proposing amendments to Rule 17a-7 to expand the types of securities eligible for cross trading under the rule to include certain OTC securities).

[6] See Release 11676 at paragraph following footnote 7.

The "readily available market quotations" requirement in the rule was intended to ensure that there is an active secondary market for securities eligible for cross-trading and to provide an independent basis for determining that the terms of a cross-trade are fair and reasonable to each participating fund and do not involve overreaching. While the readily available market quotations test is one way of achieving these goals, the Commission's subsequent adoption and the industry's implementation of Rule 22e-4, *Liquidity Risk Management Programs*,[7] can provide another way to establish that a secondary market exists for a security and that the terms of the transaction are fair and reasonable and do not involve overreaching.

3) Rule 22e-4 – An Alternative Method of Qualifying for Cross-Trading.

Under Rule 22e-4, all registered open-end funds (other than money market funds and In-Kind ETFs) are required to adopt and implement a Liquidity Risk Management Program ("Liquidity Program") that includes policies and procedures reasonably designed to require the assessment and management of the fund's liquidity risk and that also require the fund to classify the liquidity of each of its portfolio investments, taking into account relevant market, trading and investment-specific considerations.[8] A fund is further required to review the liquidity classifications of its portfolio investments on at least a monthly basis or more frequently if warranted by changes in relevant market, trading and investment-specific conditions that are reasonably expected to materially affect the classification of one or more of the portfolio investments. A fund is also required to report the liquidity classification of each of its portfolio investments to the Commission on Form N-PORT in accordance with Rule 30b1-9 under the Act.[9]

Rule 22e-4 requires that funds classify their portfolio investments into one of four categories –

(i) ***Highly Liquid Investments***, defined to mean any investment that the fund reasonably expects to be convertible into cash in current market conditions in three business days or less, without the conversion to cash significantly changing the market value of the investment;

(ii) ***Moderately Liquid Investments***, defined to mean any investment that the fund reasonably expects to be convertible into cash in current market conditions in more than three days but in seven calendar days or less, without the conversion to cash significantly changing the market value of the investment;

(iii) ***Less Liquid Investments***, defined to mean any investment that the fund reasonably expects to be able to sell or dispose of in current market conditions in seven calendar days or less, without the conversion to cash significantly changing

[7] See *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. IC-32315 (October 13, 2016)(adopting Rule 22e-4 under the Act).
[8] See Rule 22e-4(b)(1)(ii).
[9] Information regarding the liquidity classifications assigned by a fund to its portfolio securities is not made publicly available, but can be used by the Commission in its regulatory programs, including examinations, investigations, and enforcement actions. See General Instruction F to Form N-PORT.

the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendars days; and

(iv) ***Illiquid Investments***, defined to mean any investment that the fund reasonably expects cannot be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.

The adoption and implementation of Rule 22e-4 specifically has required funds and their advisers and boards to focus on the liquidity of a fund's portfolio investments with a level of scrutiny that is substantially greater than was the case when the 1980 amendments to 17a-7 were adopted. I recommend that the Staff take advantage of the liquidity rule in the context of cross-trading, by recommending that the Commission amend Rule 17a-7 to permit cross-trading in municipal securities that (i) have been classified as either "Highly Liquid Investments" or "Moderately Liquid Investments" under the the selling fund's Liquidity Program and (ii) have never been classified as Less Liquid or Illiquid Investments. Adding such a provision to the rule would recognize the heightened level of attention on portfolio liquidity required by Rule 22e-4, allowing cross trades in municipal securities for which a secondary market exists, but that do not qualify as having market quotations that are readily available as that term is defined in Rule 2a-5.[10]

B. Effecting Cross-Trades at Evaluated Prices.

Another change to Rule 17a-7 that I recommend is an amendment to paragraph (b) of the rule to provide an alternative means of determining the independent current market price at which a cross-trade in municipal securities may be effected. Such an approach would be similar to the approach taken to price cross-trades in municipal securities under prior no-action positions taken by the Staff,[11] but, as discussed below, would differ from the relief granted in those letters in two important ways.

1) The Staff Positions.

The Staff has previously taken no-action positions under Rule 17a-7 allowing funds to engage in cross-trades in municipal securities that are effected at prices provided by an independent pricing service. In a no-action response to *United Municipal Bond Fund*, the requesting party argued that using an independent pricing service to price cross-trades in municipal securities between funds would provide a reliable method of determining the value of the securities, given the steps that funds take to verify the accuracy of the prices provided by the pricing service, which included review and approval of the methodology used by the pricing service by the fund's board of directors and the regular testing of the accuracy of the prices provided by periodically

[10] I do not recommend this change as a replacement for the readily available market quotations test in rule 17a-7, but rather as an additional means of identifying a municipal security that is eligible for cross trading under the rule. Registered investment companies that are not subject to the requirements of Rule 22e-4 (i.e. closed-end funds, In Kind ETFs and money market funds) could continue to rely upon the existence of readily available market quotations to identify securities (including, where appropriate, municipal securities) eligible for cross trading under the rule.

[11] *See* United Municipal Bond Fund (pub. avail. Jan 27, 1995) and Federated Municipal Funds (pub. avail. Nov. 20, 2006).

comparing them to prices provided by another pricing service. Based on this and other representations made by the requesting party (including that the other requirements of Rule 17a-7 would be met), the Staff granted no-action relief. In a subsequent no-action letter to *Federated Municipal Funds*, the Staff confirmed that, as long as a fund complies with the conditions of the *United Municipal Bond Fund* letter, it can use prices provided by any independent pricing service to effect cross-trades in municipal securities.

2) Recommendation re: Use of Evaluated Prices.

The amendment that I am recommending would similarly allow certain cross-trades in municipal securities to be effected at the Evaluated Prices provided by an independent pricing service, with two key differences from the approach taken in the prior no-action letters. The first of these differences is that, as described above, a municipal security for which market quotations are not readily available (as defined in Rule 2a-5) would have to be classified by each fund participating in the transaction as either a "Highly Liquid" or "Moderately Liquid" investment under Rule 22e-4. The conditions of the prior no-action positions did not explicitly address the liquidity of the municipal bonds being cross-traded. Adding this liquidity test to the rule would ensure that only municipal securities for which a secondary market currently exists would qualify for cross-trading under the rule.

The second difference between the recommended amendment and the prior no-action positions arises out of an additional requirement that I would add to the rule relating to the approval, monitoring and evaluation of independent pricing services that is required by Rule 2a-5 under the Act. When adopting Rule 2a-5, the Commission recognized that pricing services play an important role in the fair value process by providing information on evaluated prices and other information that can assist in determining the fair value of fund investments.[12] The importance of this role is amplified further in the case of funds that invest in municipal securities, due to the decentralized nature of the secondary market for municipal securities and the fact that those securities do not typically trade on an daily basis.

Rule 2a-5 requires funds that use pricing services to establish a process for approving, monitoring and evaluating each pricing service provider, as well as a process for initiating price challenges. These processes were intended by the Commission to ensure that a fund's board or its valuation designee would have a reasonable basis to use the pricing information received as an input in determining fair value in good faith. The type of robust procedures for approving, monitoring and evaluating pricing services required by Rule 2a-5, in combination with the required process for initiating price challenges when appropriate, will ensure that an evaluated price provided by an independent pricing service truly represents the current market value of municipal securities held by a fund. Such values are regularly used to calculate a fund's net asset value per share for purposes of pricing transactions in fund shares. Those values should also be recognized as an appropriate independent current market price for purposes of effecting cross-trades.

[12] See *Valuation Release*, supra note 1, at text accompanying note 98.

Accordingly, I believe that the Staff should recommend that the Commission amend Rule 17a-7 to permit cross-trades in municipal securities to be effected at the evaluated price provided by a pricing service that has been approved, monitored and evaluated by each fund participating in the transaction in accordance with the fund's procedures adopted and implemented in accordance with Rule 2a-5.[13]

C. Clarifying the Definition of "Customary Transfer Fees."

Rule 17a-7(d) currently provides that no brokerage commission, fee (except for customary transfer fees), or other remuneration can be paid in connection with a cross trade effected in reliance on the rule. However, the rule does not define or describe what is meant by "customary transfer fees," which has led to some confusion as to whether custodial fees charged in connection with a transfer of securities would be permissible under the rule. To address this confusion, I would recommend that the rule be amended to clarify that the exception is available for custodial fees charged in connection with transfers of fund securities in cross trades.

D. Reliance on a Fund's Chief Compliance Officer.

Finally, the Staff should recommend that the Commission amend Rule 17a-7 to specifically recognize the important role played by a fund's Chief Compliance Officer ("CCO") in monitoring and approving the fund's participation in cross trades. The responsibilities of a fund's CCO frequently include reviewing 17a-7 cross trades and reporting to the board on any material instances of noncompliance . I recommend that this responsibility specifically be reflected in the rule, together with a related recordkeeping requirement.

* * * *

Thank you for your consideration of the above recommendations. If you have any questions or wish to discuss these issues further, please feel free to call me at 202.302.2522 or email me at jwmurph2009@gmail.com.

Sincerely,

Jack W. Murphy

Attachment: Draft Rule Text – Marked to Show Recommended Changes.

[13] My recommendation would ***not*** allow the use of an evaluated price that has been adjusted in any way by a fund, whether by reason of a price challenge or otherwise. Allowing such adjustments could compromise the independence of the evaluated price.

Proposed Rule Text

Rule 17a-7 Exemption of certain purchase or sale transactions between an investment company and certain affiliated persons thereof.

A purchase or sale transaction (i) between registered investment companies or separate series of registered investment companies, which are affiliated persons, or affiliated persons of affiliated persons, of each other, (ii) between separate series of a registered investment company, or (iii) between a registered investment company or a separate series of a registered investment company and a person which is an affiliated person of such registered investment company (or affiliated person of such person) solely by reason of having a common investment adviser or investment advisers which are affiliated persons of each other, common directors, and/or common officers, is exempt from section 17(a) of the Act; Provided, That:

(a) The transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of:

1) a security for which market quotations are readily available; or

2) "municipal securities," as defined in section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(29), that:

i. are currently classified by each investment company participating in the transaction as a "Highly Liquid Investment" or as a "Moderately Liquid Investment" under the company's Liquidity Risk Management Program as adopted and implemented in accordance with the provisions of rule 22e-4 (17 CFR 270.22e-4) under the Act; and

ii. have never been classified by an investment company participating in the transaction or its investment adviser as a "Less Liquid Investment" or as an "Illiquid Investment" under the company's Liquidity Risk Management Program.

~~iii.~~ii.

(b) The transaction is effected at the independent current market price of the security.

1) For purposes of this paragraph the "current market price" shall be:

i. If the security is an "NMS stock" as that term is defined in 17 CFR 242.600, the last sale price with respect to such security reported in the consolidated transaction reporting system ("consolidated system") or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to 17 CFR 242.602) if there are no reported transactions in the consolidated system that day; or

ii. If the security is not a reported security, and the principal market for such security is an exchange, then the last sale on such exchange or the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day; or

iii. If the security is not a reported security and is quoted in the NASDAQ System, then the average of the highest current independent bid and lowest current independent offer reported on Level 1 of NASDAQ; or

iv. For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.

2) Notwithstanding the foregoing, in the case of municipal securities, the independent current market price of the securities may be determined by the parties to the transaction to equal an evaluated price provided for that security by an independent pricing service if:

i. the independent pricing service has been approved, monitored and evaluated by each investment company participating in the transaction in accordance with procedures adopted and implemented nby the company pursuant to rule 2a-5 under the Act (17 CFR 270.2a-5); and

ii. the evaluated price is subsequently used (in the case of a purchasing investment company) or would have been used (in the case of a selling investment company) without modification or adjustment, to calculate the investment company's current net asset value that is next computed.

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(c) The transaction is consistent with the policy of each registered investment company and separate series of a registered investment company participating in the transaction, as recited in its registration statement and reports filed under the Act;

(d) No brokerage commission, fee (except for customary transfer or custodial fees), or other remuneration is paid in connection with the transaction;

(e) The board of directors of the investment company, including a majority of the directors who are not interested persons of such investment company,

1) Adopts procedures pursuant to which such purchase or sale transactions may be effected for the company, which are reasonably designed to provide that all of the conditions of this section in paragraphs (a) through (d) have been complied with, and

2) Makes and approves such changes as the board deems necessary, ~~and~~

(f) The Chief Compliance Officer of each investment company participating in the transaction determines no less frequently than quarterly whether purchase or sale transactions made during the preceding quarter were effected in compliance with the company's procedures and the requirements of this rule and promptly reports in writing any material instances of non-compliance to the company's board of directors.

(g) The board of directors of the investment company satisfies the fund governance standards defined in § 270.0-1(a)(7); and

(h) The investment company

1) maintains and preserves permanently in an easily accessible place a written copy of the procedures (and any modifications thereto) described in paragraph (e) of this section, and

2) maintains and preserves for a period not less than six years from the end of the fiscal year in which any transactions occurred, the first two years in an easily accessible place, a written record of each such transaction setting forth a description of the security purchased or sold, the identity of the person on the other side of the transaction, the terms of the ~~purchase or sale~~ transaction, as well as the information or materials upon which the determinations described in paragraph (f) ~~(e)(3)~~ of this section were made and a copy of any report made to the board under that paragraph, together with all supporting documentation.