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Cross-Trading at a Crossroads

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Once upon a time, in 1994, when I was a young lawyer in the SEC's Division of Investment Management (Division), Office of Chief Counsel, we received a request to modify a previously granted but totally impractical no-action position addressing Rule 17a-7 under the Investment Company Act of 1940 (the 1940 Act), which allowed funds to cross-trade municipal securities. The Division granted that request in January 1995, and for a number of years, funds relied on the new position to efficiently cross-trade various fixed income securities resulting in significant cost savings to the funds and their shareholders. But 30 years later, the SEC has now limited the flexibility to cross-trade securities between affiliated funds to such an extent that fund shareholders are paying literally hundreds of millions of dollars in unnecessary transaction costs annually (to the benefit of broker-dealers) for transactions in connection with which the SEC has found no systemic abuse. It is long past time to correct this counterproductive and costly position.

This article explains the history of cross-trading guidance and relief, the subsequent reluctance to embrace cross-trading, and the eventual interpretive positions and statements that essentially drove a stake through the heart of cross-trading practices. It then offers a path forward that would right this predicament in a way that would encompass the necessary controls, while greatly benefiting fund shareholders, bringing us full circle.

Legal Framework

Section 17(a) of the 1940 Act prohibits an affiliated person of a fund, or any affiliated person of such person, from selling securities to, or buying securities from, the fund. Section 2(a)(3)(C) of the 1940 Act defines "affiliated person" to include two persons under common control. Funds that are governed by the same board of trustees (board) and managed by the same investment adviser are assumed for this purpose to be under common control with each other, and thus are first-tier affiliated persons. Accordingly, the purchase of a security by one fund directly from another within the same fund complex (a cross-trade) would constitute a prohibited principal transaction under Section 17(a), absent an exemption.

Rule 17a-7 exempts from the prohibition of Section 17(a) certain transactions between funds that are affiliated solely by reason of having a common investment adviser and/or board, subject to certain conditions. Rule 17a-7 is available solely for transactions in securities for which "market quotations are readily available," and the rule also requires that the transaction (1) be for no consideration other than cash payment against prompt delivery of a security; (2) be effected at the independent current market price of the security; (3) be consistent with the

fund's investment objectives and policies; and (4) not involve any brokerage commission, fee, or payment of other remuneration by the fund other than customary transfer fees. As applicable to fixed income securities, "independent market price" is defined in the rule as the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.[1]

History: Expanded Availability of Cross-Trading

In 1991, the SEC Staff first considered a request by affiliated funds[2] seeking to cross-trade municipal bonds for which market quotations were not readily available and thus could not be priced in accordance with the requirements of Rule 17a-7. Instead of the pricing mechanism required by the rule, the funds proposed to use the price provided by a pricing vendor, described as a hand pricing methodology, which the funds used to calculate their respective net asset values (NAVs). In July 1992, the Staff granted no-action assurances that allowed the affiliated funds to cross-trade municipal securities but not on the terms requested. The Staff instead developed its own approach to valuation, requiring that the funds value the bonds by averaging prices from (1) at least three independent matrix pricing services, or (2) at least three independent bids, or (3) at least three prices obtained from some combination of pricing services and bids.[3] However, these conditions proved to be unworkable because of, *inter alia*, the limited number of pricing services and the manual intensity of the required process.

In October 1994, as referenced in the Introduction, the United Municipal Bond Fund requested reconsideration and modification of the 1992 UMB Letter, to revert to the pricing methodology originally proposed: the use of prices provided by the vendor the funds used to calculate their respective daily NAVs. The new request noted that the Staff's pricing methodology in the 1992 UMB Letter was unworkable and impractical in a number of respects, including the lack of available pricing sources as well as that the pricing methodology would result in an artificial gain or loss for the transacting funds because the transaction price would be unlikely to match the price used for calculating the NAV. Moreover, the request noted, using the average of three bid prices would always be disadvantageous to the fund selling the security.

The pricing methodology in the request for reconsideration was described as "hand pricing" by the pricing vendor, which consisted of gathering market information about the security at issue (that is, trade execution data and the latest bid and asked quotes), in addition to the same information about other securities that had similar features. As additional controls over the integrity of the transaction prices, the adviser represented that it would test a sample of prices by reference to another pricing service (other than the vendor), and also that the fund's independent auditor would compare the aggregate of the fund's prices with an aggregate of prices from its own pricing module.

In January 1995, the Staff issued the modified relief as requested.[4] The revised position was premised on the acknowledgement that cross-trading in appropriate circumstances was beneficial to fund shareholders in that it could save transaction costs, provided that the price of the underlying bond was objectively determined, fair to both sides of the transaction, and subject to verification by an independent party. Unstated, though implied, was the premise that a calculation performed for purposes of determining the fund's daily NAV was so fundamental to the integrity of fund operations (that is, that fund holdings and fund shares be accurately valued), that it should also be able to serve as the fair price for a cross-trade between affiliated funds.

Following the issuance of UMB, numerous fund complexes called the Division's Office of Chief Counsel to ask whether the representations made in UMB could be relied on to engage in cross-trading of other types of fixed income securities such as corporate bonds. In the early years following the issuance of UMB, the response provided consistently by the

Staff (orally) was that so long as the funds adhered to the same representations articulated in UMB, the letter could be relied on by affiliated funds to engage in cross-trading of corporate bonds. Years later, however, the Staff became more reticent and refused to provide assurances informally or otherwise with respect to cross-trading fixed income securities other than municipal bonds, and indeed signaled discomfort with the position in UMB more generally.

The position articulated in UMB was affirmed many years later in a letter issued to Federated Municipal Funds.[5] The Federated request was also based on the use of evaluated prices, which incorporated pricing models specific to industry sectors and security structure, taking into account trades, if any, bid-ask quotes representing executable trade levels, and trades in comparable securities. After noting that UMB was not intended to be limited to any particular pricing vendor or methodology, and affirming the UMB position, the Staff continued by clarifying a couple of additional, related issues. Specifically, the Staff reminded advisers that they had a duty of best execution to both sides of the transaction, so that the terms of the transaction had to be advantageous to both the buying and the selling fund (that is, "most favorable under the circumstances"). The Staff also made clear that the cross-trade must be in the best interest of each fund participating in the transaction. However, the Staff never formally addressed the ability to cross-trade any other type of fixed income securities, although they were clearly aware that many funds engaged in this practice.[6]

Relevant Enforcement Actions

The SEC has ample tools at its disposal to discipline investment advisers that engage in abusive cross-trading practices. Most recently, the SEC settled an action with Macquarie Investment Management Business Trust in connection with cross-trading illiquid, odd lot collateralized mortgage obligations (CMOs).[7] The trades were effected between registered and unregistered funds at allegedly inflated prices, both internally and through interposed broker-dealers, to the detriment of the registered funds. The adviser assigned vendor prices to the CMOs without adjusting the prices for odd lot positions, which traded at a discount to the round lots. The SEC order alleged that the adviser had no reasonable basis to believe it could sell the odd lot position at the prices provided by the vendor and assigned to the cross-trades. The adviser also allegedly failed to adhere to its own internal procedures, and its actions resulted in substantial losses for the registered funds when they subsequently sold the inflated CMOs. Notably, the SEC included charges not only under Sections 17(a)(1) and (2) of the 1940 Act for prohibited affiliated transactions but also under Section 206(1) of the Investment Advisers Act of 1940 (Advisers Act), scienter-based fraud.[8]

The SEC also has previously taken action against registrants that have circumvented the requirements of Rule 17a-7 through broker-interposed trades to the detriment of one fund over another.[9] The interposed trades in *Macquiarie* suffered from the same flaws as described in the other orders; notably that they were prearranged through a broker-dealer to be repurchased at an agreed upon mark up, to the detriment of the purchasing client.[10]

Notably, the *Macquarie* settlement is the only instance where internal cross-trades were involved; the other orders involved prearranged trades through a broker-dealer. Because the Division of Examinations has been keenly focused on this issue for over two decades in its routine exams, this suggests that cross-trading abuses are rare.

Subsequent Related Regulatory Developments

Section 2(a)(41)(B) of the 1940 Act directs that a "fair value" be used for purposes of calculating the fund's NAV when market quotations are not "readily available." Rule 2a-4 under the 1940 Act defines the term "current net asst value" of a redeemable security issued by a registered investment company and, similar to Section 2(a)(41)(B), provides that "portfolio securities with respect to which market quotations

are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company."

While little guidance had been given as to how to apply or interpret any of these terms, or how evaluated prices should be considered under these standards, there was an interpretive letter issued in 2001 to the Investment Company Institute (ICI) stating that "[i]f sales have been infrequent or there is a thin market in the security, further consideration should be given to whether 'market quotations are readily available.'"[11] And, in the SEC release adopting changes to the money market fund rules in 2014, the SEC noted that "evaluated prices provided by pricing services are not, *by themselves,* 'readily available market quotations,'"[12] leaving open the possibility that evaluated prices might be considered as such in appropriate circumstances. In further support of this flexibility, the potential to use evaluated prices as the basis for cross-trading also was arguably reflected in the 2016 release adopting the liquidity risk management rules: "a fund could consider specifying [in its policies and procedures for determining liquidity] the sources of the readily available market quotations to be used to value the assets and establish specific criteria for determining whether market quotations are readily available."[13] Given the flexibility built into this statement, some in the industry anticipated that these sources could arguably include evaluated prices.

In April 2020, the SEC proposed new Rule 2a-5 to adopt a comprehensive framework for fair valuing investments for which there are not readily available market quotations, noting that the accounting guidance then in place dated back to 1970, and thus the valuation framework needed to be recalibrated to the current landscape.[14] The proposed rule defined "readily available market quotations" as "a quoted price (unadjusted) in active markets for identical investments that the fund can access at measurement date, provided that a quotation will not be readily available if it is not reliable."[15] And, in the Rule 2a-5 Proposing Release, the SEC reiterated the position that "evaluated prices are not, *by themselves*, readily available market quotations,"[16] once again raising the possibility that, in certain circumstances, an evaluated price *might* represent a readily available market quotation. Notably, the older no-action positions relating to municipal bonds were not questioned. Thus, the Rule 2a-5 Proposing Release arguably left open the possibility that an evaluated price could, in certain circumstances, meet the criteria and form the basis for a cross-trade price under Rule 17a-7.[17]

Slamming the Door?

The SEC adopted Rule 2a-5 in December 2020, establishing categories of assets by available valuation factors, with Level 1 being based on readily available market quotations, and Levels 2 and 3 more derivative.[18] With respect to cross-trading, the Rule 2a-5 Adopting Release was far less encouraging than the Rule 2a-5 Proposing Release. In the Rule 2a-5 Adopting Release, the SEC stated definitively that "evaluated prices *are not readily available market quotations* as they are not based upon unadjusted quoted prices from active markets for identical investments."[19] This statement, read in the context of the Adopting Release more broadly, effectively meant that the only securities that could meet the standard set forth in Rule 17a-7 would be Level 1 assets. The SEC also acknowledged that "[w]e also understand that many cross trades today are done taking into consideration certain letters by our Staff that address, among other things, *the application of the term readily available market quotations in the context of certain transactions* under rule 17a-7. The Staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn."[20] This statement is arguably a mischaracterization of those letters, which did not, in fact, address the application of or interpret the phrase "readily available market quotations." The incoming requests and responsive no-action letters expressly acknowledge that the transactions did <u>not</u> "involve securities for which

market quotations are readily available" and that the bonds could not be priced in accordance with the definition of "current market price" included in Rule 17a-7 (hence the request for relief). Nonetheless, in those letters, the Staff took the position that the funds could engage in cross-trades based on a pricing mechanism that was deemed fair and objective given the circumstances.

After more than four years, the letters still have not been formally withdrawn. However, the text of Rule 2a-5 and the language in the Rule 2a-5 Adopting Release have renewed questions about continued reliance on UMB and Federated and the availability of Rule 17a-7 to cross-trade fixed income and other non-Level 1 assets.

Path Forward

Cross-trading fixed income securities under appropriate circumstances would enable funds and their shareholders to save a substantial amount in transaction costs—by some estimates hundreds of millions of dollars annually.[21] Indeed, by refusing to address this issue and provide clarity around permissible cross-trading, the SEC effectively shifts a substantial amount of revenue for securities dealers (and without any benefit to fund shareholders). This results in ineffective and inconsistent regulation, especially given the oblique permission to continue to cross-trade municipal bonds (given that UMB and Federated have not been withdrawn), which are often far less liquid and have less price transparency than many corporate bonds.

Many funds routinely use evaluated prices to determine NAV consistent with Section 2(a)(41) and Rule 2a-4 demonstrating that these prices also must be sufficiently accurate to be used for the purposes of cross-trade pricing. Indeed, the use of evaluated prices for purposes of calculating the fund's daily NAV was acknowledged in UMB supporting the conclusion that such prices were similarly appropriate for cross-trading. Any argument that this approach might be compromised in the context of conflicted affiliated transactions or the lack of transparency then in effect in the fixed income markets has since been addressed through advances in market structure and the rules modernizing and tightening pricing and liquidity procedures, which mitigate the opportunity to use unfair or inaccurate prices. It is thus time for Rule 17a-7 to catch up with these developments.

The sophistication and quality of pricing services, across a wide range of fixed income securities, has improved in recent years due to technological advancement. Increased transparency in the market (for example, EMMA, TRACE) and better access to market information with respect to fixed income securities has resulted in greater comfort as to the accuracy of the prices provided by pricing services; additionally, this increased transparency allows for more observable inputs to be used in the valuation of Level 2 assets. Moreover, the evaluated pricing methodology of many vendors takes into account actual transactions. Certain vendors are able to provide data feeds throughout the day that "score" bonds based on the actual number of observed bids, offers, and transactions. If these scores are clearly described and made available to funds, they could be taken into account in fund policies and procedures. For example, a fund could establish a policy that bond prices assigned a certain score or that are based on transactions within a reasonably current time frame reflect fair, independent prices for cross-trades. Of course, the odd lot versus round lot factor would have to be accounted for in any vendor price.

Arguably, the tremendous enhancements to fixed income trading liquidity and price transparency, including the vast improvements modernizing fund pricing and liquidity management, should have led the SEC to conclude that such prices may constitute "readily available market quotations" in appropriate circumstances. But, unfortunately, the language in the Rule 2a-5 Adopting Release appears to have foreclosed that outcome. As such, the cleanest solution would be for the SEC to propose a modification of the pricing provisions in Rule 17a-7 to allow for cross-trading of Level 1 and Level 2 securities in

appropriate circumstances, so long as any such trade was priced in accordance with each fund's valuation procedures. Of course, the trades would need to be in the best interest of clients on both sides of the transaction, including the duty to seek best execution.

In the meantime, the existing positions in UMB and Federated, which have not been withdrawn, arguably go beyond the technical scope of Rule 17a-7 by permitting cross-trading based on evaluated prices in circumstances where market quotations are not "readily available." While working to amend the rule, perhaps the Commission or the Staff could at least consider some temporary exemptive relief to eliminate the uncertainty surrounding these letters, possibly extending the outstanding no-action position to other types of liquid fixed income securities.

Conclusion

The steps taken by the SEC to eviscerate cross-trading fixed income securities has operated to the detriment of funds and at great cost to fund shareholders. The small number of enforcement actions in light of a practice that was highly prevalent (at least until recently), demonstrates both that there is not widespread abuse, and also that in cases of clear abuse, the SEC has the tools available to address such misconduct. Finally, the existence of a few bad actors does not justify penalizing the entire industry. Correcting this counterproductive situation should be a top priority for the next administration.

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NOTES

1 *See* Rule 17a-7(b)(4).

2 The funds were affiliated only by virtue of having the same adviser and board, consistent with the limitations in Rule 17a-7.

3 *See* United Municipal Bond Fund, Inc., SEC Staff No-Action Letter (July 30, 1992) (1992 UMB Letter).

4 United Municipal Bond Funds, SEC Staff No-Action Letter (Jan. 27, 1995), *https://www.sec.gov/divisions/investment/noaction/1995/unitedmunicipal012795.pdf* (UMB). Bonds that were in default or that had embedded derivatives were expressly excluded from the relief.

5 SEC Staff No-Action Letter (Nov. 20, 2006), *https://www.sec.gov/divisions/investment/noaction/2006/fmf112006.htm* (Federated).

6 *See* Staff Statement on Investment Company Cross Trading (Mar. 11, 2021), *https://www.sec.gov/news-room/speeches-statements/investment-management-statement-investment-company-cross-trading-031121*.

7 *Macquarie Investment Management Business Trust*, Investment Company Act Release No. 35325 (Sep. 19, 2024), *https://www.sec.gov/files/litigation/admin/2024/ia-6709.pdf* (Macquarie).

8 The order also included a number of other violations: Section 34(b) of the 1940 Act, which prohibits material misstatements (including investment performance) in SEC filings, Rule 38a-1 (the 1940 Act compliance rule), Rule 22c-1 under the 1940 Act for selling shares of registered funds at a price other than their net asset value, as well as violations of Advisers Act Section 206(2), Rule 206(4)-8 for engaging in fraud against investors in pooled investment vehicles, and Rule 206(4)-7 (the Advisers Act compliance rule).

9 *See, e.g., Palmer Square Capital Mgmt., LLC*, Investment Company Act Release No. 34017 (Sept. 21, 2020) (finding that Palmer Square "prearranged buys and sells," and while "Palmer Square sought to effect cross trades at a market price that it believed was fair to both clients," it did not engage in a process to average the bid and offer as required by Rule 17a-7); Additional facts were provided about the variability in pricing; "[f]or example, certain transactions were effected at prices informed by the prices of comparable securities or single broker quotes." A markup was also paid to the broker.

[10] *Putnam Investment Mgmt., LLC and Zachary Harrison*, Investment Company Act Release No. 33257 (Sept. 27, 2018) (prearranged trades were executed at prices more favorable to Putnam's repurchasing clients depriving selling clients of their share of the market savings); *Morgan Stanley Investment Management Inc. and Sheila Huang*, Investment Company Act Release No. 31947 (Dec. 22, 2015) (same); *Western Asset Management Co.*, Investment Company Act Release No. 30893 (Jan. 27, 2014) (same, noting that both sides of the trade were clients owed the same fiduciary duty).

[11] Investment Company Institute, SEC Staff Interpretive Letter (April 30, 2001), *https://www.sec.gov/divisions/investment/guidance/tyle043001.htm*. The letter quoted from ASR 118.

[12] *Money Market Fund Reform; Amendments to Form PF*, Investment Company Act Release No. 31166 at 286 (July 23, 2014), *https://www.sec.gov/files/rules/final/2014/33-9616.pdf* (emphasis added).

[13] *Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 at 247 (Oct. 13, 2016), *https://www.sec.gov/files/rules/final/2016/33-10233.pdf* (emphasis added).

[14] *Good Faith Determinations of Fair Value*, Investment Company Act Release No. 33845 at 8-14 (Apr. 21, 2020), *https://www.sec.gov/files/rules/proposed/2020/ic-33845.pdf* (Rule 2a-5 Proposing Release).

[15] Proposed Rule 2a-5(c). In proposing this standard, the SEC specifically noted the definition of level 1 inputs in ASC Topic 820. *See* Rule 2a-5 Proposing Release at note 129 (noting that "ASC Topic 820 defines level 1 inputs as '[q]uoted prices (unadjusted) in active markets for identical assets . . . that the reporting entity can access at the measurement date'").

[16] Rule 2a-5 Proposing Release at 59.

[17] *See generally* SEC Proposes New Framework for Fund Valuation Practices (April 30, 2020), *https://www.wilmerhale.com/insights/client-alerts/20200430-sec-proposes-new-framework-for-fund-valuation-practices*.

[18] *Good Faith Determinations of Fair Value*, Investment Company Act Release No. 34128 (Dec. 3, 2020), *https://www.sec.gov/files/rules/final/2020/ic-34128.pdf* (Rule 2a-5 Adopting Release). Level 2 assets are assets with significant other observable inputs, other than Level 1 prices, such as quoted prices for similar assets, quoted prices in markets that are not active, and other inputs that are observable. Level 3 assets are assets with significant unobservable inputs that reflect assumptions used in pricing an asset.

[19] Rule 2a-5 Adopting Release at 91 (emphasis added).

[20] *Id.* at 95 (emphasis added).

[21] The ICI estimates that in 2020 alone, funds saved nearly $329 million in transaction costs by cross trading fixed income securities. ICI, Rule 17a-7 at the Crossroads: The Right Path Forward (Apr. 2021), *https://www.ici.org/system/files/private/2021-04/33439a.pdf*.