

**MEMO# 33439**

April 20, 2021

## **ICI Submits Response to SEC Staff's Statement on Cross Trading**

[33439]

April 9, 2021 TO: ICI Members

Investment Company Directors SUBJECTS: Audit and Attest

Audit Committees

Compliance

Fixed Income Securities

Fund Accounting & Financial Reporting

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Valuation RE: ICI Submits Response to SEC Staff's Statement on Cross Trading

In December, the SEC adopted new Rule 2a-5 (the “fair value rule”) under the Investment Company Act, which addresses the fair valuation responsibilities of funds and their boards and advisers.<sup>[1]</sup> The Adopting Release discusses the implications of the fair value rule’s definition of “readily available market quotations”<sup>[2]</sup> for Rule 17a-7 (the “cross trading rule”),<sup>[3]</sup> stating that this new definition “will apply in all contexts under the Investment Company Act and the rules thereunder, including rule 17a-7.”<sup>[4]</sup> 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.” It acknowledges that funds enter into cross trades in reliance on certain SEC 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states that “[t]he staff is reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn.”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.

In March, the SEC staff issued a statement on cross trading.<sup>[5]</sup> It reiterates the above points from the Adopting Release, and requests “feedback... in evaluating what, if any, recommendations the Staff might make to the Commission in this area.”<sup>[6]</sup>

Today ICI submitted the attached response to the Staff Statement (and the SEC's December 2020 guidance) on cross trading. In our report, we explain that the SEC's December 2020 cross trading guidance in the adopting release for the fair value rule marked a sharp break from the Commission's regulatory approach to cross trading. To be eligible for cross trading under Rule 17a-7, a security must have a "readily available market quotation." But under the SEC's new definition of "readily available market quotation" (which applies for purposes of both the fair value and cross trading rules), funds' ability to cross trade fixed-income securities would be severely restricted.

We explain that regulatory action is urgently needed—without it, funds must begin complying with this new cross trading guidance on September 8, 2022. If the new cross trading restrictions take effect, funds will lose the benefits that cross trading has provided to their shareholders, including transaction cost savings and more efficient portfolio management.

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 transaction 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 over \$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. Our key findings are described in Section V. Among other things, the results show that:

- Respondents engaged in 44,976 cross trades of fixed-income securities, totaling over \$204 billion.
  - 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).
  - 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 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, 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. If the SEC staff leaves in place the 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, including 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.

- A large majority of cross trades (83 percent, in dollars) involved two registered funds, as opposed to just one fund.
- 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."

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. 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) over \$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, 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. Accordingly, 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 \$329 million to approximately \$12 million (i.e., the cross trading savings associated with investment grade and high yield municipal securities), a 96 percent decline.

Section VI describes our policy recommendations for a modernized cross trading regulatory framework with 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, the SEC could require funds to provide their boards with annual reports that 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 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 our 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.

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[Attachment](#)

## endnotes

[1] *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128, Dec. 3, 2020 (“Adopting Release”), available at [www.sec.gov/rules/final/2020/ic-34128.pdf](http://www.sec.gov/rules/final/2020/ic-34128.pdf). See also ICI [Memorandum No. 32965](#) to Members, dated December 4, 2020, for a detailed summary of the fair value rule, its companion recordkeeping rule, and their related guidance.

[2] Rule 2a-5(c) 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, provided that a quotation will not be readily available if it is not reliable.” This definition is consistent with the definition of a level 1 input in the fair value hierarchy outlined in US GAAP.

[3] Funds may enter into a cross trade in reliance on Rule 17a-7 only if the “transaction is a purchase or sale... of a security for which market quotations are readily available.”

[4] Adopting Release at 94-95.

[5] *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](http://www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121).

[6] The statement asks several questions, related to: (i) current cross trading practices; (ii) securities eligible to cross trade: pricing and liquidity; (iii) controls; and (iv) market transparency.