

March 16, 2021

Division of Investment Management Requests Comment on Rule 17a-7 Trades

On March 11, 2021, the SEC Division of Investment Management (the “Division”) issued a statement (the “[Statement](#)”) concerning fund trades made in reliance on Rule 17a-7 under the 1940 Act (“cross trades”) and soliciting “feedback on ways to enhance the regulatory regime governing investment company cross trading.” The Statement notes that consideration of potential amendments to Rule 17a-7 is on the SEC’s rulemaking agenda. The Statement’s request for feedback is important because, absent further guidance from the SEC, **Rule 17a-7 may no longer be available** for cross trades in certain fixed income securities beginning in September 2022. The Statement therefore represents an opportunity for the fund industry to provide input on potential revisions to Rule 17a-7 that could have a significant effect on their current cross trading practices.

BACKGROUND

New Rule 2a-5. In a December 2020 release (the “[Release](#)”), the SEC adopted new Rule 2a-5 under the 1940 Act (the “Valuation Rule”) to “address valuation practices and the role of the board of directors with respect to the fair value of the investments of a registered investment company” (as discussed in Ropes & Gray’s [Alert](#)). Among other things, the Valuation Rule will permit a fund’s board to designate the fund’s primary investment adviser to perform the fund’s fair value determinations. The Valuation Rule’s compliance date is September 8, 2022.

Definition of “readily available.” Under Section 2(a)(41) of the 1940 Act, if a market quotation is “readily available” for a fund’s portfolio holding, it must be valued at its market value. If market quotations are not readily available, a holding’s value is its “fair value as determined in good faith by the board.” However, the term “readily available” was not previously defined in the 1940 Act or rules thereunder. To fill this gap, the Valuation Rule provides:

For purposes of section 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 Valuation Rule’s definition of “readily available” is consistent with the definition of a “level 1” input in the fair value hierarchy under U.S. GAAP.¹ The Release stated that, “under the [Valuation Rule’s definition], a security will be considered to have readily available market quotations if its value is determined solely by reference to these level 1 inputs.” The Release specifically stated that evaluated prices, indications of interest and accommodation quotes would not be “readily available market quotations” for purposes of the Valuation Rule. The Release noted that whether a market quotation would be “unreliable” is also informed by U.S. GAAP, noting that “we will generally presume that a quote would be unreliable under [the Valuation Rule] where it would require adjustment under U.S. GAAP or where U.S. GAAP would require consideration of additional inputs in determining the value of the security.”

Additionally, the Release stated that the Valuation Rule’s definition of readily available market quotations will apply in all contexts under the 1940 Act and the rules thereunder, including Rule 17a-7. The Release recognized that, as a result, certain cross trades that could formerly have been effected in reliance on Rule 17a-7 may no longer be deemed to have

¹ FASB Accounting Standard Codification Topic 820: Fair Value Measurement (“ASC 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.”

readily available market quotations and, therefore, may be ineligible to rely on Rule 17a-7. The Release cited certain SEC staff no-action letters that permitted cross trades involving municipal fixed-income securities where market quotations were not readily available and the cross trades were effected at a price provided by an independent pricing service.² The Release went on to state that the SEC staff is “reviewing these letters to determine whether these letters, or portions thereof, should be withdrawn [and] [s]eparately, consideration of potential revisions to rule 17a-7 is on the rulemaking agenda. We welcome input from the public as we undertake our consideration of rule 17a-7.”

THE STATEMENT

Industry Response. The Statement acknowledges that the definition of “readily available” and the accompanying discussion of cross trades in the Release drew substantial industry attention. The Statement notes that industry participants accepted the SEC’s invitation in the Release to comment on the implications that the Valuation Rule would have on cross trades. The Statement reports that a number of commenters informed the SEC that funds and their affiliates “regularly engage in cross trades of certain fixed-income securities” that the commenters believed would no longer be permissible cross trades because the trades would not “qualify as having readily available market quotations under the definition of that term in the Valuation Rule.”

The Statement’s Rationale and Requests for Feedback. The Statement notes that, since the adoption of Rule 17a-7 in 1966, funds currently invest in a “greater variety of securities and other instruments, some of which did not exist decades ago,” which may present (i) greater valuation challenges and (ii) other considerations applicable to the conflicts of interest presented in cross trades. The Division believes that “funds’ cross trading practices have evolved over the last several decades” and, accordingly, “it is once again appropriate to assess what, if any, changes to rule 17a-7 may be warranted.”

The Statement solicits feedback to help evaluate what, if any, recommendations the Division might make to the SEC in this area. The Statement lists four areas where feedback would be particularly helpful. In addition, the Statement’s [Appendix A](#) (attached to this Alert) contains “additional general topics that the Staff expects to consider in connection with formulating any recommendations to the Commission” on which the Division requests comments.

The four specific areas identified in the Statement are:

1. *Current cross trading practices.* Under what circumstances do funds currently engage in cross trading? To what extent do funds’ current cross trades not have readily available market quotations as defined in the Valuation Rule? What amount of cross trading occurs between two registered investment companies as compared to cross trading between a registered investment company and another type of affiliate? What types of securities do funds currently cross trade? What types of securities do advisers believe they could cross trade under current Rule 17a-7, but choose not to rely on the rule and instead to trade in the market? What types of securities would advisers like to cross trade but believe they cannot do so under the current Rule 17a-7?
2. *Securities eligible to cross trade: pricing and liquidity.* What are the advantages and disadvantages of the threshold requirement in Rule 17a-7 that a security have a “readily available market quotation”? What sources of independent current market prices are used to cross trade securities under Rule 17a-7? What are the liquidity characteristics of securities that funds currently cross trade? Are cross traded securities valued in the same manner under Rule 17a-7 as they are under Section 2(a)(41) of the 1940 Act? What other criteria for the transactions would protect against conflicts of interest or other risks of cross trades?

² See, e.g., United Municipal Bond Fund, SEC No-Action Letter (pub. avail. Jan. 27, 1995) and Federated Municipal Funds, SEC No-Action Letter (pub. avail. Nov. 20, 2006).

3. *Controls.* What kinds of controls do advisers have in place to govern cross trading? What controls do advisers have in place to assess whether a cross trade is consistent with the adviser’s fiduciary obligation to its clients and is in the best interest of both the buying and selling fund? What controls do funds have in place to assess whether a cross trade is consistent with the investment policy of both the buying fund and the selling fund?
4. *Market transparency.* How does cross trading affect market transparency? How might transparency be enhanced for all market participants? To what extent might cross trades affect market efficiency because they are not publicly reported?

The Statement requests that comments be submitted to the Division **no later than April 12, 2021**.

OBSERVATIONS

The Statement provides an opportunity for fund complexes to comment on the impact of the definition of “readily available” and potential revisions to Rule 17a-7 on current cross trading practices. For example, to the extent that the ability to engage in cross trades of fixed income securities in reliance on Rule 17a-7 may result in significant cost savings or other benefits for fund shareholders, the Statement represents an invitation to comment on how the loss of this ability could be detrimental to fund shareholders. The Statement also represents an opportunity to address the Division’s concerns related to the potential for abuse of Rule 17a-7. For example, the Statement cited one academic study that concluded that the “price of cross-trades is set strategically to reallocate performance among sibling funds” and that “a large number of cross-trades are backdated.” However, the Statement does not cite any SEC enforcement matters that involved abuse of Rule 17a-7 (although, certainly, there have been a few).

Notably, hours after publication of the Statement, Commissioner Elad Roisman issued his own [public statement](#) in which he said:

In December 2020, I supported the Commission adopting the [Valuation Rule], to provide clearer rules for investment company boards of directors with respect to their obligations to value portfolio securities. During the comment process for that rulemaking, however, we heard that [the Valuation Rule] and its definition of “readily available market quotation” would likely affect the ability of funds to trade fixed income securities with their affiliates. These were important concerns and remain so today.

I am grateful that the staff is moving forward in reviewing Rule 17a-7 and prioritizing questions related to fixed income in particular. This past year, we have all seen that our fixed income markets are critical to the functioning of our other securities markets and our economy more broadly. I look forward to hearing insights from commenters about how we can facilitate fixed income trading in ways that benefit investors and our markets.

All of the foregoing suggests that industry participants who wish to address any new SEC skepticism regarding cross trades effected at prices provided by independent pricing services should respond to the Statement. In addition to responding to the questions in the Statement and its Appendix, it would be desirable to include hard data on commissions saved and dealer mark-ups avoided by funds to show that these cost savings, which underlie Rule 17a-7, are accruing to the benefit of funds and their shareholders.

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If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney contacts.

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Additional Cross Trade Topics of Interest to the Division of Investment Management

1. Cross trading practices

- a. Purposes for cross trading different types of securities
- b. Purposes for cross trading by investment strategy of fund, or by type of affiliated entity
- c. Connections between the ability of a fund to cross trade a security and a determination to execute a trade in that security
- d. Market conditions that make cross trading more or less beneficial to funds or their investors
- e. Prevalence of cross trading among fund complexes of different sizes
- f. Competitive advantages that cross trading may provide to certain types of funds or fund complexes

2. Pricing and liquidity

- a. Protective characteristics of pricing requirements under section 2(a)(41) and rule 17a-7
- b. Relationship between the value of securities as determined under section 2(a)(41) and under rule 17a-7
- c. Potential sources of observable pricing information that could inform the price of a security to be cross traded
- d. Potential valuation frameworks that could be used for cross trades, such as FASB Accounting Standard Codification Topic 820: “Fair Value Measurement”
- e. Role of independent pricing services or other independent pricing sources

3. Cross trading systems

- a. Potential role of trading venues or platforms in enhancing price discovery and liquidity
- b. Treatment of custodial fees or transaction fees for the funds participating in a cross trade on a venue or platform

4. Controls

- a. Existing controls that funds and advisers have in place to ensure that a cross trade is consistent with the investment strategy and targeted risk profile of each fund or affiliate
- b. Documentation and recordkeeping requirements to facilitate oversight by fund compliance, boards, and advisers
- c. Extent to which concerns about effects of cross trades on funds and their investors may vary according to the type of instrument to be cross traded or the source of pricing information

5. Transparency

- a. Reporting of cross trades to the Financial Industry Regulatory Authority’s Trade Reporting and Compliance Engine (“TRACE”), or the Municipal Security Rulemaking Board’s Real-Time Transaction Reporting System, as applicable, or other similar system that provides market transparency
- b. Transaction-specific information about cross trades, in addition to transaction size and price, that would be beneficial for market transparency

6. Potential costs and benefits

- a. Circumstances when a cross trade benefits both funds and their investors and the extent and nature of those benefits
- b. Circumstances when a cross trade could benefit one fund and its investors but harm the affiliate and its investors
- c. Differences in potential harms from cross trading depending on the type of instrument that is cross traded or the types of funds or affiliates involved in the trade