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May 6, 2021

Ms. Sarah ten Siethoff
Acting Director, Division of Investment Management
United States 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 Capital Group Companies, Inc. ("Capital Group") appreciates the opportunity to provide input on the Staff of the Division of Investment Management's (the "Staff") statement regarding the regulatory regime and practices around cross trading by investment companies. We believe this is an important area of the Investment Company Act of 1940, as amended (the "1940 Act") and are pleased the Staff is taking the opportunity to engage with the industry on issues surrounding cross trading of fixed income securities, in particular in consideration of potential amendments to rule 17a-7 under the 1940 Act.

Capital Group is one of the oldest and largest privately held investment management organizations in the United States with more than 85 years of investment experience. Through our investment adviser subsidiaries, we actively manage equity and fixed income investments across all market sectors in various collective investment vehicles and institutional client separate accounts. The vast majority of these assets consist of the American Funds family of mutual funds as well as other U.S. regulated investment companies managed by Capital Research and Management Company.

Capital Group is an active, long-term investor that uses rigorous fundamental research to identify attractive investments and manage risks. As an active manager, we strongly believe that cross trades are an important tool that assists us in seeking the best possible investment outcomes for the millions of fund investors and clients that we serve. These investors include individuals and small businesses investing for retirement, higher education, and operating needs, and who rely on pooled vehicles like mutual funds to help them meet their financial goals.

We support many of the comments submitted by the Investment Company Institute (the "ICI Letter")[1] and the Asset Management Group of the Securities Industry and Financial Markets Association (the "SIFMA Letter")[2]. In particular, we agree with the ICI and SIFMA Letters in advocating for a principles, risk-based approach to amending rule 17a-7. As discussed in more detail below, this letter provides Capital Group's perspectives on the benefits of cross trading, securities eligible to cross trade, pricing, liquidity, controls to mitigate potential conflicts of interest and market transparency considerations.

1. Benefits of cross trading

Capital Group actively manages assets across all fixed income market sectors. In addition, most fixed income assets we manage are widely held across funds and accounts with similar or overlapping investment mandates. As a result, the breadth of funds we manage that benefit from the ability to cross trade is wide and covers most if not all major fixed income asset classes.

As described in the ICI and SIFMA Letters, one of the significant benefits of cross trading is transaction costs savings on the bid/ask spread funds would realize if the trades were executed in the market. While historically, Capital Group's cross trading activity is limited, we estimate that for calendar year 2020 funds and accounts managed by Capital Group saved roughly $13 million in transaction costs as a result of their ability to engage in cross trades. This is a significant cost savings that directly benefits the funds and their investors.

Transaction cost savings afforded by cross trades is amplified by immeasurable fund investment benefits. Cross trades allow investment managers to take advantage of investment opportunities the same way they would if they saw an attractive opportunity in the market. For example, in many parts of the fixed income market such as investment grade corporates and municipals demand outpaces supply, participants' allocations of new issue deals are routinely cut back and many bonds that managers are interested in purchasing are seldom re-traded in the market. Consequently, when bonds do become available within a fund complex, managers may have interest to add to positions where they did not receive their desired allocation. While difficult to quantify, we surmise that billions of dollars in opportunity costs would be sacrificed to the market if fixed income securities were excluded from cross trade consideration. This would be particularly impactful for long-term investment managers like Capital Group.

Capital Group uses a system of multiple portfolio managers to manage fund assets -- we refer to it as the Capital System. The advantage of having multiple managers is that it creates natural buyers and sellers as each manager seeks to implement his or her independent investment ideas. This happens not only within the same fund where there are multiple managers (*i.e.,* an intrafund not subject to rule 17a-7), but also across affiliated funds. For example, one manager may decide to sell a security for a variety of reasons -- in order to raise cash to fund higher conviction investment ideas, to adjust the duration of the portfolio, or to adjust the portfolio based on the manager's macro view and the security no longer fits with that view. On the flip side, another manager may have a different view

[1] ICI Comment Letter, April 9, 2021.
[2] SIFMA Comment Letter, April 12, 2021.

and want to add the security to increase exposure to a high conviction holding. There are also external reasons why a manager may sell a security -- to meet a client redemption or as a result of a compliance issue (*e.g.*, downgrade of a security that can no longer be held under fund guidelines). Selling these securities in the market does not make sense when another fund has interest in purchasing them and, all things being equal, would otherwise do so if such securities became available. The ability to cross trade not only allows managers to implement their investment ideas, but it does so in a way that is more efficient and saves funds significant transaction costs.

2. Securities eligible to cross trade: pricing and liquidity

a. Use of term "readily available market quotations" under rule 17a-7

Under the recently adopted rule 2a-5 (the "Valuation Rule"), a security is defined as having a "readily available market quotation" if the "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."[3] This definition is consistent with the definition used for Level 1 securities in the fair value hierarchy under U.S. Generally Accepted Accounting Principles. Fixed income securities trade in over-the-counter markets and as a result most are considered Level 2 securities within the fund industry. Capital Group in fact treats most fixed income securities it invests in as Level 2 securities, with a very small percentage falling into Level 3. We currently hold no fixed income securities that would be considered Level 1.

As the adopting release to the Valuation Rule made clear, the definition of "readily available market quotation" is applicable to wherever the term is used in the 1940 Act, including rule 17a-7.[4] The result of this application, however, is that under the current construct of rule 17a-7 and based on the definition above, most, if not all fixed income securities would no longer be eligible for cross trading upon the Valuation Rule's compliance date. While we appreciate and agree with the desire to have consistency in definitions, we believe not taking into consideration the nature of the fixed income market and the fact that fixed income securities trade over-the-counter in rule 17a-7 will adversely impact funds and their investors.

Rule 17a-7 as currently structured requires a fund under subparagraph (a) to meet the threshold question of whether a cross trade involves "a security for which market quotations are readily available." As discussed in more detail below, rather than focusing on the valuation aspect at the outset, we suggest removing the "market quotations are readily available" reference from subparagraph (a) and revising the rule to require funds to adopt a principles, risk-based framework that addresses the potential conflicts of interest Section 17 and rule 17a-7 strives to protect against. Such a framework should incorporate concepts already contained in the rule such as a process for ensuring cross trades are consistent with a fund's investment objectives and guidelines and proper oversight mechanisms.[5] In other words, we would suggest starting with the investment basis for the transaction and allowing funds to implement control measures to demonstrate that the underlying

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[3] Rule 2a-5(c)
[4] Final Rule, Good Faith Determination of Fair Value, Release No. IC-34128, p. 158.
[5] *See* rule 17a-7(c) and (e).

basis for the transaction is sound. While we understand that pricing is an important component of a cross trade, as described in further detail below, we believe there are ways to address the pricing question that preserves funds' ability to cross trade while protecting against potential conflicts of interest.

b. Pricing options

Under the current 17a-7 framework, funds can utilize broker quotes to effectuate cross trades by obtaining multiple quotes and averaging the highest bid and lowest offer price.[6] We believe that broker quotes and market trades are relevant data points that should be considered for purposes of effectuating a cross trade. However, as Capital Group's traders will attest, obtaining reliable broker quotes is a challenging process. It requires outreach to multiple counterparties who do not always see the requests as a top priority because they know the inquiry will not lead to a trade being executed with them. In addition, multiple quotes are not always available for a security. For example, there may be only one or two market makers for a particular security. This does not mean however, that these market makers are not a reliable pricing source for purposes of a cross trade either directly or indirectly as discussed below.

In addition to preserving the ability to use direct market prices like broker quotes, we believe prices supplied by independent pricing vendors are a legitimate and appropriate pricing source. We are supportive of arguments contained in the ICI and SIFMA Letters on this point. We would suggest that the same valuation policies, procedures and controls for purposes of calculating a fund's net asset value can be applied to cross trades and should be the same as those that address the requirements of the recently adopted Valuation Rule which the Securities and Exchange Commission ("SEC" or "Commission") carefully considered. If an independent vendor price that an adviser determines is representative of the security's fair value under the requirements of rule 2a-5 is appropriate for purposes of calculating funds' net asset values, it should be equally as appropriate for purposes of a cross trade under rule 17a-7.

Independent pricing vendors would be subject to the same due diligence and oversight regardless of whether the prices they supply are used for purposes of calculating net asset values or conducting cross trades. The same effort would be exerted to perform due diligence and understand the vendors' pricing methodology, which as noted below includes incorporating market inputs such as trades and broker quotes. The same daily checks, periodic back-testing and reporting to valuation and investment committees as well as funds boards would also be applied.

Based on our due diligence, pricing vendors incorporate market color into the prices they supply to clients such as Capital Group. These vendor prices reflect trades, broker quotes and movements in indicators like the Treasury and municipal yield curve. Capital Group's valuation teams monitor for these same market indicators and use the same information to validate and support the prices we receive from the vendors. In addition, our traders use the same data to inform the price at which they might be able to execute a trade in the market. Given a variety of internal and external stakeholders have visibility to and are relying on the same information, we do not believe that more

[6] *See* rule 17a-7(b)(4).

credence should be put on obtaining that information directly from a broker versus a source such as an independent pricing vendor for purposes of determining the price and efficacy of a cross trade.

The Commission noted in its adopting release of rule 22e-4 of the 1940 Act (the "Liquidity Rule"), "[i]n requiring market quotations for cross-traded securities, the Commission has stated that '[r]eliance 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 or other advisory client and do not involve overreaching.'"[7] We would argue for the reasons stated above that a vendor price provided by an unaffiliated pricing vendor provides just as independent a basis for a cross trade as a broker quote.

As you are aware, the Staff has previously issued a series of no-action letters on the topic of vendor prices and cross trades.[8] We believe the concepts contained in the letters regarding the use of vendor prices should be formally extended to rule 17a-7 for all fixed income securities by broadening subparagraph (b)(4) of rule 17a-7 to allow funds to use a current market price that reflect the requirements of rule 2a-5, as well as rule 38a-1 under the 1940 Act. The letters recognized, as we described above, that pricing vendors have established processes to independently gather market information to inform the prices they deliver and advisers, as part of their normal valuation practices, have checks in place to validate that the prices are reasonable. For both the pricing vendors and investment advisers these are processes that exist across all market sectors, not just the municipal market. Accordingly, we believe the reasoning contained in the letters remains cogent and we can think of no reason why it should be limited to municipal securities and not formally applied across all sectors of fixed income. We believe connecting the cross trading rule to the valuation and compliance rules provides funds with layered and comprehensive protections against potential conflicts of interest and also creates an efficient structure that can better adapt to potential changes in the ways funds transact in the future.

c. Liquidity considerations

The Liquidity Rule adopting release stated that "it may be prudent for advisers to subject less liquid assets to careful review" before engaging in cross-trades.[9] We do not disagree that liquidity should be a consideration, however, it should not be a dispositive factor in whether a security is eligible to be cross traded. Further, we do not believe a security's placement in one of the four liquidity buckets outlined under rule 22e-4 should determine whether the security can be cross traded. In other words, the fact that a security may be deemed to be less liquid or illiquid by an adviser at a particular point in time should be considered, but it should not on its own prohibit the security from being cross traded.

There are debt instruments such as bank loans, certain municipal securities and forward commitments that may not settle within seven days and thus, under rule 22e-4, are characterized as

[7] Final Rule, Investment Company Liquidity Risk Management Programs, Release No. IC-32315, p. 244.
[8] *See e.g.,* United Municipal Bond Fund, Jan. 27, 1995; Federated Municipal Funds, Nov. 20, 2006.
[9] Final Release, *supra* footnote 7 at p. 246.

less liquid.[10] This does not mean however, that there is not a legitimate investment reason for a fund to purchase the security from an affiliated selling fund, that the security does not trade or is not quoted or that the security is not effectively valued by independent pricing vendors. On the contrary, we believe in most situations funds can sufficiently demonstrate that all of these factors are satisfied despite a security being relegated to a less liquid bucket as a result of its settlement mechanics. Therefore, while we agree that the liquidity of a security should be considered, we do not believe its liquidity profile for purposes of rule 22e-4 should be the sole or determinative factor in whether a security can be cross traded. We also note that there are requirements under the risk management framework established by the Liquidity Rule that are designed to monitor the liquidity of individual positions as well as the overall liquidity of the portfolio that further protect a fund in this regard.

3. Controls

a. Risk management framework

As noted above and discussed in other comment letters submitted, we believe regulation of cross trades would be suitable for a principles based, risk management approach. Like liquidity, valuation and the use of derivatives, there is a certain amount of judgment in the overall process that lends itself to a risk-based approach that can incorporate various considerations, as well as provide for transparency and oversight. Firms should be allowed to adopt policies and procedures that address potential conflicts of interest while taking into account their investment management structure and the types of accounts they may manage. For example, as described above Capital Group employs a multiple manager system in managing investments. Having multiple managers creates natural buyers and sellers that informs our control structure and mitigates the risks of dumping or parking bonds. Other firms, however, have different management structures, such as sub-advisory arrangements, or different areas of investment focus that may lend itself to other risk management structures that may be no less sound. For this reason, we would advise against a more prescriptive rule that may unnecessarily put certain funds at a disadvantage relative to others.

b. Pre-trade controls

Cross trades should be treated like any other transaction. That is, a cross trade should be treated as if it was a trade going through the market and subject to the same pre-trade compliance checks an adviser would complete in authorizing a market trade for a fund. These checks include determining whether the trade is appropriate given a fund's investment objective and guidelines and otherwise in compliance with established investment limits. We believe there should also be a documented investment reason for every cross trade before it is processed.

Firms could also build into their own risk management framework pre-trade checks conducive to their investment management structure. For example, a firm could consider some type of

[10] *See* rule 22e-4(b)(1)(ii).

internal independent review mechanism, such as a review by a compliance officer or investment committee when the same portfolio manager is on both sides of the transaction. For securities, like U.S. government bonds that may be appropriate investments across a wide array of strategies firms may be able to develop efficient ways to notify potential internal buyers of cross trade opportunities so that such opportunities can be shared in a pro rata manner as a way to mitigate potential conflicts of interest.

Treating cross trades like other trades also means consideration should be given to whether the cross trade meets an investment adviser's best execution obligations. In our case, a selling fund always retains the option to sell a security in the market if a portfolio manager believes that is in the best interests of the selling fund and a buying manager always has the option to look for the security in the market on better terms. Best execution is built into the investment process. For example, Capital Group's portfolio managers consult with our traders and consider both qualitative and quantitative factors in determining how to best execute the manager's investment convictions. We also note that advisers have a fiduciary duty to the funds they manage and the duties of care and loyalty, along with other reasonable post-trade checks provide additional safeguards from a best execution perspective.

c. Post-trade controls

A cross trade risk management program could also encompass post-trade controls suitable to the investment adviser's situation. For example, a system or an individual separate from the investment management process could perform a post-trade check to confirm compliance with applicable investment limits and that the adviser's valuation policy and procedures were appropriately applied to the cross trade. There could also be reporting to internal groups such as investment committees, lead portfolio managers, chief investment officers and fund chief compliance officers to provide transparency and oversight.

We note that rule 17a-7 and Staff guidance already provide a mechanism for chief compliance officers to certify to a fund's board that cross trades were accomplished in compliance with a fund's cross trade policy. Both the selling and buying fund in a cross trade has a Board that has a fiduciary responsibility to the respective fund even if the Board members are the same. As such, we believe the existing requirement to report cross trades to a fund's board also provides a control to mitigate against potential conflicts of interest. As discussed below, cross trades could be subject to further transparency and oversight if relevant data is reported to the SEC. We also note that in our experience cross trades come under regular scrutiny by the SEC's examination staff.

4. Market transparency

Capital Group supports the reporting of relevant cross trade data to the SEC through a new or existing form, such as Form N-PORT. However, we would not support publicly releasing such data without a time lag or requiring funds to post cross trade information to the market through platforms such as TRACE or EMMA. Unlike reporting to the SEC, we do not believe providing real time visibility to the market aids in the objective of mitigating potential conflicts of interest. On the contrary, distributing the information to the market only serves to benefit those who might want to use such information to the disadvantage of active, long-term investors like Capital Group. Publicizing cross trade information to the market discloses our confidential, proprietary investment strategies. There is no benefit that we can think of in publicizing that information if the securities are remaining in-house. If anything, publicizing this information could create noise in the market, creating false signals of changes in investment convictions that were actually discrete portfolio changes brought on for a variety of reasons, including compliance with fund or client guidelines. Accordingly, while we would again support providing relevant data to the SEC for purposes of satisfying your oversight responsibility, we believe providing the same information to the public would be detrimental to funds.

5. Conclusion

Cross trades are an important investment management tool. The benefits to funds and their shareholders outweigh the potential risks if appropriate safeguards are put in place. We believe this can be accomplished through a carefully designed risk management program. Therefore, while Capital Group supports the SEC's efforts to re-examine the regulatory framework around cross trades and potential updates to rule 17a-7, we urge the Commission to preserve the ability to cross trade fixed income securities in a manner consistent with the unique nature of the fixed income markets.

We would welcome any opportunity to discuss our views with the Commission and Staff. If you have any questions, please do not hesitate to contact us.

Sincerely yours,

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Capital Research and Management Company