CENTER FOR CAPITAL MARKETS COMPETITIVENESS®

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April 21, 2021

Mr. Brent Fields
Acting Associate Director for the Chief Counsel's Office
Division of Investment Management
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Investment Company Cross Trading

Dear Mr. Fields:

The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC) appreciates the opportunity to provide feedback to Staff of the Division of Investment Management (Staff) at the Securities and Exchange Commission (SEC) regarding investment company cross trading.

CCMC's members represent a broad range of firms whose sponsored funds are subject to the Investment Company Act of 1940 (the Act). In following the Act, our member firms' sponsored funds are subject to a wide array of regulations that include certain trading limits on investment products and guardrails to mitigate risks for investors. Many of our member firms manage fixed income funds and have relied on rule 17a-7 of the Act and associated no-action staff letters to cross trade fixed income securities. Cross trading, trading between accounts with the same investment manager, has provided meaningful savings to shareholders and liquidity to funds.

Importance of Cross Trading

Cross trading has been an important tool for the fixed income fund industry as it provides value and efficiencies to the benefit of shareholders. Among the challenges associated with fixed income investing is matching a buyer and a seller in the marketplace. In addition, many fixed income products cannot be valued based on observable quoted prices, but instead utilize evaluated prices that draw upon a wide array of data. Absent the opportunity to cross trade, funds would need to access the market for each of the buys and sells, and thereby incur transaction costs, the applicable bid-ask spread, and potentially a trade execution delay in sourcing the relevant security. For these reasons, cross trading, in accordance with rule 17a-7 and related no-action letters, is the most practical way for fund managers to trade fixed income securities, while also providing shareholders with significant cost-savings.

Rule 17a-7 importantly recognizes the benefits – lower costs and better pricing for investors and additional liquidity for funds – from cross trading practices. It also requires that certain investor protection safeguards be met for fund managers to engage in cross trades.

Given that rule 17a-7 strikes a clear balance between shareholder benefits and shareholder safeguards, we were surprised that the SEC's new final rule 2a-5 under the Act "Good Faith Determinations of Fair Value" (Fair Value Rule) upsets that careful balance on cross trading without undertaking a full cost-benefit assessment.

Consequences to Cross Trading from Rule 2a-5

Rule 2a-5 primarily adopts an updated regulatory framework for fund valuation practices. However, with the decision in rule 2a-5 to update the definition for "readily available market quotation," fund managers will see their ability to engage in cross trading, and in particular fixed income cross trading, per rule 17a-7 significantly curtailed.

Under new rule 2a-5, "readily available market quotation" means "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."[1] Thus, according to the rule release "for a fund to engage in a cross trade under rule 17a-7, the security first must have a 'readily available market quotation' and then the transaction must meet the other conditions of rule 17a-7."[2]

Implications to Shareholders, Markets, and End-Users

Conforming to the Fair Value Rule will severely limit cross trades to the disadvantage of the fixed income funds and shareholders. While the new definition of "readily available market quotation" is consistent with securities meeting Level 1 qualifications under the US GAAP fair value hierarchy, it would most likely preclude much, if not all, of the cross trading for Level 2 securities where much of the present cross trading for fixed income securities occurs. For the tens of thousands of trades currently subject to cross trading, once the new rule is fully implemented, fund managers would be required to sell securities into the market at greater cost to the funds and their shareholders.

As noted above, cross trading provides shareholders and end-users with important benefits and losing those benefits as a result of the new rule is de facto a new cost to these entities.

First, cross trading eliminates intermediary costs since a fund manager, by identifying opportunities to cross a fixed income security between accounts, is able to eliminate and internalize between the funds any bid-offer spread. Shareholders of fixed income funds, who are generally seeking capital preservation, income generation, and diversification of risk, benefit from cross trades through eliminating the bid-offer spread on those trades. Therefore, the Fair Value Rule will increase the costs to shareholders with no discernable benefit for the shareholders.

An increase in costs also has implications for the various end-users of fixed income funds. For example, the assets supporting the liabilities for many life insurance products, such as fixed income annuities and long-term care, are comprised of fixed income funds. As the costs of fixed income funds increase, the returns on these accounts, which are used to cover payments

[1] Release No. 34128, p. 158, https://www.sec.gov/rules/final/2020/ic-34128.pdf
[2] Good Faith Determinations of Fair Value, Release No. 34128, p. 107, https://www.sec.gov/rules/final/2020/ic-34128.pdf

associated with their various products, will also decrease. To minimize any return differences, end-users will likely need to seek new investments or raise the costs of these products.

Second, cross trading also enhances liquidity to the fund. By cross trading, funds are able to trade efficiently through same-day trading, to the benefit of their shareholders. The importance of having sufficient liquidity for funds was clearly demonstrated during the pandemic. As a result of the restriction on cross trades, we expect to see liquidity, especially in volatile markets when dealers may be less willing to transact, diminished to the disadvantage of funds and their shareholders.

Staff Review and Rulemaking

Given the expected savings losses to shareholders, lost trading efficiencies, and diminished liquidity as a result of the Fair Value Rule, we commend the SEC Staff for its current effort to review investment company cross trading. As the SEC evaluates the specific feedback it receives from various firms about their cross trading practices, pricing and liquidity, systems, controls, transparency, and costs and benefits, we encourage Staff to consider the important benefits that cross trading brings to funds and their shareholders.

In addition, we understand that the SEC's rulemaking agenda includes consideration of further revisions to cross trading under rule 17a-7.[3] We welcome a formal rulemaking process on cross trading that allows for both industry input and implements a full cost-benefit analysis. Given the critical importance of the fixed income markets to the functioning of the securities markets and economy as a whole,[4] any such review should recognize the important benefits of cross trading in preserving value and in minimizing costs to shareholders. Revisions should ensure that rule 17a-7 continues to be a viable framework from which fund managers can effectively engage in cross trades. Moreover, in light of the changes fixed income managers will already need to make to comply with the Fair Value Rule, by the compliance date of September 8, 2022, we encourage the SEC to align the timing of further changes impacting cross-trades in order to minimize overlapping or inconsistent compliance modifications required of fund managers.

CCMC thanks you for considering our comments and welcomes answering any questions on this issue.

Sincerely,

K. Malinconico

Kristen Malinconico

[3] Release No. 34128, p. 158, page 95.

[4] Commissioner Elad L. Roisman, Statement on Fixed Income Trading and Investment Company Act Rule 17a-7, https://www.sec.gov/news/public-statement/roisman-statement-rule-17a7-031121