WELLINGTON MANAGEMENT COMPANY LLP
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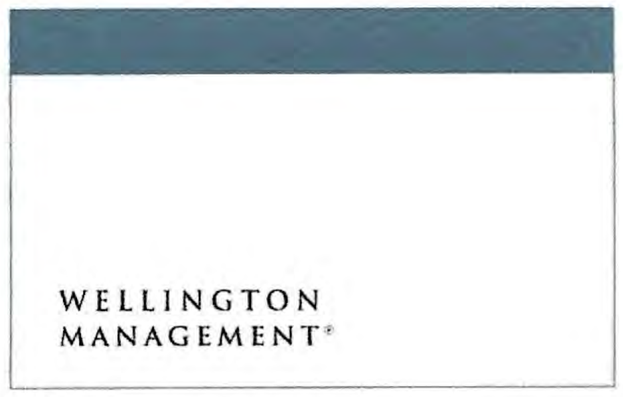

12 April 2021

Acting Director Sarah ten Siethoff
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

VIA E-MAIL: IM-Rules@sec.gov

Re: **Staff Statement on Investment Company Cross Trading and Request for Comment**

Dear Ms. ten Siethoff:

Wellington Management Company LLP ("**Wellington Management**")[1] appreciates the opportunity share our views with the staff (the "**Staff**") of the Securities and Exchange Commission ("**SEC**" or the "**Commission**") regarding the regulation of investment company cross trading. Registered investment companies ("**funds**") are only permitted to engage in cross transactions under the exemption provided by Rule 17a-7 under the Investment Company Act of 1940, as amended (the "**1940 Act**"). We strongly support the Staff reassessing Rule 17a-7, especially in light of the adoption of provisions in new Rule 2a-5 that would substantially limit the ability for US mutual funds to effect cross trades of fixed income securities.

We believe cross trading is a valuable tool that can substantially reduce transaction costs for our clients, provide additional sources of liquidity and promote efficient portfolio management. Unfortunately, the requirements currently imposed by Rule 17a-7 do not permit funds to fully capture these benefits. We also note that funds are the primary vehicle through which retail investors can access credit exposure, and Rule 17a-7 does not restrict crossing for other types of accounts. As a result, we are concerned that Rule 17a-7, without amendments, will create structural disadvantages for retail investors in the United States.[2] Therefore, we urge the Staff to recommend that the Commission adopt amendments to Rule 17a-7 not only to ensure that funds may continue to effect cross trades of fixed income securities after the compliance date of new Rule 2a-5, but also to extend Rule 17a-7 to allow funds to more frequently take advantage of the ability to execute cross transactions.

In sum, we recommend the Staff consider four targeted amendments to Rule 17a-7:

- Eliminate the requirement that cross trades may only be executed for "securities for which market quotations are readily available";
- Strengthen the Rule 17a-7 pricing requirements to require:

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1 Wellington Management is a registered investment adviser structured as a private partnership. We are privileged to serve as subadviser to over 200 US mutual funds representing over $500 billion in mutual fund assets and over $1.15 trillion in client assets globally across a wide variety of equity, fixed income and asset allocation strategies.

2 We note that in the European Union it is an accepted practice to use pricing services for cross trades.

- cross trades to be executed at a "current market price" established after reasonable inquiry, which may include reference to a price provided by an independent data provider, so long as the vendor price has been validated by reference to other observable market inputs; and
- subject to the investment adviser's duty of best execution;

- Strengthen the investor protection provisions of Rule 17a-7 to require enhanced policies, procedures and board reporting; and
- Permit the payment of nominal transaction fees for operational services performed by third-parties in connection with executing a cross trade.

BENEFITS OF CROSS TRADING FOR FUNDS

Transaction Cost Savings

Cross trading equity securities relieves the crossing parties from the obligation to pay commissions;[3] cross trading fixed income securities allows the parties to transact without paying a "spread" between the prevailing bid and ask. For investment grade fixed income, our clients typically save around 10 basis points of spread by effecting transactions as cross trades; the savings for high yield transactions is even greater at approximately 23 basis points. As discussed in more detail below, the current pricing requirements in Rule 17a-7 make cross trades for funds too challenging for us to effect in scale, but were we permitted to execute cross trades based, in part, on a vendor price, we would expect to be able to save our fund clients, in the aggregate, anywhere from $3.5 million to $25 million per year, depending on underlying client trading activity.

In addition to the explicit savings, cross trading can provide more immediate transactions, allowing funds to benefit from faster execution. In fact, where cross trading is prohibited, we have adopted procedures to avoid inadvertent cross trades by sequencing transactions in such a way as to minimize the possibility that selling funds would sell securities to indirectly to buying funds we advise. This can, especially in fixed income markets, add days or weeks to transactions that could, if crossing were permitted, be accomplished almost immediately.

Additional Source of Liquidity

Crossing creates new liquidity opportunities because investment advisers to funds are able to access organic buyers and sellers among their own client base. This is an important source of liquidity because as markets have evolved in the 13 years since the 2008 financial crisis, structural changes have created disincentives for broker-dealers to maintain inventory of fixed income securities. Since the financial crisis in 2008, broker-dealers have become primarily owned by bank holding companies, who are have become subject to requirements with respect to the utilization of their capital. We estimate that broker dealer inventory is now significantly less than the assets we manage for clients. Specifically, we estimate that the aggregate high yield corporate bond position among our trading counterparties is approximately $3 billion. As of April 2021, our clients' positions in high yield corporate bonds total approximately $40 billion. In investment grade, the numbers are similar, almost $10 billion of counterparty inventory versus approximately $125 billion of assets we manage.

As a result, cross trading allows us to access a liquidity pool that is almost 12 times as deep as the inventory held by broker dealers. This additional source of liquidity is advantageous in normal market conditions, but can be a critical safety valve in times of market stress. We estimate that had Rule 17a-7 offered flexibility to effect cross trades based on vendor prices (as discussed below), in the market turmoil in March of 2020 we could have used cross trades to move positions more quickly and save our clients, in the aggregate, around $10 million.

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[3] We note that some international markets require brokers to effect cross trades and charge commissions.

Efficient Portfolio Management Practices

Funds with the same investment adviser may have crossing opportunities for a variety of legitimate reasons. For example, as time progresses, a long term-bond will become a medium-term bond and ultimately, a short-term bond. As it progresses through each of these categories, it becomes a viable holding for a different category of fund. Funds with long-term bond investment strategies will often seek to sell bonds that are moving into medium-term status; funds with medium-term strategies will be natural purchasers of those bonds and will seek to sell bonds becoming short-term bonds. Similarly, funds with strategies focused on credit ratings (e.g., investment grade or high yield) may have natural opportunities to transact with each other as issuers receive higher (or lower) ratings. Investment grade funds may seek to purchase securities whose credit profile has improved from high yield funds, and vice versa. In other examples, a fund may need to liquidate certain positions to meet redemption requests, and the portfolio manager of that fund may want to acquire those securities in other accounts she manages. In other cases, different portfolio managers at the same investment adviser may have differing fundamental views on a security, and one manager may be a seller of that security whereas the other may want to purchase the same security.

Another key benefit of cross trading is that, for fixed income securities, crossing allows investment adviser to retain securities that they have researched and recommended within their own client base. Fixed income markets are significantly more fragmented than equity markets, with tens of thousands of individual issuances, and the market is generally a "buy and hold" market, with transactions being driven less by opportunistic investing and more by the cash needs of the investors. As a result, once a security is sold into the market, it is often impossible to re-purchase that same security, requiring the investment adviser to research other alternatives and perhaps recommend a security that is available for purchase, but for which the adviser has less conviction.

LEGAL BACKGROUND

While cross trading can provide significant benefits to funds, it also presents the possibility for transactions that involve overreaching, a primary policy concern underlying Section 17(a) of the 1940 Act. This overreaching can generally take two forms: (i) crossing at a disadvantageous price determined by an affiliate (i.e., the investment adviser); or (ii) "dumping" or "parking" transactions that are not in the best interests of one or more of the participating funds.

Pricing is a concern because cross trades are not necessarily representative of an arm's length negotiation as would be the case for a market transaction. Instead, the investment adviser determines a price for both funds. An unscrupulous adviser, could, for example, direct a less favored fund to purchase undesirable securities from a favored fund at an inflated price relative to what such securities would cost at the market.

"Dumping" and "parking" represent transactions that are not in the best interests of one or both of the participating funds. "Dumping" transactions occur where an unscrupulous adviser, for example, directed one fund to purchase undesirable securities from another fund for the sole purpose of benefitting the selling fund and not because the purchase was in the best interests of the acquiring fund. "Parking" transactions are similar to "dumping" transactions: a fund is directed to purchase securities from another fund in order to provide the selling fund cash, for example, to pay redemptions, and those securities are later repurchased by the selling fund once its cash needs had been met.

Rule 17a-7 was intended to permit cross trades[4] subject to conditions designed to address the above regulatory concerns.[5] The original rule addressed the pricing issue by permitting cross trades to occur only with respect to securities "traded on a national securities exchange" at "the independent current market price" on such securities exchanges; it addressed "parking" and "dumping" concerns by requiring any such transaction to be consistent the investment policy of the participating fund.

In 1981, Rule 17a-7 was amended to include fixed income securities.[6] Unlike equity securities, fixed income securities are not traded on exchanges, so Rule 17a-7 was extended from applying only to securities "traded on a national securities exchange" to securities "for which market quotations are readily available."[7] In making this amendment, the Commission intended to ensure that cross trades were effected a price that was determined independently of the investment adviser.[8] In addition, since fixed income securities could not be priced by reference to a price on a securities exchange, these amendments introduced the requirement that fixed income securities be crossed at a prices representing "the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry" (the "**Reasonable Inquiry Standard**"). Over a series of no action letters and through other guidance, the Reasonable Inquiry Standard has been generally interpreted as requiring multiple firm bids and offers to establish a price for a cross trade.

SHORTCOMINGS OF EXISTING RULE 17A-7

Unfortunately, current Rule 17a-7 suffers from two shortcomings that effectively frustrate its original purpose, one new and one old. The new shortcoming relates to the adoption of a new definition of "market quotations are readily available" in new Rule 2a-5. The older shortcoming arises from the impracticality of the Reasonable Inquiry Standard in markets as they have evolved over the years since 1981 and more acutely, since the financial crisis in 2008.

Readily Available Market Quotations

The Commission recently adopted new Rule 2a-5 under the 1940 Act, which addresses valuation practices of funds. New Rule 2a-5 includes a new definition of "readily available market quotations" which is intended to apply in all contexts under the 1940 Act, including Rule 17a-7.[9] Under this new definition, a quotation is "readily available" where there are "quoted prices in active markets for identical assets," a definition consistent with level 1 inputs in the fair value hierarchy outlined in U.S. GAAP.[10] Substantially all fixed income securities are not valued based on level 1 inputs,

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4 "[I]t appears that the interests of investors will be served by the rule (§ 270.17a-7) in that it permits affiliated investment companies which heretofore may have chosen to avoid the application procedures of section 17(b) of the Act by purchasing or selling securities on the open market, thereby incurring duplicate brokerage charges, to avoid the payment of brokerage by effecting such transactions with each other." Exemption of Certain Purchase or Sale Transactions Between Affiliated Registered Investment Companies. Sec Rel No IC-4694, (Sep. 15, 1966).

5 "[The] conditions are designed to limit the exemption to those situations where the Commission, upon the basis of its experience, considers that there is no likelihood of overreaching of the investment companies participating in the transaction. *Id.*

6 Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof. SEC Rel No IC-11676. (Mar. 17, 1981).

7 *Id.*

8 "Reliance upon [readily available] market quotations provides an independent basis for determining that the terms of the transaction are fair and reasonable to each participating investment company and do not involve overreaching. If the rule were expanded to include securities for which market quotations are not readily available, the independent basis for determining the value of securities would be eliminated" *Id.*

9 Good Faith Determinations of Fair Value. Sec Rel No IC-34128 (Dec. 3, 2020).

10 *Id.* at 89 ("This definition is consistent with the definition of a level 1 input in the fair value hierarchy outlined in U.S. GAAP. Thus, under the final 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.").

and therefore will not qualify as securities with "readily available market quotations." As a result, fixed income securities will generally not be eligible for cross trading under Rule 17a-7 upon the compliance date of new Rule 2a-5. This result is somewhat ironic, as the 17a-7 limitation to securities for which "market quotations are readily available" was adopted as a way to *permit* funds to cross trade fixed income securities, but with the new definition set forth in Rule 2a-5, these same words would serve to *restrict* funds from cross trading fixed income securities.

Reasonable Inquiry Standard

The Reasonable Inquiry Standard was adopted for fixed income securities as an alternative to exchange pricing. It was intended to provide clarification to funds on the interpretation of "current market price" with respect to fixed income securities. In practice, however, the Reasonable Inquiry Standard has become a significant impediment for funds to cross trading fixed income securities at all.

The primary challenge associated with the Reasonable Inquiry Standard is the difficulty associated with obtaining the requisite bids and offers. As noted above, our observation is that dealers are carrying fewer securities in inventory and are at the same time more cautious about buying securities for their own account. As a result, they are more reluctant to offer bids to purchase securities where they have not yet identified a follow-on purchaser for those bonds. This has made obtaining bids for securities more difficult. In some instances, we may face one-sided markets, where either bids or offers may be available for a security, but not both. We have also observed that dealers are reluctant to engage in offering bids or offers on securities where we have requested both bids and offers. Dealers are less willing to commit resources to generating firm bids or offers when they do not think there is the possibility of actually effecting a transaction.

Finally, we note that many of the most significant crossing opportunities involve many different securities in a single trading opportunity. For example, a fund client may be raising cash to satisfy a large redemption request or may be changing investments to accommodate a revised or new investment strategy or a transition to a new portfolio manager. In these cases, there may be cross trade opportunities for literally hundreds of individual securities; however, we have found that obtaining a large number of bids and offers to meet the Reasonable Inquiry Standard for many securities at once so challenging as to be effectively prohibitive.

RECOMMENDATIONS

Eliminate Reference to "Readily Available Market Quotations"

At a minimum, the Staff should consider recommending amendments to Rule 17a-7 that would allow for funds to continue to effect cross trades of fixed income securities after the compliance date of new Rule 2a-5. To that end, we recommend that the "market quotations are readily available" standard be eliminated from Rule 17a-7 in favor of strengthened pricing and investor protection provisions discussed below. As noted above, this standard was adopted to ensure that cross trades were effected on the basis of an independent price. Given the exponential increase in available market data, we believe that prices can be determined on an independent basis through other means (e.g., pricing vendor), and elimination of this requirement will ensure funds are able to continue to effect cross trades after the compliance date of new Rule 2a-5.

Strengthened Cross Trade Pricing Requirements

As noted above, we believe the Reasonable Inquiry Standard required under current Rule 17a-7 is unnecessarily restrictive. We further believe that vendor prices, when validated by other market inputs, provide just as reliable (if not more reliable) of a pricing mechanism as broker quotes. Therefore, we recommend that the pricing provisions of Rule 17a-7 be amended to require the following:

- cross trades must be effected at a price that represents the "current market price" of the securities to be crossed, based on reasonable inquiry, which may include the average of current bids and offers or prices provided by an independent pricing vendor;
- if the price was provided by a pricing vendor, the investment adviser has:
    - made an independent judgment, based on observable market factors, that the price is a reasonable reflection of current market price; and
    - established oversight mechanisms over the independent pricing source, including annual reviews, back-testing and challenging prices that do not comport with the advisers' expectations of the current market price;
- the cross trade must represent best execution for all participating funds (i.e., all participating funds will realize cost savings and/or enhanced execution);

The above amendments would permit funds effect cross trades based on prices established by the existing Reasonable Inquiry Standard or by reference to a price provided by an independent third-party vendor. Critically, if a vendor price is used, the price must still be evaluated by the investment adviser to confirm it reasonably represents a "current market price." This evaluation requires the review of the vendor price against other available market inputs to determine its validity. For example, in evaluating a vendor price for a potential cross trade, the investment adviser may compare that price to recently executed prices in the same or similar securities, posted bids and offers, TRACE prints, or prices provided by other independent pricing services. In other words, the adviser must independently conclude that the vendor price is a reasonable reflection of current market price – blind reliance on vendor prices would not meet the requirements of the above recommendation.

In addition, an investment adviser who intends to utilize pricing vendors should also have established robust oversight mechanisms over the independent pricing service, including back-testing and annual reviews, similar to the vendor oversight requirements in new Rule 2a-5.[11] This oversight is designed to ensure that the adviser is aware of potential weaknesses in the pricing vendor's methodology that could suggest an unreliable price.

As an additional safeguard, the adviser must also conclude that the proposed cross transaction effected at the current market price as determined above would represent best execution for all participating funds. This requirement effectively requires the investment adviser to view the proposed price (whether determined by reference to a vendor or through obtaining sufficient bids and offers) as a bid or offer for the securities to be purchased/sold by the participating fund. If that transaction, considering all relevant factors, including, price, size and urgency of the transaction, represents best execution (i.e., better execution than could be obtained in a market transaction) for all participating funds, then and only then, could the adviser execute the transaction as a cross trade. By way of example,

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11 The adopting release for new Rule 2a-5 notes six factors that boards should generally consider in determining to use a pricing service, specifically: (i) the qualifications, experience, and history of the pricing service; (ii) the valuation methods or techniques, inputs, and assumptions used by the pricing service for different classes of holdings, and how they are affected (if at all) as market conditions change; (iii) the quality of the pricing information provided by the service and the extent to which the service determines its pricing information as close as possible to the time as of which the fund calculates its net asset value; (iv) the pricing service's process for considering price challenges, including how the pricing service incorporates information received from price challenges into its pricing information; (v) the pricing service's actual and potential conflicts of interest and the steps the pricing service takes to mitigate such conflicts; and (vi) the testing processes used by the pricing service. *Id*. at 37.

an investment adviser may conclude that a vendor price is representative of a current market price based on recent transaction information and/or posted bids and offers, but may also conclude that a cross trade at that price is not representative of best execution for the selling or buying funds where there are one-sided markets; the expectation being that pricing would move in the favor of the buying or selling funds, as applicable.

We believe that the combination of independent price validation and best execution analysis ensures that cross trades will only be executed at prices that do not represent overreaching on the part of a fund's investment adviser. In fact, we believe that these provisions would actually increase investor protection with respect to establishing cross trading prices.

Strengthened Investor Protection Provisions

We also propose that Rule 17a-7 be amended to include provisions that would mitigate the risk of overreaching transactions such as "dumping" and "parking." Specifically, we propose that funds be only permitted to effect cross trades where:

- the adviser has adopted policies and procedures to ensure that the cross trades are in the best interests of each participating fund, for example:
    - post-trade forensic testing to identify potential "dumping" or "parking" (e.g., identification of patterns of significant pricing movements or short-term round-trip transactions);
    - separating the determination of whether to execute a trade as a cross trade from the purchase or sale decision; and
    - the rationale for the transaction is documented and such documentation is maintained;
- the board of trustees of the fund receives quarterly reporting that includes information sufficient for them to evaluate the benefits of the cross trades, including:
    - the rationale for the transaction;
    - best execution analysis;
    - a description of pre-trade indicative and executable prices available, and subsequent pricing / price moves; and
    - an analysis of cross trades relative to aggregate trade performance and trends.

Under these proposed requirements, we believe it would be exceptional for "dumping" and "parking" transactions to occur undetected. The required policies and procedures would include testing to review cross trades for any evidence of overreaching. For example, a Chief Compliance Officer ("**CCO**") or her designee could review of all cross transactions that immediately preceded significant price moves or that were reversed within a short period (e.g., 30 days). Additionally, the CCO could review cross trades to ensure they aligned with the funds investment strategy and risk profile and appeared to be the product of the portfolio manager's investment process. By way of example, transactions in new types of securities effected through cross trading would could be flagged for additional review.

Concerns related to overreaching are also mitigated where the determination of whether to execute the trade as a cross trade or a market trade is made independently of the portfolio management decision to purchase or sell. In a separated structure, a portfolio manager would be unable to engineer transactions that resulted in overreaching the participating funds.

Investment advisers would also be required to document the rationale for the purchase or sale that resulted in the cross transaction. This record, which could be reviewed by the fund's CCO, board or SEC staff, would establish that the transactions had valid rationale and were in the best interests of the participating funds.

Finally, while boards should be permitted to rely on CCOs for the day-to-day compliance oversight of their funds, the board reporting that would ensure that fund boards are aware of crossing activity and can apply appropriate oversight of these transactions with sufficient raw information to detect any instances of overreaching.

Permit Funds to Pay Nominal Transaction Fees

Separate from the concerns surrounding pricing, "dumping" and "parking," we also request that funds be permitted to pay nominal transaction fees to third parties to effect cross trades. Cross trades can be operationally complex to execute and settle, especially when transacted across funds with multiple different custodians. Investment advisers do not all have the infrastructure to efficiently address these operational complexities, so investment advisers may engage broker-dealers to handle the settlement issues. In such a case, we would request that the funds be permitted to pay a nominal fee to support the administrative work associated with the trade settlement.

CONCLUSION

We appreciate the Staff's reassessment of Rule 17a-7, and we believe that amendments in line with the recommendations set forth above would create opportunities for significant savings for mutual fund shareholder while strengthening the protections against the overreaching activities Section 17(a) was intended to address. We strongly encourage the Staff to recommend amendments to the Commission in advance of the compliance date of new Rule 2a-5 to ensure that funds may continue to realize the benefits from crossing fixed income securities. We further hope that any such proposed amendments will allow funds to realize more benefits from cross trading. Please be in touch with me at the number above if you have any questions.

Sincerely,

Lance C. Dial
Managing Director and Counsel