



**March 29, 2019**

Paul Cellupica  
Deputy Director and Chief Counsel, Division of Investment Management  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

**Re: Clarification of no-action relief under Rule 17a-7**

Dear Paul,

As discussed, here is an outline relating to our request for clarification of no-action relief under Rule 17a-7. We welcome the opportunity to discuss this with you further.

**Part I. Requested relief**

1. In no-action letters, the staff (the “Staff”) of the Securities and Exchange Commission (the “Commission”) has agreed that it would not recommend enforcement action to the Commission under Section 17(a) of the Investment Company Act of 1940, as amended (the “ICA”), if registered investment companies engage in cross trades (as defined below) under Rule 17a-7 under the ICA of municipal securities for which market quotations were not readily available using a price provided by an independent pricing service as the “current market price” of the securities, subject to certain conditions.<sup>1</sup>

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<sup>1</sup> Section 17(a) of the ICA generally prohibits first and second tier affiliates of a registered investment company from selling a security or other property to, or buying a security or other property from, the registered investment company (“cross trades”). Rule 17a-7 under the ICA exempts from the prohibitions of Section 17(a) cross trades of securities that meet certain conditions. Rule 17a-7 is only available for securities “for which market quotations are readily available” (Rule 17a-7(a)) and requires that the transaction be effected at the independent current market price of the security (Rule 17a-7(b)).

The no-action letters were issued to United Municipal Bond Fund (pub. avail. July 30, 1992) (the “1992 Letter”) and (pub. avail. Jan. 27, 1995) (the “1995 Letter”) and Federated Municipal Funds (pub. avail. Nov. 20, 2006) (the “2006 Letter” and, together with the 1992 Letter and the 1995 Letter, the “Letters”). We request that the Staff confirm that this no-action relief also allows funds to engage in cross trades of other securities, in addition to municipal securities, using a price provided by an independent pricing service. We believe that this clarification is appropriate for the reasons and subject to the conditions set forth below.

## **Part II. Reasons for the relief and benefits of the relief to funds and shareholders**

1. ***The principles set forth in the Letters apply equally to other types of securities, and with greater force as pricing services have become increasingly sophisticated and have benefitted from significant technological advancements.*** In the Letters, the Staff was comfortable that pricing service prices were acceptable substitutions for market quotations for municipal bonds in an environment in which it was challenging to obtain market quotations. Since the Letters, the sophistication and quality of pricing services, across a wide range of fixed income securities, has only increased. Public trade reporting systems have expanded to cover additional asset classes and new types of information (e.g., FINRA’s Trade Reporting and Compliance Engine (TRACE<sup>®</sup>) and MSRB’s Electronic Municipal Market Access (EMMA<sup>®</sup>)) (see Letter from Interactive Data Pricing and Reference Data LLC to the Commission, p. 10 (Dec. 18, 2015) (“Interactive Data Pricing Letter”). Increased transparency and better access to market information with respect to these asset classes results in greater comfort as to the accuracy of the prices provided by pricing services (see Interactive Data Pricing Letter, p. 10). The fact that funds are generally allowed to use prices supplied by independent pricing services to determine their net asset values (“NAV”) consistent with Section 2(a)(41) of the ICA and Rule 2a-4 thereunder further demonstrates that these prices are sufficiently accurate to be used to value securities for purposes of cross trades under Rule 17a-7. Confirming that the relief in the Letters covers securities other than municipal securities would acknowledge these developments and appropriately modernize the application of Rule 17a-7.

2. ***Engaging in the increasingly cumbersome process of obtaining and using bids and quotes for purposes of compliance with Rule 17a-7 is unnecessary, given the improvements in pricing service coverage and quality.*** A reduced willingness on the part of banks and dealers to provide market pricing information (i.e., bids and offers) for some types of securities, particularly fixed income securities, has caused this information to be frequently unavailable to funds, or available only with unnecessary effort. Without the use of prices provided by pricing services, funds may have difficulty engaging in cross trades under Rule 17a-7 in these circumstances. In addition, even when funds have access to market pricing

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“Current market price” is defined in Rule 17a-7(b). For all securities other than reported securities, securities whose principal market is an exchange, and securities quoted in the NASDAQ System, the “current market price” is calculated by averaging the highest and lowest current independent bid and offer determined on the basis of reasonable inquiry (Rule 17a-7(b)(4)).

information for their securities, they should not be required to solicit multiple broker quotes and to execute cross trades at the average of the highest bid and lowest offer of these quotes when accurate and reliable prices are available through pricing services. The Letters allow the use of pricing service prices for cross trades of municipal securities for which market quotations are not readily available; the case is even stronger for confirming that this relief applies to other securities for which market transaction prices often are available and are incorporated into, thus improving the quality of, pricing service prices.

3. ***Allowing funds to engage in cross trades of securities provides benefits to funds and their shareholders.*** Although cross trading can simultaneously benefit both buyer and seller, funds may not take full advantage of Rule 17a-7 with respect to transactions in fixed income securities because of the challenges in obtaining dealer quotes (Interactive Data Pricing Letter). The Staff should confirm that the relief in the Letters covers securities other than municipal securities to allow funds and their shareholders to experience benefits such as those described below to the greatest extent possible.

a. Cross trading allows funds that are mutually interested in a securities transaction to save transaction costs and avoid generating a market impact (*see* Release No. IC-32315, *Investment Company Liquidity Risk Management Programs*, p. 243 (Oct. 13, 2016) (“Liquidity Risk Management Release”). In an open market transaction, both funds typically pay commissions and other transaction costs (*e.g.*, mark-ups or mark-downs) on their separate buy and sell transactions. In a cross trade, these costs can be reduced or eliminated for both funds (*see* 1992 Letter; Letter from Securities Industry Association to Pension and Welfare Benefits Administration, p. 3 (May 19, 1998) (“SIA Letter”). In addition, because cross trades are private transactions between funds, they are not exposed to the market and, therefore, generally do not have a market impact (*see* Liquidity Risk Management Release, p. 243).

b. Cross trading enhances a fund’s ability to complete a purchase or sale transaction that is determined to be in the fund’s best interest. If securities are sold by one fund on the open market, there is no assurance that those securities will be available to another fund wishing to purchase the securities (1992 Letter). In addition, efficiencies can be gained in cross trades by avoiding the uncertainties involved with locating counterparties for a fund’s trades and eliminating the need to break down or assemble blocks of securities (*see* SIA Letter, p. 3).

4. ***The interpretive relief is consistent with the policy goals of Section 17(a), which was designed to prevent self-dealing and other forms of overreaching of a registered investment company by its affiliates.***

a. Rule 17a-7 requires that market quotations be readily available for each cross traded security. This reflects the Commission’s view that the existence of market quotations “provides an independent basis for determining that the terms of the transaction are fair and reasonable” and “do not involve overreaching” (Release No. IC-11676, *Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof* (Mar. 10, 1981) (“Rule 17a-7 Release”). The Commission has historically declined to extend Rule 17a-7 to apply to cross trades of securities for which market quotations were not readily available and where independent current market prices were not available due to the potential for abuse (*see* Rule 17a-7 Release). The Letters, however, allow the use of a price provided by an independent pricing service for cross trades of municipal securities for which market quotations are not readily available because using such a pricing service is consistent with the principles of independence and reasonable inquiry underlying Rule 17a-7 (*see* 1992 Letter). Similarly, if a

pricing service is an independent third-party and approved by the fund's board of directors,<sup>2</sup> there is no overreaching involved if the price is used to facilitate a cross trade and the transaction price is objectively fair to both funds, just as there is no overreaching if the price is used in NAV calculation.

b. Prices from an unaffiliated third-party pricing service represent a reliable and independent evaluation of market prices for securities involved in cross trades. This helps to ensure that the investment adviser obtains best price and execution on behalf of both funds participating in the transaction.

c. Rule 17a-7 imposes certain recordkeeping requirements on funds that engage in cross trades, including that the funds maintain a written record of each transaction that sets forth a description of the security involved, the identity of the other participant to the transaction and the terms of the purchase or sale transaction (Rule 17a-7(g)). These requirements provide the Commission with a mechanism to validate the independence and reliability of prices used for cross trades and confirm that there was no overreaching involved.

d. Cross trades of securities pursuant to Rule 17a-7 are effected subject to policies and procedures that are elements of a fund's compliance program under Rule 38a-1 under the ICA. The fund's chief compliance officer is responsible for administering policies and procedures that

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<sup>2</sup> In discussing the role of a fund's board of directors in overseeing pricing services for valuation purposes, the Commission has indicated that the board has a "non-delegable responsibility" to determine whether a price provided by a pricing service represents a fair value for a fund's portfolio security (Release No. IC-31166, *Money Market Fund Reform; Amendments to Form PF*, p. 286-8 (Jul. 23, 2014)). Specifically:

Before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, the fund's board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change. In choosing a particular pricing service, a fund's board may want to assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value. In addition, the fund's board should generally consider the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities where, for example, the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.

are reasonably designed to comply with Rule 17a-7 and for reporting annually to the fund's board of directors regarding the operation of such policies and procedures.<sup>3</sup>

5. ***Cross trading can be a useful and important liquidity risk management tool for funds.*** The Commission has emphasized the importance of the role of fund liquidity and liquidity management in reducing the risk that a fund will be unable to meet its redemption obligations, while also minimizing the impact of those redemptions on remaining fund shareholders (*see* Liquidity Risk Management Release, p. 7). Accordingly, the Commission has expressed a desire to provide funds with additional tools to mitigate potential investor dilution and to manage fund liquidity (*see* Liquidity Risk Management Release, p. 8). When a fund receives redemption requests from shareholders, the fund may sell portfolio assets to generate cash and generally has discretion to select the assets that are sold (Liquidity Risk Management Release, p. 28). Under these circumstances, an investment adviser may cause funds to enter into a cross trade as a means of selling securities to meet redemption demands, so long as the transaction is in the best interests of both the buying fund and the selling fund, consistent with the adviser's duty to seek best execution for each fund and duty of loyalty to each fund (2006 Letter). The Staff has acknowledged that there may be a liquidity benefit (*i.e.*, a higher sale price) to the selling fund from a purchase and sale transaction that is not exposed to the market, although the adviser should not cause a buying fund to participate in a Rule 17a-7 transaction that benefits only the selling fund (*see* 2006 Letter). For purposes of engaging in a cross trade under Rule 17a-7, although certain less liquid assets may lack market quotations, the relative illiquidity of a security alone should not be determinative of whether prices are available for the security (*see* Liquidity Risk Management Release, p. 246). As described above, the practice of using a price provided by an independent pricing service for cross trades of securities (whether or not market quotations are readily available) is consistent with the principles of independence and reasonable inquiry underlying Rule 17a-7. If a fund has any reason to doubt the reliability or accuracy of a price provided by an independent pricing service – for example, if the security involved is highly illiquid – the fund will not engage in a cross trade of such security, and the interpretive relief would not extend to these securities.<sup>4</sup>

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<sup>3</sup> In the Letters, the funds represented that they would take appropriate steps to verify the accuracy of the prices calculated by the independent pricing service used by the funds for cross trades.

<sup>4</sup> The requests for relief in the Letters did not seek relief for cross trades of municipal securities which were illiquid as a result of “an embedded swap, cap or floor, or other derivative structure” or which the adviser knew to be in default, presumably recognizing that under these circumstances, the liquidity of the securities could be impaired (1995 Letter). To the extent a security is illiquid, there may be less confidence that an independent pricing service's valuation of the security would approximate its “current market price.”

### **Part III. Terms of no-action relief**

We propose that the Staff confirm that the relief is subject to the following conditions:

1. Funds may use a price provided by an independent pricing service as the current market price of the security involved in a cross trade, in satisfaction of Rule 17a-7(b)(4).<sup>5</sup>
2. The independent pricing services will not be affiliated persons of the funds or affiliated persons of affiliated persons of the funds under Section 2(a)(3) of the ICA.<sup>6</sup>
3. The independent pricing services will not, directly or through affiliated persons, underwrite or distribute the securities they price.<sup>7</sup>
4. No brokerage commission, fee (except for customary transfer fees and pricing servicing fees) or other remuneration will be paid in connection with the transaction.<sup>8</sup>
5. The requirements of paragraphs (c), (e), and (f) of Rule 17a-7 will be complied with.<sup>9</sup>

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<sup>5</sup> This condition is from the 1995 Letter and 2006 Letter. This superseded the Staff's position in the 1992 Letter requiring a fund trading municipal securities to calculate a current market price by "averaging prices obtained from at least three independent matrix pricing services, or by averaging three independent bid prices, or by averaging three prices obtained from some combination of independent pricing services and independent bid prices" (1992 Letter). The 1995 Letter relaxed this position to allow the use of a single pricing service to avoid the creation of artificial gains and losses from using a price that is different from the price used in determining NAV. The 2006 Letter clarified that this relief was not limited to the pricing service named in the 1995 Letter and that funds could use other independent pricing services and pricing methodologies for these purposes.

<sup>6</sup> This condition is from the 1992 Letter.

<sup>7</sup> This condition is from the 1992 Letter.

<sup>8</sup> This condition is from the 1992 Letter. Given that electronic platforms now exist to support crossing (including price verification, confirmation, and settlement of the transaction), we believe the charges imposed by such platforms would constitute a customary transfer and/or pricing service fee.

<sup>9</sup> This condition is from the 1992 Letter. For purposes of the requirements of paragraph (e)(3) of Rule 17a-7, consistent with the no-action letter from the Staff to the Independent Directors Council (pub. avail. Oct. 12, 2018), a fund's board of directors may rely on a quarterly written representation from the chief compliance officer that transactions effected in reliance on Rule 17a-7 complied with the procedures adopted by the board pursuant to Rule 17a-7, instead of the board itself determining compliance.

6. The independent pricing services used for pricing a fund's cross trades under Rule 17a-7 may be different from the independent pricing services used for determining the fund's NAV pursuant to Section 2(a)(41) and Rule 2a-4.<sup>10</sup> However, funds will apply the same diligence and board approval requirements to the independent pricing services used for cross trades as they apply to the independent pricing services used for NAV determinations.<sup>11</sup>

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<sup>10</sup> While the Letters emphasized that the prices of the municipal securities for purposes of funds' cross trades under Rule 17a-7 were the same as the prices used for determining the funds' NAV consistent with Section 2(a)(41) and Rule 2a-4, we do not believe this should be a requirement of the relief. In many instances we expect that a fund would use the same independent pricing service for purposes of pricing cross trades and determining the fund's NAV. However, there are some circumstances in which it would be appropriate to use a different service for each purpose. For example, a fund may use a different pricing service for intraday cross trades than it uses for NAV calculations, and subadvised funds that seek to cross trade with other subadvised funds within a fund complex may each use a different pricing service for NAV calculations. So long as there is no reason to doubt the independence, reliability or accuracy of a price provided by an independent pricing service for valuing a cross trade, it should not matter whether that pricing service also provides the price for determining the fund's NAV. This principle was implicitly endorsed by the Staff when it originally permitted municipal bonds in a cross trade to be valued by averaging prices obtained from at least three different independent pricing services (1992 Letter).

<sup>11</sup> With respect to the diligence requirement, as noted above, the funds represented in the Letters that they would take appropriate steps to verify the accuracy of the prices provided by the independent pricing services for purposes of cross trades (1995 Letter). With respect to the board approval requirement, if an independent pricing service is already a board-approved service for purposes of calculating NAV, then no additional board approval would be necessary. If an independent pricing service to be used for cross trades is not already used under a fund's pricing procedures, board approval of such service for purposes of Rule 17a-7 transactions would be required.

SIFMA AMG sincerely appreciates your consideration of our request and welcome the opportunity to discuss this with you further at a time of convenience for you and your staff. Please do not hesitate to reach out to either of us with any questions or to schedule a meeting with our members. Tim Cameron can be reached at 202-962-7447 or [tcameron@sifma.org](mailto:tcameron@sifma.org), and Lindsey Keljo can be reached at 202-962-7312 or [lkeljo@sifma.org](mailto:lkeljo@sifma.org).

Sincerely,

A handwritten signature in black ink, appearing to read 'Tim Cameron', with a long horizontal line extending to the right.

Timothy W. Cameron, Esq.  
Asset Management Group – Head Securities  
Industry and Financial Markets Association

A handwritten signature in blue ink, appearing to read 'Lindsey Keljo', with a large loop at the beginning.

Lindsey Weber Keljo, Esq.  
Asset Management Group – Managing Director  
and Associate General Counsel  
Securities Industry and Financial Markets  
Association