

Rule 17a-7 at the Crossroads: Supplemental Information on Equity Cross Trading

OCTOBER 2021

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I. Executive Summary

Section 17(a) of the Investment Company Act of 1940 (“Investment Company Act”) prohibits any affiliated person of a registered investment company (“fund”), or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. However, Rule 17a-7 (the “cross trading rule”) conditionally allows affiliated funds to cross trade with one another. Cross trading generates benefits to funds and their shareholders that they otherwise would not have realized if they instead transacted on the open market, including reduced transaction costs and settlement risk and more efficient portfolio management and compliance with investment policies. In December 2020, the Securities and Exchange Commission (SEC) issued cross trading guidance that will greatly reduce these benefits by severely restricting funds’ ability to cross trade fixed-income securities.¹

In response to the anticipated negative impact of the December guidance and the March request for comment on cross trading from the SEC Staff (“Staff”),² our April report focused on funds’ fixed-income cross trading activity. It included detailed survey results, a summary of the quantitative benefits of cross trading, and policy recommendations.³

This report provides detailed information about funds’ *equity* cross trading activity, and it complements our April report. We do not believe that the December guidance will have a meaningful impact on funds’ equity cross trading. Even so, we prepared this report to provide the SEC with comprehensive data to inform its rulemaking efforts referred to in the Fair Value Adopting Release and Staff Statement and included on the SEC’s spring 2021 regulatory agenda.

ICI conducted a member survey to better understand and quantify funds’ equity cross trading activity. Forty-four ICI member firms responded, representing more than \$24.5 trillion, or approximately 75 percent of US-registered fund assets, as of July 31, 2021. Among other things, the results show that:

- » Respondents engaged in 667,949 cross trades of equity securities, totaling \$185 billion, in 2020.

¹ *Good Faith Determinations of Fair Value*, SEC Release No. IC-34128 (Dec. 3, 2020) (“Fair Value Adopting Release”), at 88–95, available at www.sec.gov/rules/final/2020/ic-34128.pdf.

² *Staff Statement on Investment Company Cross Trading*, SEC Division of Investment Management Staff (March 11, 2021) (“Staff Statement”), available at www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121.

³ *Rule 17a-7 at the Crossroads: The Right Path Forward*, Investment Company Institute (April 2021) (the “April report”), available at www.sec.gov/file/investment-company-institute.pdf.

- » This cross trading activity (in dollars) was largely concentrated in US equities (\$166 billion, or 90 percent), with a smaller portion in international equities (\$19 billion, or 10 percent).
- » Fifty-seven percent of respondents indicated that at least one of their funds cross traded an equity security in 2020. In total, at least 926 of respondents' funds engaged in at least one equity cross trade.⁴
- » A large majority of cross trades (estimated at 84 percent) involved two registered funds, as opposed to just one registered fund cross trading with other adviser client types (e.g., a nonregistered pooled vehicle or a separately managed account).⁵
- » A little more than half of respondents' equity cross trading activity was approximately the same (56 percent) in March and April 2020 as compared to the remainder of 2020.
- » We estimate that funds' equity cross trading activity in their mutual funds and exchange-traded funds (ETFs) represents about 1.8 percent of their total trading activity in equity securities. This is a small portion of funds' overall equity trading activity, and therefore, an even smaller portion of trading activity in the equity markets for all market participants.
- » Sixty-eight percent of respondents that engaged in equity cross trading in 2020 described it as "very beneficial," with another 32 percent calling it "moderately beneficial."

Funds' 2020 equity cross trading activity (in dollars) was somewhat less than funds' fixed-income cross trading activity, in both absolute and relative terms. That said, funds value the ability to cross trade equity securities because it provides fund shareholders with meaningful benefits, including reduced transaction costs and settlement risk and more efficient portfolio management and compliance with investment policies.

⁴ One respondent indicated that its fund complex engaged in at least one equity cross trade in 2020 but did not provide the specific number of funds that had engaged in such cross trading. As a result, the number cited above (926 funds) is a lower bound.

⁵ This percentage is an estimate based on the respondents that engaged in equity cross trades and identified the counterparties by type (i.e., whether both parties were registered funds). Twenty-two of 25 relevant respondents provided this counterparty detail, representing more than \$143 billion of total equity cross trading activity.

This report is organized as follows:

- » Section II provides background on Rule 17a-7.
- » Section III briefly summarizes the April report.
- » Section IV discusses the equity survey’s methodology and presents its key findings.
- » Section V offers ICI’s conclusions on the issue.

The SEC and Staff recognize the need to modernize the 55-year-old cross trading rule—it has appeared on the SEC’s rulemaking agenda in 2019, 2020, and 2021. We too have supported updating the rule to better reflect the developments in markets and fund investment practices and provide clear parameters for conducting mutually beneficial cross trades of equity *and* fixed-income securities. Recent SEC guidance underscores the importance of amending the rule to preserve cross trading’s benefits for fund shareholders. Indeed, if the SEC does not act prior to September 8, 2022 (the compliance date for the new guidance), funds would experience increased transaction costs and less-efficient portfolio management. This would be a deeply undesirable outcome.

Fortunately, it is not too late to avoid this outcome. We strongly urge the SEC to act promptly to modernize the rule in a manner that allows funds to continue to realize cross trading’s clear, quantifiable, and substantial benefits, subject to appropriate guardrails.

II. Background on Rule 17a-7

Section 17(a) of the Investment Company Act prohibits any affiliated person of a fund, or any affiliated person of such a person, from selling securities to, or purchasing securities from, the fund. This broad statutory prohibition reflects the policy concern for potential abuses that may accompany affiliated transactions. For instance, one fund could “dump” unwanted securities into another fund, or the transaction could be priced in a way that favors the buying or selling fund.

Under its rulemaking authority, the SEC has adopted several rules under Section 17(a) to exempt certain transactions from this prohibition, including the cross trading rule. This rule conditionally allows affiliated funds to cross trade with one another to avoid paying costs that each would otherwise incur if transacting on the open market.

In December 2020, the SEC issued cross trading guidance in the adopting release for new Rule 2a-5 (the “fair value rule”).⁶ This guidance marked a sharp break from the Commission’s prior regulatory approach to cross trading. To be eligible for cross trading, a security must have a “readily available market quotation.” But under the SEC’s new definition of this term (which applies for purposes of both the fair value and cross trading rules), few fixed-income securities have “readily available market quotations,” and therefore, funds’ ability to cross trade fixed-income securities would be severely restricted.

The guidance also noted that Rule 17a-7 reform was on the SEC’s rulemaking agenda, and the Staff in March requested “feedback...in evaluating what, if any, recommendations the Staff might make to the Commission in [regard to cross trading and Rule 17a-7].”⁷ In June, the SEC’s spring 2021 regulatory flexibility agenda was published, and it includes proposing amendments to Rule 17a-7.⁸

⁶ See *supra*, note 1.

⁷ See *supra*, note 2.

⁸ The SEC’s regulatory agenda can be accessed through the SEC’s website at www.sec.gov/news/press-release/2021-99. The item related to the cross trading rule states, “The Division [of Investment Management] is considering recommending that the Commission propose amendments to rule 17a-7 under the Investment Company Act of 1940 concerning the exemption of certain purchase or sale transactions between an investment company and certain affiliated persons.”

III. Summary of ICI's April Report

In April, we provided a detailed report responding to the Staff's March request for comment.⁹ The April report:

- » provided a history of the cross trading rule, explaining how both its scope and conditions had generally expanded in the years prior to the December 2020 guidance;
- » described how, in addition to minimizing transaction costs, cross trading facilitates efficient portfolio management and compliance with investment policies;
- » included detailed member survey results, showing that in 2020, respondents engaged in 44,976 cross trades of fixed-income securities, totaling more than \$204 billion;
- » estimated 2020 cost savings by applying bid-ask spread estimates across 11 fixed-income asset classes to the total dollars cross traded in each asset class, conservatively showing that fixed-income cross trading saved funds and their shareholders nearly \$329 million and advisers' clients generally (i.e., funds, other pooled investment vehicles, and separately managed accounts) more than \$390 million;
- » using those survey results, explained the significant deleterious effect that this latest SEC guidance would have on funds' fixed-income cross trading practices; and
- » recommended changes to the cross trading regulatory framework that would preserve funds' ability to cross trade fixed-income securities, subject to appropriate investor protections and guardrails.

The April report focused on fixed-income cross trading because the December guidance places it in jeopardy. By contrast, equity securities that funds commonly hold (e.g., those that trade on exchanges) generally have "readily available market quotations" under the new definition, and therefore, the new guidance does not threaten funds' current equity cross trading activity.¹⁰ Also, funds have generally found the rule's terms clear and workable as applied to equity cross trading.

⁹ See *supra*, note 3.

¹⁰ We note, however, that where the fund adjusts the last sale closing price of an exchange-traded international equity security for significant events that take place subsequent to the foreign market close and prior to the fund's valuation time (typically 4:00 p.m. eastern time), the equity security would be classified as Level 2 in the US GAAP fair value hierarchy. See ASC Topic 820-10-35-41C(b). Accordingly, such a "fair valued" equity security would not have a readily available market quotation and would not be eligible for cross trading *at its adjusted, fair valued price*. But such a security *could* be cross traded if its price has not been adjusted (e.g., if the security is priced and cross traded while the principal exchange on which it trades is open, or shortly after the exchange's close).

IV. ICI's Equity Cross Trading Survey: Methodology and Key Findings

A. Description of the Survey's Methodology

Beginning in June, we surveyed members to better understand their equity cross trading practices. Forty-four ICI member firms responded, representing more than \$24.5 trillion, or approximately 75 percent of US-registered fund assets, as of July 31, 2021.

Structured in a broadly similar way to the fixed-income survey (although somewhat less detailed),¹¹ this survey focused on equity cross trading activity during calendar year 2020.¹² We collected these data separately for US equities and international (i.e., non-US) equities.

For each of these two categories, we asked respondents to provide data regarding:

- a) total number of cross trades;
- b) total dollars cross traded; and
- c) of the total reported in subitem (b), the amount traded (in dollars) where both parties to the trade were 1940 Act-registered funds.¹³

B. Equity Cross Trading Is a Common Practice

Fifty-seven percent of respondents indicated that at least one of their funds cross traded an equity security in 2020. Further, at least 926¹⁴ of respondents' funds engaged in at least one equity cross trade in 2020.

C. Funds' Aggregated Equity Cross Trading Is Meaningful and Concentrated in US Equity Securities

In 2020, fund complexes cross traded \$185 billion in equity securities. To provide some context for this figure, those fund complexes that completed the survey had purchases and sales of equity securities in their equity mutual funds and gross redemptions and gross creations in their equity ETFs totaling approximately \$14.4 trillion and \$4.1 trillion, respectively, according to ICI data.¹⁵ Thus, based on our data, we estimate that funds'

¹¹ For this survey, we asked for complete equity cross trading data divided into two subcategories only—US and international (i.e., non-US) equities. We also did not request information about pricing sources for these transactions, US GAAP fair value hierarchy classifications of the traded securities, or the sizes of the individual trades.

¹² We asked each respondent to: (i) complete the survey for its fund complex only, and avoid reporting as a subadviser (if applicable), to avoid the possibility of double-counting data for certain questions; (ii) report information for equity securities only; and (iii) include only transactions conducted pursuant to Rule 17a-7 (responses included transactions where at least one party was a registered fund, and did not include transactions facilitated by investment advisers where *neither* party to the transaction was a registered fund).

¹³ We asked this question to ascertain to what extent this cross trading activity involves registered funds on both sides.

¹⁴ See *supra*, note 4.

¹⁵ The mutual fund figure represents total purchases and sales of equity securities by equity mutual funds. Because we do not have comparable data on purchases and sales of equity securities by equity ETFs, we use gross issuance and gross redemptions of equity ETFs as a proxy.

equity cross trading activity in their equity mutual funds and ETFs represents about 1.8 percent of their total trading activity in equity securities.¹⁶

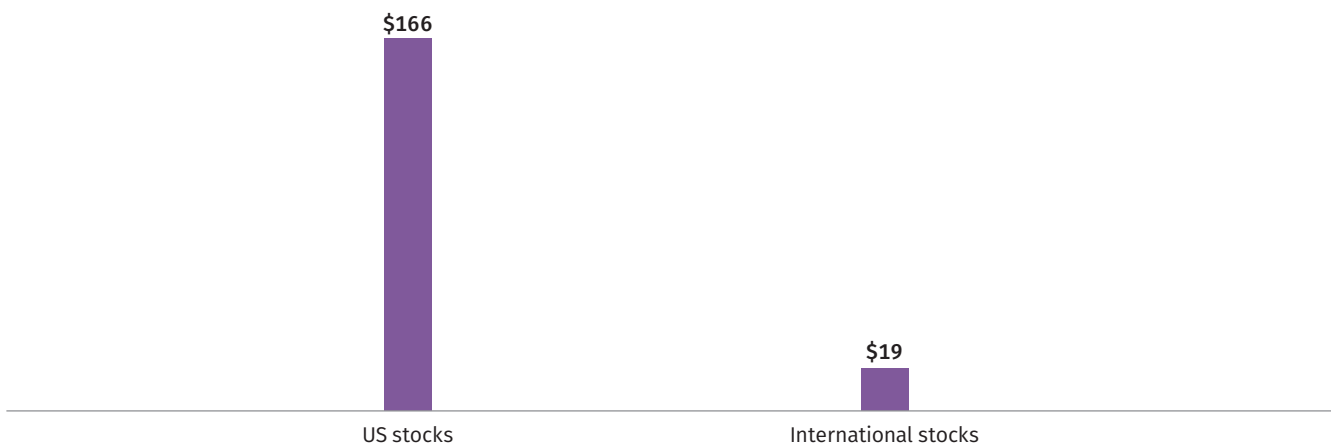
It is critical that funds continue to have available all means of transacting in equity securities for the benefit of their shareholders. Still, this relatively small percentage suggests that funds and advisers are prudent and judicious in their use of cross trading. And because cross trading makes up only a small portion of funds' overall trading activity, it is an even smaller portion of trading activity in equity markets for all market participants.¹⁷

As indicated in Figure 1, this cross trading activity (in dollars) was concentrated heavily in US equity securities.

FIGURE 1

US and International Equity Cross Trading Activity

Billions of dollars, annual, 2020



Source: Investment Company Institute survey of equity cross trading activity

¹⁶ In 2020, respondents' equity mutual funds and ETFs cross traded, in total, approximately \$185 billion dollars in equity assets. Double counting the cross trades where funds were on both sides (to capture both purchases *and* sales) and counting only once those trades where a fund was only on one side (to capture purchases *or* sales), the total cross trading activity of respondents' equity funds during 2020 was \$339 billion ((2 × \$154.3 billion) + \$30.3 billion), or 1.8 percent of the \$18.5 trillion dollars traded in equity assets by respondents' equity funds.

¹⁷ The Staff Statement asks, "To what extent might cross-trades affect market efficiency because they are not publicly reported?" Because cross trading represents a small percentage of funds' overall equity trading activity, and funds' overall trading in the equity markets represents only a portion of overall equity trading among market participants, we do not believe that fund cross trading materially affects market efficiency. And as discussed in Section VI of the April report (the fifth recommendation), we would support making publicly available aggregated cross trading data reported by funds to the SEC on Form N-PORT.

Respondents reported 667,949 individual equity cross trades in 2020, with the vast majority concentrated in US stocks (Figure 2).

FIGURE 2
Total Number of US and International Equity Cross Trades
Annual, 2020



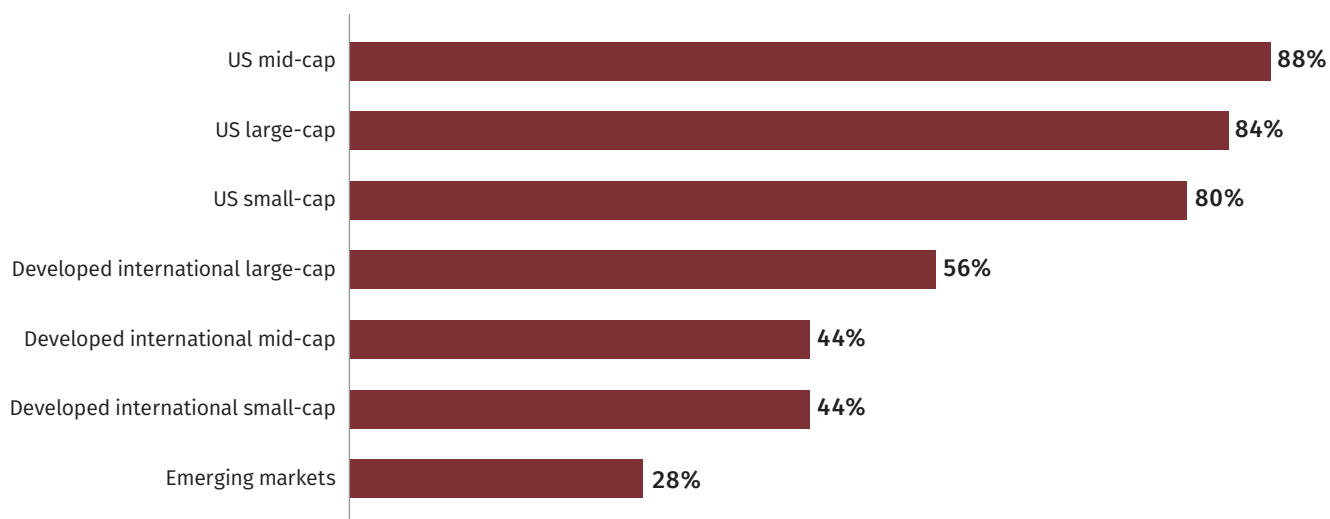
Source: Investment Company Institute survey of equity cross trading activity

To get a more granular sense of the subcategories of equities cross traded (e.g., by market capitalization and geography), we asked each respondent that cross traded equities to identify which of seven equity types its fund complex cross traded at least once in 2020. Eighty-eight percent of respondents reported cross trading at least one US mid-cap stock, followed by US large-cap, and US small-cap stocks (Figure 3). Fewer respondents reported cross trading at least one international stock.

FIGURE 3

Equity Types Cross Traded at Least Once in 2020

Percentage of equity cross trading fund complexes

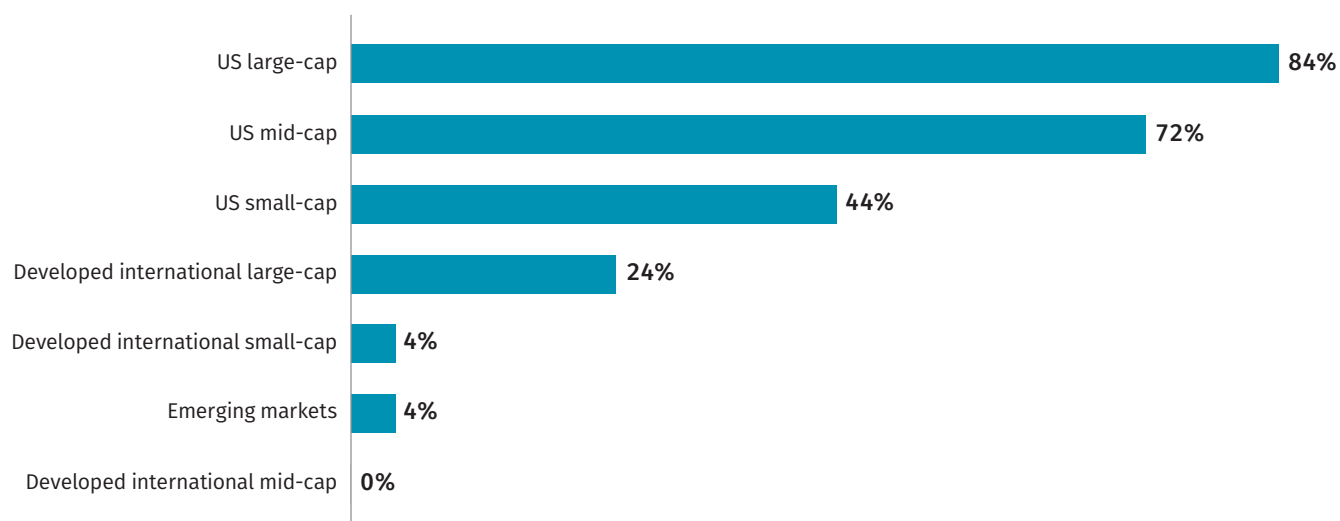


Source: Investment Company Institute survey of equity cross trading activity

In addition, we asked each respondent that cross traded equities to identify the types of equity security for which its cross trading activity was most common (relative to its equity trading generally) in 2020, choosing no more than three. Compared to the prior question, this was meant to give a better sense of the relative concentrations in, and importance of, cross trading among these seven categories. US equities generally—and US large-cap equities in particular—emerged as most important (Figure 4).

FIGURE 4
Equity Types Most Commonly Cross Traded in 2020

Percentage of equity cross trading fund complexes



Source: Investment Company Institute survey of equity cross trading activity

In dollars, funds' 2020 equity cross trading was somewhat less than funds' fixed-income cross trading (more than \$184 billion vs. more than \$204 billion). In relative terms, equity cross trading is smaller still—our estimate of funds' 2020 equity cross trading activity (as a percentage of funds' overall equity trading) is 1.8 percent, compared to our estimate of 3.7 percent for fixed-income cross trading as a percentage of funds' overall fixed-income trading in the April report. For additional context, total net assets in equity funds and bond funds were \$16.9 and \$6.3 trillion, respectively, as of December 31, 2020.

The total number of equity cross trades was significantly higher than that for fixed-income cross trades (667,949 vs. 44,976), however, indicating that the dollar values of individual equity cross trades tend to be much smaller than those of fixed-income cross trades.

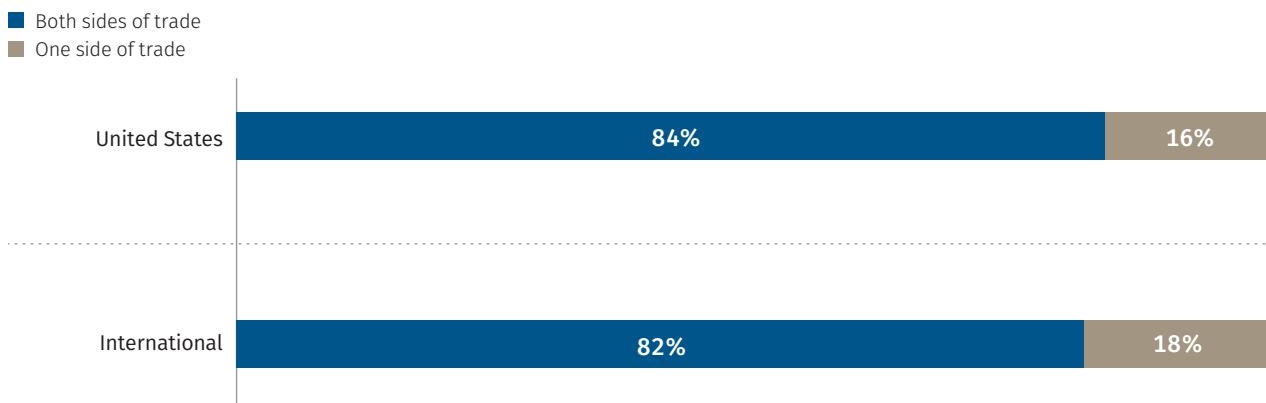
D. Most Equity Cross Trading Involves Registered Funds on Both Sides

As indicated in Figure 5, a large majority of cross trades (in dollars) involved two registered funds.

FIGURE 5

Large Majority of Equity Cross Trades Involved Registered Funds on Both Sides

Percent, annual, 2020*



* This percentage is an estimate based on the respondents that engaged in equity cross trades and identified the counterparties by type (i.e., whether both parties were registered funds). Twenty-two of 25 relevant respondents provided this counterparty detail, representing more than \$143 billion of total equity cross trading activity.

Source: Investment Company Institute survey of equity cross trading activity

The April report indicated that the large majority of fixed-income cross trades—83 percent, in dollars—involved two registered funds (as opposed to just one fund trading with other investment adviser client types), nearly identical to the 84 percent total figure estimated for equity cross trades.

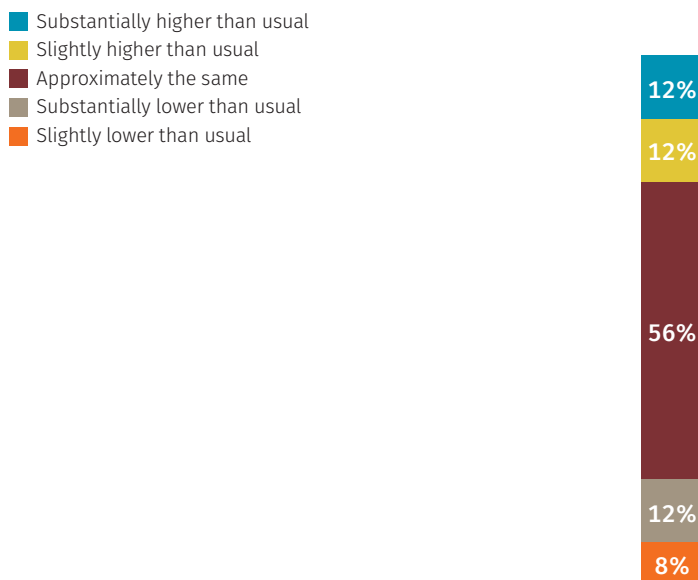
E. Equity Cross Trading Was Not Significantly Different in March and April 2020

To better understand potential variation in activity during 2020, our survey asked how equity cross trading activity during March and April 2020 compared to the fund complex's normal level of equity cross trading activity. Figure 6 shows the responses. Overall, industry activity appears to have been relatively consistent during March and April, with a little more than half of respondents stating that their activity was "approximately the same" (56 percent) during those months.

FIGURE 6

Equity Cross Trading Activity Was Mostly the Same in March and April 2020

Percentage of equity cross trading fund complexes



Source: Investment Company Institute survey of equity cross trading activity

These equity responses were markedly different from those in the April report, which showed that most respondents' fixed-income cross trading activity was either approximately the same (41 percent) or higher (46 percent) in March and April 2020 as compared to the remainder of 2020.

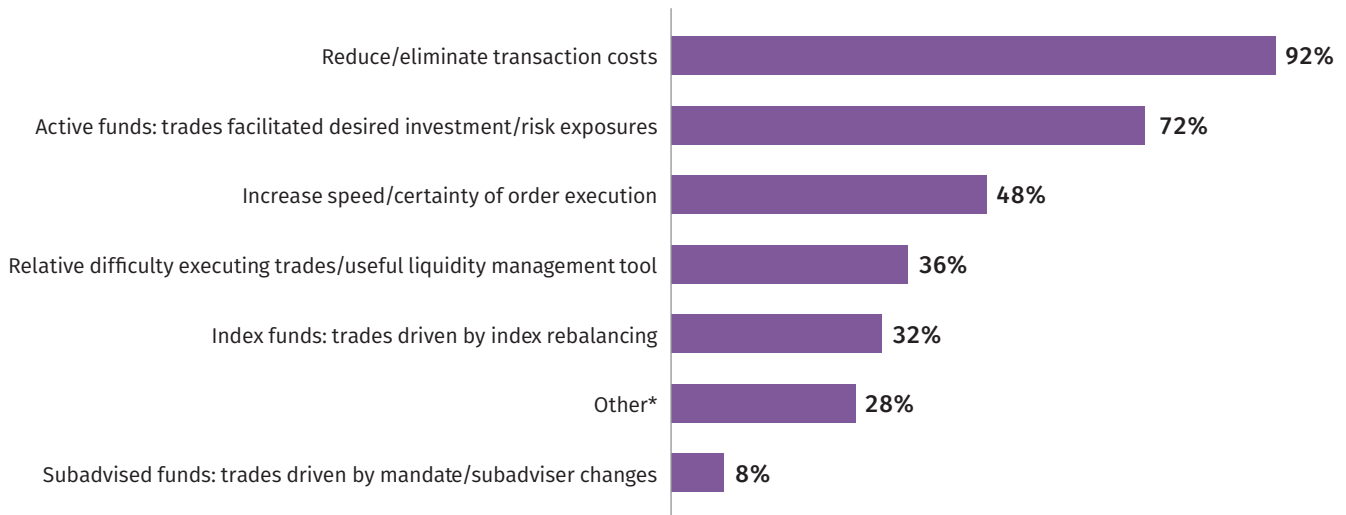
F. Respondents View Equity Cross Trading as Beneficial to Their Fund Complexes

To get a better sense of *why* funds cross trade equity securities, we asked each respondent its reason(s) for cross trading equities in 2020. The responses are summarized in Figure 7.

FIGURE 7

Reasons for Cross Trading Equities in 2020

Percentage of all responses



* "Other" responses predominantly consisted of elaborations on other specified options (e.g., "raise cash and reduce cash") and also included "quicker settlement," "adjust minimum % active weight," and "transfer fund accounts to separately managed accounts."

Source: Investment Company Institute survey of equity cross trading activity

In text responses to a follow-up question, respondents identified as additional benefits:

- » "allow[ing] fund managers to obfuscate from the market trading activity that otherwise might be discernable from a combination of portfolio holdings reports and index changes....market participants...may otherwise take full advantage of this information by trading against these fund positions to the detriment of individual investors."
- » "tax loss harvesting."

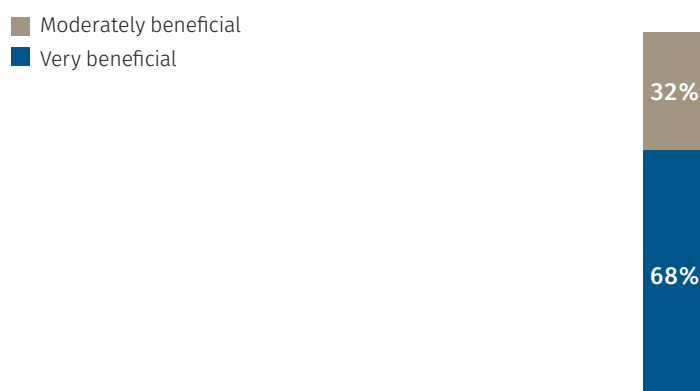
While the relative benefits of equity and fixed-income cross trading may differ somewhat (e.g., generally speaking, the transaction cost savings for fixed-income cross trades are higher, as are the “search costs” associated with executing fixed-income trades), the motivations for cross trading these securities are broadly similar. In addition to reducing transaction costs and facilitating more timely and certain execution, cross trading of all securities facilitates efficient portfolio management and compliance with investment policies.¹⁸ In the April report, we explained how certain sales of fixed-income securities may be explained by how changes in a bond’s characteristics (e.g., its time-to-maturity, or its credit rating) intersect with a fund’s investment objective, policies, and strategies and may create offsetting purchase-and-sale opportunities within a fund complex. Similarly, certain characteristics of an equity security (e.g., financial measures) are not immutable. To give just one example, an equity’s capitalization classification (e.g., large, medium, or small) may change, and as the market capitalization of a small-cap equity grows, a fund complex’s small-cap fund may wish to sell it, while the complex’s mid-cap equity fund may wish to buy it.¹⁹

We also asked respondents that cross traded equities to provide more subjective feedback on the importance of that activity to their fund complexes. Sixty-eight percent of respondents described it as “very beneficial,” with another 32 percent calling it “moderately beneficial” (Figure 8).

FIGURE 8

Cross Trading Equities Is Very Beneficial for Fund Complexes

Percentage of equity cross trading fund complexes



Source: Investment Company Institute survey of equity cross trading activity

¹⁸ See Section III.B in the April report for a more detailed description of the reasons for cross trading.

¹⁹ See *Frequently Asked Questions About Rule 35d-1 (Investment Company Names)*, SEC Division of Investment Management Staff, Question 6 (expressing the Staff’s position that terms such as “small-, mid-, or large-capitalization” suggest a focus on a particular type of investment, and funds that use these terms (i) will be subject to the 80 percent investment requirement of Rule 35d-1, and (ii) should define these terms in their discussions of their investment objectives and strategies in their prospectuses), available at www.sec.gov/divisions/investment/guidance/rule35d-1faq.htm#P72_9874.

Similarly, in the April report, 70 percent of respondents described fixed-income cross trading as “very beneficial,” with another 27 percent calling it “moderately beneficial.”

G. The Cross Trading Rule Generally Works Well for Equity Cross Trading

Finally, we asked respondents whether any aspects of Rule 17a-7 unreasonably impede their ability to cross trade equity securities. Eighty-six percent of respondents answered “no.” Of those that answered “yes,” the more noteworthy responses included the following:

- » “Compliance and reporting requirements are too great. [The] SEC’s scrutiny is not proportionate to [the] risk.”
- » “For international securities, due to unique local regulatory requirements surrounding transfer of securities (e.g., exchange requirements, fees, etc.), additional clarification regarding what are permissible fees under Rule 17a-7(d) would be helpful when determining whether or not a Rule 17a-7 transaction is permissible for a non-US listed equity security.”
- » “It might assist the industry for clarification on what is included in ‘except for customary transfer fees’ for Rule 17a-7(d) particularly for international markets where customary market fees may be calculated in basis points.”

V. Conclusion

The SEC adopted the cross trading rule in 1966 and last substantially revised it in 1981, more than 40 years ago. The recent guidance—and the severely limiting effect it would have on fixed-income cross trading—adds to the urgency for reform. Rulemaking provides the Commission with the opportunity to mitigate any potential conflicts of interest while preserving demonstrable benefits for funds and their shareholders, which we have detailed in these reports.

Rule 17a-7 is at a crossroads, and the need for modernization is clear and compelling. We stand ready to assist the Commission as it moves forward on this important matter.



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