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FUND BOARD VIEWS

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Fund directors: What do you need to know about cross trades?

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By Robert E. Plaze, partner, Stroock & Stroock & Lavan LLP (for *Fund Board Views*)

Each quarter, directors of mutual funds registered under the Investment Company Act of 1940 are required to approve any cross trades involving their funds that have occurred during the previous quarter. Therefore, directors should be familiar with the regulatory and fiduciary issues involved in cross trading, and they should understand the role they play in the approval process.

In the simplest terms, a cross trade is the sale of a security held by one client to another client who shares the same investment adviser. By "crossing" the trade, each client avoids brokerage costs that it would have paid had the adviser sold the security to a third party through a broker-dealer, a consequence advantageous to everyone involved (except the broker-dealer) and one that should be embraced by directors.

Directors may ask why, then, does the Securities and Exchange Commission require that we approve such trades? Getting to the answer requires some understanding of the laws pertaining to cross trades and the circumstances under which the SEC will permit such transactions.

Cross trades are "affiliated transactions" that are prohibited under Section 17(a) of the Investment Company Act because each fund in a fund complex is generally considered to be an "affiliated person" of each other fund in the complex. That means the purchase and sale of securities or other property between funds in a single fund complex is prohibited unless specifically permitted by the SEC.[1]

The SEC adopted Rule 17a-7 in 1966 to permit cross trading between funds having a common adviser[2] and expanded it in 1981 to, among other things, permit trades between different series of one investment company and trades with other clients of the investment adviser such as separate accounts and hedge funds.[3] Rule 17a-7 contains a number of conditions designed to limit the permitted trades to those the SEC believed would be unlikely to disadvantage one fund in the transaction.

- *Client Eligible to Participate*. Rule 17a-7 is available only if the clients involved are affiliated persons of each other solely as a result of having a common investment adviser, common directors, or common officers.[4] This would, for example, preclude a cross trade between a fund and a proprietary account of the adviser.[5] The SEC has viewed transactions by persons who meet the exemption requirement to be of less concern because the adviser arranging the trade has no direct proprietary interest in the transaction, *e.*, its conflict is less acute.[6] Moreover, the adviser's role in arranging the cross trade is that of an adviser which owes fiduciary obligations to both sides of the transaction and which presumably would require it to treat both funds fairly. (More about this later.)

- *Trading Costs*. The cross trade must be effected without payment of any commission, spread, or other types of brokerage costs, other than customary transfer fees.[7] The primary assertion of fund managers who sought the exemption was that funds would benefit by payment of lower transaction costs, and the exemption is limited accordingly.

- *Transactions for Cash*. The transaction must be a purchase or sale "for no consideration other than cash payment against prompt delivery of a security," which means the cross trade must be effected DVP ("delivery versus payment").[8] Although the rule precludes "in kind" transactions, the SEC staff has issued no-action letters permitting them in certain circumstances.[9]

- *Investment Policies*. A cross trade must be consistent with the investment policies of each fund participating in the transaction.[10] This provision has not raised issues over the years because all investments of a fund must be consistent with its investment objectives.

- *Types of Securities*. Rule 17a-7 is available for transactions in both debt and

is available only for transactions in securities for which "market quotations are readily available,"[12] at the "independent current market price," which generally means the last sale price, the average of the highest bid and lowest independent offer, or average of bid/ask determined after reasonably inquiry (in order of preference).[13] This provision limits cross trades to securities actively traded in agency or dealer markets.

The SEC limited cross trades to those securities for which market quotations "are readily available" because it concluded that such quotations provide "an independent basis for determining, in part, that the terms of the transaction are fair and reasonable to any participating [fund] and do not involve overreaching."[14] But it also appears to limit transactions to those in liquid securities and, if so, this provision operates to prevent an adviser from using the buying fund to provide liquidity for the selling fund by buying securities the selling fund needed to sell to meet redemption demands.

Staff Interpretation

Two SEC staff interpretive letters on this provision illuminate the operation of the rule and the problems it presents. In *United Municipal Bond Fund* (July 30, 1992), the SEC staff agreed to permit a municipal bond fund to effect cross trades in municipal securities for which market prices were not readily available with another fund managed by the same adviser. The funds involved would trade the securities at the price provided by an independent pricing service, which would be approved by the funds' board of directors and audited by their independent public accountant. Although the SEC had specifically stated that Rule 17a-7 would not be available for cross trades in municipal securities,[15] the logic of the letter seems compelling: A price that is sufficiently accurate to support calculating a fund's net asset value each day should be adequate to support cross trades.

But the *United Municipal Bond Fund* letter did not address the liquidity concerns discussed above. In a cross trade complying with the terms of 17a-7, the buying fund could be forced to acquire securities it did not want because the selling fund needed cash to meet redemptions. Moreover, in such circumstances, the price of the cross trade might very well be unfair to the buying fund even though the transaction was effected at current market prices specified in the rule.

A cross trade of an illiquid security prevents exposure of the sale to the market, which likely would have made it available to the buying fund at a lower price (notwithstanding the payment of a commission or spread). Where the selling fund holds a position in a thinly traded security, the sale of even a small portion could establish a new lower price at which the selling fund's entire position must be re-priced (not only the portion being sold), in which case the advantages of the cross trade to the selling fund may be significant, and the pressure on the adviser

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Advisers who propose to engage in cross trades in such illiquid securities may view avoidance of market impact as a neutral trading technique, but it may very well favor the selling fund. As the SEC explained in a different context "[a]lthough cross trades can be appropriate in many circumstances, they also can create the possibility of a conflict of interest for an adviser: the better the price the adviser obtains for the selling clients, the worse it is for the buying clients, and vice versa."[16]

The SEC staff confronted such concerns in connection with Rule 17a-7 for the first time in a 2006 no-action letter, *Federated Municipal Funds* (Nov. 20, 2006). The letter responded to a request to the staff to approve a different pricing service than the one used in the 1992 *United Municipal Bond Fund* letter. The staff again gave assurances that a fund could engage in cross trades pursuant to the rule in municipal securities for which market prices are not readily available. This time, however, the staff explained that compliance with Rule 17a-7 alone might not satisfy the adviser's obligations under the federal securities laws. An adviser proposing a cross trade also must consider the fiduciary obligations it owes to *both* funds under the Investment Advisers Act of 1940, which includes the duty to seek best execution and the duty of loyalty.[17]

The letter went on to explain that the duty to seek best execution means that if the "adviser to the selling fund can obtain greater proceeds for that fund by selling the security in the market, rather than by selling it to another fund in a 17a-7 transaction, the adviser should sell the security in the market." Moreover, the adviser's duty of loyalty would prohibit an adviser from causing a fund to enter into a cross trade unless doing so would be in its best interest. "Thus, for instance, the buying fund should not participate in a 17a-7 transaction that benefits only the selling fund; if the buying fund were to participate in such a transaction, it may forgo an opportunity to make a better investment in a different security."

The staff therefore concluded that restraints on cross trades of illiquid securities are addressed outside of Rule 17a-7. This approach seems appropriate for two reasons. First, the letters permitting transactions in securities at prices other those readily available in the market are limited to municipal bonds, which often trade generically by rating and thus are often substitutable. That a specific municipal bond trades infrequently does not mean that it is not liquid, *i.e.*, that it cannot be sold at approximately the price at which the fund is holding it.

Second, the conflicts involved are not limited to illiquid securities. A fund that sells a very large position in a publicly traded equity security, for example, could place sufficient downward pressure on prices such that the fund's adviser might prefer cross trades to mute the impact. The SEC staff's focus on advisers' universal obligations as fiduciaries rather than a narrow interpretation of Rule

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SEC Enforcement Action

In 2014, the SEC brought a settled enforcement action against an adviser to a fund for causing the funds to engage in improper cross trades.[18] During the financial crisis of 2008, many of the adviser's clients experienced significant redemptions requiring the adviser to sell securities. The adviser entered into pre-arranged sale and purchase agreements with dealers which resulted in the selling fund's securities to be repurchased by other funds at the bid price, which allocated the benefits of the savings to the buying clients, effectively "depriving its affected clients of their share of the market savings."

The cross trades did not meet the requirements of 17a-7 for a number of reasons, including that the adviser caused the fund to pay a dealer spread.[19] The SEC alleged violations of Section 17(a) and Section 206 (the anti-fraud provisions) of the Investment Advisers Act for the adviser's breach of loyalty to its clients and for failing to seek best execution. Among other penalties, the adviser was ordered to pay more than $7 million to compensate harmed clients. No enforcement action was brought against either the funds involved or the fund directors, from whom the adviser presumably concealed (by interposing the dealer) the nature of the trades.

The SEC release discussing its enforcement action failed to acknowledge that the buying funds were the ones more likely to have been disadvantaged by the cross trades, since they would likely have been able to purchase the same securities at a lower price in the market.[20] Any benefits the selling funds received in avoiding market action were had at the expense of the buying funds. The motivation of an adviser forced to sell securities into declining markets is not so much the loss of good investments but to avoid the losses incurred to which its own sales will have contributed.

Directors' Role

The SEC added directors' responsibilities to Rule 17a-7 in 1981,[21] explaining that they were designed to "enhanc[e], insofar as feasible, the role of investment company directors and particularly disinterested directors as watchdogs of shareholder interests. The Commission believes that the first line of responsibility for determining compliance with [the amendments] should be with each investment company's directors."[22]

Rule 17a-7 requires that the fund's board of directors—including a majority of independent directors—approve policies and procedures pursuant to which cross trades may be effected in accordance with the rule, and make and approve any changes the board deems necessary.[23] Cross trading policies and procedures

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fund's compliance policies and procedures adopted pursuant to Rule 38a-1 under the Investment Company Act.[24]

Cross trading policies should set forth the circumstances under which the funds may enter into a cross trade. Policies often exclude trades with some clients of the fund's adviser, such as a pension plans subject to ERISA and clients who have instructed the adviser not to engage in such trades. In some cases the policies will limit cross trades to those that implement a specific event, such as a change made to a composite index, rebalancing client accounts, or trades determined by a computer-generated investment model. These types of restrictions are designed to limit cross trades to those "discovered" *after* an investment decision is made, reducing the possibility that the cross trade could be arranged to benefit a favored client.

It is important that cross trading policies specify the responsibility of advisory personnel who are authorized to approve cross trades. Compliance personnel should review these transactions, periodically evaluate the effectiveness of the fund's policies, and report their conclusions to the fund board.[25] Finally, it is important that cross trading policies require full documentation of the terms of the trade and the reasons for trade.[26]

Board Approval

As discussed above, the fund board also must determine, no less frequently than quarterly, that cross trades effected during the previous quarter were made in conformity to Rule 17a-7. The rule by its terms does not, therefore, require that the fund's board determine that the transactions were fair or did not involve overreaching on the part of any person, the standard by which the SEC is required to evaluate affiliated transactions before issuing an order permitting them.[27] Nonetheless, fund boards have their own fiduciary obligations to protect the interests of fund shareholders from unfair transactions and from the failure of the fund's adviser to meet its fiduciary obligations.[28] Thus, a fund board would be ill advised to rely on the narrow reading of Rule 17a-7 when considering whether to approve a cross trade that was unfair to one of the funds yet met the technical terms of the rule.

Rule 17a-7 contemplates that the board would approve cross trades as long as four months after they have occurred. The rule thus anticipates retroactive approval of cross trades, but it does not address what must happen if the directors fail to approve the transaction. The rule's requirement of director approval suggests that such a trade must be reversed as if it were a product of a trading error.[29] And, as in the case of a trading error, the adviser responsible may be required to bear the burden of any losses.[30] The settlement in a recent enforcement case required the fund adviser to compensate clients that were

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benefited had the cross trades been effected in accordance with Rule 17a-7, plus interest.[31]

But what if the board *can't* approve the cross trades even though it views them as fair to all the funds involved? This could occur if the adviser was late in seeking the board's approval, which must be obtained at the next quarterly meeting.[32] Although the exemption provided in rule 17a-7 is conditioned on timely approval by the fund's board, the SEC surely could not have intended that otherwise proper cross trades be unwound for such a minor infraction. Thus, the practice has developed whereby the board will determine that the cross trades comply with all other provisions of rule 17a-7, and such determination is so noted in the minutes of the board's meeting.

The board alone must approve the transactions, although directors typically rely on certificates and/or reports on compliance with Rule 17a-7 by the fund's CCO, legal counsel or other responsible executive of the adviser in forming their view.[33] This permits boards to focus on the larger questions posed by cross trades:

- Why are they occurring?
- How are they benefiting the funds involved?
- Is one fund being used for the benefit of another fund?

These are not always easy questions to answer and require directors to exercise their judgment.

For example, perhaps the most benign form of cross trade involves a buy and sell order that appear at the fund's trading desk at approximately the same time from two portfolio managers who have different views on the company or who have different investment needs. Those same trades, however, could be the result of a meeting between two portfolio managers at which one agreed to do a favor for the other (such as helping to correct an error). That said, some cross trade favors are indeed benign. A national tax-exempt fund could agree to sell scarce municipal bonds needed by a single-state fund in the same fund complex, for which it could easily obtain a substitute from another municipal issuer. Cross trades of commercial paper also typically involve few issues unless, of course, the selling fund is a money market fund and the commercial paper is distressed for some reason.[34] Cross trades among a complex of index funds occurring upon the periodic rebalancing of their portfolios are also common.

In light of the compliance risks involved with some types of cross trades, directors and fund advisers also need to consider whether they actually provide much benefit to the funds involved. In 1966 when Rule 17a-7 was adopted, commission

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batch of strategies developed by funds to avoid high fixed commission rates. Today, typical commissions on execution-only institutional brokerage trades are a small fraction of the 1966 rates, reducing the value of the ability to do a cross trade.

Be Curious

Fund boards satisfy the role the SEC expects them to play by asking questions to the fund's management as well as the chief compliance officer to assure themselves that the reasons for the cross trade were evaluated and are proper. Directors should pay particular attention to cross trades involving illiquid securities or large amounts of securities after a significant redemption out of one or more funds, which may suggest the adviser is seeking to use other funds to purchase the securities in order to avoid a fire sale into the market.

Fund boards should view justifications by fund management that involve avoidance of market action skeptically because, as discussed above, they may indicate the use of one fund for the benefit of another. Market action that imposes costs on the selling fund would benefit the buying fund, and vice versa. Recent academic papers suggest the use of cross trades by fund complexes may be designed (or at least have the effect) of favoring certain funds over others.[35] The SEC's attention to such questions cannot be far behind.

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If you would like to write a *Viewpoints* article, please contact *Fund Board Views* Founding Editor Hillary Jackson at hillary.jackson@fundboardviews.com.

[1] Section 17(a) of the Investment Company Act, among other things, prohibits an affiliated person of a fund or an affiliated person of such person, acting as principal, knowingly from selling to, or purchasing a security or other property from, the fund. An affiliated person is defined by Section 2(a)(3)(C) of the Investment Company Act to include any person directly or indirectly controlling, controlled by, or under common control with, such other person. The term "controlled" is defined in Section 2(a)(9) of the Investment Company Act to mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Two investment companies with a common investment adviser may be deemed to be affiliated persons of each other as a result of common control of the adviser. *See* Investment Company Act Release No. 4697 (Sept. 8, 1966) ("Release

based upon control would depend upon the facts of the given situation, including such factors as extensive interlocks of officers, directors or key personnel, common investment advisers or underwriters, etc.").

[2] *Id.*

[3] Investment Company Act Release No. 11676 (Mar. 10, 1981).

[4] Rule 17a-7 (first paragraph).

[5] *See, e.g.*, *Counselors Capital Appreciation Fund*, SEC Staff No-Action Letter (June 2, 1987) (Rule 17a-7 is unavailable when the adviser serves also as a general partner with a proprietary interest in the assets of a limited partnership proposed to be involved in the transaction).

[6] Investment Company Act Release No. 11136) (Apr. 21, 1980) ("When a purchase or sale involves registered investment companies and those of its affiliated persons which are affiliates exclusively by virtue of having a common investment adviser, directors and/or officers, generally, no person who is responsible for evaluating an approving the terms of a proposed transaction on behalf of such a person would have a significant personal financial improperly influencing those terms.").

[7] Rule 17a-7(d).

[8] *Counsellors Capital Appreciation Fund*, *supra* note 5

[9] *See, e.g.*, *GE Institutional Funds*, SEC Staff No-Action Letter (Dec. 21, 2005).

[10] Rule 17a-7(c).

[11] Rule 17a-7, as originally adopted, provided an exemption only for cross trades involving securities traded on a national exchange. Investment Company Act Release No. 4697, *supra* note 1.

[12] Rule 17a-7(a).

[13] Rule 17a-7(b).

[14] Release No 11136, *supra* note 6.

[15] Release No. 11136, *supra* note 6.

[16] *Highland Capital Management, L.P.,* Investment Advisers Act Release No.

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[17] Section 206 of the Advisers Act, which prohibits advisers from defrauding clients, has been construed by the courts as imposing a fiduciary obligations on advises to act in their clients' best interest. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963).

[18] *Western Asset Management Co.*, Investment Company Act Release No. 30893 (Jan. 27, 2014).

[19] Interposing a dealer in such a transaction does not work to remove it from the prohibitions on affiliated transactions in Section 17(a) of the Investment Company Act so that such transactions need not comply with Rule 17a-7. Section 48(a) of the Act makes it unlawful for any person, directly or indirectly, to do something through or by means of another person which it would be unlawful for the person to do under the Act. *See* Release No. 11136, *supra* note 6.

[20] One can only speculate, but it is possible that the adviser in the *Western Asset Management Co.* enforcement matter chose to effect the transactions at the bid price to compensate the buying funds for providing liquidity to the selling funds.

[21] Release No. 11676, *supra* note 3.

[22] Release. No 11136, *supra* note 6. One could argue, however, that the directors are a second line of defense because, as noted in the *Federated Municipal Funds* staff letter, fund advisers have fiduciary obligations that should prevent them from recommending transactions that are unfair to either of the participants in a proposed cross trade.

[23] Rule 17a-7(e).

[24] Unlike cross trading policies and procedures, compliance policies and procedures adopted pursuant to Rule 38a-1 may be changed without the approval of the fund's board. *See* Rule 38a-1(4)(iii)(A).

[25] Rule 38a-1 under the Investment Company Act (requiring each fund to have compliance policies and procedures administered by a chief compliance officer that must report at least annually to the board on the operation of the compliance policies). *See also* Investment Company Act Release No. 26299 (Dec. 17, 2003) in which the SEC stated that the Rule 38a-1 requires, among other things, a fund to have in place compliance policies and procedures to prevent unlawful affiliated transactions.

[26] Rule 17a-7(g) requires that the fund preserve a copy of the procedures and a

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identity of the person on the other side of the trade from the fund, the terms of the trade, and any information or materials upon which the fund's board has approved the cross trade.

[27] See Section 17(b) of the Investment Company Act.

[28] *Galfand v. Chestnutt Corp.,* 402 F. Supp. 1318 (S.D.N.Y. 1975), re*v'd in part,* 545 F.2d 807 (2d.Cir. 1976).

[29] A trade that the board fails to approve would not meet Rule 17a-7's conditions and thus would retroactively violate Section 17(a)'s prohibition on affiliated transactions.

[30] *Charles Lerner*, SEC Staff Letter (Oct. 25, 1988) (an investment adviser is responsible for losses from an inaccurate or erroneous order placed for an advised account).

[31] *Western Asset Management Co.*, *supra* note 19..

[32] Rule 17a-7(e)(3).

[33] Letter from Michael S. Didiuk of the SEC to Dorothy A. Berry of the Independent Directors Council and Jameson A. Baxter of the Mutual Fund Directors Forum (Nov. 2, 2010).

[34] Rule 17a-7 does not permit cross trades at prices determined by use of the amortized cost method at which most money market funds (at least today) carry their holdings. *See* Investment Company Act Release No. 11676, *supra* note 3.

[35] Luis Goncalves-Pinto and Juan M. Sotes-Paladino, *The Invisible Hand of Internal Markets in Mutual Fund Families,* Working Paper (Aug. 25, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567267; Lorenzo Casavecchia and Ashish Tiwari, *Cross-Trading by Investment Advisers: Implications for Mutual Fund Performance,* Working Paper (June 15, 2014), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2022808* ; Jose-Miguel Gaspar, Massimo Massa, and Pedro Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, The Journal of Finance, Vol. LXI, No.1 (Feb. 2006).

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