

SEC Proposes to Extend Cross-Trading Relief to Most Fixed-Income Securities—but Not Level 3 Assets

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Background

On October 9, 2026, the Securities and Exchange Commission (the "SEC") proposed amendments (the "Proposal") to Rule 17a-7 (the "Rule") under the Investment Company Act of 1940, as amended (the "1940 Act"). The Rule provides a conditional exemption from Section 17(a) of the 1940 Act, which generally prohibits affiliated persons of registered investment companies ("Registered Funds"), or an affiliated person of such a person, from knowingly selling securities to, or purchasing securities from, Registered Funds.¹ First adopted in 1966, the Rule permits a Fund to engage in cross trade transactions with certain affiliates ("Eligible Affiliates") when, among other things, the security has readily available market quotations, and the trade satisfies pricing, governance and recordkeeping conditions designed to ensure that its terms are reasonable and fair and do not involve overreaching.² The Proposal would restore cross trading for most fixed-income securities but would pair that relief with new pricing, best-interest, compliance and reporting conditions.³

The Proposal addresses a challenge the registered fund industry has urged the SEC to address since 2021. When the SEC adopted Rule 2a-5 under the 1940 Act ("Rule 2a-5") to modernize fund valuation practices, the SEC also issued cross trading guidance in the adopting release for new Rule 2a-5. This guidance marked a significant break from the SEC's regulatory approach to cross trading. To be eligible for cross trading, a security must have a "readily available market quotation." However, under the SEC's new definition of this term (which applies for purposes of both fair value and cross trading

¹ Business development companies ("BDCs") are also subject to certain similar restrictions on affiliated transactions under section 57 of the 1940 Act. Business development companies ("BDCs" and, together with Registered Funds, "Funds") may rely on the Rule through Section 57(i) of the 1940 Act. Pursuant to Section 57(i) of the 1940 Act, until the SEC adopts rules for BDCs under section 57, BDCs are permitted to rely on Rule 17a-7.

² See Investment Company Cross Trading, Investment Company Act Release No. IC-36358, File No. S7-2026-36, (Oct. 9, 2026) (the "Proposing Release") at 5-8.

³ See the Proposing Release, Sections I.A, I.D and II.

rules), very few fixed income securities have “readily available market quotations” and therefore, Funds’ ability to cross trade fixed income securities would be severely restricted. As a result, since Rule 2a-5’s compliance date, most fixed income securities were ineligible for cross trading, reversing decades of market practice.⁴ The SEC’s own data show that quarterly corporate bond cross trading between mutual funds fell from approximately \$6.24 billion before Rule 2a-5’s compliance date to approximately \$0.85 billion afterward, a decline of more than 85%.⁵

This Debevoise In Depth summarizes the principal features of the Proposal and explains why Funds that hold primarily Level 3 assets, such as BDCs and private credit interval funds, are likely to find the relief of limited use.

What Is Being Proposed

Eligible Securities

The Proposal would expand the securities eligible for cross trading. Currently, the Rule limits eligibility to securities with readily available market quotations, that is, securities valued solely by reference to Level 1 inputs under the fair value hierarchy in U.S. generally accepted accounting principles (“GAAP”). The Proposal would add securities a Fund values based on inputs that are observable, directly or indirectly (“Level 2” inputs), including quoted prices for similar securities in active markets, quoted prices for identical or similar securities in markets that are not active, and other observable inputs such as interest rates, credit spreads and yield curves. A security would not qualify if any input that is significant to its valuation is unobservable, even if the other inputs are observable. Securities valued using significant unobservable inputs (“Level 3 assets”) and non-leveled securities (i.e., investments that are not categorized within the fair value hierarchy), such as certain private fund interests valued at net asset value (“NAV”) as a practical expedient, would remain ineligible.⁶ The SEC also noted that Level 2 classification can require more judgment than Level 1 classification, and stated that existing audit, Rule 2a-5 testing, and chief compliance officer (“CCO”) oversight should

⁴ See Proposing Release at 13-14, 124-125.

⁵ See Proposing Release at 126-127 and 166 (Table 4). The Investment Company Institute (the “ICI”) has estimated that in 2020 Rule 17a-7 fixed-income cross trading saved Funds and their shareholders nearly \$329 million. See Investment Company Institute, Recommendations and Additional Support for Amending Rule 17a-7 to Permit Cross Trading of Fixed-Income Securities, Letter to Chairman Paul S. Atkins (Aug. 7, 2025) (the “ICI Letter”) at 1-2.

⁶ See Proposing Release at 22-27; id. at 26 n.53 (citing ICI Letter for the finding that 99.6% of the fixed income securities ICI member funds cross traded in 2020 were Level 2 assets).

guard against a Fund classifying a security as Level 2 principally in order to cross trade it.⁷

Pricing

The Proposal would replace the Rule's security-specific pricing provisions, including the requirement that over-the-counter securities be priced at the average of the highest current independent bid and lowest current independent offer, with a choice between two methods: (1) the "NAV Pricing" method and (2) the "Current Market Pricing" method. Under "NAV Pricing," the cross trade would be priced using the value the security receives in the Fund's next NAV calculation on the trade date. Under "Current Market Pricing," the Fund's investment adviser (the "Adviser") would determine a price that reasonably reflects the current market price using one or more unaffiliated pricing sources, such as pricing services, broker dealer quotes, or trading platform data, and would be required to review the reasonableness of those prices periodically.⁸

Importantly, NAV Pricing would be available only on days on which a Fund computes its NAV. Current Market Pricing may be used intraday and on days on which a Fund that prices less frequently does not compute its NAV.

Best Interest Determination

The Proposal would require an Adviser, before executing a cross trade, to determine that the trade is in the best interest of each participating Fund, independent of any benefit to the Eligible Affiliate on the other side. Satisfying the Rule's other conditions, including the pricing condition, would not by itself establish that the trade is in a Fund's best interest. Relevant factors include, among other things, the investment rationale for the trade, the liquidity of the security, whether better pricing or execution is available in the open market, trade size relative to trading volume, and prevailing market conditions.⁹

Oversight and Reporting

The Proposal would shift day to day compliance oversight from a Fund's board of directors (the "Board") to the CCO. Under the current Rule, the Board must adopt cross-trading procedures, approve any changes to them, and determine at least quarterly that all cross trades complied with those procedures. Since 2018, a staff no-action letter has permitted the Board to rely instead on a quarterly written representation from the CCO.¹⁰ The Proposal would go further. It would eliminate both the Board's quarterly determination and requirement that the Board adopt and approve procedures. The CCO would instead (1) review all cross trades at least quarterly for compliance with the Rule's

⁷ See Proposing Release at 129.

⁸ See Proposing Release at 29-35.

⁹ See Proposing Release at 55-57.

¹⁰ See Independent Directors Council, SEC Staff No-Action Letter (Oct. 12, 2018).

conditions and (2) review at least annually whether cross trades or a pattern of cross trades, may have disadvantaged the Fund relative to an Eligible Affiliate, including through parking, dumping, or cherry picking, and by reference to prices at which securities acquired in cross trades were later sold.¹¹ The Proposal does not specify how long a Fund must track a cross traded security for back testing, so if the Proposal is adopted as proposed, the CCO may be required to assess a sale occurring a significant time after the cross trade. The CCO would report the results of both reviews to the Board, which the SEC expects to remain actively engaged and ask questions about cross-trading activity.

Funds that rely on the Rule would also be required to report aggregate cross trading activity, by asset class, on Form N-PORT or Form N-MFP, as applicable. BDCs do not file Form N-PORT and would not be subject to this reporting requirement, although the SEC separately asks whether cross trading disclosure should instead be added to a BDC's Form 10-K.¹²

Transaction Fees

The Proposal would retain the Rule's general prohibition on remuneration in connection with a cross trade, as well as its requirement that the only consideration be cash payment against prompt delivery of the security. It would, however, replace the current exception for "customary transfer fees," which industry participants have described as unclear, with an exception for de minimis payments to unaffiliated parties for clearing, settlement, custody, recording, or reporting of the transaction. The SEC did not propose a numerical threshold. Whether a payment is de minimis would depend on the facts and circumstances, but the SEC stated that such amounts generally would be small relative to size of the transaction and less than what the Fund would pay in brokerage commissions, spreads, or mark-ups and mark-downs in an open-market trade. According to the SEC, the exception would reach service or administrative fees that custodians, broker-dealers and trading platforms charge to settle a cross trade, as well as stamp duties, transaction taxes, and similar charges that are unavoidable in certain non-U.S. markets. It would not reach payments to the Adviser or other affiliated serviced providers. The SEC also expects Fund's Rule 38a-1 policies and procedures to address how the Fund determines that a fee is de minimis and is incurred for permissible purposes.

¹¹ See Proposing Release at 61-64. According to the Proposal "[t]he CCO would also be required to conduct at least annual back testing of cross trades, which must include analyses of the ultimate prices realized when any security purchased by a fund through a cross trade is ultimately sold, to look for patterns suggesting disadvantages to the fund relative to affiliates and report the results to the board."

¹² See Proposing Release at 76-77, 86.

Economic Analysis

The SEC estimates that the Proposal would generate annual monetized benefits of approximately \$173 million, a figure that could exceed \$320 million using stressed market spreads, against estimated compliance costs of approximately \$15.9 million initially and \$13.7 million annually.¹³

Why Private CREDIT BDCs Are Positioned for a Smaller Benefit

The Proposing Release states that BDCs generally hold significant Level 3 assets, and that, because Level 3 assets would remain ineligible for cross trading, the amendments may not materially expand the set of transactions available to BDCs and are therefore less likely to confer meaningful benefits on BDCs relative to other types of Funds.¹⁴

Two additional features of private credit BDCs may compound that limitation. First, many BDCs strike NAV monthly or quarterly rather than daily. Under the Proposal, NAV Pricing would be available to them only on those dates; if they wish to cross on other days, they would need to use Current Market Pricing which, under the Proposal, requires unaffiliated pricing sources and periodic Adviser review of the resulting prices. Second, a counterparty that is not a Registered Fund, such as a private fund, qualifies as an Eligible Affiliate only if its affiliation arises solely by reason of a common investment adviser (or affiliated investment advisers), common directors, or common officers. A sponsor's ownership stake in, or control of, an affiliate private fund could create an additional basis for affiliation and prevent the private fund from satisfying that "solely" condition.¹⁵

The benefit to BDCs is not zero. Credit focused BDCs may hold some broadly syndicated loans or other liquid credit alongside their directly originated book, and those holdings often classified as Level 2, which would make them eligible for cross trading if the Proposal is adopted.

Notably, the SEC has not foreclosed further relief for Level 3 assets. The Proposing Release specifically requests comment on whether Level 3 securities should be made eligible subject to additional safeguards and separately acknowledges that extending eligibility to Level 3 assets could have the greatest incremental effect on BDCs, which generally hold a higher concentration of Level 3 assets than Funds generally.¹⁶

¹³ See Proposing Release at 166-167.

¹⁴ See Proposing Release at 123-124.

¹⁵ See Proposing Release at 109, n. 162.

¹⁶ See Proposing Release at 181.

By contrast, traditional publicly traded BDCs with meaningful exposure to broadly syndicated loans and closed-end funds holding investment grade or high yield corporate bonds, actively traded bank loans, or municipal securities, are positioned to capture most of the benefit the Proposal offers, since their portfolios more closely resemble the fixed income funds on which the SEC's economic analysis is based. The determining factor is portfolio composition and availability of observable pricing inputs, not whether a Fund is listed, non-traded, or structured as a BDC.

Next Steps

Comments on the Proposal are due 60 days after publication in the Federal Register. The current Rule, including Rule 2a-5's definition of a readily available market quotation, remains in effect until the SEC adopts final amendments. In the interim, Advisers should inventory fixed income holdings by fair value level to identify recurring, offsetting positions among affiliated Funds, confirm whether affiliated Registered Funds share valuation processes that would produce the same price, as NAV Pricing requires for a trade between two Registered Funds, and begin assessing best interest documentation and CCO review procedures. Private credit sponsors should consider assembling data on valuation controls and independent pricing practices to support comments addressing the treatment of Level 3 assets.

Conclusion

The Proposal addresses a well-documented issue that arose as an unintended consequence of Rule 2a-5's definition of readily available market quotations. Funds holding Level 2 securities could see lower transaction costs and more efficient portfolio management if the Proposal is adopted substantially as proposed.

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Please do not hesitate to contact us with any questions.



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