

SEC Issues Risk Alert – Investment Adviser Principal and Agency Cross Trading Compliance Issues

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On September 4, 2019, The Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued an alert providing an overview of the most common compliance issues identified by OCIE related to principal trading and agency cross transactions under Section 206(3) of the Advisers Act, which were identified during examinations of investment advisers.

Background: Section 206(3) – Principal Trades: It is unlawful for any investment adviser, directly or indirectly (including through an affiliated broker-dealer), to act as a principal for their own account and knowingly sell any security to a client or purchase any security from a client ("principal trades"), without disclosing to the client the capacity in which the adviser is acting and obtaining client consent. This disclosure must be in writing and the consent from the client must be received before the completion of such transaction (prior to settlement). This disclosure and consent process is required on a transaction-by-transaction basis, therefore, a blanket disclosure and consent is not sufficient.

Rule 206(3)-2 – Agency Cross Trades: Section 206(3) prohibits an adviser, acting directly or indirectly as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client (“agency cross transactions”), without disclosing in writing the capacity and obtaining consent from the client.

206(3)-2 permits certain agency cross transactions without requiring the adviser to provide transaction-by-transaction disclosure and consent if, among other things: (1) the client has executed a written consent prospectively authorizing agency cross trades after receiving full written disclosure of the conflicts involved and other information described in the rule; (2) the adviser provides a written confirmation to the client at or before the completion of each transaction providing, among other things, the source and amount of any remuneration it received; (3) the adviser provides a written disclosure statement to the client, at least annually, with a summary of all agency cross transactions during the period; and (4) the written disclosure documents and confirmations required by the rule conspicuously disclose that consent may be revoked at any time.

Important Notes:

- A “cross transaction,” although not a defined term, generally refers to a transaction in which an adviser causes the purchase and sale of a particular security between two or more advisory client accounts without charging a fee for effecting the transaction. If the adviser charges a transaction based fee for effecting the trade, it would need to do so as a registered broker-dealer or through an affiliated broker-dealer and the transaction would be deemed an “agency cross transaction”. However, cross transactions have other consequences that require attention including disclosure in Form ADV Part 2, fair market value considerations and that the transaction is beneficial to all clients involved.
- The SEC staff has stated that a principal account includes a private investment fund in which the investment adviser or its controlling persons own, in the aggregate, more than 25% of the fund. The SEC staff, however, has not clarified whether the 25% amount should include (1) the ownership interests of non-control personnel of an adviser; (2) the ownership interests of a control person’s family members, including a spouse or dependent child; or (3) an adviser’s incentive fees/allocations.

Common Investment Adviser Compliance Issues Related to Principal and Agency Cross Trading:

1. Advisers acting as principal for their own accounts, purchased securities from, and sold securities to individual clients without recognizing that such principal trades were subject to Section 206(3). Thus, these advisers did not make the required written disclosures to the clients or obtain the required client consents.
2. Advisers recognized that they engaged in principal trades with a client, but did not meet all of the requirements of Section 206(3), such as:
 - a. Failing to obtain appropriate prior client consent for each

principal trade.

- b. Failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction.
3. Advisers that had obtained client consent to a principal trade after the completion of the transaction.
4. Advisers that effected trades between advisory clients and an affiliated pooled investment vehicle, but failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle would cause the transaction to be subject to Section 206(3).
5. Advisers that effected principal trades between themselves and pooled investment vehicle clients, but did not obtain effective consent from the pooled investment vehicle prior to completing the transactions (consent from a conflicted review committee is not sufficient).
6. Advisers that disclosed to clients that they would not engage in agency cross transactions, but in fact engaged in numerous agency cross transactions.
7. Advisers that effected numerous agency cross transactions, but could not produce documentation that they had complied with the written consent, confirmation, or disclosure requirements.
8. Failure to have policies and procedures relating to principal trades and agency cross transactions and/or failed to follow existing policies and procedures regarding principal trades and agency cross transactions when engaging in such transactions.

Conclusion: OCIE encourages advisers to review their written policies and procedures and the implementation of those policies and procedures to ensure that they are compliant with the principal trading and agency cross transaction requirements. The Investment Advisers Act of 1940 places restrictions on the ability of an investment adviser to engage in certain transactions with clients, primarily by requiring advisers to make trade-by-trade disclosures and receive client consent. Section 206(3) of the Advisers Act, which governs principal and agency cross transactions, continues to pose practical and interpretive challenges and neither this summary nor the OCIE alert is a complete guide to the issues relating to trading issues. We encourage people with compliance responsibilities to reach out to their compliance experts for guidance to the OCIE Alert and trading matters.

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