

Locke Lord QuickStudy: Risk Alert – Investment Adviser Principal and Cross Trading Compliance Issues Specifically Related to Fixed Income Securities

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On July 21, 2021, the Securities and Exchange Commission (the “SEC”), Division of Examinations (the “Division”), issued new guidance regarding “[Fixed Income Principal and Cross Trades by Investment Advisers from an Examination Initiative](#)”, which aggregates results of approximately 20 examinations of Advisers held over the course of two years called the “FIX Initiative”. This Risk Alert builds on the SEC’s Office of Compliance and Examinations’ (which is the former name of the Division) prior guidance issued on September 4, 2019, titled “[Investment Adviser Principal and Agency Cross Trading Compliance Issues](#)”(the “2019 Risk Alert”).

A “principal trade”, as defined in Section 206(3) of the Investment Advisers Act of 1940, as Amended (the “Advisers Act”), generally involves the purchase or sale of a security between (i) an advisory client and (ii) the Adviser (or any person who controls, is controlled by, or is under common control with the Adviser).

An “agency cross trade”, as defined in Section 206(3) of the Advisers Act and Rule 206(3)-2 thereunder, occurs when an Adviser arranges for a trade to be executed between a client and another party through a broker-dealer who controls, is controlled by, or is under common control with, the Adviser, and a “cross trade” occurs when an Adviser effects a trade between two or more of its advisory clients’ accounts, but does not charge a fee for effecting the transaction (collectively, “cross trades”).

2019 Risk Alert

In the 2019 Risk Alert, the Division identified major themes of compliance failures including failures that resulted in (i) breach of fiduciary duties, (ii) conflicts of interest, and (iii) absence of or deficiencies in compliance procedures. Some examples that were included in the 2019 Risk Alert include:

- Advisers, acting as principal for their own accounts, had 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 written disclosures to the clients or obtain the required client consents;
- Advisers 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);
- Advisers disclosed to clients in their investment management agreements and Forms ADV that they would not engage in agency cross transactions, but in fact engaged in numerous agency cross transactions in reliance on Rule 206(3)-2;

- Advisers effected numerous agency cross transactions and purported to rely on Rule 206(3)-2, but could not produce any documentation that they had complied with the written consent, confirmation, or disclosure requirements of the rule; and
- Division staff observed that many Advisers either (i) did not have any policies or procedures relating to Section 206(3) even though they engaged in principal trades and agency cross transactions, or (ii) Advisers who had policies and procedures regarding principal trades and agency cross transactions could not produce documentation to demonstrate compliance with their policies and procedures.

FIX Initiative

The FIX Initiative focused on Advisers' compliance with a subset of the issues identified in the 2019 Risk Alert – namely compliance requirements for principal trades and agency cross trades as they related to conflicts of interest, compliance programs, and disclosures.

During the course of the FIX Initiative, the Division observed continued issues with policies and procedures for principal trades and agency cross trades.

- Hoisted by Its Own Petard. The Division found that while most Advisers it examined did have policies and procedures related to principal trades and agency cross trades, most deficiencies resulted from the Adviser's failure to follow or failure to document following its policies and procedures. Major groups of deficiencies included that Advisers' policies and procedures:
 - lacked specific procedures to validate that: (1) principal trades, cross trades, or both were completed in a manner consistent with the advisers' disclosures to clients and their policies and procedures; and (2) appropriate consent was received from, and disclosure provided to, the involved clients prior to completing the transactions;
 - prohibited portfolio managers and traders from entering into principal trades, cross trades, or both. However, the Advisers' trading records identified that such prohibited trades were, in fact, executed;
 - required portfolio managers and/or traders to obtain prospective written approval for cross trades from the advisers' compliance departments in connection with these trades. However, in practice, such approvals were not obtained; and
 - required clear written disclosure to clients participating in principal trades that the clients' written consent authorizing the trades may be revoked within five days of giving it. However, the disclosures were provided only in the trade confirmations, which in some cases may not have been received by the client in a timely manner.
- A View from 20,000 Feet. Some Advisers' policies and procedures lacked sufficient detail or guidance to properly instruct the advisers' personnel to achieve compliance when executing principal trades and agency cross trades.
 - The Advisers' policies and procedures required the trades to be executed in the best interests of the clients. However, the policies and procedures did not: (1) specify the factors advisory personnel should consider in making these best interest determinations; and/or (2) include a requirement to document why the trades were considered to be in the best interests of the participating clients; and
 - Where Advisers' policies and procedures required certain ERISA accounts to be maintained in compliance with ERISA, there was no statement that ERISA prohibits all principal and cross trades.
- Testing 1, 2, 3 . . . The Division found that many of the Advisers that it examined failed to test the implementation of their written compliance policies and procedures for principal and cross trades.
 - Some Advisers failed to review their trade blotters to identify unreported principal trades, cross trades, or both. The Division found that some advisers who prohibited such trades were unaware that these trades had occurred. Other firms that permitted such transactions did not follow the steps required in their compliance policies and procedures for the approval, review, and analysis of these trades.
- Disclosure is My Friend. The Division found examples where Advisers failed to use "best execution" despite having a requirement to do so in their compliance manuals and disclosure documents. In other cases, the

Division found that the Adviser charged undisclosed mark-up fees on principal trades, cross trades or both. Moreover, a significant number of Advisers did not include disclosures in their Form ADV Part 2As, advisory agreements, or separate written communications to clients regarding the conflicts of interest created by Advisers that were providing guidance to their clients on both sides of the trades or acting as a broker for both sides of the transactions.

Key Take-Aways

- Advisers should review Section 206 and Rule 206(3)-2 of the Advisers Act to ensure that its policies and procedures meet the applicable requirements;
- Compliance personnel need to train the business personnel regarding principal trade and cross trade requirements, and ensure that there are no gaps regarding how to implement the instructions;
- Establish controls to identify principal trades and cross trades;
- Regularly test principal trades and cross trades for compliance with Section 206, Rule 206(3)-2 and the Adviser's policies and procedures;
- Review and update compliance policies and procedures at least annually to address any deficiencies in documentation, execution or controls.

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal advice.