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SEC Division of Examinations Issues Risk Alerts on Cross Trades and Wrap Fee Programs

WRITTEN BY

Jay A. Dubow | Ghillaine A. Reid | Stephanie Pindyck Costantino | Genna Garver | Meredith Sherman

On July 21, the Securities and Exchange Commission's Division of Examinations (Division) released two separate "risk alerts,"[1] encouraging investment advisers to implement written policies and procedures or review existing policies and procedures for (1) principal and cross trades to ensure consistency with the Investment Advisers Act of 1940 (Advisers Act) and the rules promulgated thereunder; and (2) "wrap fee" arrangements to address certain associated risks, conflicts, and challenges.

For principal and cross trades, all investment advisers — whether registered, exempt, or otherwise — must comply with the antifraud provisions of Section 206(3). Advisers should review and update their existing policies and procedures in accordance with the best practices and suggestions laid out in the risk alerts and contact their legal counsel or compliance consultants with any questions.

Risk alert on fixed-income principal and cross trades

The Division's risk alert on fixed-income principal and cross trades follows on and provides greater detail on its September 2019 risk alert[2] on the same topic.[3] In its earlier alert, the Division reviewed the disclosure and consent provisions of Section 206(3) of the Investment Advisers Act as applied to principal and cross trades.[4] The Division noted common issues and deficiencies arising from investment advisers engaging in those transactions, specifically relating to the existence, sufficiency, or timing of the disclosures and consent required under the Advisors Act.[5] It also encouraged advisers to review their written policies and procedures to enhance compliance.

In its newest alert, the staff provided greater detail on the previously raised compliance issues, specifically focusing on fixed-income trades. While Section 206(3)'s prohibitions on principal and cross trades apply whether the transactions involve fixed-income securities or other types of securities, advisers' policies and procedures should be tailored to address the nuances for fixed-income products. The risk alert reflects the results of 20 examinations focused on registered investment advisers that engaged in cross trades, principal trades, or both, specifically involving fixed-income securities (FIX Initiative). During the FIX Initiative, the staff examined advisers managing $2 trillion in assets for over two million client accounts, evaluating conflicts of interest, compliance programs, and disclosures. Nearly two-thirds of the examined advisers received deficiency letters in one or more of those areas. In many instances, advisers' practices and disclosures were inconsistent with the policies and procedures adopted by the firm, and even firms that believed the principal and cross trades were prohibited were unaware that such trades had in fact occurred. In other instances, conflicts of interests were not adequately identified or disclosed.

The Division observed that compliance programs varied greatly. Advisers that appeared to have the most effective compliance had adopted compliance programs that enforced policies and procedures with certain characteristics. Strong compliance programs had policies and procedures that incorporated all legal and regulatory requirements, articulated all covered activities, set standards, included supervisory policies and procedures, and established testing and controls. Regarding disclosure deficiencies, the staff also suggested that advisers provide full and fair disclosure of all material facts in multiple documents, specifically Form ADV Part 2A, advisory agreements, separate written communications, and/or private fund offering documents.

Wrap Fee Programs

As part of the Division's assessment of market risks for retail investors saving for retirement, the Division also issued a second risk alert on "wrap fee" programs. The Division explained that its focus on wrap fees relates to continued growth of investor assets in wrap fee arrangements and the staff's observance — during previous examinations — of certain conflicts and disclosure issues in these arrangements.

Typically, in a wrap fee program, the wrap fee is one bundled fee that includes the investment adviser's services and brokerage services generally (rather than charging a fee on a transaction-by-transaction basis in the client account). Bundled services could include investment advice; trade execution costs; research; administrative expenses, such as custodial fees; and other fees and expenses, including mutual fund fees and expenses. However, not all wrap fees are the same, and some of these fees and expenses may be charged separately and in addition to the bundled fee. Because the services are bundle into a single fee, total fees to a wrap fee client may be more or less than obtaining such services separately. The Division's risk alert notes that these programs may create conflicts of interest for advisers and risks to investors by, among other things, increasing client expense or incentivizing less frequent trading than would be in the clients' best interest.

The Division examined over 100 wrap fee arrangements and cited numerous ways in which advisers could improve common deficiencies concerning compliance and oversight, including adopting, reviewing, and enforcing policies and procedures on the tracking and monitoring of the wrap fee programs, as well as disclosures relating to conflicts, fees, and expenses. The examinations focused on fiduciary obligations (including whether the advisers had a reasonable basis to believe the wrap fee programs were in the best interest of participating clients, as well as documentation of their analysis); the adequacy of the examined advisers' disclosures (whether the examined advisers provided full and fair disclosures of all material facts to their clients participating in the wrap fee programs); and the effectiveness of the compliance programs.

The staff found certain common deficiencies in practices relating to fiduciary duties. The staff noticed certain advisers did not have a reasonable basis to believe their wrap fee programs were in their clients' best interest because they did not monitor the frequency of trading activity in clients' accounts; only monitored it in a small sample size of client accounts; or did not consider the question on an ongoing basis.

Concerning disclosure obligations, the staff noted that some disclosures relating to wrap fees were potentially misleading because advisers omitted disclosures or certain documents (such as firm brochures) containing discrepancies. At other times, advisers did not provide the full disclosures or failed to reveal that certain lower fee options were available. In particular, the firm brochure did not provide full disclosures regarding fees that were not included in the wrap fee (*e.g.,* fixed-income markups and trade-away fees) or otherwise included inconsistencies

with the fee terms set forth in the client advisory agreements.

Finally, regarding compliance programs, the staff found that certain advisers did not adopt compliance policies or procedures at all, or alternatively, that compliance policies and procedures were inadequate, inconsistently implemented, or inadequately enforced. In other instances, the policies and procedures were not reviewed annually, or at all, after initial implementation.

In light of the alert, compliance programs should include written policies and procedures and should be monitored for best execution. Best practices for wrap fee programs involve both initial and periodic reviews to assess whether the wrap fee disclosures are adequate with respect to conflicts of interests, services, and expenses. Further, firms should undertake initial and periodic reviews of whether the arrangements are in their clients' best interest by evaluating information provided directly by the clients. Advisers should also periodically remind clients to report any changes to their situations or objectives and should otherwise communicate with clients to prepare and educate them when recommending wrap fee accounts.

Please reach out to Troutman Pepper with any questions regarding the alerts or your firm's adoption or review of policies and procedures with the Division's recommended guidance and best practices.

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[1] *See* https://www.sec.gov/files/wrap-fee-programs-risk-alert_0.pdf and https://www.sec.gov/files/fixed-income-principal-and-cross-trades-risk-alert.pdf.

[2] *See* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Principal%20and%20Agency%20Cross%20Trading.pdf.

[3] In March 2021, the Division of Investment Management staff also published an Investment Company Act release discussing Rule 17a-7's general requirements that cross trades: (a) involve a security for which market quotations are readily available; and (b) close at the independent current market price of the security. Rule 17a-7 contains several other requirements for cross trades, including that the transaction be consistent with the policy of each fund; that no commission, fee, or other remuneration be paid in connection with the transaction; that the board (including a majority of independent directors) take certain actions; and that the fund maintain certain records. *See* https://www.sec.gov/news/public-statement/investment-management-statement-investment-company-cross-trading-031121.

[4] By way of background, Section 206(3) makes it unlawful for an investment adviser acting as principal for his own account to knowingly, directly or indirectly, sell to or purchase any security from a client (principal trades) without meeting certain disclosure and consent requirements. The adviser must disclose the adviser's role to the client, in writing, in advance of the transaction and obtain the client's consent. Disclosure and consent may not be "blanket," but instead must be obtained on a transaction-by-transaction basis.

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Section 206(3) also prohibits an adviser acting as a broker for a person other than the advisory client from knowingly, directly or indirectly, affecting any sale or purchase of any security for the account of that advisory client (agency cross transactions) without disclosing the adviser's role to the client, in writing, prior to completion of the transaction and obtaining the client's consent. Distinct from principal trades, for agency cross transactions, the Advisers Act permits a "blanket" disclosure in limited circumstances, where, among other things that: (1) the client has executed a written, prospective consent after receiving a full written disclosure of conflicts; (2) the adviser provides the client with the source and amount of any remuneration it received; (3) the adviser provides written disclosure at least annually with a summary of all agency cross transactions during the period; and (4) the disclosure and consent forms conspicuously disclose that consent may be revoked at any time.

See Risk Alert: Investment Adviser Principal and Agency Cross Trading Compliance Issues (September 4, 2019).

[5] Certain advisers failed to make the written disclosures at all, while others made disclosures that were insufficient, failed to obtain client consents as required, or obtained the consent in an untimely fashion (*i.e.,* following the completion of a transaction). The Division also noted that certain advisers falsely claimed that they do not engage in agency cross transactions. Others could not produce any documentation of compliance with the requirements of the rule.

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