RISK ALERT
OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS

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Investment Adviser Principal and Agency Cross Trading Compliance Issues

In this Alert: *The most frequent principal trading and agency cross transaction compliance issues identified by OCIE staff in examinations of advisers.*

I. Introduction

This Risk Alert provides an overview of the most common compliance issues identified by the Office of Compliance Inspections and Examinations ("OCIE")* related to principal trading and agency cross transactions under Section 206(3) of the Advisers Act,[1] which were identified in examinations of investment advisers.[2]

Section 206(3) - Principal Trades

Section 206(3) makes it unlawful for any investment adviser, directly or indirectly, acting as principal for his own account knowingly to (a) sell any security to a client or (b) purchase any security from a client ("principal trades"), without disclosing to such client in writing before the completion of such transaction the capacity in which the adviser is acting and obtaining the consent of the client to such transaction. Section 206(3) requires an adviser entering into a principal trade with a client to satisfy these disclosure and consent requirements on a transaction-by-transaction basis – blanket disclosure and consent are not permitted.[3]

Section 206(3) and Rule 206(3)-2 – Agency Cross Trades When Acting as a Broker

Section 206(3) also prohibits an adviser, directly or indirectly, acting 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 to that client in writing

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* The views expressed herein are those of the staff of OCIE. This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has expressed no view on the contents of this Risk Alert. This Risk Alert has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. This document was prepared by OCIE staff and is not legal advice.

1 This Risk Alert does not discuss all of the requirements of Section 206(3) and Rule 206(3)-2 thereunder, nor does it provide an exhaustive list of compliance considerations concerning these provisions.

2 This Risk Alert discusses certain issues identified in select deficiency letters from adviser exams completed during the past three years. This Risk Alert does not discuss all types of deficiencies or weaknesses related to Section 206(3) and Rule 206(3)-2 that have been identified by staff.

3 *Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Investment Advisers Act Rel. No. 1732 (July 17, 1998), 63 FR 39505 at 39507 (July 23, 1998) ("[A]n adviser may comply with Section 206(3) either by obtaining client consent prior to execution of a principal or agency transaction, or after execution but prior to settlement of the transaction.").

before the completion of the sale or purchase the capacity in which the adviser is acting and obtaining the consent of the client to the sale or purchase. However, Advisers Act Rule 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.[4]

Compliance with the disclosure and consent provisions of Section 206(3) alone may not satisfy an adviser's fiduciary obligations with respect to a principal or agency cross trade. To ensure that a client's consent to a principal trade or agency cross transaction is informed, the Commission has stated that Section 206(3) should be read together with Advisers Act Sections 206(1) and (2) to require the adviser to disclose facts necessary to alert the client to the adviser's potential conflicts of interest in a principal trade or agency cross transaction.[5]

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

Below are examples of the most common deficiencies or weaknesses identified by OCIE staff in connection with Section 206(3) and Rule 206(3)-2.

A. *Section 206(3) requirements not followed.* OCIE staff observed advisers that did not appear to follow the specific requirements of Section 206(3). For example, OCIE staff observed:

- Advisers that, 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 the required written disclosures to the clients or obtain the required client consents.

- Advisers that had recognized that they engaged in principal trades with a client, but did not meet all of the requirements of Section 206(3), such as:

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[4] Advisers and their broker-dealer affiliates should consider that Section 206(3) may apply to certain situations involving advisers that cause a client to enter into a principal or agency transaction that is effected by a broker-dealer that controls, is controlled by, or is under common control with, such adviser. *See id.* at 39505 n.3.

[5] *See id.* at 39506; *see also* *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Rel. No. 5248 at 21-23 (June 5, 2019) ("The duty of loyalty requires that an adviser not subordinate its clients' interests to its own…To meet its duty of loyalty, an adviser must make full and fair disclosure to its clients of all material facts relating to the advisory relationship… [and] must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested"). An investment adviser also has a duty to seek best execution of a client's transactions where the adviser has the responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). *See id* at 19.

- Failing to obtain appropriate prior client consent for each principal trade.

- Failing to provide sufficient disclosure regarding the potential conflicts of interest and terms of the transaction.[6]

- Advisers that had obtained client consent to a principal trade *after* the completion of the transaction.

B. *Principal trade issues related to pooled investment vehicles.* OCIE staff observed advisers that engaged in certain transactions involving pooled investment vehicle clients where such advisers did not appear to follow the requirements of Section 206(3). For example, OCIE staff observed:

- Advisers that effected trades between advisory clients and an affiliated pooled investment vehicle, but failed to recognize that the advisers' significant ownership[7] interests in the pooled investment vehicle would cause the transaction to be subject to Section 206(3).[8]

- 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.[9]

C. *Agency cross transactions.* OCIE staff observed advisers' practices that gave rise to compliance issues in connection with agency cross transactions. For example, OCIE staff observed:

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6 *See* Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 1732 (July 17, 1998), 63 FR 39505 at 39506 (July 23, 1998) ("Section 206(3) expressly requires that a client be given written disclosure of the capacity in which the adviser is acting, and that the adviser obtain its client's consent to a Section 206(3) transaction. The protection provided to advisory clients by the consent requirement of Section 206(3) would be weakened, however, without sufficient disclosure of the potential conflicts of interest and the terms of a transaction. In our view, to ensure that a client's consent to a Section 206(3) transaction is informed, Section 206(3) should be read together with Sections 206(1) and (2) to require the adviser to disclose facts necessary to alert the client to the adviser's potential conflicts of interest in a principal or agency transaction ").

7 The Commission has entered into settlement agreements when the adviser effected transactions between their advisory clients and accounts in which the principals of the advisers held significant ownership interests. *See* SEC v. Beacon Hill Asset Management, LLC, Litigation Rel. No. 18950 (Oct. 28, 2004) (settled matter); and In the Matter of Gintel Asset Management, Investment Advisers Act Rel. No. 2079 (Nov. 8, 2002) (settled order).

8 Staff in the Division of Investment Management ("IM Staff") has stated its view that Section 206(3) does not apply to a transaction between a client account and a pooled investment vehicle of which the investment adviser and/or its controlling persons, in the aggregate, own 25% or less. *See* Gardner Russo & Gardner, IM Staff No-Action Letter (June 7, 2006).

9 The Commission has entered into settlement agreements where an adviser to a pooled investment vehicle failed to obtain effective consent to principal trades because the review committee established by the adviser to approve the pricing of the trades in an attempt to satisfy the requirements of Section 206(3) was itself conflicted. *See* Paradigm Capital Mgmt., Inc., Advisers Act Rel. No. 3857 (June 16, 2014) (settled order).

- Advisers that disclosed to clients 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 that 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.

D. *Policies and procedures related to Section 206(3).* OCIE staff observed advisers that did not have policies and procedures relating to Section 206(3) even though the advisers engaged in principal trades and agency cross transactions.[10] OCIE staff also observed advisers that established—but failed to follow—policies and procedures regarding principal trades and agency cross transactions.

III. Conclusion

In response to the issues identified in the deficiency letters, many of the advisers modified their written policies, procedures and practices to address the issues identified by OCIE staff. 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 provisions of the Advisers Act and the rules thereunder.

This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance, and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.

[10] *See* Advisers Act Rule 206(4)-7(a) (requiring advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Act and the rules that the Commission has adopted under the Act).