RISK ALERT
DIVISION OF EXAMINATIONS

July 21, 2021

Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from An Examination Initiative*

I. Introduction

An adviser that arranges for a security to be purchased from or sold to a client from its own account – as opposed to purchasing or selling the security in the secondary markets – is engaging in a "principal trade." An "agency cross trade" occurs when an adviser arranges for a trade to be executed between a client and another party, 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"). An adviser that enters its clients into these types of transactions implicates a variety of legal obligations under the Investment Advisers Act of 1940 ("Advisers Act"), particularly its fiduciary duty.[1]

On September 4, 2019, the Division of Examinations (the "Division") published a Risk Alert highlighting the most common compliance issues observed by the staff related to principal and agency cross trades under the Advisers Act ("Principal Transactions Risk Alert").[2] In this follow-up Risk Alert, the Division supplements the staff's observations made in the Principal Transactions Risk Alert by providing greater detail on certain compliance issues. These observations are derived from an examination initiative that focused on SEC-registered investment advisers ("examined advisers") that engaged in cross trades, principal trades, or both, involving fixed income securities ("FIX Initiative").[3]

The staff conducted over 20 examinations as part of the FIX Initiative. The examined advisers collectively managed approximately $2 trillion in assets for over two million client accounts, including more than one million retail clients, nearly 3,000 pension and profit sharing plans, and over 150 mutual funds.[4]

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* The views expressed herein are those of the staff of the Division of Examinations, formerly known as the Office of Compliance Inspections and Examinations or OCIE (the "Division"). This Risk Alert is not a rule, regulation, or statement of the Securities and Exchange Commission (the "SEC" or the "Commission"). The Commission has neither approved nor disapproved the content 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 Division staff and is not legal advice.

[1] *See*, *e.g.*, Advisers Act Sections 206(1), (2), and (3) and Rules 206(3)-2 and 206(4)-7. An adviser's obligation as a fiduciary is enforceable through Advisers Act Section 206.

[2] *See* Division (published as the Office of Compliance Inspections and Examinations or "OCIE"), Risk Alert: Investment Adviser Principal and Agency Cross Trading Compliance Issues (September 4, 2019).

[3] *See* Division (published as OCIE), Examination Priorities (2017).

[4] This Risk Alert is intended to highlight staff observations regarding the examined advisers' principal and cross trading practices and their compliance with the Advisers Act and the rules thereunder (while the staff focused on both principal and cross trades, the staff

II. Scope of the FIX Initiative and Legal Requirements

During the FIX Initiative, the staff reviewed the examined advisers' practices for principal and cross trades by focusing on the following areas:

- Conflicts of interest, such as whether these trades appeared to be made in the clients' best interests, rather than to further the interests of the advisers.[5]
- Compliance programs, such as whether the advisers' adopted written policies and procedures pursuant to the "Compliance Rule" effectively addressed these trades.[6]
- Disclosures, such as whether the conflicts of interest related to these trades were fully and fairly disclosed to clients.[7]

To understand better the legal requirements and provisions that may be implicated for advisers engaging in principal and cross trades, the staff recommends reviewing the Principal Transactions Risk Alert, along with this Risk Alert.[8] Collectively, these documents provide a discussion of the legal requirements applicable to advisers that engage in principal and cross trades, compliance issues identified by the staff when reviewing such transactions, and helpful resources regarding Commission actions and interpretative guidance relevant to this topic.

III. Staff Observations Related to the FIX Initiative Focus Areas

Nearly two-thirds of the examined advisers received staff-issued deficiency letters, which addressed the staff's observations regarding a variety of topics. However, the vast majority of deficiencies the staff observed were related to compliance program issues, conflicts of interest, and disclosures, as discussed below.

- *Compliance programs.* Over half of the deficiencies the staff observed were related to issues with the examined advisers' compliance policies and procedures. Below are some examples

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observed that cross trades were executed with greater frequency than principal trades). The Alert does not address practices and compliance with the Investment Company Act of 1940 that apply to cross trading by mutual funds.

5 *See*, *e.g.*, Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Rel. No. 5248 at 21-23 (June 5, 2019) ("an adviser must not place its own interest ahead of its client's interests").

6 *See* Advisers Act Rule 206(4)-7 and Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2204 (December 17, 2003) (requiring SEC-registered advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder). Also, certain types of advisory clients, such as retirement plans subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and SEC-registered investment companies, may need to comply with other regulations that generally prohibit or restrict them from engaging in principal trades, cross trades, or both.

7 *See* supra note 5 (An adviser must "make full and fair disclosure to its clients of all material facts relating to the advisory relationship… [and] 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."). Also, where an adviser selects broker-dealers to execute client trades, it has a duty to seek best execution. Lastly, Advisers Act Section 206(3) and Rule 206(3)-2 require an adviser entering into a principal or agency cross trade, respectively, to satisfy certain disclosure and consent requirements.

8 *See* supra notes 1 and 2. The Commission has taken action against advisers that failed to comply with these legal requirements. *See*, *e.g.*, In re Talimco LLC, Advisers Act Rel. No. 5202 (March 15, 2019) (settled) (alleging that assets were inappropriately crossed between two advisory clients' accounts, and later sold at a profit, resulting in the adviser receiving ill-gotten management and performance fees); and In re Hamlin Capital Management LLC, Advisers Act Rel. No. 4983 (August 10, 2018) (settled) (alleging that mispriced crossed trades of securities improperly favored one party over the other).

of the types of compliance program-related deficiencies the staff observed when the advisers had engaged in principal trades, cross trades, or both, during the examination review period.

- *Policies and procedures were inconsistent with the examined advisers' practices, its disclosures, and/or regulatory requirements*. In many cases, the examined advisers had written compliance policies and procedures that addressed principal and cross trades, undisclosed arrangements, and conflicts of interest. However, in some cases, the compliance programs did not include 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.[9] Below are some examples of issues the staff identified when reviewing the examined advisers' practices.

    - Advisers prohibited portfolio managers and traders from entering into principal trades, cross trades, or both. However, when the staff reviewed the advisers' trading records, the staff identified that such prohibited trades were, in fact, executed.

    - Advisers 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.

    - Advisers 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.

- *Policies and procedures lacked certain considerations or guidance, such that the examined advisers' personnel did not have the full scope of information that may be necessary to achieve compliance.* Some advisers included standards in their written compliance policies and procedures addressing under what circumstances principal and cross trades are appropriate, but they did not always provide sufficiently detailed information for advisory personnel to know whether they were complying with these written standards. Examples of the issues the staff observed include:

    - The advisers' policies and procedures required the trades to be executed in the best interests of the clients and supervised persons to use standardized cross trading reporting forms. However, these advisers did not: (1) specify in their procedures the factors advisory personnel should consider in making these best interest determinations; and/or (2) include a section in their cross trading reporting forms to document why the trades were considered to be in the best interests of the

[9] *See* Advisers Act Section 206(3) (an adviser may not knowingly engage in principal trades without, before the completion of each transaction: (1) disclosing to its client in writing the capacity in which the adviser is acting; and (2) obtaining consent of the client to such transaction. This section also places similar prohibitions on agency cross trades.). *See also*, Advisers Act Rule 206(3)-2 (permitting certain agency cross transactions without requiring the adviser to provide transaction-by-transaction disclosure and consent as long as certain conditions are met ("blanket consent")).

participating clients or have advisory personnel, in practice, memorialize such assessments elsewhere.

    - When managing ERISA client accounts, advisers often committed in their contractual relationship with the clients to manage the clients' portfolios in compliance with ERISA investment restrictions. However, some advisers' compliance programs did not contain any policies or procedures on what the advisers must do to be in compliance with such ERISA investment restrictions, including those prohibiting principal and cross trades. The lack of any policies and procedures to meet a contractual obligation rooted in legal requirements could result in an adviser breaching its fiduciary duty to its advisory client.

    - When executing cross trades, the advisers' policies and procedures specified that the advisers would obtain multiple quotes from different broker-dealers to use as the crossing value for the trades, but the procedures did not specify which value (or calculation thereof) advisory personnel should use for valuing the trades if the quotes differed.

  - *Policies and procedures were not effectively tested.* Many examined advisers did not effectively test the implementation of their written compliance policies and procedures for principal and cross trades, such as analyzing their trade blotters to identify unreported principal trades, cross trades, or both. As a result, the staff observed that advisers, including firms that prohibited such trades, were unaware that these trades had occurred. Since the firms were unaware of the trades: (1) the firms that prohibited such transactions did not prevent them from being executed; and (2) the 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. For example, the advisers did not perform timely annual compliance reviews of cross trading activities, receive clients' consent for principal trades, and conduct prescribed best execution analysis of these trades.

- *Conflicts of interest.* The staff's review of the examined advisers' practices often identified conflicts of interest associated with cross trades that were not identified by the advisers and mitigated, disclosed, or otherwise addressed by their compliance programs. For example, the staff observed cross trades that were:

  - Contrary to the advisers written policies and procedures in that they were not executed at independent market prices for the securities and did not use best price and best execution efforts, which resulted in at least one of the participating clients receiving an unfair price for the securities.

  - Subject to markups or other fees that were not fully disclosed.

- *Written Disclosures.* The staff observed that over one-third of the cross trade-related deficiencies addressed disclosure issues. For example, in addition to the disclosure issues discussed above, the staff observed that the examined advisers:

  - Omitted certain relevant information concerning cross trading activities in their Form ADVs.

- Had no disclosures regarding the conflicts of interest associated with executing such trades in their Form ADV Part 2As.
- Did not include disclosures in their Form ADV Part 2As, advisory agreements, and 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.

IV. Staff Observations on Ways to Improve Compliance

The staff observed that the content and effectiveness of the examined advisers' compliance programs varied greatly. Below are some of the practices the staff observed at the examined advisers that appeared to be effective.

Compliance Programs

- *Adopt and enforce compliance policies and procedures that: (1) incorporate all applicable legal and regulatory requirements; (2) clearly articulate the activities covered by the advisers' written compliance policies and procedures; (3) set standards that address the firms' expectations for each of these activities; (4) include supervisory policies and procedures; and (5) establish controls to determine whether policies and procedures are being properly followed and documented in the required manner.* Examples of practices the staff observed that may help to support compliance with advisers' policies and procedures include:
    - *Define covered activities.* The examined advisers' written compliance policies and procedures typically defined principal trades, cross trades, or both. However, the definitions varied, as did the specificity. Specific and detailed definitions were more likely to be consistently followed. For example, when defining cross trades, the staff observed that the more detailed definitions included the time frame within which the transactions must occur to be considered cross trades, such as stating that crossing must occur on the same day or within three days of the trade date.
    - *Set standards.* Nearly all of the examined advisers had adopted written compliance policies and procedures that addressed their expectations for engaging in cross trades, some of which prohibited all cross trading. Similarly, all of the examined advisers that permitted the execution of principal trades had adopted written compliance policies and procedures to address such trades. The examined advisers' written compliance policies and procedures typically included one or more of the standards listed in the chart below and often included all of these standards.

Standards Observed	Cross Trade	Principal Trade
Transactions should be fair and equitable to all participating client accounts.	✔	✔
Pricing methodologies used to execute the transactions are prescribed.	✔	✔
Periodic evaluations of the quality of execution are performed.	✔	✔
Periodic reporting to the legal or compliance departments occurs.	✔	✔
Clients receive written information regarding the capacity in which the advisers acted.	✔	✔
Portfolio managers or traders get advanced written approval from senior management or compliance personnel in order to execute the trades.	✔	✔
Clients must provide written consent prior to the completion of each transaction.*		✔

* In seeking client consent, the advisers also often stated the reason for recommending the trade and obtained valuations from at least two unaffiliated broker-dealers.

Many of the standards the staff observed above are included in the advisers' written policies and procedures because they correspond to legal requirements in the Advisers Act, such as Section 206 and Rule 206(3)-2. However, these written standards also promote compliance with the advisers' policies and procedures and provide greater clarity regarding the advisers' expectations for the conduct of their advisory personnel when engaging in principal trades, cross trades, or both.

- *Conduct testing for compliance with policies and procedures.* The advisers with written policies and procedures were more likely, as compared to advisers with no or informal practices, to analyze their books and records to identify undisclosed principal and cross trades, and any associated undisclosed conflicts of interest or other issues. Some of the examined advisers, when conducting their own internal compliance reviews, identified issues or risks associated with their practices with respect to principal trades, cross trades, or both. Some of the self-identified issues include instances where the advisers did not:
    - Maintain documentation or information regarding the trade, such as the determination that a fair and equitable price was used or best execution was achieved.
    - Provide full and fair disclosure regarding the trades to clients, or seek consent from clients, which is inconsistent with the advisers' fiduciary duty.
    - Identify and/or report these trades or related breaches or risks (*e.g.*, the inter-positioning of broker-dealers in cross trades).
    - Restrict transacting in impermissible or prohibited accounts (*e.g.*, ERISA accounts).
- *Place conditions, qualifications, or restrictions on the execution of principal trades, cross trades, or both within clients' accounts.* The examined advisers often placed conditions on the execution of these trades within their clients' accounts to, among other things, promote compliance with or adherence to their fiduciary obligation, legal requirements, clients' mandates, compliance policies and procedures, and/or disclosures. The most common of such conditions are identified below, with several advisers imposing <u>all</u> of the conditions.

- The securities must only be purchased by or sold to another client when there is a need and securities meet each participating client's investment objectives.
- The client accounts involved in these trades are not ERISA accounts.
- The trades received best price and best execution (*e.g.*, several required independent prices for the assets to be obtained from third-party broker-dealers).
- The adviser, its affiliated persons, and its supervised persons may not receive commissions or any other compensation with respect to these trades.

Written Disclosures

- *Provide clients with full and fair disclosure of all material facts surrounding principal and cross trades.* Consistent with their fiduciary duty, many of the examined advisers provided disclosures to their clients concerning the conflicts of interest associated with executing cross trades. Several advisers that permitted principal trades also provided disclosures regarding the associated conflicts of interest. These disclosures often included a description of the nature and significance of the advisers' conflicts of interest relative to the impacted clients. The staff observed examined advisers that had more robust disclosures. Common topics discussed that contributed to this assessment are listed in the chart below.

Disclosures Observed	Cross Trade	Principal Trade
How the adviser addressed the conflicts of interest that were identified.	✔	✔
The circumstances under which the adviser may engage in these transactions.	✔	✔
Any costs associated with these transactions, including describing the pricing methodologies used by the adviser to value the securities transactions.	✔	✔
The total amount of all commissions or other remuneration received or to be received by the adviser or any affiliated persons in connection with these transactions.	✔	✔
The option for clients to revoke their written blanket consent to execute cross trades without penalty at any time by written notice to the adviser.*	✔	
The total number of principal trades entered into during the period (since the date of the last statement or summary).		✔

See Advisers Act Rule 206(3)-2. Clients may not give blanket consent for principal trades.

Many of the disclosures described above were provided because they correspond to legal requirements in the Advisers Act, such as Section 206 and Rule 206(3)-2. However, all of the information assists clients in better understanding the advisers' conflicts of interest associated with principal trades, cross trades, or both.

- *Provide disclosures to clients regarding principal and cross trading practices in multiple documents.* Typically, the examined advisers provided disclosures in the following documents: (1) Form ADV, Part 2A; (2) advisory agreements; (3) separate written communications to clients; and/or (4) private fund offering documents, when applicable. In addition to their written disclosures, some advisers discussed their rationale for executing principal trades during oral conversations with their clients.

III. Conclusion

The examinations conducted within the scope of this review resulted in a range of actions. In response to the staff's observations, some examined advisers elected to amend disclosures, revise compliance policies and procedures, or change other practices. The Division encourages advisers to review their written policies and procedures regarding principal and cross trades, including the implementation of those policies and procedures, to ensure that they are consistent with the Advisers Act and the rules thereunder.

This Risk Alert is intended to highlight for firms risks and issues that the Division staff has identified. In addition, this Risk Alert describes risks that firms may consider to (1) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (2) 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.