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Memorandum

SEC Risk Alert Highlights Compliance Issues Relating to Investment Adviser Principal and Agency Cross Transactions

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Last week, the Office of Compliance Inspections and Examinations ("OCIE") of the U.S. Securities and Exchange Commission ("SEC") published a Risk Alert (the "Risk Alert")[1] highlighting compliance issues identified in investment adviser exams relating to principal trading and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act").[2] Below we outline the Section 206(3) compliance issues identified in the Risk Alert and highlight some key takeaways for investment advisers that manage private funds.

Key Takeaways

The Risk Alert does not present any new interpretation of Section 206(3). Instead, the Risk Alert should be viewed as evidence that OCIE staff continues to focus on compliance issues relating to principal and agency cross transactions, including those involving pooled investment vehicles, as an examination priority. Importantly, the Risk Alert acknowledges the view taken by the staff that Section 206(3) principal trade requirements do 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.[3]

Advisers to private funds should ensure they fully comply with Section 206(3) requirements in connection with any principal or agency cross transactions entered into by their funds. In addition, advisers are encouraged to carefully review existing policies and procedures to ensure they are reasonably designed to (i)

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[1] *Investment Adviser Principal and Agency Cross Trading Compliance Issues*, Risk Alert SEC OCIE (Sept. 4, 2019).

[2] The Risk Alert states that identified compliance issues were cited in deficiency letters from adviser examinations that were completed over the past three years.

[3] Although these transactions are not subject to Section 206(3) principal trade requirements, an adviser whose client enters into this type of transaction would need to consider (i) whether its agreements with the client require that any action be taken in connection with the transaction and (ii) whether any conflicts of interest are being handled properly under the circumstances.

identify principal and agency cross transactions and (ii) meet disclosure and consent obligations required under Section 206(3). More generally, private fund advisers should ensure that any transactions their funds enter into with affiliated entities—including transactions outside the scope of Section 206(3)—are consistent with the governing documents of the applicable funds and the fiduciary duties owed to the funds under the Advisers Act.

Background

Under Section 206(3), an investment adviser may not, directly or indirectly, acting as principal for its own account, knowingly buy or sell securities from or to a client ("principal trades") without (i) disclosing to the client in writing—before the completion (*i.e.*, settlement) of the transaction—the capacity in which the adviser is acting and (ii) obtaining the client's consent to the specific transaction. Consent must be obtained on a transaction-by-transaction basis, not through blanket consent.

Section 206(3) also prohibits an adviser from, directly or indirectly, acting as broker for a person other than the advisory client, knowingly effecting any sale or purchase of any security for the account of that client ("agency cross transactions") without (i) disclosing to that client in writing—before the completion (*i.e.*, settlement) of the transaction—the capacity in which the adviser is acting and (ii) obtaining the client's consent to the sale or purchase. However, Rule 206(3)-2 under the Advisers Act permits an adviser to effect agency cross transactions without obtaining client consent separately for each individual agency cross transaction, provided that the adviser satisfies certain consent, confirmation and disclosure requirements set forth in the rule.[4]

Risk Alert

OCIE's Risk Alert reports common compliance deficiencies owing to adviser failures to comply with Section 206(3) requirements, noting specific issues involving pooled investment vehicle clients, agency cross transactions and policies and procedures regarding principal and agency cross transactions. The Risk Alert also explains that compliance with disclosure and consent obligations under Section 206(3) should be read

[4] Specifically, under Rule 206(3)-2, advisers need not obtain client consent separately for each individual agency cross transaction, provided: (1) the client executes a written consent prospectively authorizing agency cross transactions after receiving full written disclosure as to the potential conflicts of interest involved and other information described in the rule; (2) the adviser provides a written confirmation to the client, at or before completion of each transaction, detailing, among other things, the source and amount of any remuneration it received; (3) the adviser provides to the client an annual written disclosure statement with a summary of all agency cross transactions made since the last statement, containing details of all commissions and remuneration received by the adviser; (4) each such written confirmation and disclosure includes a conspicuous statement that the client's consent may be revoked at any time; and (5) no such transaction is effected in which the same adviser (or an adviser and another person controlling, controlled by or under common control with the adviser) recommended the transaction to both the seller and purchaser.

together with an adviser's obligation to make full and fair disclosure of facts material to an advisory relationship, including conflicts of interest that prevent an adviser from rendering disinterested advice.[5]

OCIE identified the following as the most common deficiencies related to Section 206(3).

Section 206(3) Requirements Not Followed Generally

OCIE staff observed advisers that purchased or sold securities from or to their clients without recognizing they were acting as principal for their own accounts for purposes of Section 206(3) and therefore did not make the required disclosures or obtain the appropriate consents. Other advisers recognized the capacity in which they were acting but failed to obtain consent and/or make adequate disclosure regarding the conflicts of interest and terms of the principal trades. Other advisers did not obtain the required consent prior to the principal trade and only obtained consent after the completion of the transaction.

Principal Trade Issues Related to Pooled Investment Vehicles

OCIE staff also identified unique issues facing advisers managing pooled investment vehicles. In particular, OCIE staff observed that advisers failed to recognize that, in effecting transactions between advisory clients and affiliated pooled investment vehicles, the adviser's significant ownership interest in the affiliated vehicle caused the transaction to be subject to Section 206(3).[6] Because these advisers failed to recognize that such transactions were principal trades subject to Section 206(3), they did not provide the required disclosures or obtain effective consents. In addition, advisers effecting trades between themselves and pooled investment vehicle clients did not obtain effective consent from the clients prior to the completion of the transactions. Concerns around whether consent is effective arise where an adviser creates a committee or appoints an individual that is conflicted and thus unable to provide effective consent.[7]

Agency Cross Transaction Issues

OCIE staff found examples of advisers that disclosed to clients they would not engage in agency cross transactions only to later engage in such transactions without providing adequate disclosure. OCIE staff also identified other advisers that engaged in agency cross transactions, purportedly in reliance on Rule 206(3)-2,

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[5] *See* *Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Investment Advisers Act Rel. No. 5248 (June 5, 2019).

[6] As the Risk Alert acknowledges, the staff has taken the view that Section 206(3) principal trade requirements would not apply to a cross transaction between a client account and an account of which the adviser and/or its controlling persons, in the aggregate, own 25% or less. In contrast, Section 206(3) principal trade requirements would apply to a cross transaction between a client account and an account of which the investment adviser and/or a controlling person, in the aggregate, own(s) more than 25%. *See* *Gardner Russo & Gardner*, IM Staff No-Action Letter (June 7, 2006).

[7] *See* *Paradigm Capital Mgmt., Inc.*, Advisers Act Rel. No. 3857 (June 16, 2014).

but were unable to produce documentation to demonstrate their compliance with the consent, confirmation and disclosure requirements of Rule 206(3)-2.

Policies and Procedures

Finally, OCIE staff observed advisers that either did not establish policies and procedures relating to Section 206(3) or did establish such policies and procedures but failed to follow them when engaging in principal and agency cross transactions.

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