

## Investment Management

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# SEC Identifies Common Principal and Agency Cross Trading Compliance Deficiencies

*Suggests that advisers reevaluate supervisory, compliance, and investor consent and disclosure systems*

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The Securities and Exchange Commission's (SEC's) Office of Compliance Inspections and Examinations (OCIE) recently issued an alert listing the most common compliance failures that investment advisers commit with regard to principal trades and agency cross trades. Specifically, OCIE observed that advisers often overlook the notice and consent requirements associated with these trades. This oversight tends to occur when advisers' policies are insufficient or are not followed in fast-paced trading practices.

### 1. Applicable Rules

#### a. Principal Trades - Section 206(3)

A "principal trade" occurs when an investment adviser, **acting as a principal for its own account**, knowingly (i) sells any security to a client or (ii) purchases any security from a client. Section 206(3) prohibits advisers from making principal trades unless the adviser **discloses** all material information about the proposed trade to, and **obtains the consent** of, such client **before the completion of the transaction**. Notably, blanket disclosure and consent do not suffice—disclosure and consent are required for each such transaction.

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

An "agency cross transaction" occurs when an investment adviser, **acting as broker for a person other than the advisory client**, knowingly makes a sale or purchase of any security for the account of that client. Section 206(3) prohibits

investment advisers from making agency cross trades unless the investment adviser **discloses** material information about the trade to the client **before the completion of the sale or purchase** and **obtains the consent** of the client to such transaction. Notably, if the investment adviser takes additional precautions under Rule 206(3)-2, it may not be required to effect transaction-by-transaction disclosure and consent for certain agency cross transactions.

#### c. Disclosing Conflicts of Interest - Sections 206(1) and (2)

Finally, the SEC cautioned that Section 206(3) should be read together with Sections 206(1) and (2) so that the adviser further discloses any potential conflicts of interest invoked by a trade.

### 2. Examples of Common Investment Adviser Compliance Deficiencies

The SEC highlighted the following examples of common investment adviser compliance deficiencies with respect to principal trades and agency cross trades.

#### Failure to Recognize Nature of Trade

- Failing to recognize that a trade was a principal trade subject to Section 206(3) and thus to make the required disclosures and obtain the required consents.
  - Or if the principal trade was recognized as such, not making adequate disclosure/not obtaining adequate consent (e.g., obtaining consent *after* the completion of the trade).

## Improper Disclosure

- Disclosing to clients that the investment adviser would not engage in agency cross transactions but nonetheless engaging in such transactions.

## Non-Adherence to Policies and Procedures

- Inability to produce documentation evidencing compliance with internal compliance policies and procedures and applicable law.
- Failing to establish Section 206(3) policies and procedures or, if such policies were established, failure to follow such policies and procedures.

### **3. Addressing the Problem**

There are a number of ways for investment advisers to help ensure that they follow the principal and agency cross trading requirements described above, including the following:

- Maintaining an updated list of principal accounts (including private funds and other entities when the investment adviser and/or its control persons own more than 25% of any such entity) and requiring preapproval by the investment adviser's Chief Compliance Officer (or his or her designee) of any proposed trades between an advisory client and an account on that list;
- Programming trading or compliance software to flag any trades with enumerated principal accounts prior to execution;
- Maintaining a comprehensive checklist to be used when effecting affiliate transactions that raise conflicts of interest (including principal and agency cross trades) to trigger awareness of and sensitivity to compliance concerns around such transactions;
- Requiring the Chief Compliance Officer's (or his or her designee's) approval of any affiliate transactions that give rise to conflicts of interest, whether such transactions rise to the level of principal or agency cross trades or otherwise;
- Retraining adviser personnel on the definitions of principal and agency cross trades (and other affiliate transactions that give rise to conflicts of interest) and an investment adviser's compliance policies and procedures related thereto;
- Appointing independent representatives to approve principal and agency cross trades on behalf of private fund and managed account clients to ease and streamline disclosure and consent requirements; and

- Contemporaneously documenting all steps taken to approve transactions that give rise to conflicts of interest (including the disclosure and consent requirements of principal and cross trades).

## **Takeaways**

The SEC's recent alert focusing on principal and agency cross trades is consistent with its long-standing focus on conflicts of interest and the SEC's recent alert regarding standards of conduct for investment advisers. Investment advisers need to ensure that they are familiar with their own policies and either strictly follow those policies (if the policies are sufficient) or work with counsel to revise the policies to reflect (i) the principal and agency cross trading requirements and (ii) actual firm practices. Even where affiliate transactions do not rise to the level of principal and/or agency cross trades, compliance policies and procedures (including Chief Compliance Officer preapproval) should address conflicts of interest raised by such transactions. Training refreshers are always a good idea when the SEC highlights a topic with a risk alert. Refreshers can be done in periodic training sessions, or in a brief memorandum calling employees' attention to this recent SEC alert and an investment adviser's related policies and procedures.

With respect to advisory clients that are private funds (and even managed account clients), there is still flexibility on who can receive disclosure and consent on behalf of such client. As a result, investment advisers (with proper disclosure and consent, where necessary) can establish limited partner advisory committees, independent directors or other independent client representatives prior to effecting principal transactions, agency cross trades or other affiliate transactions that give rise to conflicts of interest, to make disclosure and consent quicker and more practical when required or desired.

Please contact one of the listed authors of this Alert or your regular Lowenstein Sandler contact if you have any questions with respect to the SEC's guidance regarding principal trading and agency cross transactions responsibilities of investment advisers or would like assistance reviewing and updating your supervisory, compliance and risk management systems in response to this guidance.

# Contacts

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