Investment Management Alert

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Cross Trades and Principal Transactions – New SEC Guidance for Private Fund Managers

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On July 21, 2021, the Securities and Exchange Commission's Division of Examinations issued a Risk Alert on cross trades and principal transactions.[1] The Risk Alert's guidance and warnings were based on over 20 examinations of investment advisers that engaged in cross trades or principal transactions involving fixed income instruments, but the Staff's observations and guidance should be considered by private fund managers trading and investing in a broad range of instruments, irrespective of whether the managers are registered with the SEC.

Cross Trades and Principal Transactions

A cross trade occurs when an investment adviser causes a trade to occur between two or more of its advisory clients' accounts. A principal trade takes place when an adviser arranges for a security to be purchased from or sold to a client from its own account (which can include a fund in which the adviser or its personnel have a substantial ownership interest). In the Risk Alert, the Staff warned that "an adviser that enters its clients into these types of transactions implicates a variety of legal obligations under the Investment Advisers Act … particularly its fiduciary duty."

The Division's most recent comments follow an earlier alert that was issued in 2019, which focused on common cross trade and principal transaction deficiencies observed in examinations conducted over a three-year period.[2] As a follow-up to that alert, the Division conducted an examination initiative focused on SEC-registered investment advisers that engaged in cross trades or principal transactions involving fixed income securities and issued the July 21 Risk Alert to provide additional guidance, suggestions, and cautions to all registered advisers.

In the July 21 Risk Alert, the Staff emphasized that, with respect to principal trades, Section 206(3) of the Investment Advisers Act requires advisers to make written disclosures and obtain the consent of the affected client before the transaction is completed. However, the Staff also warned that "[c]ompliance 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 cross trade." According to the Staff, there could be circumstances where more particularized conflicts disclosures may be

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required under the more general anti-fraud provisions of the Investment Advisers Act (i.e., Sections 206(1) and (2)).

Shortcomings Observed by the SEC Staff

Nearly two-thirds of the advisers examined received deficiency letters and, according to the July 21 Risk Alert, the vast majority of deficiencies related to compliance programs, conflicts of interest, and inadequate disclosures.

Violations

The Staff found numerous examples of fixed income principal transactions and cross trades being conducted in situations where:

- An adviser's policies prohibited such trades;
- Required internal approvals were not timely obtained; and
- Required external client consents were not timely obtained.

Policy and Procedure Shortcomings

The SEC Staff also concluded that many of the examined advisers' compliance policies and procedures were themselves deficient, citing examples such as the following:

- Policies that failed to mention that personnel should consider the best interests of clients when effecting principal transactions or cross trades;
- Policies that did not require contemporaneous documentation to show that cross trades and principal transactions were in the best interests of clients;
- Cross trade and principal transaction procedures that were not sufficiently detailed, (e.g., policies that failed to specify which value investment advisory personnel should use when multiple, non-identical, broker/dealer quotes were obtained);
- A lack of procedures designed to prevent cross trades and principal transactions prohibited by contractual restrictions with clients (such as ERISA accounts);
- A lack of systems to detect principal transactions and cross trades; and
- A lack of testing to validate (i) that principal trades and cross trades were conducted in a manner consistent with the investment adviser's disclosures and (ii) any required consents were obtained in connection the provision of related disclosure materials.

Conflicts of Interest

The Risk Alert noted a number of deficiencies related to conflicts of interest, including failures to obtain independent market prices and the inclusion of mark-ups and fees in connection with principal transactions and cross trades that were not fully disclosed.

Written Disclosures

The Division noted that a number of investment advisers omitted information concerning cross trades (and the associated conflicts of interests) in their Form ADV Brochures and their disclosure documents.

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Suggestions for and Expectations of Private Fund Managers

The Risk Alert set forth certain "observations on ways to improve compliance," which are not expressly limited to fixed income instruments (and likely apply broadly to principal transaction and cross trade situations). The Staff's suggestions include:

Definitional Suggestions

Clearly define both a "principal transaction" and a "cross trade" in a manner that will allow investment personnel (i.e., not just compliance personnel) to identify such trades and follow appropriate compliance procedures. The guidance suggests that definitions included in cross trade policies for fund managers include a reference to the 25% ownership presumption embodied in the *Gardner Russo & Gardner* no action letter and address when a transaction is deemed to be a cross trade.

Substantive Suggestions

The Risk Alert indicated that investment advisers that permit cross trades include standards in their compliance policies such as the following:

- Requiring that transactions be fair and equitable to all participating client accounts.
- Describing and prescribing pricing methodologies used to execute the transactions.
- Performing periodic evaluations of execution quality.
- Making periodic reports to the legal or compliance departments.
- Testing to ensure compliance policies effectively capture potential principal transaction and cross trade violations.
- Instituting conditions and restrictions on principal transactions and cross trades designed to ensure compliance with any applicable restrictions and fiduciary duties.
- Requiring portfolio managers or traders to get advance written approval from senior management or compliance personnel in order to execute principal transactions or cross trades and to document compliance with the adviser's policies.

Suggestions on Disclosures

Based on its review of disclosures used by a number of investment advisers, the Division summarized common disclosures for all cross trades:

- A description of the nature and significance of the conflicts of interest for those clients.
- 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.

Additional disclosure obligations, such as those included in Advisers Act Release IA-1732[3] ("Interpretation of Section 206(3) of the Investment Advisers Act of 1940"), may be required for principal transactions and cross trades.

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Next Steps for Private Fund Managers

Given the extensive list of "observations on ways to improve compliance," compliance officers of private fund managers should review the text of the Risk Alert itself. Because the target audience of the Risk Alert is so broad (i.e., it is directed at all investment advisers), legal and compliance personnel of private fund managers should assess each suggestion and determine its applicability to that manager's business, as well as any adaptations that may be useful or necessary for an effective implementation. Also, managers should not necessarily assume that all of the Risk Alert's suggestions are limited just to fixed income instruments, and should consider them in the context of cross trades and principal transactions across a much broader universe of securities, commodity interests, and other instruments.

In reviewing the Risk Alert, legal and compliance officer may consider taking the following steps:

First, assess the magnitude of the situation for that manager, i.e., how frequent and sizable are cross trade and principal transactions?

Second, consider reviewing applicable disclosures and contractual commitments regarding principal transactions and cross trades.

Third, review the manager's applicable compliance policies and procedures.

Fourth, assess the amount of compliance or non-compliance, and determine if additional policies, procedures, training, or other measures are needed.

As in all areas, private fund managers should consider reviewing and testing their compliance policies to determine whether their policies are consistent with their practices, are well defined enough to allow front-office advisory personnel to recognize applicable trades and consider relevant factors in considering such trades, including the best interests of clients, and are tailored enough. Documentation evidencing that an investment adviser has taken steps to satisfy its fiduciary duties, regulatory requirements and internal policies with respect to principal transactions and cross trades is often helpful in annual compliance reviews, regulatory examinations, and investor due diligence meetings.

[1] Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from An Examination Initiative (July 21, 2021)

[2] "Investment Adviser Principal and Agency Cross Trading Compliance Issues" (Sept. 4, 2019)

[3] "Interpretation of Section 206(3) of the Investment Advisers Act of 1940," Release IA-1732 (July 20, 1998)

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