A REVIEW OF PRINCIPAL TRANSACTIONS UNDER THE ADVISERS ACT

To prevent overreaching, Section 206(3) of the Advisers Act prohibits an adviser from knowingly engaging in securities transactions with its clients, as a principal, without informing them of its interest in the transaction and obtaining their consent. The SEC has addressed a number of issues relating to the scope of the prohibition, the required disclosures, and the nature and timing of the prerequisite consent.

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The Investment Advisers Act of 1940 places restrictions on the ability of an investment adviser to engage in principal transactions with clients, primarily by requiring advisers to make trade-by-trade disclosures and receive client consent. Section 206(3) of the Advisers Act, which governs principal transactions, continues to pose practical and interpretive challenges. This article presents an in-depth review of the issues that arise under Section 206(3) and the guidance provided by the SEC in rule releases, interpretive guidance, and enforcement actions.

The article begins with a brief overview of Section 206(3) and its legislative history. It then considers the meaning of each clause in Section 206(3). Finally, the article discusses related issues that arise when considering the application of Section 206(3) in various circumstances.

SECTION 206(3) AND ITS LEGISLATIVE HISTORY

In general terms, a principal transaction occurs when an adviser, acting for its own account, buys a security from, or sells a security to, a client’s account. Section 206(3) prohibits an investment adviser from knowingly effecting a principal transaction without disclosing to the client in writing the capacity in which the adviser is acting and obtaining the consent of the client prior to completing the transaction.1

1 More specifically, Section 206(3) prohibits any investment adviser using the U.S. mails or any means or instrumentality of interstate commerce from, directly or indirectly, acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.
Congress included Section 206(3) in the Advisers Act at the time it originally enacted the statute in 1940. The legislative history, however, contains only a brief reference to Section 206(3). The Congressional Record cites David Schenker, then Chief Counsel, SEC Investment Trust Study, as stating that “if a fellow feels he has a sour issue and finds a client to whom he can sell it, then that is not right.” The SEC has relied on the legislative history to support its view that Section 206(3) is intended to address the concern that advisers might use advisory accounts to “dump” unmarketable securities or those that advisers fear may decline in value. At times, the SEC has also cited the prevention of potential price manipulation as a rationale for Section 206(3).

**ELEMENTS OF THE STATUTE**

Almost every clause of Section 206(3) has, at some point, been the subject of interpretation by the SEC. Nevertheless, some uncertainty remains when applying each clause in different contexts. This section of the article examines the meaning of each clause and, in the absence of clear SEC guidance, provides suggestions as to how the clause may, or should, be interpreted.

**“Acting as Principal for his Own Account”**

Section 206(3) begins with a clause stating that the provision applies to an investment adviser "acting as principal for his own account.” The SEC has interpreted this clause broadly to cover a variety of accounts associated with an adviser. When Congress enacted Section 206(3), it likely viewed investment advisers primarily as solo practitioners and therefore used the phrase “as a principal for his own account.” Accordingly, in the case of advisers who are solo practitioners, “his own account” includes any account owned in a proprietary capacity by the individual adviser. The SEC would likely extend the list of proprietary accounts to include personal accounts in which a solo practitioner has an indirect financial interest, such as accounts owned by a spouse or financially dependent children.

The SEC also has provided limited guidance regarding the application of the term “his own account” when the investment adviser is an entity rather than a solo practitioner. For instance, the SEC has clarified that an advisory firm’s “own account” includes the firm’s proprietary accounts. The SEC staff also has suggested that an advisory firm’s “own account” includes the personal accounts of any person who controls the advisory entity. In addition, the SEC has taken the position that the restriction on principal transactions applies to proprietary accounts of any entity that controls, is controlled by, or is under common control with the adviser. As discussed more fully below, the SEC has relied on this position to bring enforcement actions against investment advisers who effected “riskless” principal transactions through affiliated broker-dealers.

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7 See Hartzmark & Co., SEC No-Action Letter (Nov. 11, 1973) and Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Adv. Act Rel. No. IA-1732 (1998) at n.3, available at www.sec.gov/rules/interp/ia-1732.htm. Note also that Section 202(a)(12) of the Advisers Act defines the term “control” to mean “the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company.”
In addition, the SEC staff has stated that a principal account includes a private investment fund in which the investment adviser and/or its controlling persons own, in the aggregate, more than 25% of the fund. The SEC staff, however, has not clarified whether the 25% amount should include (1) the ownership interests of non-control personnel of an adviser; (2) the ownership interests of a control person’s family members, including a spouse or dependent child; or (3) an adviser’s incentive fees/allocations. As a practical matter, an adviser likely should resolve these issues as follows:

- the ownership interests of non-control personnel should be presumed to count toward the 25% threshold, particularly for smaller advisory firms, in order to avoid difficult and potentially erroneous determinations of a person’s control status;

- the ownership interests of a control person’s family members should be presumed to count toward the 25% threshold because the SEC might apply a “beneficial ownership” test; and

- incentive fees/allocations likely should be viewed as counting toward the 25% threshold only if actually earned (or vested) and kept in the fund, but not, for example, intra-year calculations of incentive fees/allocations the adviser could potentially earn, since the fees could be viewed as speculative until the fund’s year-end date when the adviser is actually entitled to such fees/allocations.

The SEC staff also has not addressed whether Section 206(3) should apply to a purchase and sale of securities between two funds where the adviser and its control persons own more than 25% of each fund and own substantially the same percentage of each fund.

Finally, other circumstances could arise in which an advisory firm could be deemed to act as principal. These situations may include, for example, when an advisory firm or its affiliate: (1) underwrites an issuer’s securities pursuant to a firm commitment underwriting and the advisory firm purchases those securities for a client in the underwriting; (2) warehouses investments for a private fund in a proprietary account and transfers those investments to the fund after the fund accepts investments from third parties; and (3) provides seed capital for a private fund and redeems its interest in the fund when the fund initially accepts third-party investors.

“Knowingly”

Section 206(3) applies when an investment adviser “knowingly” effects a principal transaction with a client. The SEC has not provided any guidance regarding the meaning of the term “knowingly” in this context. The term, therefore, ought to be given its common sense meaning. Under this view, an adviser would be deemed to knowingly engage in a principal transaction where it has prearranged a trade, even if executed through a third-party broker. A more challenging question arises when an adviser places trades for principal accounts and client accounts in the open market with the possibility that the trades may get crossed. In these circumstances, the likelihood of a “knowing” principal transaction presumably turns on a number of factors, such as (1) whether two different brokers were used to effectuate the trade and whether suggestions were made to either broker about finding a counterparty; (2) the timing of trade orders and whether the orders were placed simultaneously; and (3) the daily trading volume for the issuer’s securities and the corresponding size of the adviser’s particular orders.

“Sell” or “Purchase”

Section 206(3) applies when an investment adviser sells any security to or purchases any security from a client. Although the Advisers Act contains no definition of the terms “sell” or “purchase,” most transactions can be clearly identified as such. In limited circumstances, however, an adviser may encounter transactions that are not easily categorized as either a sale or purchase. The SEC staff has provided limited guidance regarding certain types of transactions that are not “purchases” or “sales” for Section 206(3) purposes.

8 See Gardner Russo & Gardner, supra note 6.

9 Investment advisers that are part of larger, full-service financial firms might reasonably determine to limit ownership interests for purposes of the 25% threshold to advisory personnel and senior management.


11 In other contexts under the federal securities laws, the SEC has interpreted the terms differently depending on whether the interpretation furthers the underlying purpose of the statute at issue. Note also that the Supreme Court has stated that the terms “purchase” and “sale” must be interpreted in the context of the particular provision of the securities law that is at issue. See Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453, 465 (1969).
First, the SEC staff has stated that an advisory client’s granting of a security interest in any security, property, or other obligation held by an affiliated prime broker for the client in connection with maintaining a margin account does not constitute a purchase or sale within the meaning of Section 206(3). In providing this guidance, the SEC staff noted that the purpose of Section 206(3) is to prevent price manipulation and the dumping of unwanted securities by an investment adviser into client accounts. The staff agreed that the granting of a security interest for the purpose of maintaining a margin account does not create the potential for the conflicts of interest that Section 206(3) was intended to address. Because the SEC staff guidance regarding the granting of a security interest was provided in the limited context of margin accounts, it is not clear that this guidance would apply in other contexts.

Second, the SEC staff has addressed the issue of sales and purchases in connection with short-sale transactions. In a short-sale transaction, a broker-dealer loans securities to a client so that the client can sell the securities needed to effectuate the short sale. The SEC staff has stated that a transfer or loan of a security by an affiliated prime broker to facilitate a short sale would not constitute a sale of a security to an advisory client for purposes of Section 206(3). The SEC staff noted the argument that in this context the client is merely obligated to replace the exact number of securities that it borrowed and that there is no transfer of economic exposure to or from the owner of a borrowed security at any point in the transaction. Accordingly, the SEC staff acknowledged that a transfer or loan of securities to facilitate a short sale does not appear to present the same potential for abuse as an actual sale of securities by an investment adviser to its client.

Finally, the SEC staff has not addressed the sale-and-purchase issue in connection with repurchase agreements. In a repurchase agreement, one party sells securities to a counterparty at a specified price with a commitment to buy the securities back at a later date for the same price plus interest. A repurchase agreement is similar to a secured loan in economic reality in that the buyer does not take risk or benefit of price movements in the securities and receives collateral to protect against default. However, the transaction involves an actual purchase and sale of securities. Thus, repurchase agreements do not appear to fall within the SEC staff guidance provided in the Goldman no-action letter and therefore are likely subject to Section 206(3).

“Any Security” (and Non-Securities)

Section 206(3) applies to the purchase and sale of any “security.” The Advisers Act defines the term “security” broadly. Nevertheless, certain instruments, such as real property, bank loans, commodities, and currency, generally fall outside this definition. As such, transactions in such instruments fall outside a literal reading of Section 206(3). The SEC, however, would likely view those transactions as subject to the general antifraud provisions of Sections 206(1) and (2) and expect advisers to follow the same client notice and consent requirements of Section 206(3).

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13 Id. The SEC staff noted that an adviser nevertheless may have a conflict to the extent it recommends to clients that they enter into arrangements with an affiliated prime broker, including margin accounts, from which the affiliated prime broker may benefit and that any such arrangements would be subject to the antifraud provisions of Sections 206(1) and (2).
14 Note that Section 17(a) of the Investment Company Act of 1940 prohibits a fund affiliate (including a fund’s investment adviser) from purchasing from or selling to the fund any security or other property. The SEC has granted exemptive relief under Section 17(a) with respect to pledges of securities and certain borrowing transactions where applicants asserted that such transactions may constitute a purchase or sale.
15 See Goldman, Sachs & Company, SEC No-Action Letter (Feb. 22, 1999). Note, however, that the SEC staff has taken the position that a loan of a security involves a sale for purposes of Section 17(e) of the Investment Company Act (which generally prohibits any affiliated person of a fund, acting as agent, from accepting compensation from any source for the purchase or sale of a security). The staff took this position based on its view that, for example, when an affiliated custodian accepts a fee for arranging a loan of the fund’s securities, the transaction presents the potential for a conflict of interest that Section 17(e) was intended to address. See United Services Funds, SEC No-Action Letter (Apr. 23, 1993).
16 See Goldman, Sachs & Company, supra note 15. The SEC staff noted that an adviser nevertheless may have a conflict to the extent it recommends to clients that they engage in short sales through an affiliated broker-dealer from which the affiliated broker-dealer may benefit and that any such arrangements would be subject to the antifraud provisions of Sections 206(1) and (2).
17 See Section 202(a)(18) of the Advisers Act.
18 See, e.g., Boston Advisory Group, SEC No-Action Letter (Dec. 5, 1976) (Sections 206(1) and 206(2) apply to the sale of...
“Client”

Section 206(3) applies to principal transactions with an investment adviser’s “client.” The Advisers Act does not contain a definition of the term “client” and the SEC has not provided guidance on the meaning of this term for purposes of Section 206(3). A client presumably includes any person or entity to whom an investment adviser provides investment advice. The use of the term client, nevertheless, presents practical challenges in certain contexts, including with respect to private investment funds and brokerage clients.

In the context of private investment funds, the SEC has not stated whether the fund or its investors should be viewed as the client for purposes of Section 206(3). As explained in more detail below, the better view appears to be that the fund, rather than the investors, should be viewed as the client in this context. Nevertheless, when complying with the requirements of Section 206(3), an adviser likely should make disclosures to and receive consent from some combination of investors (or other persons) independent of the adviser. (An in-depth discussion of investor consent issues is included later in this article.)

In the context of dually registered investment advisers/broker-dealers, Section 206(3) specifically provides that the provision does not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction. In addition, Rule 206(3)-1 states generally that an adviser who is also a registered broker-dealer is exempt from Section 206(3) in connection with any transaction in relation to which the broker-dealer is acting as an investment adviser solely (1) by means of publicly distributed written materials (i.e., those which are distributed to 35 or more persons who pay for the materials); (2) by means of written materials or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (3) through the issuance of statistical information containing no expressions of opinion as to the investment merits of a particular security; or (4) any combination of the foregoing services, provided that the materials and oral statements include a statement that if the purchaser of the advisory communication uses the services of the adviser in connection with a sale or purchase of a security which is a subject of such communication, the adviser may act as principal for its own account or as agent for another person.

“Without Disclosing to Such Client”

Section 206(3) provides that an investment adviser may not knowingly effect a principal transaction with a client “without disclosing to such client” the capacity in which the adviser is acting (and obtaining the client’s consent). The SEC takes the position that an adviser must make the required disclosures and receive consent on a trade-by-trade basis and cannot satisfy this obligation by making a general disclosure and obtaining prospective, blanket consent.¹⁹

Notwithstanding the SEC’s general position on trade-by-trade disclosure and consent, the SEC staff has issued two no-action letters granting narrow relief from this requirement. First, the staff permitted an investment adviser to obtain prospective, blanket consent (or “global consent”) from certain clients in connection with the purchase of OTC-covered call options from an affiliated derivatives dealer. The investment adviser requested SEC no-action assurance based on the adviser’s particular investment program that relied in part on the adviser purchasing OTC-covered call options for its clients. Absent the staff’s relief, each client in the investment program would be required to establish an account with multiple third-party derivatives dealers. The SEC staff granted the relief so that the adviser’s client could instead purchase OTC call options from the investment adviser’s affiliated derivatives dealer at prices established based on bids from third-party dealers.

The affiliated derivatives dealer would then effect a simultaneous sale of an offsetting OTC call option with a third-party dealer on terms that mirrored those of the contract purchased from the client. The SEC staff placed numerous conditions on the arrangement, including up-front disclosure and consent with an annual renewal of the consent; disclosure about the capacity in which the adviser and its affiliate would be acting; the potential conflicts and the nature and maximum amount of compensation charged by the derivatives affiliate; a minimum client commitment of $10 million to the investment program (and generally a minimum net worth of at least $20 million); and certain other conditions.\footnote{See Credit Suisse First Boston, LLC, SEC No-Action Letter (Aug 31, 2005), available at www.sec.gov/divisions/investment/noaction/csfb083105.htm.}

After granting this relief, the SEC staff informally indicated that the letter should not be read as having any broader application and is strictly limited to the facts presented in the no-action letter. The SEC staff also indicated a strong reluctance to grant any further relief on similar sets of facts.

Second, the SEC staff granted relief from the disclosure and consent requirements of Section 206(3) for the purchase of mutual fund shares through affiliated broker-dealers acting as distributors of the fund’s shares in a principal capacity, even though the staff concluded that the transactions were principal transactions. The staff’s relief was based on a number of conditions, including, among others, that the affiliated broker-dealers received no transaction-based compensation for effecting the trades; the affiliated broker-dealers simultaneously bought and sold the mutual fund’s shares at the same net asset value; and the shares passed through the affiliated broker-dealers’ accounts only to satisfy advisory clients’ orders. Moreover, the staff cautioned that its position “should not be construed to extend to other riskless principal transactions with clients.”\footnote{See Merrill Lynch Trust Company, FSB, SEC No-Action Letter (July 6, 2000).}

“In Writing”

Section 206(3) specifies that an adviser must provide required disclosures to clients in writing. An adviser may make the written disclosures (and receive client consents) electronically, including by e-mail. An adviser relying on electronic communication, however, must meet the requirements established by the SEC in its 1996 guidance on the use of electronic media.\footnote{See Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, Adv. Act Rel. No. IA-1562 (1996), available at www.sec.gov/rules/interp/33-7288.txt.} This guidance requires that an adviser generally must (1) obtain a client’s informed consent to receiving disclosures electronically; (2) ensure that a client can effectively access the electronically delivered disclosures; and (3) obtain evidence that the client received delivery of the disclosures.

Notwithstanding the written disclosure requirement, the SEC has adopted a Rule 206(3)-3T, a temporary rule that allows dually registered investment advisers/broker-dealers to provide required disclosures orally when effecting principal transactions for certain of their advisory accounts.\footnote{See Temporary Rule Regarding Principal Trades with Certain Advisory Clients, Adv. Act Rel. No. IA-2653 (2007), available at www.sec.gov/rules/final/2007/ia-2653.pdf.} To rely on the rule, (1) the client account must be managed on a non-discretionary basis; (2) the adviser must also be registered as a broker-dealer; and (3) the account must be a brokerage account subject to the Securities Exchange Act of 1934 and rules thereunder, as well as the rules of the self-regulatory organization(s) of which the adviser/broker-dealer is a member. The rule contains a number of additional conditions, including generally that the adviser/broker-dealer:

- provide a client with written prospective disclosure regarding the conflicts arising from principal transactions;
- obtain written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;
- make certain disclosures, either orally or in writing, and obtain the client’s consent before each principal transaction;
- send to the client a written confirmation at or before the completion of the transaction stating that the adviser may be acting as principal with respect to the transaction, that the client authorized the transaction, and that the adviser sold the security to,
or bought the security from, the client for its own account; and

- deliver to the client an annual report itemizing the principal transactions.

**“Before the Completion of Such Transaction”**

An adviser engaging in a principal transaction must make required disclosures and obtain the client’s consent “before the completion of such transaction.” The SEC takes the position that a transaction is completed at settlement, not at execution. As discussed below, the disclosures that an adviser makes about a particular transaction will vary somewhat depending on whether they are provided before or after execution. In addition, the SEC has cautioned that an adviser seeking a client’s consent after execution but before settlement should not condition the consent on the client bearing any loss due to price movements between the time of execution and settlement.\(^{24}\)

**“The Capacity in Which He is Acting”**

Section 28(e) requires an investment adviser to disclose “the capacity in which he is acting” when effecting a principal transaction. The SEC has provided fairly consistent guidance on the trade-by-trade disclosures that an adviser must make to satisfy this requirement. In 1945, the SEC’s general counsel issued an opinion stating that an adviser must disclose any adverse interest it may have, as well as any other information in its possession which a client should possess in order to determine whether to enter into the principal transaction. The SEC’s general counsel added that disclosure should include, at a minimum, (1) the capacity in which the adviser proposes to act (i.e., as principal); (2) the cost to the adviser of any security which it proposes to sell to the client (or if the adviser proposes to buy the security from the client and knows or is reasonably certain of the price at which it is to be resold, a statement to that effect); and (3) the best price at which the transaction could be effected by or for the client elsewhere if such price is more advantageous than the actual transaction price.\(^{25}\)

Since 1945, the SEC issued additional releases identifying the relevant information that an adviser may be required to disclose when effecting principal transactions with clients.\(^{26}\) In one of those releases, issued in 1998, the SEC acknowledged that the timing of the consent would impact the disclosure of information regarding the final execution price, best price, and final commission charges.\(^{27}\)

For pre-execution consent, the disclosures should include (1) the current quoted price for the securities involved in the proposed transaction; (2) if applicable, the current best price information (alternatively, the adviser could undertake to its clients to match or better the price in the market at the time the adviser receives the client’s consent); and (3) proposed commission charges. For post-execution, pre-settlement consent, the disclosures should include (1) final transaction price information; (2) best price information; and (2) final commission charges.

Finally, while the SEC has described various disclosure requirements, it also acknowledged that the facts and circumstances surrounding a particular transaction may impact the disclosures. In a 1975 release, the SEC reiterated the categories of relevant information that an adviser should disclose to its clients. The SEC then added that whether those categories or other facts must be disclosed to the client depends on “both the materiality of such facts in each situation and upon the degree of the client’s trust and confidence in and reliance on the investment adviser with respect to the transaction.”\(^{28}\) This statement likely amounted to an acknowledgement that some categories of information may not be applicable in every type of principal transaction.

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25 Adv. Act Rel. No. IA-40 (1945). The SEC’s general counsel further stated that any disclosure of the cost to the adviser (or price it expects to receive on resale) should be phrased so that its full meaning is obvious to the client. In addition, the disclosure should include a statement of the total amount of the cost or resale price (or total profit) in dollars and cents, rather than merely express a formula by which the amounts may be computed, or to limit the disclosure to a percentage figure or to a maximum number of points or dollars per share or bond.


transaction. In those circumstances, where certain
categories of information may not be applicable, an
adviser should provide information comparable to the
enumerated disclosures described above and any other
facts relevant to the transaction (e.g., the exact role of
the adviser and any affiliates in the transaction, all fees
to be received by the adviser and its affiliates in
connection with the transaction, etc.). The SEC’s
statement likely does not support the position that an
adviser may provide clients with materially less
information or alter the trade-by-trade notice and
consent requirement.

**“Obtaining the Consent of the Client to Such Transaction”**

As a threshold matter, the requirement to obtain client
consent raises issues as to whether a client may provide
oral consent and whether a client may provide negative
consent. First, the SEC staff has acknowledged that
Section 206(3) does not require an investment adviser to
obtain a client’s written consent to a principal
transaction. Rather, a client may provide oral consent. Most investment advisers, however, obtain written
consent for evidentiary purposes to demonstrate that the
consent was actually received. Second, although the
SEC has never explicitly stated that an investment
adviser must receive a client’s affirmative consent,
rather than a negative consent, this conclusion appears
implicit in the SEC staff’s guidance on the ability to
obtain oral consent.

A more significant issue arising in connection with
the need to obtain client consent involves identifying the
person or persons authorized to provide consent on
behalf of the client. When an investment adviser
engages in a principal transaction with a client who has a
separately managed account, the adviser should make
the required disclosures to, and obtain consent from, the
individual client (or an authorized representative of the
client in the case of an institutional account). When the
client is a private investment fund, however, the answer
is not clear and the SEC has not provided any formal
guidance on this issue.

Investment advisers managing private investment
funds may consider several options for obtaining client
consent to a principal transaction. These options and
their relative merits include the following:

- **Every investor.** An investment adviser could
  consider making disclosures to, and obtaining
  consent from, each investor in the fund. This
  approach, however, may significantly raise
  transaction costs and the concern that a single
  investor could refuse to provide consent to the
detriment of the other investors.

- **Investor committee.** An investment adviser could
  consider making disclosures to, and obtaining
  consent from, a committee of investors who are not
  affiliated with the adviser. Although the SEC has
  not addressed this approach formally, the staff has
  informally acknowledged the practice without
  objection. The use of an investor committee also
  seems to be the most common approach used by
  private fund managers. Investment advisers using
  this approach typically incorporate the mechanism
  into a fund’s organizational documents, or if not
  specifically addressed in the documents, by
  subsequent vote of the investors consistent with the
  fund’s partnership or LLC agreement. The
  committee typically consists of a handful of key
  investors, each of whom is not affiliated with the
  adviser.

- **Majority of unaffiliated assets.** As an alternative
  approach in the absence of an investor conflicts
  committee, an investment adviser could consider
  making disclosures to, and obtaining consent from,
  investors representing a majority of the fund’s assets
  who are not affiliated with the adviser (also referred
to as a “majority in interest”). This approach would
  seem acceptable on the theory that most partnership
  or LLC agreements call for the affirmative vote of a
  majority in interest to approve changes to the
  agreement. Accordingly, an affirmative vote of the
  majority in interest could be used to establish a
  conflicts committee and, therefore, also consent to a
  principal transaction.

- **Independent representative.** An investment adviser
  could consider making disclosures to, and obtaining
  consent from, an independent representative acting
  on behalf of the fund. In an analogous situation,
  Advisers Act Rule 206(4)-2, the “Custody Rule,”
generally permits investors to designate an
  independent representative to receive, on their
  behalf, notices and account statements (or the fund’s
  annual audited financial statements) as generally

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29 See Dillon, Read & Co., Inc., SEC No-Action Letter (Aug. 6,
1975).

30 The requirement to obtain affirmative consent also is implicit in
Rule 206(3)-3T, where the SEC determined to require dually
registered investment adviser/broker-dealers to obtain
affirmative client consents.
required under the rule.\(^{31}\) The SEC staff’s view on this approach, however, is not clear and the use of an independent representative does not appear to be a common practice.\(^{32}\)

- **The general partner or managing member.** Some investment advisers have suggested that disclosures could be made to, and consent received from, a private fund’s general partner or managing member. The SEC likely does not embrace this approach.\(^{33}\) Since Section 206(3) is intended to address a specific type of conflict of interest, the SEC might carefully scrutinize any arrangement whereby the adviser (through its affiliated general partner or managing member) essentially consents to its own

(conflict. Those investment advisers who support this view generally point to the recent appeals court decision in *Goldstein v. SEC*,\(^{34}\) where the court stated generally that an investment adviser’s client is the private fund, not the fund’s investors, and that an adviser owes a fiduciary duty to the fund, not the fund’s investors.\(^{35}\)

The approach ultimately taken by the investment adviser for obtaining client consent should be fully disclosed in the fund’s offering documents or subscription agreements.

**Brokerage Clients of Dually Registered Advisers**

Section 206(3) specifically provides that it does not apply to any principal transaction with a customer of a dually registered investment adviser/broker-dealer if the broker or dealer is not acting as an investment adviser in relation to the transaction. The SEC has provided guidance regarding two instances where it believes a broker-dealer would not be acting as an investment adviser in relation to a transaction.

First, the SEC staff has agreed, in the context of a prime brokerage arrangement, that if an affiliated broker-dealer liquidated securities held in the margin account of an advisory client, the broker-dealer would not be acting as adviser with respect to the transaction. As a result, the sales would not be subject to Section 206(3). In reaching this position, the staff noted that (1) any decision to make a margin call, and any liquidation transaction, would be wholly separate from any advice

31 See Rule 206(4)-2(a)(4). The SEC staff has confirmed that a single representative “can serve for all limited partners, so long as the representative is, in fact, independent and satisfies the definition in rule 206(4)-2(c)(2).” See *Staff Responses to Questions About Amended Custody Rule* (Updated Jan. 10, 2005) at question VI.3, available at: www.sec.gov/divisions/investment/custody_faq.htm. A person satisfies the definition of an “independent representative” if generally the person (1) acts as agent for the fund’s limited partners (or members) and by law or contract is obliged to act in the best interest of the limited partners or members; (2) does not control, is not controlled by, and is not under common control with the adviser; and (3) does not have, and has not had within the past two years, a material business relationship with the adviser.

32 In certain circumstances, offshore private investment funds are formed as corporations and those corporations have boards of directors. Where the directors are independent of the fund’s investment adviser, it should be acceptable to provide disclosures to and receive consents from the independent directors. In taking this approach, however, investment advisers should consider the relative degree of a director’s independence and the actual deliberation conducted by the director in reviewing each potential principal transaction.

33 In an analogous situation, however, the SEC staff addressed client consents in the context of registered investment funds where certain agency cross transactions were subject to Section 206(3) (and not eligible for relief provided under Rule 206(3)-2 because the adviser advised both sides of the transaction). In a no-action letter, the staff agreed that a portfolio manager, acting on behalf of a registered fund, could consent to agency cross transactions to satisfy the requirements of Section 206(3), subject to certain reporting requirements to the fund’s board and related board approvals. *See Merrill Lynch Asset Management, SEC No-Action Letter* (Apr. 28, 1997). The staff, however, has not issued similar letters and this letter likely does not have any broader application beyond the specific facts described in the requesting letter.


35 Since this issue was not central to the matter before the court, the SEC may view the court’s statement as dicta and not determinative in the context of Section 206(3). Also, prior to the *Goldstein* decision, the SEC staff had suggested in an analogous context that fund investors are clients of the adviser at least for purposes of Form ADV delivery requirements. *See Implications of the Growth of Hedge Funds Staff*, Report to the United States Securities and Exchange Commission (Sept. 2003) at n.317, citing *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Adv. Act Rel. No. IA-1862 n.117 (2000). More recently, however, the SEC reproposed amendments to the Form ADV and was silent as to whether an investment adviser must treat private fund investors as clients for purposes of Form ADV delivery thereby leaving the inference that private fund investors are not the adviser’s clients. *See Amendments to Form ADV*, Adv. Act Rel. No. IA-2711 (2008), available at http://www.sec.gov/rules/proposed/2008/ia-2711.pdf.
provided by the adviser and (2) the broker-dealer personnel who administer the margin requirements are separate from the personnel responsible for making investment management decisions.  

Second, the SEC staff has agreed that a broker-dealer sponsor of a wrap fee program generally will not be acting as adviser with respect to program clients’ trades that are directed to the broker-dealer by third-party portfolio managers. By way of background, the SEC has taken the position that broker-dealers who sponsor wrap fee programs are acting as investment advisers with respect to the program. Moreover, wrap fee clients may be considered advisory clients of both the sponsoring broker-dealer, as well as any underlying investment advisers who participate in the program. Accordingly, when an underlying portfolio manager directs trades for program clients through the broker-dealer sponsor, Section 206(3) generally applies to any transaction executed by the broker-dealer on a principal basis.

The SEC staff has agreed, however, that a broker-dealer sponsor generally will not be acting as adviser with respect to program clients’ trades that are directed to the broker-dealer sponsor by participating portfolio managers who have investment discretion to manage program client accounts, provided generally that (1) the broker-dealer and the portfolio managers are unrelated to each other; (2) the broker-dealer does not recommend, select, or play any role in the portfolio manager’s selection of particular securities to be purchased for, or sold on behalf of, program clients; and (3) the broker-dealer does not select, control, or influence the selection or retention of the participating portfolio managers in order to influence their decision to purchase or sell particular securities through the broker-dealer.  

ADDITIONAL CONSIDERATIONS

In addition to the interpretive matters associated with each clause of Section 206(3), a number of other issues arise in connection with principal transactions. These include (1) the application of Section 206(3) to unregistered and offshore advisers; (2) related types of transactions that may not constitute principal transactions; (3) additional disclosure obligations; and (4) restrictions on principal transactions imposed by other regulatory schemes. These additional issues are discussed below.

Unregistered and Offshore Advisers

The SEC has provided guidance regarding the application of Section 206(3) to both unregistered advisers and to registered advisers located offshore (i.e., advisers with their principal office and place of business outside the United States). First, the SEC takes the position that the restrictions on principal transactions apply equally to registered and unregistered investment advisers. However, for Section 206(3) to apply to an unregistered adviser, the adviser must make use of the U.S. mails or any means of U.S. interstate commerce.

Second, the SEC has stated that Section 206(3) would not apply to an offshore registered adviser’s dealings with its non-U.S. clients. In addition, the SEC has stated that an offshore private investment fund (i.e., a fund organized under the laws of a country other than the United States) would be viewed as a non-U.S. client for this purpose.

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exercise of investment discretion with respect to Program Client accounts in order to cause particular securities to be purchased or sold through the [broker-dealer].” The staff further stated that “such indirect participation could cause Section 206(3) to apply to transactions undertaken on behalf of Program Clients.”


See Release No. 2333 at n.210 and related discussion. (“Because we do not apply most of the substantive provisions of the [Advisers] Act to the non-U.S. clients of an offshore adviser, and because the offshore fund would be a non-U.S. client, the substantive provisions of the Act generally would not apply to the offshore adviser’s dealings with the offshore
Riskless Principal, Cross, and Agency Cross Transactions

Three types of transactions often raise issues for advisers regarding the application of Section 206(3). These include riskless principal transactions, cross transactions, and agency cross transactions. Each type is discussed below.

First, a “riskless principal transaction” arises where an adviser (assuming it is also registered as a broker-dealer or acting through an affiliated broker-dealer) purchases or sells for an advisory client a security that trades on a principal basis (e.g., most OTC and debt securities). In executing the transaction, the adviser locates the desired security in the marketplace and, when found, simultaneously buys or sells the security for the client through an offsetting transaction in the adviser’s own account (or the account of an affiliated broker-dealer). In this way, the security briefly, or at least notionally, passes through the account of the adviser (or its affiliate broker-dealer), and the adviser charges a small markup or markdown rather than a commission.

Although riskless principal transactions economically resemble agency transactions, the SEC treats these types of trades as principal transactions fully subject to the requirements of Section 206(3). The SEC has brought a number of enforcement actions involving riskless principal transactions and the failure to comply with Section 206(3).40

Second, a “cross transaction,” although not a defined term, refers generally to a transaction in which an adviser causes the purchase and sale of a particular security between two or more advisory client accounts without charging a fee for effecting the transaction. If the adviser charges a fee for effecting the transaction, it would need to do so as a registered broker-dealer or through an affiliated broker-dealer and the transaction would be deemed an “agency cross transaction,” as discussed below.

A cross transaction between client accounts is not a principal transaction subject to Section 206(3) (assuming that no client account involved in the transaction is owned more than 25% by the adviser and/or its control persons, as discussed above). In addition, the SEC has stated that a cross transaction is not an agency cross transaction subject to Section 206(3) because the adviser would not be “acting as broker” with respect to the transaction (assuming that neither the adviser nor an affiliate charges a fee for effecting the trade).41

The SEC has cautioned, however, that cross transactions are nevertheless subject to Sections 206(1) and (2) of the Advisers Act and that an adviser may need to disclose information about cross transactions. Accordingly, an adviser who engages in cross transactions should (1) disclose this fact in its Form ADV Part II, including that the adviser may have a conflicting duty of loyalty in advising both sides of the transaction; (2) ensure that the transaction is effected at fair market value consistent with the adviser’s valuation policies and procedures; and (3) ensure that the transaction is beneficial to clients on both sides of the transaction. The SEC staff has further cautioned that when one of the clients to a cross transaction is a private investment fund in which the adviser and/or its personnel have an ownership interest (though 25% or less) the adviser should also (1) disclose this fact and (2) consider monitoring the terms of transactions involving those accounts.42

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Third, an “agency cross transaction” refers to a transaction in which a person acts as an investment adviser in relation to a transaction in which the adviser, or any affiliated broker-dealer, also acts as broker for both an advisory client and for another person on the other side of the transaction. An agency cross transaction differs from a “cross transaction” in that the adviser (if also registered as a broker-dealer) or an affiliated broker-dealer charges a transaction fee for effecting the trade.

Section 206(3) applies to agency cross transactions, even though neither the adviser nor the affiliated broker-dealer acts as principal with respect to the trade. Section 206(3) covers agency cross transactions through the clause that states “or acting as broker for a person other than such client.” However, the SEC adopted Rule 206(3)-2, which permits an investment adviser to effect agency cross transactions based on prospective, blanket consent from an advisory client. In proposing the rule, the SEC noted that an agency cross transaction for an advisory account, unlike a principal transaction, is negotiated by an investment adviser at arm’s length with an independent third party and is subject to many of the checks of free and competitive forces. The rule contains a number of conditions, including certain disclosure and reporting obligations. In addition, the rule is not available where the investment adviser and/or its affiliated broker-dealer recommend the transaction to both sides of the trade. Finally, Rule 206(3)-2 is not available when a security trades on a principal basis (which would typically result in a riskless principal transaction, as discussed above).

Finally, an adviser may choose to execute a securities transaction through a broker-dealer who acts as agent on behalf of the adviser’s client. The broker-dealer charges a commission for representing the adviser’s client in effecting the trade. These types of transactions are referred to simply as “agency transactions.” Section 206(3) does not apply to agency transactions, even if the broker-dealer is an affiliate of the adviser (and assuming that the affiliate broker-dealer does not also represent the person on the other side of the transaction). However, in these circumstances, an adviser has a general obligation to disclose that it may use an affiliated broker-dealer and that the adviser will indirectly benefit from any commissions paid to the affiliated broker-dealer.

**Additional Disclosure Obligations**

In addition to the specific trade-by-trade disclosure and consent requirements arising under Section 206(3), an adviser engaging in principal transactions has additional disclosure obligations. Most significantly, an adviser must make certain specific disclosures in its Form ADV. Item 8.A (1) of Part 1 requires an adviser to check, if applicable, that the adviser or a related person buys securities for itself from advisory clients or sells securities it owns to any advisory clients. Item 9.A of Part II requires an adviser to check, if applicable, that it or a related person “as principal, buys securities for itself from or sells securities it owns to any client.” In addition, if an adviser checks “yes” to this item, the adviser must describe on Schedule F when the adviser or a related person engages in principal transactions “and what restrictions, internal procedures, or disclosures are used for conflicts of interest in those transactions.”

Section 206(3) does not require an adviser to disclose information about its principal transaction practices in its advisory agreements with clients. Some advisers, however, choose to include such information in their advisory agreements as an additional means of client disclosure. Similarly, Section 206(3) does not require an adviser to a private fund to disclose information about its principal trading practices in its fund offering.

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43 There may be circumstances other than agency cross transactions that are covered by this clause, such as where an affiliated broker-dealer acts as broker for a counterparty, even though neither the adviser nor the affiliated broker-dealer would be viewed as acting as broker for the advisory client in the transaction.

44 See *Method for Compliance with Section 206(3) of the Investment Advisers Act of 1940 with Respect to Certain Transactions*, Adv. Act Rel. No. IA-557 (1976). In the release, the SEC stated further that “in arm’s-length negotiations by an investment adviser acting in the best interest of his advisory clients, the negotiated price should approximate the best available in the open market, an independently determinable gauge of performance.”


46 Note that the SEC has proposed significant changes to Form ADV Part 2, which would require an adviser to prepare a narrative brochure in “plain English,” rather than use the current “Part II” check-the-box and Schedule F format. The revised Part 2 would require a registered adviser to disclose in response to Item 11.B whether it or a related person recommends to clients, or buys or sells for clients, securities in which the adviser or a related person has a material financial interest. If so, an adviser also would need to discuss this practice in its brochure along with the conflicts presented. See *Amendments to Form ADV*, Adv. Act Rel. No. IA-2711 (2008), available at http://www.sec.gov/rules/proposed/2008/ia-2711.pdf.
documents. However, as a cautionary measure and to address Exchange Act Rule 10b-5 concerns that all material facts be disclosed to potential investors, fund offering documents typically include information about the manager’s policies regarding potential principal transactions.

**Other Regulatory Schemes – Prohibitions**

While this article is intended to cover only the restrictions that accompany principal transactions under the Adviser’s Act, other regulatory schemes may apply to principal transactions depending on the type of client. For example, the Investment Company Act of 1940 applies to an investment adviser’s management of registered investment companies. Section 17(a) of the Investment Company Act prohibits principal transactions between a registered investment company and its investment adviser or any affiliate of the adviser. In addition, the Employment Retirement Income Security Act of 1974 (“ERISA”) applies generally to covered pension plans. Section 406(a) of ERISA prohibits principal transactions between a covered pension plan and the investment adviser to the plan or any affiliate of the adviser. ■