OCIE Publishes Risk Alert Regarding Principal and Agency Cross Trading

On September 4, 2019, the Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert (the "Risk Alert") listing examples of the most common compliance issues its staff identified relating to principal and agency cross transactions under Section 206(3) of the Investment Advisers Act of 1940, as amended ("Advisers Act") and Rule 206(3)-2 thereunder.[1] The Risk Alert serves as a reminder that this is an ongoing focus area for OCIE. We provide below a brief summary of the Risk Alert.

Section 206(3) and Rule 206(3)-2

Section 206(3) prohibits an adviser from effecting a securities transaction (1) with an advisory client while acting (or while its affiliate is acting) as principal[2] and (2) for an advisory client while acting (or while its affiliate is acting) as broker for the other party to the transaction, in each case without disclosing in writing to such advisory client before the completion of the transaction the capacity in which the adviser (or its affiliate) is acting and obtaining the consent of the advisory client to the transaction. The SEC interprets Section 206(3) to require disclosure to the advisory client of all facts necessary to alert the advisory client to the adviser's conflicts of interest and obtain consent from the advisory client on a transaction-by-transaction basis.[3]

Advisers Act Rule 206(3)-2 permits an adviser to effect transactions for advisory clients in which it (or its affiliate) acts as broker for both the advisory client and the other party to the transaction, provided that the disclosure and other conditions of Rule 206(3)-2 are satisfied.

Compliance Issues

OCIE staff identified the following common deficiencies or weaknesses in connection with advisers' principal and agency cross transaction practices:

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1 Risk Alert, Investment Adviser Principal and Agency Cross Trading Compliance Issues (Sept. 4, 2019).

2 The staff of the Securities and Exchange Commission ("SEC") considers a transaction between an advisory client and an entity which is 25% or more owned by the adviser and/or the adviser's controlling persons to be a principal transaction. See Gardner Russo & Gardner, SEC No-Action Letter (June 7, 2006).

3 Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Rel. No. 1732 (July 17, 1998) ("[A]n adviser may comply with Section 206(3) either by obtaining client consent prior to execution of a principal or agency transaction, or after execution but prior to settlement of the transaction.").

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Principal Transactions

- Advisers that engaged in principal transactions without making the required disclosures to, or obtaining the required consent from, clients.
- Advisers that obtained client consent to a principal transaction after the trade was completed.

Principal Transactions Involving Pooled Investment Vehicles

- Advisers that effected trades between advisory clients and an affiliated pooled investment vehicle but failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle would cause the transaction to be a principal transaction.
- Advisers that effected principal transactions between their own accounts and pooled investment vehicle clients without obtaining effective consent from the pooled investment vehicles prior to completing the transaction.

Agency Cross Transactions

- Advisers that engaged in agency cross transactions despite disclosure to clients that they would not do so.
- Advisers that failed to document their compliance with the requirements of Rule 206(3)-2.

Policies and Procedures

- Advisers that engaged in principal and agency cross transactions but did not have policies and procedures relating to Section 206(3) or failed to follow their policies and procedures relating to Section 206(3).

Conclusion

On numerous occasions in the past, the SEC has brought enforcement actions against advisers for failure to comply with Section 206(3). We encourage our clients to review their written policies and procedures, and their implementation of such policies and procedures, to ensure compliance with Advisers Act Section 206(3) and Rule 206(3)-2.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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