Simpson Thacher

Regulatory and Enforcement Alert

SEC Staff Issues Follow-Up Risk Alert on Principal and Cross Trade Compliance Issues Involving Fixed Income Securities

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On July 21, 2021, the Division of Examinations[1] of the U.S. Securities and Exchange Commission published a Risk Alert[2] highlighting certain compliance issues relating to principal transactions (also known as "principal trades"), agency cross transactions and other cross transactions (also known as "cross trades") involving fixed income securities.[3] The Risk Alert supplements a 2019 Risk Alert[4] that identified deficiencies with respect to principal transactions and agency cross transactions by registered investment advisers generally. The publication of another Risk Alert on the same topic strongly indicates that the SEC and its staff remain focused on these types of transactions and the conflicts of interest and other fiduciary issues they can present.

The observations identified in the Risk Alert are derived from an examination initiative that focused on principal and cross trades involving fixed income securities. Nearly two-thirds of the advisers examined as part of this initiative received staff-issued deficiency letters identifying conflicts of interest, compliance program and other deficiencies. Some of these advisers were able to resolve deficiencies (without enforcement) by amending disclosures, revising their compliance policies and procedures, or changing other practices. The vast majority of deficiencies concerned:

- Compliance programs (adequacy of adopted written policies and procedures and proper implementation);
- Conflicts of interest; and
- Disclosures (incomplete or inaccurate disclosures and full and fair disclosure of relevant trades in compliance with the requirements of the Advisers Act).

The staff also provided observations regarding effective practices by examined advisers in administering their compliance programs and providing effective disclosures to clients. These observations and proposed best

[1] Formerly known as the Office of Compliance Inspections and Examinations.

[2] SEC Division of Examinations Risk Alert, *Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from an Examination Initiative,* July 21, 2021.

[3] The Risk Alert explicitly does not address other issues with respect to principal and cross trades that may arise for mutual funds and their advisers under the Investment Company Act of 1940.

[4] For more on the 2019 Alert, *see*, Simpson Thacher & Bartlett LLP, *SEC Risk Alert Highlights Compliance Issues Relating to Investment Adviser Principal and Agency Cross Transactions*, Sept. 12, 2019.

practices demonstrate that the staff will take a granular approach to reviewing an adviser's disclosures, policies, practices and documentation with respect to principal and cross trades.

Key Takeaways and Reminders

The Risk Alert builds on many of the principles already identified in the 2019 Alert, but seeks to make some practical observations for all SEC-registered investment advisers to bear in mind in their operations and in preparing for possible SEC examination. The takeaways are generally applicable, even for advisers that do not trade in fixed income securities.

- **Documentation remains essential.** Documentation of all key aspects of principal and cross trade activity is essential for advisers hoping to demonstrate effectively to the staff that they have an appropriately designed compliance program. An adviser needs appropriate—and specific—policies to identify principal and cross trade activities and to ensure that they are escalated to appropriate parties who can make sure that required disclosures are made and required consents are obtained. Internal evaluations and considerations for permitting (or denying) principal or cross trades should also be maintained and should contain sufficient detail to demonstrate that appropriate weight was given to fair and equitable principles, pricing considerations and other elements needed to meet fiduciary obligations. The onus is on the adviser to demonstrate that appropriate considerations were, in fact, evaluated prior to, and contemporaneously with, approving and making principal and cross trades.
- **Technology can be crucial.** While technology is not addressed specifically in the Risk Alert, the staff's focus on undetected principal and cross trades demonstrates that advisers should have appropriate trade and monitoring systems to pre-clear or detect principal and cross trades (and in order to make timely disclosures). Particularly for advisers that have a significant number of client accounts or engage in a large amount of overall trading, having appropriate systems that incorporate policy requirements (*e.g.*, the number of days where a trade is still deemed a cross trade) can reduce the risk for human error or oversight and demonstrate credibly that the adviser has invested in their client account oversight mechanisms. Robust technology may also be leveraged to assist with periodic compliance testing for principal and cross trade requirements.
- **Consistent disclosures are key.** Generally, the examination staff is looking for evidence that an adviser's internal controls are well maintained and consistently applied. Discrepancies in policies and procedures, client disclosures and other statements, including Form ADV, can create the impression that an adviser's practices are inconsistent or not properly followed (even if such discrepancies are innocuous or merely result from out-of-date policy documents or disclosures). As part of their periodic compliance hygiene, advisers should ensure that their disclosures and description of compliance practices remain up-to-date and consistent across disclosure type.

Below we discuss the legal framework for principal and cross trades, followed by an in-depth review of the Risk Alert's observations.

Background–Advisers Act

Under Section 206(3) of the Advisers Act, an investment adviser may not engage in a principal securities transaction with a client (including a private fund) without: (1) disclosing to the client in writing—*before* the completion (*i.e.*, settlement) of the transaction—the capacity in which the adviser is acting and certain information about the transaction; and (2) obtaining the client's consent to each specific transaction. Consent must be obtained on a transaction-by-transaction basis, not through blanket consent, which can often prove to be a trap for the unwary when engaging in inadvertent or unidentified principal transactions.

Section 206(3) also imposes restrictions on so-called "agency cross trades," which are transactions in which an adviser effects a sale or purchase of a security for the account of a client while (directly or through an affiliate) acting as a broker for the other party to the transaction. Advisers are prohibited from engaging in an agency cross trade without first providing disclosure to the client and obtaining their consent. Unlike in the case of principal transactions, an adviser is permitted to effect agency cross trades without obtaining client consent separately for each individual transaction, *provided* that the adviser satisfies certain consent, confirmation and disclosure requirements set forth in Rule 206(3)-2 under the Advisers Act.[5]

Advisers Act Section 206(3) does not explicitly apply to "no-fee" (*i.e.*, non-agency) cross transactions between advisory clients. Such cross transactions, however, may create conflicts for the adviser with respect to the fair treatment of both clients and could, in this respect, implicate the adviser's fiduciary duty obligations under the Advisers Act. Accordingly, an adviser that effects such a cross transaction should ensure that the transaction is completed in a manner that satisfies its fiduciary duty and any other contractual obligations.[6] The Risk Alert refers to both agency cross trades and non-agency cross trades as "cross trades."

Compliance Program Deficiencies

As described in the Risk Alert, over half of the deficiencies the staff observed were related to issues with the examined advisers' compliance policies and procedures. Below are examples of compliance program-related deficiencies observed.

[5] 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.

[6] In addition, advisers should also ensure that they comply with any requirements for such transactions in the governing documents of the affected advisory clients, as often disclosure or consent may be required under such documents.

INCONSISTENT POLICIES AND PROCEDURES AND ADHERENCE

During the exams, the staff observed policies and procedures that were inconsistent with actual practices, disclosures and/or regulatory requirements. In some cases, compliance programs did not include specific procedures to validate that: (1) principal trades, cross trades, or both, were completed in a manner consistent with client disclosures and the advisers' policies and procedures; and (2) consent was received from, and disclosure was provided to, clients prior to completing the transactions (where applicable). Some examples of issues the staff identified included that:

- Principal trades, cross trades, or both, were executed by investment professionals while prohibited by the firm's policies.
- Required written compliance department approvals were not obtained with respect to trades where required by a firm's policies.
- Required written disclosures to clients participating in principal trades, including that their consent to trades may be revoked within five days of giving it, were not made or may not have been received by clients in a timely manner (*e.g.*, where included in trade confirmations after the required notification period elapsed).

POLICIES AND PROCEDURES LACKED SUFFICIENT GUIDANCE NECESSARY FOR ADVISORY PERSONNEL TO ACHIEVE COMPLIANCE

The staff observed that some advisers included standards in their written compliance policies and procedures addressing when principal and cross trades were appropriate, but the advisers did not always provide sufficient information for advisory personnel to know whether they were complying with these written standards. Specifically, the staff observed issues related to:

- **Determining and documenting when a trade has been executed in the best interests of the client.** Though the advisers' policies and procedures required the trades to be executed in the best interests of the clients, some advisers did not: (1) specify in their procedures the factors that advisory personnel should—or presumably, could appropriately—consider in making these best interests determinations; and/or (2) include a section in their cross trading reporting forms to document why the trades were considered to be in the best interests of the clients or have advisory personnel memorialize these assessments elsewhere.
- **Lack of guidance on how to value cross trades if crossing value quotes differ.** Though the advisers' policies and procedures specified that advisers would obtain multiple quotes from different broker-dealers to use as the crossing value for the cross trades, the Division found that those procedures failed to specify which value (or calculation thereof) advisory personnel should use for valuing the trades if the quotes differed.

- **Compliance with ERISA investment restrictions.** When managing client accounts subject to the Employee Retirement Income Security Act of 1974 (ERISA) and the rules promulgated thereunder, advisers often must manage client portfolios in compliance with ERISA investment restrictions and avoid engaging in certain prohibited transactions under ERISA. Some advisers' compliance programs, however, did not contain any policies or procedures on what the advisers must do to be in compliance with ERISA investment restrictions (including avoiding non-exempt prohibited transactions), including those prohibiting principal and cross trades.

POLICIES AND PROCEDURES WERE NOT EFFECTIVELY TESTED

The Risk Alert indicates that many examined advisers did not effectively test the implementation of their written compliance policies and procedures for principal and cross trades, including as part of their annual compliance reviews as required under the Advisers Act. As a result, the staff observed that advisers—including those that prohibited these trades—were unaware that these trades had occurred. Being unaware of them, the advisers that prohibited them did not prevent them from being executed. Separately, the advisers that did permit them failed to follow their compliance policies and procedures and obtain proper consent where required.

Issues Associated With Conflicts of Interest

During examinations, the staff identified conflicts of interest associated with cross trades that were not identified by the advisers and mitigated, disclosed, or otherwise addressed by their compliance programs. For example, the staff observed cross trades that were:

- Contrary to the adviser's written policies and procedures because they were not executed at independent market prices for the securities and did not use best price and/or satisfy best execution efforts, resulting in at least one of the participating clients receiving an unfair price.
- Subject to markups or other fees that were not fully disclosed.

Disclosure Deficiencies

The Risk Alert stated that over one-third of the cross trade-related deficiencies concerned disclosure issues. For example, the staff observed advisers that:

- Omitted relevant information concerning cross trading activities and/or omitted disclosures relating to cross trade conflicts of interest in their Form ADVs.
- Did not include conflicts of interest disclosures in their Form ADV Part 2As, advisory agreements, and separate written communications or other disclosures to clients. Specifically, these omitted disclosures concerned conflicts of interest created by cross transactions involving advisory clients or advisers acting as brokers in agency cross transactions.

Staff Observations on Improving Compliance Programs

With respect to improving compliance programs, the Risk Alert outlined some of the adviser practices that the staff observed that appeared to be effective.

The Risk Alert urges advisers to adopt and enforce compliance policies and procedures that: (1) incorporate all applicable legal and regulatory requirements; (2) clearly articulate the activities covered by their written compliance policies and procedures; (3) set standards that address their expectations for each of these activities; (4) include supervisory policies and procedures; and (5) establish controls to determine whether policies and procedures are being properly followed and documented in the required manner. Additionally, practices that may help to support compliance include:

- **Using specific and detailed definitions for covered activities.** Specific and detailed definitions in written compliance policies and procedures are more likely to be consistently followed. For example, the staff observed that more detailed definitions for cross trades, which, for example included the time frame within which a cross transaction would be deemed to occur, were more likely to be followed. The Division did not specifically address, but presumably they would also want to ensure that the examples of likely principal and cross trades match the types of investment activities conducted by the adviser and relevant accounts.
- **Setting written standards for how advisory personnel will conduct principal and cross trades.** The Risk Alert notes that written standards promote compliance with the advisers' policies and procedures and provide greater clarity regarding the advisers' expectations for the conduct of their advisory personnel when engaging in (or not engaging in) principal trades, cross trades, or both. Several standards are identified in the Risk Alert, including that transactions should be fair and equitable to all participating client accounts, pricing methodologies used to execute the transactions are prescribed, and periodic evaluations of the quality of execution are performed, among other standards.
- **Conducting testing for compliance with policies and procedures.** The Risk Alert notes that advisers with written policies and procedures were more likely to analyze their books and records to identify undisclosed principal and cross trades, undisclosed conflicts of interest, or other issues. When conducting their own internal compliance reviews, some advisers identified issues associated with their principal trade or cross trade practices, such as instances where advisers did not:
    - Maintain documentation or information regarding the trade (including documentation of determinations with respect to the adherence to Advisers Act requirements);
    - Provide clients full and fair disclosure regarding trades, or seek client consent, as required; or
    - Comply with trading restrictions or account requirements (*e.g.*, prohibitions on trades or compliance with ERISA requirements).

- **Placing conditions, qualifications or restrictions on the execution of principal trades, cross trades, or both, within client accounts.** The staff observed that advisers were imposing some or all of the following conditions (with several advisers adhering to all):
    - The securities must only be purchased by or sold to another client when there is a need and the securities meet each participating client's investment objectives;
    - The client accounts involved in these trades are not ERISA accounts;
    - The trades received best price and best execution efforts; and
    - The adviser, its affiliated persons or its supervised persons may not receive commissions or any other compensation arising from these trades.

Staff Observations on Improving Disclosure

With respect to improving disclosure, the Risk Alert outlined some of the adviser practices that the staff observed that appeared to be effective. Specifically, to provide clients:

- **Full and fair disclosure of all material facts associated with principal and cross trades.** The staff considered certain adviser's disclosures to be more robust, including details regarding how the adviser has addressed conflicts of interest, when the adviser may engage in principal and cross trades, associated costs, commissions (or other remuneration) received or to be received by the adviser or any affiliated persons, the option to revoke blanket consent for cross trades without penalty at any time by written notice, and the total number of principal trades since the date of the last statement or summary.
- **Disclosures regarding principal and cross trading practices in multiple documents.** The staff observed that advisers provided disclosures in: (1) Form ADV Part 2A; (2) advisory agreements; (3) separate written communications to clients; and/or (4) private fund offering documents, when applicable. Some advisers additionally discussed their rationale for executing principal trades during oral conversations with their clients.

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