OCIE Issues Risk Alert on Principal and Agency Cross Transactions

September 23, 2019

On September 4, 2019, the SEC's Office of Compliance Inspections and Examinations (OCIE) released a new risk alert on certain principal and agency cross trading compliance issues identified in deficiency letters in connection with investment adviser exams completed during the past three years.

Background

Section 206(3) of the Investment Advisers Act of 1940 (Advisers Act) requires an investment adviser entering into a principal trade with a client (i.e., buying a security from, or selling a security to, a client) to obtain the consent of the client to the transaction on a transaction-by-transaction basis (i.e., blanket disclosure and consent are not permitted). With respect to private funds, the staff of the SEC's Division of Investment Management has stated that the principal trading restrictions of Section 206(3) do not apply to a transaction between a client account and a pooled investment vehicle in which the investment adviser and/or its controlling persons, in the aggregate, has a greater than 25% beneficial ownership stake in the vehicle.

Section 206(3) of the Advisers Act also prohibits an investment adviser, directly or indirectly, while acting as broker for a person other than the advisory client, from knowingly effecting any sale or purchase of any security for the account of that client (i.e., engaging in "agency cross transactions") without disclosing to that client that the adviser, or an affiliate of the adviser, is acting as broker and obtaining the consent of the client to the sale or purchase.[1]

Common Deficiencies Identified

With respect to principal trades, the risk alert noted that the OCIE staff had observed instances where investment advisers either did not recognize that they were engaging in principal trades (e.g., an affiliate of the adviser held a greater than 25% beneficial ownership interest in a party to the transaction), or failed to either provide sufficient disclosure or obtain the required consent from clients prior to the execution or settlement of the transactions.

In connection with agency cross transactions, the risk alert referenced situations where investment advisers either (i) engaged in agency cross transaction, despite disclosures to the contrary made to advisory clients, or (ii) were unable to produce any documentation that the adviser had complied with the written consent, confirmation, or disclosure requirements of Advisers Act Rule 206(3)-2.

Finally, OCIE staff noted instances where investment advisers either (i) did not have adequate compliance policies and procedures relating to Section 206(3) even though the advisers engaged in principal trades and agency cross transactions, or (ii) failed to follow established policies and procedures regarding principal trades and agency cross transactions.

Key Takeaways

Investment advisers to private funds should pay close attention when contemplating transactions between a private fund and another of the investment adviser's clients, (e.g., another private fund or managed account) where the investment adviser and/or affiliates collectively hold a greater than 25% beneficial ownership stake in one of the parties to the transaction. These situations can often arise in the early stages of a fund's life, when ownership by affiliates can represent a higher percentage. Also, if investments are "warehoused" by another vehicle beneficially owned by an affiliate of the adviser prior to fund launch, then a later transfer of the investment to the fund may be a principal transaction requiring prior consent.

With respect to agency cross transactions, investment advisers should be careful not to receive any special or one-time fees or other compensation when reallocating investments between private funds managed by the adviser. Such fees may also raise an obligation to register as a broker-dealer under the Securities Exchange Act of 1934 and applicable state laws.

Recent SEC settlements with private fund managers have reflected the SEC's view that where a private fund's general partner is affiliated with the fund's investment adviser, any consent provided by the general partner may be viewed as insufficient as a result of what the SEC considers to be an inherent conflict of interest. Conversely, if a private fund's governance documents provide for a limited partner advisory committee (LPAC) or similar body that is properly authorized to provide consent on behalf of the fund, then the consent of the LPAC is usually sufficient, provided that the adviser makes a full and fair disclosure of the material facts. Absent the presence of an LPAC, advisers may be required to obtain consent directly from a private fund's investors, usually by reference to the applicable thresholds required for amendment of the private fund's governing documents.

Finally, registered investment advisers should review their written compliance policies and procedures adopted pursuant to Advisers Act Rule 206(4)-7(a) to ensure that reasonable methods are in place for the identification and management of potential transactions that may raise disclosure and consent obligations under Section 206(3).

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[1] Advisers Act Rule 206(3)-2 permits certain agency cross transactions without requiring the adviser to provide transaction-by-transaction disclosure and consent provided that certain conditions in the rule are satisfied.

Related Professionals

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