

# SEC's Division of Examinations Publishes Risk Alert on Investment Adviser Principal and Cross Trading Practices

August, 12, 2021

On July 21, 2021, the Division of Examinations (“Exams”) issued a risk alert on principal and cross trading practices by investment advisers (the “Risk Alert”).<sup>[1]</sup> This Risk Alert supplements a prior risk alert published by Exams in 2019 that highlighted the most common compliance issues observed by Exams staff.<sup>[2]</sup>

A cross trade occurs when an adviser causes one client to sell a security to another client. A principal trade occurs when an adviser causes a security to be sold to or purchased from a client from or to the adviser’s own account (or an account of a related person). A cross trade involving a fund advised by the adviser and another client can be a principal trade if the adviser and its control persons have a significant ownership interest in the fund.<sup>[3]</sup>

The Risk Alert notes that principal and cross trading implicates a variety of legal obligations under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), in particular an adviser’s fiduciary duty to its clients.<sup>[4]</sup> Although the Risk Alert does not provide any new insight into the legal or regulatory issues around principal or cross trading practices, it serves as a useful reminder that this remains an area of focus by Exams staff.

The Risk Alert is based on the staff’s observations as part of an initiative of over 20 examinations that focused on registered investment advisers that engaged in cross trades and/or principal trades involving fixed income securities. The Risk Alert states that nearly two-thirds of the examined advisers received deficiencies, and that “the content and effectiveness of the examined advisers’ compliance programs varied greatly.” During the exam initiative, Exams staff focused its review on three general areas:

- Compliance programs – whether the advisers’ compliance policies and procedures effectively addressed these trading practices.
- Conflicts of interest – whether trades were made in clients’ best interests.
- Disclosure – whether conflicts of interest were fully and fairly disclosed to clients.

The Risk Alert provides observations regarding common deficiencies in each of these three areas, as well as examples of “some of the practices the staff observed at the examined advisers that appeared to be effective.”

## **Compliance Program Deficiencies**

### 1. Failure to Comply with the Adviser’s Own Compliance Policies

- Advisers engaged in principal trades which were prohibited by their compliance policies.
- Personnel failed to obtain required compliance approvals prior to engaging in trades.
- Clients failed to receive clear written disclosure before participating in principal trades.
- Cross trades were not executed at an independent market price for securities, as disclosed to clients.

### 2. Failure to Adopt Adequate Policies

- Policies did not include factors for personnel to consider when determining that a trade was in the client’s best interest.
- Policies did not include provisions designed to meet specific clients’ compliance obligations to which the adviser had agreed, for example ERISA restrictions on principal and cross trades.
- Policies did not include procedures to “validate” that principal trades and cross trades were effected in a manner that conformed to client disclosures and the Advisers Act.

### 3. Failure to Disclose

- Failure to adequately disclose principal and cross-trading activities.

## **Suggested Improvements**

The Risk Alert suggests several ways to improve compliance programs based on the staff's observations.

1. **Define Terms.** Although compliance programs typically define a principal trade or cross trade, the level of specificity and clarity of these definitions varied. The staff suggested that when determining whether a trade executed by a third party broker should be deemed to be a cross trade, an adviser's compliance policy might presume that a cross trade has occurred when the same security is sold for one client and purchased for another client within a fixed time period, e.g., within one or three days.
2. **Standards to be Observed.** The staff identified seven standards that they commonly observed in advisers' compliance policies, which reflect an adviser's obligations under the Advisers Act:
  - Transactions are fair and equitable to all participating clients.
  - Pricing methodologies to be followed.
  - Periodic evaluation of execution.
  - Periodic reporting to compliance department.
  - Delivery to clients of written information regarding capacity in which the adviser acted.
  - Require written approval from senior management or compliance personnel for certain trades.
  - In the case of principal trades, require prior written consent before the completion of each trade.[\[5\]](#)
3. **Written Disclosure.** The Risk Alert also sets out written disclosures advisers may consider providing clients:
  - A description of the nature and significance of the conflicts for participating clients.
  - The circumstances under which the adviser will engage in these transactions.
  - Pricing methodologies used to determine at what price the trade will occur.
  - Costs (e.g., brokerage commissions) associated with the transactions.
  - The total amount of commissions or other remuneration associated with these transactions.

The SEC has previously discussed the conflicts of interest disclosures that advisers engaging in principal trades must provide to affected clients in order to satisfy their fiduciary obligations as well as the requirements of Section 206(3) of the Advisers Act.[\[6\]](#)

## **Takeaways**

The Risk Alert is a helpful summary of what advisers can expect Exams staff to focus on during an examination of an adviser's principal or cross trading practices. Advisers that engage in principal or cross trades should use the Risk Alert as an opportunity to review their compliance policies, their trading practices, and their client disclosure.

A key takeaway from the Risk Alert is that compliance policies related to principal and cross trades must include a sufficient level of detail to provide advisory personnel with guidance necessary to either avoid these transactions or to properly execute on them. Principal and cross trades remain an area of focus by Exams staff and have been the subject of many enforcement actions over the years. Many of the deficiencies in this area involve investment personnel who are not always sufficiently sensitive to the conflicts of interest presented by these trades.

Finally, as with all compliance matters, documenting internal decision-making and compliance regarding principal and cross trades is of particular importance. Robust and well-documented controls will serve the adviser well in complying with its compliance obligations under the Advisers Act and surviving the inevitable SEC examination.

[\[1\] Risk Alert: Observations Regarding Fixed Income Principal and Cross Trades by Investment Advisers from an Examination Initiative \(July 21, 2021\).](#)

[\[2\] Risk Alert: Investment Adviser Principal and Agency Cross Trading Compliance Issues \(Sept. 4, 2019\).](#)

[\[3\] When is a Cross-Trade a Principal Trade? SEC Brings Enforcement Action Against a Fund Manager That Appears not to Have Understood](#), Capital Commitment Blog (Mar. 18, 2020).

[4] Section 206(3) of the Advisers Act prohibits an investment adviser, “acting as principal for its own account,” from knowingly selling any security to or buying any security from a client, without disclosing to the client in writing that it is acting as a principal and obtaining the client’s consent.

[5] The risk alert suggests that client consent must be in writing; however, Section 206(3) requires only that disclosure by the adviser must be in writing.

[6] *Interpretation of Section 206(3) of the Investment Advisers Act of 1940*, Advisers Act Rel. No. 1732 (July 17, 1998).