OCIE Risk Alert on Principal and Agency Cross Transactions

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On September 4, 2019, the Office of Compliance Inspections and Examinations ("OCIE") published a risk alert identifying the most frequent compliance issues involving principal and agency cross transactions from exams completed over the last three years.[1]

Principal and Agency Cross Transactions

Section 206(3) under the Advisers Act prohibits any investment adviser or its affiliate from effecting a securities transaction with a client while (i) acting as principal for its own account (a "principal transaction") or (ii) acting as a broker on behalf of a person other than the advisory client (an "agency cross transaction"), without disclosing to the client in writing the capacity in which the adviser is acting and obtaining the consent of the client to the transaction before its completion.[2] In addition, to ensure that the client's consent is informed, the SEC reads Sections 206(1), (2), and (3) of the Advisers Act together to require disclosure of the facts necessary to alert the client to the adviser's potential conflicts of interest.[3]

In general, the disclosure and consent requirement may not be satisfied by blanket disclosure and consent—instead, the requirement must be satisfied separately for each transaction. Rule 206(3)-2 under the Advisers Act provides conditions under which certain agency cross transactions may be effected without satisfying the disclosure and consent requirements separately for each transaction.

Of particular interest to advisers managing private investment funds, the SEC staff takes the position that an investment adviser or its affiliate may be deemed to be acting as principal for purposes of Section 206(3) if a party to the transaction is a pooled investment vehicle in which the adviser or its personnel has an interest, depending on the facts and circumstances, including the extent of the interest. The staff has expressed the view that Section 206(3) is not implicated if the interest of the adviser and its controlling persons in the pooled investment vehicle does not exceed 25%.[4]

For a transaction to constitute an agency cross transaction, the investment adviser must be "acting as a broker" with respect to the transaction. The SEC interprets "acting as a broker" to require that the adviser receive compensation (other than its advisory fee) for effecting the transaction.[5] Accordingly, Section 206(3) does not apply to cross trades effected by an investment adviser between advisory clients using a third-party broker or if the adviser or its affiliate does not otherwise receive compensation (other than its advisory fee) to effect the trades.[6]

Compliance Deficiencies and Weaknesses

As to principal transactions, the most common compliance deficiencies and weaknesses identified by the OCIE examiners were the following:

- Advisers not recognizing they had effected a principal transaction;
- Advisers failing to obtain effective client consent before effecting a principal transaction;[7]
- Advisers failing to provide disclosure of the terms of, and the potential conflicts of interest raised by, a principal transaction;
- Advisers failing to realize that its and its controlling persons' ownership interest in an pooled investment vehicle was sufficient to cause a transaction involving the vehicle and another advisory client to constitute a principal transaction; and
- Advisers failing to have, or to follow, policies and procedures regarding principal transactions.

As to agency cross transactions, the most common compliance deficiencies and weaknesses identified by OCIE examiners were the following:

- Advisers disclosing to clients that they would not engage in agency cross transactions, but nonetheless doing so in reliance on the Rule 206(3)-2;
- Advisers effecting agency cross transactions in reliance on Rule 206(3)-2, but not maintaining documentation evidencing compliance with the rule's requirements; and
- Advisers failing to have, or follow, policies and procedures regarding agency cross transactions.

Conclusion

As this risk alert and SEC enforcement actions demonstrate, principal and agency cross transactions are a continued focus of the SEC. Investment advisers are encouraged to review and supplement as necessary their policies and procedures, and the practices actually employed by firm personnel, regarding principal and agency cross transactions to ensure that they are in compliance with Section 206(3) of the Advisers Act and the advisers' fiduciary duties to their clients.

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1. OCIE Risk Alert (September 4, 2019)

2. The SEC interprets "completion" to mean by the settlement of the transaction. Advisers Act Release No. 1732 (July 17, 1998).

3. Id.

4. Gardner Russo & Gardner, IM Staff No-Action Letter (June 7, 2006).

5. Advisers Act Release No. 1732.

6. Cross trades nonetheless raise potential conflicts of interest, including the possibility that one client may be advantaged at the expense of another, and are subject to the other anti-fraud provisions of the Advisers Act.

7. These failures included not seeking consent, obtaining consent after the completion of the transaction, and obtaining consent that was not effective. In order to be effective, the body providing consent on behalf of the pooled investment vehicle cannot itself be conflicted with respect to the applicable transaction, and the SEC has brought settlement agreements where consent failed to be effective for this reason. See Paradigm Capital Mgmt., Inc., Advisers Act Rel. No. 3857 (June 16, 2014).

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