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SEC Outlines Principal Trading Compliance Issues

On September 4th, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published a Risk Alert¹ highlighting the most frequent compliance issues identified by its staff during examinations of investment advisers ("advisers") relating to § 206(3) of the Advisers Act.² Among other things,³ § 206(3) prohibits an adviser, directly or indirectly, from effecting a securities transaction in which the adviser acts as principal for its own account (or the account of an affiliate) in a transaction with an advisory client ("principal trade"), unless the adviser has provided each client with written disclosure prior to the completion of such transaction and obtained each client's prior consent to such transaction.

The following are certain highlights of the Risk Alert regarding principal trades:

Effective Consent. OCIE observed principal trades between advisers and advisory clients where effective consent was not obtained from the client, including failing to: (i) obtain appropriate prior client consent for each⁴ principal trade; (ii) provide sufficient disclosure regarding potential conflicts of interest⁵ and terms of the transaction; and (iii) obtain client consent prior to the completion⁶ of the transaction.

Pooled Investment Vehicles. OCIE observed cross trades between advisory clients and affiliated pooled investment vehicles where advisers failed to recognize that the advisers' significant ownership interests in the pooled investment vehicle would cause the transaction to be subject to the principal trade restrictions of § 206(3). In this regard, the SEC generally considers a cross trade involving an account or fund in which the adviser (or its owners, employees, and affiliates) owns, in the aggregate, *more than 25%* of such account or fund to be a principal trade. Importantly, however, the SEC generally will *not* view cross trades between funds to be principal trades where the adviser (or its owners, employees, and affiliates) owns, in the aggregate, *25% or less in either fund.*⁷

Key Takeaways. Advisers who engage in principal trades may want to consider, among other things:

- monitoring their ownership levels (including ownership levels of affiliates and related persons) in advisory clients that are pooled investment vehicles, such as private funds;
- reviewing whether the governing documents of pooled investment vehicles that are advisory clients permit the appointment of a representative (*e.g.*, an advisory board, independent committee or independent person) to approve principal trades on behalf of the investors in such vehicles;
- assessing what information is to be provided to such representative when approval of a principal trade is sought, in light of the instruments to be traded (*e.g.*, substantiation of value for hard-to-value positions, disclosures of other conflicts);

- reviewing their written policies and procedures regarding principal trades; and
- reviewing their implementation of those policies and procedures to ensure that they are compliant with the Advisers Act and the rules thereunder.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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- ¹ [Risk Alert Office of Compliance Inspections and Examinations: Adviser Principal and Agency Cross Trading Compliance Issues](#) (September 4, 2019).
 - ² The Investment Advisers Act of 1940, as amended (the “Advisers Act”).
 - ³ OCIE’s Risk Alert also identifies compliance deficiencies relating to agency cross transactions, which are also covered by Advisers Act § 206(3) and Rule 206(3)-2 thereunder.
 - ⁴ Disclosure and consent for principal trades must be obtained on a transaction-by-transaction basis (*i.e.*, a blanket consent from a client to principal transactions is not sufficient).
 - ⁵ The SEC has stated that in order to ensure that a client’s consent to a principal trade or agency cross transaction is informed, § 206(3) should be read together with the “anti-fraud” provisions of Advisers Act §§ 206(1) and (2) to require the adviser to disclose facts necessary to alert the client to the adviser’s potential conflicts of interest in a principal trade or agency cross transaction.
 - ⁶ Client consent may be obtained either prior to execution of the transaction or after the transaction’s execution but before its settlement.
 - ⁷ [Gardner Russo & Gardner](#), SEC No-Action Letter, June 7, 2006.