



## Division of Examinations Risk Alert: Observations Regarding Fixed-Income Principal and Cross Trades by Investment Advisers from an Examination Initiative

August 2021

On July 21, 2021, the SEC's Division of Examinations (the Division) issued a Risk Alert detailing more than 20 examinations of investment advisers who engaged in cross trades, principal trades, or both, involving fixed-income securities as part of the Division's FIX Initiative. The July 21, 2021, Risk Alert is a follow-up to the Sept. 4, 2019, Risk Alert highlighting common compliance issues observed by the Division of Examinations (then the Office of Inspections and Examinations) related to principal and agency cross trades.

A principal trade is the purchase from or sale to a client from the investment adviser's own account. An agency cross trade involves an adviser arranging for a trade to be executed between a client and another party. A cross trade occurs when an adviser effects a trade between two or more of its advisory clients' accounts but does not charge a fee for effecting the transaction. Generally, principal trades and cross trades are subject to Advisers Act Section 206(3) and Rule 206(3)-2.

The Division Staff focused on the following areas in their reviews: (i) Conflicts of Interest; (ii) Compliance Programs; and (iii) Disclosures.

### **Conflicts of Interest**

**The Staff focused on whether trades were made in clients' best interests rather than to further the interest of the adviser.**

### **Compliance Programs**

**The Division noted the following deficiencies relating to advisers' compliance programs and principal/cross trade activities:**

- Compliance policies and procedures that were inconsistent with advisers' practices, disclosures and/or regulatory requirements;

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- Procedures were not implemented to confirm that principal/cross trades were completed consistent with advisers' disclosures to clients and procedures;
  - Provision of disclosure and receipt of client consent not received prior to completing a transaction;
  - Advisers maintained policies and procedures providing that advisers did not engage in principal/cross trades when in fact advisers did engage in such trading activity;
  - Compliance policies and procedures that lacked necessary specificity and guidance to adequately assist supervised persons with compliance;
    - Example: Policies and procedures did not specify the factors that should be considered when making a determination that a principal/cross trade is in the best interest of a client and did not provide a form to document a best-interest determination; and
    - Lack of testing of compliance policies and procedures.

## **Disclosures**

**The Division examined whether advisers fully and fairly disclosed conflicts to clients.**

In issuing the Risk Alert, the Division provided observations regarding principal/cross trade activities best practices. Following is a summary of these observed best practices.

## **Standards/Conditions**

**Advisers included specific standards/conditions to their compliance policies and procedures – which generally correspond to the requirements under Advisers Act Section 206 and Rule 206(3)-2. The Division referenced the following example standards/conditions:**

- Transactions should be fair and equitable to all participating clients (cross and principal trades);
  - Pricing methodologies used to execute the transactions are prescribed (cross and principal trades);
    - Trades received best price and best execution, including the performance of periodic evaluations of the quality of execution (cross and principal trades);
      - Periodic reporting to legal or compliance department occurs (cross and principal trades);
      - Clients receive written information regarding the capacity in which the adviser acted (cross and principal trades);
      - Portfolio managers or traders get advanced written approval from senior management or compliance personnel in order to execute trades (cross and principal trades);
        - Clients must provide written consent prior to the completion of each transaction (principal trade);
        - No involved client accounts are ERISA accounts (cross and principal trades); and
        - The adviser and its supervised persons may not receive commissions or other compensation related to the trades (cross and principal trades).

## **Testing**

**Testing was utilized to ensure compliance with policies and procedures.**

## Disclosures

Advisers provided clients with full and fair disclosure of all material facts surrounding principal and cross trades, inclusive of conflicts of interest. Disclosure is encompassed in various documents by advisers, including ADV Part 2A, advisory agreements, separate written documents and private fund offering documents. The Division noted the following topics encompassed in disclosures:

- How the adviser addressed conflicts of interest that were identified (cross and principal trades);
- The circumstances under which advisers may engage in these transactions (cross and principal trades);
- Any cost, including describing pricing methodologies used by advisers to value the securities (cross and principal trades);
- Total amount of commissions or other remuneration to be received by advisers or any affiliated people (cross and principal trades);
- The option for clients to revoke their written blanket consent to execute cross trades without penalty at any time by written notice (cross trades – blanket consent not permitted for principal trades); and
- The total number of principal trades entered into during the period (principal trades).

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