

MEMO# 31422

October 5, 2018

SEC Sanctions a Fund Adviser and its Portfolio Manager for Unlawful Cross Trades

[31422]

October 5, 2018 TO: ICI Members
Investment Company Directors
Chief Compliance Officer Committee
Compliance Advisory Committee
Investment Advisers Committee SUBJECTS: Compliance
Investment Advisers
Litigation & Enforcement RE: SEC Sanctions a Fund Adviser and its Portfolio Manager for Unlawful Cross Trades

The Securities and Exchange Commission has announced the settlement of an enforcement proceeding against an adviser (Adviser) and its portfolio manager (PM) for violating the Investment Company Act (ICA) and rules thereunder by engaging in unlawful cross trading.[\[1\]](#) Based on these violations, which are summarized below, the Adviser and PM were ordered to cease and desist from further violation, the Adviser was fined \$1 million, and the PM was suspended for nine months and fined \$50,000.

According to the Order, the PM was also a trader of non-agency residential mortgage-backed securities (RMBS) on the structured credit trading desk in the Adviser's fixed income department from March 2009 until May 2016. Prior to these roles, he had been a fixed income quantitative research analyst for the Adviser. In his role as PM, he was responsible for making investment decisions and buying and selling non-agency RMBS on behalf of the Adviser's advisory clients. The market for such securities was generally illiquid.

Between April 2011 and September 2015, for various reasons, certain advisory clients of the Adviser needed to sell positions in the RMBS. The PM, viewing these securities as desirable investments, wanted them transferred to other accounts advised by the Adviser. As described in the Order:

Rather than attempting to sell the securities into the market, [the PM] prearranged with broker-dealers to temporarily sell the securities and repurchase them at a small mark-up, usually the next business day. [The PM's] conduct caused [the Adviser] to prearrange dealer-interposed cross trades in

which trading counterparts purchased fixed income securities from certain of [the Adviser's] advisory accounts and then resold the securities to other of [the Adviser's] advisory accounts.

Most of these cross trades were between the accounts of registered investment companies or between accounts of registered investment companies and accounts affiliated with registered investment companies.

The PM's conduct resulted in undisclosed favorable treatment of certain advisory clients over others. This is because the PM "executed the sell side of each cross trade at the highest or only bid he received for the securities" and then he executed "the repurchases at a small markup over the sales price." By cross trading the securities at the bid, rather than at an average between the highest current independent bid and the lowest current independent offer, the PM caused the Adviser "to favor the buyers in the transactions over the sellers, even though both were advisory clients to which [the Adviser and PM] owed the same fiduciary duty."

In addition to violating the cross-trading prohibitions of the ICA, the Order found that the Adviser did not adopt and implement policies and procedures reasonably designed to prevent unlawful cross trading, failed to reasonably supervise the PM, and filed Forms ADV with the Commission that contained untrue statements of material fact and omitted material facts required to be stated in the Form ADV.

The violations committed by the Adviser and the PM are detailed in the Order as follows:

- Sections 17(a)(1) and (2) of the ICA, which prohibits engaging in securities transactions with a registered investment company unless the transaction complies with the exemptive requirements of Rule 17a-7 under the ICA or the adviser obtains an exemptive order under Section 17(b) of the ICA. According to the Order, the Adviser did not seek an exemptive order for the PM's RMBS transactions and they were not exempt from the prohibition of Rule 17a-7 "because the trades were not executed at a price equal to the average of the highest current independent bid to purchase that security and the lowest current independent offer to sell that security and were made through one or more broker-dealers who received remuneration in connection with the transactions;"
- Section 206(2) of the Advisers Act, which prohibits fraudulent conduct. The Order found that, through its interposed cross transactions, the Adviser favored certain of its clients and did not seek to obtain best price and execution for certain of its clients in the cross trades;
- Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of law. The Order found that the Adviser did not have policies and procedures to ensure compliance with the cross-trading prohibitions and, as a result, executed such transactions in a manner that favored certain of its clients and did not seek to obtain best execution for some clients;
- Section 206(2) of the Advisers Act, which prohibits filing with the Commission any report (*i.e.*, the Form ADV) containing false or misleading information; and
- Section 203(e)(6) of the Advisers Act, which requires an adviser to reasonably supervise with a view to preventing violations of the securities laws.

Prior to imposing the sanctions discussed above based on these violations, the Order noted

the Adviser's cooperation and remedial efforts following the PM's disclosure of "certain details of his conduct." These efforts included:

- Firing the PM;
- Retaining outside counsel to conduct an internal investigation in the trading practices;
- Self-reporting the PM's suspected misconduct and the results of outside counsel's internal investigation to the staff of the SEC;
- Placing over \$1 million in escrow to be paid to compensate harmed clients;
- Promptly retaining a compliance consultant to review and make recommendations regarding the Adviser's policies and procedures relating to cross trading and best execution;
- Voluntarily implementing changes to its policies and procedures in response to the compliance consultant's recommendations; and
- Conducting a training session in early 2017 for all fixed income traders concerning the Adviser's amended policies and procedures related to cross trading.

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endnotes

[1] See *In the Matter of Putnam Investment Management, LLC and Zachary Harrison*, SEC Release No. IA-5050 (September 27, 2018) (the "Order"), which is available at: <https://www.sec.gov/litigation/admin/2018/ia-5050.pdf>.

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