

MEMO# 33698

July 23, 2021

SEC's Division of Examinations Publishes Risk Alert on Fixed Income Principal and Cross Trades by Advisers

[33698]

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TO: ICI Members

Accounting/Treasurers Committee

Chief Compliance Officer Committee

Fixed-Income Advisory Committee

SEC Rules Committee

Security Valuation Operations Committee SUBJECTS: Compliance

Fixed Income Securities

Investment Advisers RE: SEC's Division of Examinations Publishes Risk Alert on Fixed Income Principal and Cross Trades by Advisers

The SEC's Division of Examinations has published a Risk Alert highlighting its observations from conducting twenty examinations focused on ensuring that, in connection with the investment advisers' fixed income principal and cross trades, the advisers: (1) made trades that were in the clients' best interests; (2) had compliance policies and procedures that effectively address their fixed income trading; and (3) provided their clients full and fair disclosure of the conflicts of interest related to the trades. The Risk Alert notes that its observations are intended to supplement those in the Division's 2019 Risk Alert, Investment Adviser Principal and Agency Cross trading Compliance Issues, and it encourages registrants to read the 2019 Risk Alert alongside the current one.[\[1\]](#) As discussed in more detail below, the current Risk Alert both discusses common deficiencies the staff observed in its examinations and practices the staff observed that appeared to be effective.

Deficiencies Observed During the Division's Examinations

According to the Division, nearly two-thirds of the examined advisers received deficiency letters. The vast majority of the deficiencies related to deficient compliance programs, conflicts of interest, and disclosure. The deficiencies observed in these three areas are briefly summarized below.

Compliance Program Deficiencies

The staff observed the following three compliance program deficiencies:

- Policies and procedures that were inconsistent with the adviser's practices, its disclosures, and/or regulatory requirements. The staff observed advisers failing to have specific procedures to validate that: (1) principal trades, cross trades, or both were completed in a manner consistent with the adviser's disclosures to their clients and their policies and procedures; and (2) appropriate consent was received from, and disclosure provided to, the involved clients prior to the trades' completion. For example, the staff observed some advisers executing fixed income principal trades, cross trades, or both even though their compliance policies and procedures prohibited such trades. It also observed advisers failing to enforce policies they had that required their portfolio managers or traders to obtain prospective written approval of their cross trades. Another compliance failure involved advisers failing to provide clients timely disclosure of the clients' ability to revoke principal trades.
- Policies and procedures that lacked certain considerations or guidance, such that the examined advisers' personnel did not have the full scope of information that may be necessary to achieve compliance. This compliance failure involved advisers failing to provide advisory personnel sufficient information necessary for them to know whether their fixed income principal and cross trades were appropriate. For example, some advisers failed to provide advisory personnel the factors they should consider in determining whether the trade was in the clients' best interest and some advisers failed to include a section in their cross trading reporting forms that would enable advisory personnel to document why they believed the trades were in the clients' best interests. The staff also observed advisers having policies and procedures saying they would operate in compliance with ERISA investment restrictions while failing to provide advisory personnel information about those restrictions - including ERISA provisions prohibiting principal and cross trades. Another deficiency observed by the staff involved advisers requiring advisory personnel to obtain multiple quotes from different broker-dealers to use as the value for crossing the trades without specifying which quote should be used if they differed from one another.
- Policies and procedures that were not effectively tested. The staff observed instances in which, the advisers' failure to effectively test their policies and procedures relating to principal and cross trades resulted in: (1) firms executing such trades even though they had policies that prohibited them; and (2) firms that permitted such trades without following the steps in their compliance policies and procedures that required the approval, review, and analysis of the trades. Also, firms failed to perform timely annual compliance review of cross trading activities, receive clients' consent for principal trades, and conduct prescribed best execution analysis of the trades.

Conflicts of Interest

The staff observed advisers' compliance programs failing to identify, mitigate, disclose, or otherwise address the conflicts associated with cross trades. For example, the staff observed advisers failing to fully disclose markups or fees associated with the cross trades and failing to use best price and best execution efforts in executing the trades.

Written Disclosures

One-third of the cross-trade deficiencies documented by the staff involved inadequate disclosures, including in the Form ADV. The ADV disclosure failures observed included advisers: omitting information about cross trading; failing to include in Form ADV Part 2A any information relating to the conflicts of interest associated with cross trading; and failing

to discuss the conflicts of interest created by advisers that were acting on behalf of the clients on both sides of the trades or acting as a broker for both sides of the transactions.

Staff Observations on Ways to Improve Compliance

As noted above, the Risk Alert discusses practices the staff observed to be effective in addressing the above deficiencies.[\[2\]](#) These practices are identified in the Risk Alert as Ways to Improve Compliance. These practices included the following:

- Adopting and enforcing compliance policies and procedures that: (1) incorporate all applicable legal and regulatory requirements; (2) clearly articulate the activities covered by advisers' written compliance policies and procedures; (3) set standards that address firms' expectations for each of these activities; (4) include supervisory policies and procedures; and (5) establish controls to determine whether policies and procedures are being properly following and documented in the required manner.
- Providing detailed information on what constitutes a cross trade. According to the Risk Alert, when an adviser defines cross trades in its compliance policies and procedures, the more detailed the definition the better. For example, advisers should consider including the time frames within which the transactions must occur to be considered a cross trade.
- Setting written standards to govern their advisory personnel engaging in principal trades, cross trades, or both. The Risk Alert includes a chart that lists the following standards the adviser may want to consider incorporating into its compliance policies and procedures: the fairness of the transactions; the pricing methodologies used to execute the trades; the periodic evaluation of the quality of execution; periodic reporting to the legal or compliance department; providing clients written information regarding the adviser's capacity in executing the trades; portfolio managers or traders getting advanced approval from senior management or compliance personnel in order to execute the trades; and written client consent prior to completion of the transaction. The Risk Alert notes that many of these standards correspond to requirements in the Investment Advisers Act (the "Advisers Act"), such as Section 206 and Rule 206(3)-2.
- Maintain documentation or information regarding the trades, such as the determination that a fair and equitable price was used or best execution was achieved.
- Provide clients full and fair disclosure regarding the trade or seek consent from clients.
- Identify and/or report the trades or related breaches or risks.
- Restrict transactions in impermissible or prohibited accounts (e.g., ERISA accounts).
- Place conditions, qualifications, or restrictions on the execution of principal trades, cross trades, or both within clients' accounts. These conditions might: require that the securities can only be purchased by or sold to another client when there is a need and the securities meet each participating client's investment objectives; the accounts are not ERISA accounts; the trades receive best price and execution; and, the adviser, its affiliated persons, and its supervised persons do not receive commissions or any other compensation related to the trades.

With respect to disclosure deficiencies, the effective disclosures observed by the staff:

- Provided clients with full and fair disclosure of all material facts surround the principal and cross trades. The Risk Alert includes a chart listing the following material facts that might comprise robust disclosure:

- How conflicts of interests are addressed;
- The circumstances under which the adviser may engage in these transactions;
- The costs associated with such trading, including pricing methodologies;
- The commissions to be received by persons involved in the transactions;
- The clients' revocation options; and
- The total number of principal trades entered into during the period since the date of the last statement or disclosure.

According to the Risk Alert, many of these disclosures correspond to legal requirements in Section 206 or Rule 206(3)-2 of the Advisers Act.

- Provided disclosures to clients regarding principal and cross trading practices in multiple documents. The staff observed that advisers with robust disclosure provided clients disclosure in the following documents: Form ADV, Part 2A; advisory agreements; separate written communications; and/or private fund offering documents, when applicable. These written disclosures may have been supplemented by oral disclosures explaining the adviser's rationale for executing principal trades.

The Division encourages advisers to review the Division's two Risk Alerts on the topic of principal and cross trading and to review their written policies and procedures governing these trades and to implement policies and procedures necessary to ensure consistency with the requirements of or under the Advisers Act.

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endnotes

[1] The 2019 Risk Alert is available at: <https://www.sec.gov/risk-alert-principal-cross-trading>.

[2] According to the Risk Alert, "the content and effectiveness of the examined advisers' compliance programs varied greatly."