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SEC Settles Charges with Adviser Related to Valuation of Cross-Traded Securities

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TO: ICI Members
Chief Compliance Officer Committee
Compliance Advisory Committee SUBJECTS: Compliance
Disclosure
Fixed Income Securities
Litigation & Enforcement
Valuation RE: SEC Settles Charges with Adviser Related to Valuation of Cross-Traded Securities

Last month, the Securities and Exchange Commission settled charges with a registered investment adviser for overvaluing certain fixed-income securities, inappropriately cross trading them among affiliated accounts, and related disclosures deemed false and misleading.[1] The adviser agreed to pay nearly $80 million to settle the charges without admitting or denying the SEC's findings.

Background

The adviser implemented a fixed-income investment strategy that invested primarily in "highly liquid" U.S. agency mortgage-backed securities, treasury futures, and agency collateralized mortgage obligations ("CMOs"). From January 2017 to April 2021 (the "relevant period"), the adviser acted as either the adviser or sub-adviser to twenty advisory clients, including 11 registered investment companies ("RICs") and 9 unregistered vehicles ("Unregistered Vehicles"), with exposure to the strategy. It engaged a third-party pricing service to provide prices for all strategy-related investments that represented "what the holder would receive in an orderly transaction for an institutional round lot position under current market conditions" ("Pricing Vendor Marks").[2] The third-party service intentionally did not provide evaluations for "odd lot" positions.[3]

Mispricing. According to the settlement order, during the relevant period, the adviser purchased approximately 4,900 CMO positions, 90 percent of which were largely illiquid, odd lot positions that "traded at a significant discount to round lot positions (i.e.,

institutional, larger-sized positions) of the same bonds."[4] The adviser's compliance policies required that pricing for all debt securities be based on the third-party service's values but, if values were not available, then quotes would be obtained from broker-dealers valuing the instruments at the mean between the bid and the offer price, the bid price, or the last available price, if available and appropriate; otherwise a pricing committee would determine the instruments' fair value. Despite this, the adviser used the third-party service's round lot prices to value the odd lot CMO positions for the RICs and Unregistered Vehicles and did not obtain market quotes from broker-dealers or take steps to fair value the odd lot CMO positions. Notwithstanding marketing representations from the adviser to the contrary, these CMOs were "largely illiquid and could not be sold at the Pricing Vendor Marks."[5] As a result, thousands of CMO positions were marked at inflated prices resulting in overstated valuations and performance to the Unregistered Vehicles and RICs.

In August 2018, the adviser convened its pricing committee, responsible for determining fair value for portfolio instruments, to address the apparent pricing variance between the Pricing Vendor Marks and the market prices for odd lot CMOs. The pricing committee directed the portfolio management team for the investment strategy to analyze the trading discount for odd lot CMOs and to determine the funds' exposure to them. In response, the portfolio management team prepared an internal pricing report estimating that odd lot positions traded between 3 percent and 38 percent below the Pricing Vendor Marks. Despite the discrepancy, the pricing committee concluded that it was appropriate to continue utilizing the Pricing Vendor Marks with no adjustment for lot size, reasoning that it was "industry practice" to do so.

The order states that the adviser did not implement the applicable pricing procedures contained in its compliance policies and improperly valued the odd lot CMOs.

Inappropriate Cross Trades. During the relevant period, the adviser also arranged for the execution of two types of cross trades. First, the adviser executed more than 175 dealer-interposed cross trades to satisfy redemption requests from investors in certain Unregistered Vehicles in which the adviser temporarily sold odd lot CMO positions from the Unregistered Vehicles to third-party broker-dealers and then repurchased those same positions for allocation to one or more other RICs and Unregistered Vehicles. Second, when investors in one Unregistered Vehicle sought to redeem, the adviser partially funded the requests by internally cross trading odd lot CMO positions in the Unregistered Vehicle to certain RICs. It initiated several of these cross trades to avoid or minimize losses to the selling Unregistered Vehicle and executed them at the CMOs' round lot prices. The adviser's compliance department approved these transactions without verifying that the portfolio manager for all accounts had approved them, which was required under the adviser's cross trade approval policy.[6]

In engaging in the cross trades, the order states that the adviser provided liquidity to the redeeming Unregistered Vehicles despite the investments being largely illiquid and minimized trading losses for the redeeming clients. Because the cross trades were not executed at current market prices, the other funds (primarily the RICs) absorbed the trading losses that otherwise would have been borne by the redeeming Unregistered Vehicles. The order concludes that the cross trades violated the affiliated transaction prohibitions in Section 17(a) of the Investment Company Act of 1940[7] and the adviser's own internal compliance policies, which among other things required that any RIC cross trades comply with Rule 17a-7 under the Investment Company Act—an exemptive rule which allows affiliates to cross trade certain securities with registered investment companies under certain conditions.[8] Due to the undisclosed conflicts of interest that

inherently benefited some advisory clients over others, the order also found the adviser to have breached its fiduciary duty under the Investment Advisers Act of 1940.

Misleading Disclosures. Throughout the relevant period, the adviser continued to distribute marketing materials, due diligence questionnaires, performance reports, monthly commentary to investors, board reports, and Forms N-CSR with materially false and misleading statements and omissions about performance, liquidity, asset valuation, and cross trading. In its marketing materials, the adviser described the strategy's investments as "highly liquid" and, in due diligence responses, the adviser noted that "100 [percent] of securities can be liquidated within 1-3 days, within 5 [percent] of current prices." No marketing materials disclosed that odd lots were being valued at higher, round lot prices or that the securities were generally illiquid. For annual reports, the adviser noted that the CMOs contributed to positive performance of the RICs, though no annual report disclosed that the CMOs were overvalued and had not been priced consistent with the adviser's compliance policies. In addition, the annual reports materially misstated the rationale for selling the CMOs and their resulting losses. In its quarterly compliance reports to the RIC boards, the adviser's Compliance Department also misrepresented that all cross trades executed were conducted consistent with Rule 17a-7 under the Investment Company Act and the RICs' compliance procedures.

Charges and Undertakings

As a result of the overvaluation of the CMOs, improper cross trades, materially false and misleading disclosures, and corresponding compliance failures, the SEC found that the adviser willfully violated or caused to be violated:

(i) Sections 206(1), 206(2), 206(4) of the Investment Advisers Act, and Rules 206(4)-7 and 206(4)-8 thereunder;[9] and

(ii) Sections 17(a)(1), 17(a)(2), 34(b) of the Investment Company Act, and Rules 22c-1 and 38a-1 thereunder.[10]

The adviser was ordered to pay disgorgement of $7,633,671, prejudgment interest of $2,197,535, and a civil monetary penalty of $70 million.

In addition, the adviser undertook to engage in several actions, including:

- Continuing to retain (and bearing all costs associated with) the services of a compliance consultant;
- Cooperating fully with the compliance consultant and providing it access to all files, books, records, and personnel, as reasonably requested;[11]
- Requiring the compliance consultant to conduct a comprehensive review of the adviser's compliance policies and procedures relating to: (1) valuation of CMOs and associated liquidity risks; (2) cross trading; and (3) advisory conflicts of interest and disclosure with respect to (1) and (2) above ("relevant policies and procedures"). In addition, the compliance consultant must provide the adviser with any recommendations for changes or improvements to the effectiveness and implementation of the relevant policies and procedures that the compliance consultant deems appropriate;[12]
- Adopting all recommendations contained in the initial report within 45 days of the date of the report, provided that within 30 days of the report, the adviser shall in writing advise the compliance consultant and the Commission staff of any recommendations it considers to be unduly burdensome, impractical, or

inappropriate;[13]
- Attempting in good faith to reach an agreement on an alternative proposal within 60 days after the submission of the initial report for any recommendations that the adviser and compliance consultant do not agree;[14]
- Abiding by the compliance consultant's determination and shall within 30 days after the final agreement adopt and implement all recommendations the compliance consultant deems appropriate;
- Agreeing to generally avoid other business relationships with the compliance consultant and certain of its related parties;[15]
- Preserving for a period of at least 6 years from the fiscal year last used, the first 2 years in an easily accessible place, any record of compliance with the undertakings.
- Certifying, in writing, compliance with the undertakings, identifying the undertakings, providing written evidence of compliance in the form of a narrative, and supporting the evidence with exhibits sufficient to demonstrate compliance; and
- Cooperating fully with the Commission in any and all investigations, litigations or other proceedings relating to or arising from the matters described in the order.[16]

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Notes

[1] See Macquarie Investment Management Business Trust, Investment Company Act Rel. No. 35325 (Sept. 19, 2024), available at https://www.sec.gov/files/litigation/admin/2024/ia-6709.pdf.

[2] Id. at 2 (emphasis added).

[3] Although the third-party service did not define "odd lot" and "round lot" transactions, the adviser evaluated an institutional round lot for the CMO positions as having at least $1 million current value. Id.

[4] Id.

[5] Id. at 11.

[6] In addition to the cross trades, throughout September and October 2018, the adviser sold more than 80 odd lot positions in an Unregistered Vehicle by aggregating them with identical positions held in RICs and other Unregistered Vehicles to create a round lot or larger odd lot position and to reduce losses for the Unregistered Vehicle. Nevertheless, those odd lot portfolio positions still sold at a loss from the Pricing Vendor Marks. The adviser never disclosed the overvaluation of odd lot positions to investors, even when asked, and instead attributed the losses to "market conditions."

[7] Sections 17(a)(1) and 17(a)(2) of the Investment Company Act generally prohibit any affiliated person of a registered investment company or any affiliated person of an affiliated person, acting as principal, from knowingly selling a security to or purchasing a security from a registered investment company unless the person obtains an exemptive order from

the SEC.

[8] Rule 17a-7 permits the purchase and sale of securities between a fund and certain affiliates, subject to detailed conditions to protect against potential abuses (e.g., dumping of unwanted securities; pricing that favors one side of a trade over the other). Cross trading generates benefits to a fund and its investors that otherwise would not have been realized if the fund had transacted with a third-party dealer on the open market. These benefits include lower transaction costs, reduced settlement risk, and greater efficiencies with respect to portfolio management and compliance with investment policies.

To be eligible for cross trading, a security must have a "readily available market quotation." In its December 2020 rulemaking on fair valuation, the SEC redefined that term and, in so doing, severely restricted funds' ability to cross trade fixed-income securities under Rule 17a-7. The SEC staff subsequently requested public comment on possible recommendations concerning cross trading, but this item abruptly fell off the SEC's rulemaking agenda shortly thereafter.

[9] Section 206(1) of the Investment Advisers Act makes it unlawful for an investment adviser to employ any device, scheme, or artifice to defraud any client or potential client. Scienter is required to establish a violation of Section 206(1). Section 206(2) of the Investment Advisers Act prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Section 206(4) of the Investment Advisers Act and Rule 206(4)-7 thereunder require an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules thereunder. Section 206(4) of the Investment Advisers Act and Rule 206(4)-8 thereunder make it unlawful for an investment adviser to a pooled investment vehicle to make any untrue statement of material fact or omit to state a material fact necessary to make the statements made not misleading, to any investor or prospective investor in the pooled investment vehicle or otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

[10] See supra note 7 (discussing Sections 17(a)(1) and (2)). Section 34(b) of the Investment Company Act makes it unlawful for any person to make any untrue statement of material fact in any registration statement or other document filed with the SEC under the Investment Company Act or the keeping of which is required pursuant to Section 31(a) of the Investment Company Act, or to omit from any such document any fact necessary in order to prevent the statements made therein from being materially misleading. Rule 22c-1 under the Investment Company Act generally prohibits a registered investment company from selling, redeeming, or repurchasing the investment company's redeemable securities except at a price based on the current net asset value of such security. Rule 38a-1 under the Investment Company Act requires a registered investment company to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws.

[11] The adviser (1) shall not have authority to terminate or replace the compliance consultant without prior written approval of the Commission staff; and (2) shall compensate the compliance consultant and persons engaged to assist the compliance consultant for services rendered pursuant to the order at reasonable and customary rates.

[12] The compliance consultant shall review the adviser's relevant policies and procedures

for 2 years and generate an initial report in February 2025 assessing whether the relevant policies and procedures comply with the Investment Company Act and the Investment Advisers Act, and the regulations thereunder, and making specific recommendations to improve the relevant policies and procedures. In addition, the compliance consultant shall generate a final report 24 months after its initial engagement. It will conduct a review of the adoption and implementation of its recommendations and provide a final assessment as to whether the relevant policies and procedures are reasonably designed to prevent violations of the federal securities laws. The adviser shall provide a copy of both reports to the Commission.

[13] The adviser need not adopt those recommendation at that time but shall propose in writing an alternative policy, procedure, or system designed to achieve the same objective or purpose.

[14] Within 15 days after the conclusion of the discussion and evaluation by the adviser and compliance consultant, the adviser shall require that the compliance consultant inform it and the Commission staff in writing of the compliance consultant's final determination concerning any recommendation to which the adviser has objected.

[15] For a period during the engagement to two years after the completion of the engagement, the adviser will not (1) engage the compliance consultant for any other professional services outside the services described in the order; (2) enter into any other professional relationship with the compliance consultant; or (3) enter, without the Commission's prior written consent, into any such professional relationship with the compliance consultant's present or former affiliates, employers, directors, officers, employees, or agents.

[16] In connection with such cooperation, the adviser shall (i) produce, without service of a notice or subpoena, any and all non-privileged documents and other information requested by the Commission staff subject to any restrictions under the law of any foreign jurisdiction; (ii) use its best efforts to cause its officers, employees, and directors to be interviewed by the Commission staff at such time as the staff reasonably may direct; and (iii) use its best efforts to cause its officers, employees, and directors to appear and testify without the service of a notice or subpoena in such investigations, depositions, hearings or trials as may be requested by the Commission staff.
