



**Risk Management Update
August 2015**

PRINCIPAL TRADING AND AGENCY CROSS TRANSACTIONS FOR ADVISORY CLIENTS: ARE YOUR POLICIES AND PROCEDURES COMPLIANT?

Principal and Agency Cross Transactions Require Disclosure and Client Consent:

Does your firm perform Principal and/or Agency Cross Transactions? If so, are you meeting the applicable rule requirements? Do your Policies and Procedures adequately reflect these requirements?

A Principal Trade is one where the RIA (or an affiliate) trades from its own account and sells to, or buys, from the client from its own inventory. Principal Trades are commonly done on fixed income securities. An Agency Cross Trade is a transaction between two accounts managed by the same advisor. Principal and Agency cross transactions are governed by Rule 206(3)-2 of the Investment Advisers Act of 1940.

Your Requirements under Rule 206(3)-2

Section 206(3) of the Investment Advisers Act of 1940 makes it unlawful for any investment adviser, directly or indirectly "acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."¹

Additionally, the rule states "the investment adviser, or any other person relying in this rule, sends to each such client, at least annually, and with or as part of any written statement or summary of such account from the investment adviser or such other person, a written disclosure statement identifying the total number of such transactions during the period since the date of the last such statement or summary, and the total amount of all commissions or other remuneration received or to be received by the investment adviser or any other person relying on this rule in connection with such transactions during such period"

In order to be in Compliance with Rule 206(3)-2, an Investment Advisory firm should ensure:

- Prior written approval has been obtained from the Client prior to performing the transaction; as a matter of practice, firms should have standardized forms for requesting client permission if you will be conducting principal or cross trades;

¹ See Securities and Exchange Commission 17 CFR Part 276 (Release No. IA-1732) Interpretation of Section 206(3) of the Investment Advisers Act of 1940.

- The client accounts involved are not ERISA accounts;
- The security being sold is only being purchased by another client when there is a need and such security meets the purchasing client's investment objectives and is attractively priced;
- Independent prices for the security have been obtained by third party broker-dealers;
- The transaction is fairly priced;
- No Associated Persons will receive commissions or any other compensation with respect to the transaction
- Each client participating in the order will be notified promptly in writing; and
- Annually, the Firm will provide clients a summary of the principal and internal cross trades transacted in their account during the year.

Dually Registered Firms Note: Also applicable is Rule 206(3)-3T which provides temporary relief to dual registrants. Rule 206(3)-3T allows dual registrants executing non-discretionary trades to obtain verbal approval. This rule has been extended through 12/31/16.

Penalties for Non-Compliance

The Securities and Exchange Commission is vigilant and has taken action against firms for improper Principal Transactions and Agency Cross Trades. One case example is *In the Matter of Parallax Investments, LLC, John P. Bott, II, and F. Robert Falkenberg*,² where the administrative summary stated: "By failing to disclose principal transactions and obtain consent, Parallax and Tri-Star Advisors deprived their clients of knowing in advance that their advisers stood to benefit substantially by running the trades through an affiliated account," said Marshall S. Sprung, co-chief of the SEC Enforcement Division's Asset Management Unit.

In another case, *In the Matter of Strategic Capital Group, LLC and N. Gary Price*,³ the SEC stated "beginning May 3, 2011, registered investment adviser SCG engaged in hundreds of securities transactions with advisory clients on a principal basis through its affiliated registered broker-dealer, RP Capital, LLC ("RP Capital"), without providing prior written disclosure to, or obtaining consent from, the clients. RP Capital purchased fixed-income securities from other broker-dealers and then resold them at a higher price to SCG clients without SCG disclosing for more than a year that it was acting as principal through RP Capital and without obtaining required transaction-by-transaction consent"

As you can see from these cases, regulators will take action against firms who fail to disclose or obtain consent for these types of trades. It is imperative that your policies and procedures adequately address these trades and your procedures are being followed closely by your employees.

² See <https://www.sec.gov/litigation/admin/2015/34-75625.pdf>

³ See <https://www.sec.gov/litigation/admin/2014/ia-3924.pdf>

Conclusion

Fiduciary responsibilities to your client require that you act in their best interests. This is a particularly important responsibility when it comes to trading. Disclosure of Principal Trading and Agency Cross Trades are important factors when considering your obligation to your clients. Based on the regulatory importance placed on this responsibility, firms should review not only their policies and procedures regarding Principal and Agency Cross trades, but their practical application as well. For example, in reviewing the trade blotter, any transactions in the same security, same trade date, same price but opposite sides of the trade should be examined to see if they were cross trades. If a reviewer is not looking for this they probably will not detect cross trades. Finally, if your firm utilizes principal trading and agency cross transactions in your business model, this is a vital subject for compliance training.

For more information on this topic, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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