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Risk Management Update
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PRINCIPAL TRADING REQUIREMENTS FOR INVESTMENT ADVISERS

Under Section 206(3) of the Investment Advisers Act of 1940 (the "Advisers Act"), investment advisers, whether or not registered with the Securities and Exchange Commission ("SEC"), are prohibited from performing principal transactions for their clients unless the adviser discloses the details of the transaction to the client in writing, and also obtains client permission prior to the settlement of each such transaction. Section 206(3) generally describes principal trading by an adviser as acting as principal for its own account and knowingly selling any security to or purchasing any security from a client.

Examples of principal trading by investment advisers include, but are not limited to:

- buying or selling a security to/from an advisory client with the advisory firm's proprietary account as the counterparty to the transaction; and/or

IA Firm or Pooled Fund ↔ Client

- buying or selling a security to/from an advisory client with an account where the adviser or employee has a controlling interest (*e.g.,* personal accounts or pooled investment funds) as the counterparty to the transaction.

Importantly, the SEC has outlined in two no-action letters[1] that the application of Section 206(3) to transactions between an adviser's client and an unregistered investment fund in which the adviser has an ownership interest will depend upon all of the facts and circumstances surrounding the transactions, including the ownership percentage held by the adviser. In addition, in the *Gardner Russo & Gardner* SEC No-Action Letter, the Commission stated that Section 206(3) would not apply to a transaction between a client account and an account of which the investment adviser and/or its controlling persons own in the aggregate 25% or less.

Notably, the SEC has brought enforcement actions against investment advisers and their principal owners for violating Section 206(3) in situations where the advisory firms effectuated transactions between their advisory client accounts and accounts in which the adviser and/or their principal owners held significant ownership interests.[2]

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[1] See American Bar Association Subcommittee on Private Investment Entities, SEC No-Action Letter (pub. avail. Dec. 8, 2005) and Gardner Russo & Gardner, SEC No-Action Letter (pub. avail. June 7, 2006).
[2] See SEC v. Beacon Hill Asset Mgmt., LLC, Litigation Release No. 18950 (Oct. 28, 2004) and In re. Gintel Asset Mgmt., Investment Advisers Act Release No. 2079 (Nov. 8, 2002) (settled order).

How Principal Trading Requirements Differ for Broker-Dealers and Investment Advisers

Investment advisers and broker-dealers are governed by different regulatory authorities and must follow different regulations. As broker-dealers are not regulated under the Advisers Act (with the exception of dually registered firms), they are not held to the same prohibitions regarding principal trading. In fact, Section 206(3) specifically states that prohibitions governing principal transactions "shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction."

Principal transactions performed by broker-dealers are commonly performed and most typically occur where the executing broker is trading from its inventory account and consequently, serves as a dealer in the transaction. Broker-dealers are required to provide certain disclosures to their brokerage clients when executing principal transactions, but are not required to obtain client consent prior to settlement of each trade.

Investment advisers, on the other hand, are by definition fiduciaries and as such have an implicit duty to put their clients' interest ahead of their own. Since an adviser can benefit from a principal trade which could be at the expense of an advisory client, the adviser must provide disclosure and obtain prior consent from such client.

Section 206(3) of the Advisers Act also applies to investment advisers that control, are controlled by, or are under common control with a broker-dealer ("control affiliate"), in addition to dually registered firms. In fact, there have been a number of enforcement actions issued against advisers for Section 206(3) violations for effecting principal transactions (including riskless principal transactions) through a control affiliate without first providing disclosure and obtaining client consent.[3] Rule 206(3)-3T of the Advisers Act (Temporary Rule Regarding Principal Trades with Certain Advisory Clients) provides for an alternative means for dually registered firms to comply with principal transaction regulatory requirements.

Requirements for Disclosure and Consent

The requirements of Section 206(3) clearly state that an investment adviser must provide written disclosure and obtain client consent prior to the settlement of each trade. What are missing are details of what the disclosure must contain and whether or not the client consent must be in writing.

The most recent guidance provided by the SEC on this subject is contained in their written report to Congress issued on January 21, 2011. In that report, the SEC specifically instructs advisers to disclose not only the desired transaction, but also any compensation that the adviser receives for its role in such transaction. To fully satisfy an adviser's

[3] See In the Matter of Rothschild Investment Corporation, Investment Advisers Act Release No. 1714 (Apr. 13, 1998) (settled order); In the Matter of Stern Fisher Edwards Inc., Investment Advisers Act Release No. 1803 (June 18, 1999) (settled order); In the Matter of ABN AMRO-NSM International Funds Management, B.V., Investment Advisers Act Release No. 1767 (Sept. 30, 1998) (settled order).

fiduciary obligations, the adviser must also disclose facts necessary to alert the client to the adviser's potential conflict of interest in the principal trade.

Addressing the consent requirement, the SEC states in the report that: "While the disclosure must be in writing, Section 206(3) does not require that the client's consent be in writing. Written disclosure must be provided and consent must be obtained separately for each transaction, i.e., a blanket consent for transactions is not sufficient."[4]

Compliance Risk Management Tips

To help ensure that clients remain fully informed about a firm's principal trading practices, and to ensure compliance with Section 206(3), advisory firms that effect principal transactions on behalf of their clients should consider taking the following steps:

1. Provide detailed information in Form ADV Part 2A regarding the firm's policies and procedures regarding principal trading, the conflicts associated with such activity, along with a description of how the firm addresses the conflicts;
2. Have specific client consent language in standard advisory agreements;
3. Establish internal controls to ensure that written disclosures are provided to clients and consent is obtained prior to the settlement of each principal trade; and
4. Provide each affected client with an annual summary of all principal transactions executed in their accounts.

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

Author: Tina Mitchell, Compliance Consultant; Editor: Michelle L. Jacko, CEO, Core Compliance & Legal Services ("CCLS"). CCLS works extensively with investment advisers, broker-dealers, investment companies, hedge funds, private equity firms and banks on regulatory compliance issues. For more information about this topic and other compliance consultation services, please contact us at (619) 278-0020, info@corecls.com or visit www.corecls.com.

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[4] Notable enforcement actions issued for providing only blanket disclosures and consent are: In the Matter of Stephens, Inc., Investment Advisers Act Release No. 1666 (Sept. 16, 1997) (settled order); In the Matter of Clariden Asset Management (New York) Inc., Investment Advisers Act Release No. 1504 (July 10, 1995) (settled order).