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SEC Risk Alert Cites Frequent Principal and Agency Cross Trading Issues for Advisers

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On September 4, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert (the "Risk Alert") describing the most frequent issues relating to principal trades and agency cross transactions it had identified in examinations of registered investment advisers. The Risk Alert is one of a number of risk alerts issued by OCIE in recent years, including those noted in prior AIMs. Following past OCIE risk alerts, Kirkland attorneys have noticed increased focus on the identified areas by SEC exam staff. As such, advisers, including private fund managers, should consider this guidance in light of the manager's current practices.

Principal Trades

Section 206(3) of the Investment Advisers Act prohibits managers[1] from directly or indirectly purchasing securities from, or selling securities to, a client (e.g., a private fund) without disclosing in writing the capacity in which the manager is acting and obtaining the client's consent before the transaction. Additionally, when a manager and certain of its personnel own more than 25% of a fund it manages (e.g., as part of a general partner and/or limited partner commitments), the manager must treat cross transactions it effects involving such fund as principal transactions.[2]

The Risk Alert noted failures by managers to:

- make written disclosure to clients when purchasing securities from, or selling securities to, clients for the manager's own account;
- sufficiently disclose the potential conflicts of interest; and

- obtain consent after such disclosure, and prior to the completion of the transaction.

Additionally, the Risk Alert noted several issues specifically related to pooled investment vehicles, such as private funds, including:

- causing trades between pooled investment vehicles advised by the manager where, due to the manager's significant ownership of the vehicle, such trades were principal transactions subject to Section 206(3); and
- effecting principal trades between the manager and its pooled investment vehicle clients, but not obtaining effective consent because the committee granting consent on behalf of the pooled investment vehicle was itself conflicted.

Agency Cross Transactions

With respect to agency cross transactions, a particular type of transaction where a manager or its affiliates acts both as an adviser to a client and also acts as a broker for another party to such transaction,[3] the Risk Alert notes OCIE had observed managers who:

- disclosed to clients that they would *not* engage in agency cross transactions, but did so anyway in contravention of their disclosure; and
- did not sufficiently document their compliance with the Rule 206(3)-2 safe harbor[4] regarding agency cross transactions.

Policies and Procedures

The Risk Alert also described certain recurring deficiencies in managers' policies and procedures as they related to principal trades and agency cross transactions, including:

- failure to adopt policies and procedures relating Section 206(3), even though the manager engaged in principal trades and/or agency cross transactions; and
- failure to follow their established policies and procedures.

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1. Section 206(3) applies to both registered and unregistered investment advisers.↩

2. Gardner Russo & Gardner, S.E.C. No-Action Letter (June 7, 2006).↩

3. Such transactions are consequently relatively uncommon among private equity, credit, real estate and other closed-ended fund managers.↩

4. In general, Rule 206(3)-2 permits an adviser to rely on a client's prospective consent to certain agency cross transactions provided that the client receives full written disclosure of certain information with respect to such transactions prior to granting its consent; the adviser sends a written confirmation of each transaction at or before its completion; on at least an annual basis, the adviser provides disclosure regarding the number of transactions and the associated commissions; and each written disclosure provides notice that the client may revoke its prospective consent at any time.↩

Authors

Norm Champ, P.C.

Partner / New York

Scott A. Moehrke, P.C.

Partner / Chicago

Kevin R. Bettsteller

Partner / San Francisco

Lisa Cawley

Partner / London

Michael Chu

Partner / Chicago

Matthew Cohen

Partner / San Francisco

Marian Fowler

Partner / Washington, D.C.

Nicholas A. Hemmingsen

Partner / Chicago

Alpa Patel

Partner / Chicago

Jaime Doninger Schechter

Partner / New York

Aaron J. Schlaphoff, P.C.

Partner / New York

Christopher J. Scully

Partner / Chicago

Nathan R. Schuur

Associate / New York

Robert H. Sutton

Partner / New York

Ryan P. Swan

Partner / Chicago

Jamie Lynn Walter, P.C.

Partner / Washington, D.C.

Josh Westerholm

Partner / Chicago

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