PAUL HASTINGS

STAY CURRENT

August 2018

SEC Pursues Investment Adviser's Cross Trade Pricing Practices

By Nicholas Morgan, John Nowak, Thomas Zaccaro & Inna Coleman

Recently, the Securities and Exchange Commission ("SEC") announced that it settled charges against an investment adviser (the "Adviser") for alleged mispricing of cross trades of fixed income, non-rated, thinly-traded municipal bonds.[1] The SEC alleged that, over the course of approximately a four-and-a-half year period, the Adviser improperly used its month-end valuation prices for the purposes of pricing internal cross trades of illiquid bonds between its buy- and sell-side clients. The SEC alleged that this practice of pricing cross trades improperly favored one party over the other, even though the Adviser owed the same fiduciary duty to both. In connection with this practice, the SEC also alleged that the Adviser failed to adopt and implement effective compliance policies governing the pricing and to disclose the practice in its Form ADV and elsewhere.

The settlement suggests that the SEC may take a more aggressive approach with regard to inherently subjective valuation practices involving illiquid assets—where sophisticated experts might disagree on price. Additionally, it suggests that, during the course of an adviser examination, the SEC staff might inquire as to how, and under what circumstances, an adviser applies valuation pricing to other areas of its business. As such, this settlement should serve as a warning to investment advisers to analyze whether their valuation pricing influences other aspects of their investment operations and to identify potential weaknesses in their policies and disclosures.

SEC Allegations

The SEC alleged that, from November 2011 through March 2016, the Adviser invested its fixed income portfolios primarily in non-rated, tax-exempt, and thinly-traded municipal bonds, in which the Adviser often held a controlling, institutional position across its client accounts. Over the course of the investments, the Adviser purportedly arranged cross trades in these securities, representing both the buyer and seller in the transaction. By arranging these cross trades between clients—as opposed to purchasing or selling the securities in the secondary market—the SEC alleged that the Adviser was able to maintain its controlling position in the securities while also providing its clients with liquidity in an otherwise illiquid security.

The settlement implies that the Adviser's valuation approach was part of its core investment strategy and that the Adviser tailored its analysis of the bonds' value to align with a long-term strategy. And the SEC even acknowledged that the Adviser's extensive experience in the bonds and controlling positions afforded it a sophisticated depth of knowledge as to the valuation of these otherwise thinly-traded securities.

Nonetheless, the SEC alleged that the Adviser violated the Investment Advisers Act in arranging the cross trades because the valuation method used for pricing the trades improperly favored one side—either the buyer or seller—over the other, in contravention of the fiduciary duty the Adviser owed each of the parties. According to the SEC, the Adviser executed cross trades at month-end bid-side prices it obtained from the bond's underwriter. Although the month-end bid-side prices were apparently sufficient to value the bonds at month end, the SEC alleged that it was improper to use them to price the cross trades because it benefited one of the Adviser's clients over the other. Separately, the SEC alleged that in certain instances the Adviser improperly influenced the price at which the underwriter priced that securities and thereafter executed cross trades at that price. Lastly, the SEC alleged that the Adviser's internal policies and disclosures were inconsistent and did not accurately reflect and document its actual valuation methodology.

Valuation of Cross Trades at the Bid Price

The SEC claimed that the Adviser routinely arranged cross trades that were executed at the month-end bid-side indicative quote supplied by the bonds' underwriter, with the sell-side party receiving an executed price at a small discount from that bid price. As a result, the Adviser's buy-side clients allegedly received favorable pricing by avoiding having to pay a portion of the full bid/ask price spread. The SEC estimated that the Adviser's valuation pricing strategy saved its buy-side clients hundreds of thousands of dollars over the four-and-one-half-year period. At the same time, however, the Adviser deprived its sell-side clients of the full benefit of the spread.

Influencing Broker Valuation of Cross Trades

The SEC alleged that the Adviser likewise disadvantaged its clients in a total of 21 cross trades during a four-and-a-half-year period by executing the trades at valuations that the Adviser had influenced. For example, the Adviser would first seek and obtain end-of-month bond prices from the pricing broker, who may have provided prices consistent with the most recent interdealer market trades in those securities. The Adviser would then challenge the price and persuade the pricing broker to change its valuation, without documenting any basis it may have provided to the pricing broker for the proposed change. Subsequently, the Adviser would execute cross trades at the influenced price, even if it was higher than the prices in recent independent trades of that security.

As a result, the SEC alleged that the Adviser's buying clients paid more for the bonds in the cross trade executed by the Adviser than they would have paid in a secondary market transaction. The SEC estimated the overpayment amount to be approximately $194,500.

Deficiencies in Compliance Policies and Procedures and Disclosures

In addition to allegations regarding the Adviser's valuation methods themselves, the SEC also alleged that the Adviser's compliance policies and procedures, as well as its ADV disclosures, were inadequate.

With regard to the execution of cross trades at the bid price, the SEC alleged that the Adviser's conduct ran afoul of its internal compliance procedures, which recognized that cross trades may advantage one client over another and required the Adviser to cross bonds at the bonds' "current market price—the last reported price—average of the bid and ask prices," later revised to "current market prices provided by the executing broker." Even though the bid prices were apparently sufficient for the month-end valuation for these illiquid securities, the SEC took the view that crossing bonds at the bid price did not comport with either iteration of the Adviser's written policy as it was not the equivalent of a "current market price."

Moreover, the Adviser's valuation practice and its compliance policy were inconsistent with its Form ADV disclosures, which stated that the Adviser "maintain[ed] procedures which require that all cross transactions are made at an independent current market price." Although the Adviser ultimately revised its disclosure to be in line with its policy that allowed execution of cross trades at "current market price provided by the executing broker," the SEC alleged the disclosure was nonetheless materially misleading because the Adviser proposed and executed its cross trades at bid prices it provided to the pricing brokers.

With regard to the Adviser's purported influence of valuation pricing, the SEC notably took no issue with the Adviser's challenge of the brokers' pricing (in fact, the SEC recognized that the Adviser had substantial familiarity with and knowledge of the value of the bonds)—it instead focused on the Adviser's failure to adopt and implement reasonably designed policies and procedures for its valuation practices. The SEC alleged that the Adviser's policies were defective in that:

- the Adviser's portfolio manager—who had a potential conflict of interest—was afforded wholesale and unsupervised discretion to challenge brokers' valuations;
- the Adviser lacked a valuation committee or any other form of oversight over the basis of the valuation challenges; and
- the Adviser failed to properly maintain documentation supporting the basis of its valuation challenges.

Takeaways

This settlement serves as yet another reminder to investment advisers to appropriately document the basis of their valuation methods, maintain adequate compliance polices and disclosures regarding their valuation practices, and—perhaps most importantly—ensure consistencies between on-the-ground valuation practices, compliance policies, and public disclosures. The SEC's willingness to look beyond valuation practices to other aspects of an investment adviser's business—such as the accuracy and consistency of its compliance protocols and disclosures with its actual valuation practice—means that advisers should likewise analyze derivative aspects of their valuation practices for potential weaknesses.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Nick Morgan
1.213.683.6181
nicolasmorgan@paulhastings.com

Thomas A. Zaccaro
1.213.683.6185
thomaszaccaro@paulhastings.com

New York

John P. Nowak
1.212.318.6493
johnnowak@paulhastings.com

Inna Coleman
1.212.318.6404
innacoleman@paulhastings.com

[1] *In the Matter of Hamlin Capital Management, LLC*, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (Aug. 10, 2018), https://www.sec.gov/litigation/admin/2018/ia-4983.pdf.