Permissibility of Principal Transactions in Fee-Based Consulting

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From time-to-time IMCA members and CIMA licensees will contact IMCA seeking advice about matters they believe may be in conflict with the IMCA Code of Professional Responsibility. Often the matter is brought (anonymously) before the IMCA Ethics Committee for comment and insight.

The following is an example of a recent case that the Committee believes may be of use to the general membership. It is described here as a reminder that IMCA is a valuable resource that can help you think through ethical dilemmas.

Issue

Thinly traded securities are held in a closed-end (proprietary) fund. In an effort to provide liquidity to both the fund(s) and the securities, the fund sponsor recently has modified its prospectus to allow principal transactions.

Question

Under what circumstances, if any, are principal transactions permissible for a CIMA-licensed, fee-based consultant?

Pertinent Section of the Investment Advisors Act of 1940

Section 206 of the Act imposes a fiduciary duty on investment advisors. Fiduciary duty represents the highest degree of trust and confidence that the investment advisor will act in the best interest of the client.

More specifically, Section 206(3) states:

'It shall be unlawful for any investment advisor, by use of the mails or any means or instrumentalities of interstate commerce, 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. The prohibitions of this paragraph (3) 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 advisor in relation to such transaction.'

Pertinent Section(s) of IMCA Code of Professional Responsibility

1. Serve the financial interests of clients. Each professional shall always place the financial interests of the client first. All recommendations to clients and decisions on behalf of clients shall be solely in the interest of providing the highest value and benefit to the client.

2. Disclose fully to clients services provided and compensation received. All financial relationships, direct or indirect, between consultants and investment managers, plan officials, beneficiaries, sponsors, or any other potential conflicts of interest shall be fully disclosed on a timely basis.

8. Maintain the highest standard of personal and professional conduct.

Recommendations of the Ethics Committee

Recognizing that even subtle variations in factual circumstances may lead to different treatment, the following comments should be taken as a whole and are meant to be helpful guidelines for CIMA designees and not a blanket directive or specific rule.

The Committee’s foundational premise is that a CIMA designee should always “take the high road” and avoid even the perception of a conflict of interest. In that regard, the Committee agrees that principal transactions are a form of self-dealing and should be prohibited regardless of client consent or notification. Perhaps more importantly, the nature of the CIMA standards...
situations with block-trade and cross-trade scenarios, excerpts from the newly promulgated Pension Reform Act of 2006 are reproduced below.

**Excerpts from Pension Reform Act of 2006**

**B. Prohibited Transaction Rules Relating to Financial Investments**

(secs. 408, 412(a), and 502(i) and new sec. 3(42) of ERISA, and sec. 4975 of the Code)

1. **Exemption for Block Trading Present Law**

   Present law provides statutory exemptions from the prohibited transaction rules for certain transactions. Present law does not provide a statutory prohibited transaction exemption for block trades. For purposes of the prohibited transaction rules, a fiduciary means any person who

   1) exercises any authority or control respecting management or disposition of the plan’s assets,

   2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or

   3) has any discretionary authority or responsibility in the administration of the plan.

**Explanation of Provision**

The provision provides prohibited transaction exemptions under ERISA and the Code for a purchase or sale of securities or other property (as determined by the secretary of labor) between a plan and a disqualified person (other than a fiduciary) involving a block trade if: 1) the transaction involves a block trade; 2) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor) does not exceed 10 percent of the aggregate size of the block trade; 3) the terms of the transaction, including the price, are at least as favorable to the plan as an arm’s length transaction with an unrelated party; and 4) the compensation associated with the transaction must be no greater than the compensation associated with an arm’s length transaction with an unrelated party. For purposes of the provision, block trade is defined as any trade of at least 10,000 shares or with a market value of at least $200,000 that will be allocated across two or more unrelated client accounts of a fiduciary. Examples of property other than securities that the secretary of labor may apply the exemption to include but are not limited to future contracts and currency.

   In addition, under ERISA section 408(a), the secretary of labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the secretary of treasury. An exemption may not be granted unless the secretary of labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

7. **Exemption for Cross Trading Present Law**

   Present law provides statutory exemptions from the prohibited transaction rules for certain transactions. Present law does not provide a statutory prohibited transaction exemption for cross trades.

**Explanation of Provision**

The provision provides prohibited transaction exemptions under ERISA and the Code for a transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager if certain requirements are met. These requirements are:

- the transaction is a purchase or sale, for no consideration other than cash payment against
prompt delivery of a security for which market quotations are readily available;

- the transaction is effected at the independent current market price of the security;
- no brokerage commission fee (except for customary transfer fees, the fact of which is disclosed) or other remuneration is paid in connection with the transaction;
- a fiduciary (other than the investment manager engaging in the cross trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of the parties) the investment manager to engage in cross trades at the investment manager’s discretion, after the fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if the disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager;
- each plan participating in the transaction has assets of at least $100 million, except that, if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust has assets of at least $100 million;
- the investment manager provides to the plan fiduciary who has authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information as applicable: the identity of each security bought or sold, the number of shares or units traded, the parties involved in the cross trade, and the trade price and the method used to establish the trade price;
- the investment manager does not base its fee schedule on the plan’s consent to cross trading and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan’s consent to cross trading;
- the investment manager has adopted, and cross trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program and that include a description of the manager’s pricing policies and procedures, and the manager’s policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and
- the investment manager has designated an individual responsible for periodically reviewing purchases and sales to ensure compliance with the written policies and procedures and, following such review, the individual must issue an annual written report no later than 90 days following the period to which it relates, signed under penalty of perjury, to the plan fiduciary who authorized the cross trading, describing the steps performed during the course of the review, the level of compliance, and any specific instances of noncompliance.

The written report also must notify the plan fiduciary of the plan’s right to terminate participation in the investment manager’s cross-trading program at any time. 

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