Simpson Thacher

Regulatory and Enforcement Alert

SEC Sanctions Investment Adviser That Engaged in Principal Transactions in Violation of Section 206(3)

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On February 24, 2020, the U.S. Securities and Exchange Commission ("**SEC**") announced a settlement with Lone Star Value Management LLC ("**Lone Star**") and its CEO for alleged violations of Section 206(3) of the Investment Advisers Act of 1940 (the "**Advisers Act**"). As part of the Order announcing the settlement, Lone Star and its CEO agreed to cease and desist from further violations and to sanctions of $100,000 and $25,000, respectively.

In 2014, Lone Star, while reporting to the SEC as an exempt reporting adviser ("**ERA**"), effected 19 interfund cross trades between two funds it managed. Then in 2015, while registered as an investment adviser, Lone Star effected two trades between a fund it managed and a separately managed account ("**SMA**") for which Lone Star served as an investment adviser. According to the SEC, these 21 trades were made on a principal basis because the Lone Star CEO's ownership stake in the Lone Star fund involved in each of the trades was more than 35%. The SEC alleged that Lone Star violated Section 206(3) by not disclosing to the clients that Lone Star was acting as principal for each transaction prior to completion of each transaction and by failing to obtain client consent on a transaction-by-transaction basis.[1] The SEC also alleged that the Lone Star CEO caused such violations of Section 206(3).

Takeaways

This case highlights the SEC's continued focus on principal transactions and compliance with Section 206(3). As previously highlighted in its 2019 Risk Alert, the SEC staff has observed that advisers managing pooled investment vehicles were failing to recognize that the adviser's ownership interest in an affiliated vehicle could cause a transaction between such affiliated vehicle and another advisory client to be a principal transaction.[2]

[1] Under Section 206(3), an investment adviser may not, directly or indirectly, acting as principal for its own account, knowingly buy or sell securities from or to a client ("principal trades") without (i) disclosing to the client in writing—before the completion (*i.e.*, settlement) of the transaction—the capacity in which the adviser is acting and (ii) obtaining the client's consent to the specific transaction. Consent must be obtained on a transaction-by-transaction basis, not through blanket consent.

[2] For more information on this Risk Alert, *see* Simpson Thacher & Bartlett LLP, *SEC Risk Alert Highlights Compliance Issues Relating to Investment Adviser Principal and Agency Cross Transactions*, Sept. 12, 2019.

Advisers managing private funds should consider whether their own significant ownership interest[3] in an affiliated pooled investment vehicle could cause a transaction between that vehicle and an advisory client to be a principal transaction. In such transactions, advisers should ensure that they provide required disclosures and obtain effective transaction-specific consents.

It is also significant that the SEC found that the Section 206(3) violations occurred both when Lone Star was an ERA and when Lone Star was a registered investment adviser. Section 206(3) prohibits an adviser, regardless of whether it is registered under the Advisers Act, from selling any security to, or purchasing any security from, a client for its own account, without disclosing to the client in writing the capacity in which it is acting and obtaining the client's consent.

Last, unlike many settlements involving private fund sponsors, the SEC elected to also charge the firm's senior-most executive for his involvement in the transactions at issue. While the Lone Star CEO made all of the investing and trading decisions for the Lone Star funds and the SMA—and was thus undeniably aware of the principal nature of the transactions—the case serves as reminder that the SEC may pursue individual accountability even in cases involving technical compliance with the Advisers Act.

Reminder for Private Fund Sponsors

Advisers to private funds should ensure they fully comply with the requirements of Section 206(3) in connection with any principal transactions entered into by their funds. In addition, advisers are encouraged to carefully review existing policies and procedures to ensure they are reasonably designed to (i) identify principal transactions—including those transactions that may be principal transactions due to the adviser's significant ownership in an affiliated pooled investment vehicle participating in the transaction—and (ii) meet the disclosure and consent requirements set forth in Section 206(3).

[3] Section 206(3) principal trade requirements would not apply to a cross transaction between a client account and an account of which the adviser and/or its controlling persons, in the aggregate, own 25% or less, but would apply in cases of more than 25% ownership. *See* *Gardner Russo & Gardner*, SEC IM Staff No-Action Letter (June 7, 2006).

For further information regarding this Alert, please contact one of the following:

NEW YORK CITY

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Allison Scher Bernbach
+1-212-455-3833
allison.bernbach@stblaw.com

Manny M. Halberstam
+1-212-455-2388
manny.halberstam@stblaw.com

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com