Morgan Lewis Ascendant Compliance Conference April 8-10, 2013 **Current Trading Issues** for Advisers H

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Current Focus

- Best execution is the subject of increased focus for the SEC
 - SEC's enforcement and exam units have hired industry experts on trading
- SEC is better at detecting execution quality and trading issues in routine exams, which increases the chances that the SEC will actually challenge execution quality on a substantive basis
- All of this increases the chances that best execution issues will be a key focus of adviser exams and the subject of criticism in exam comment letters or possible referrals for enforcement action

Bedrock Concepts & Requirements

• Fiduciary obligations

- Advisers Act
- ERISA
- Best price and execution

- Special conflicts issues
 - Principal trades
 - Agency trades
 - Cross trades
 - Fair allocation (and inclusion of prop accounts)
 - Fills
 - Time of execution
 - Discretionary and
 nondiscretionary accounts
 - Step out trades
 - Interpositioning
 - Trade errors
 - Broker selection

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SEC on Best Execution

 In the SEC's view, "[i]nvestment advisers have an obligation to seek best execution of clients' securities transactions [and in] meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients in such a manner that the client's total cost or proceeds in each transaction are the most favorable under the circumstances."

Best Execution

- Both quantitative and qualitative factors (a partial list)
 - Overall trading costs (i.e., net price paid or received), including commissions, mark-ups & -downs or spreads
 - Quality of execution accurate and timely execution, clearance and error/dispute resolution
 - Receipt of soft dollar research/services
 - Reputation, financial strength and stability
 - Block trading and block positioning capabilities
 - Willingness to execute hard trades

- Willingness and ability to commit capital
- Access to underwritten offerings and secondary markets
- Ongoing reliability
- Nature of the security and the available market makers
- Desired timing and size of trade
- Market intelligence regarding trading activity
- Confidentiality
- OTHER FACTORS YOU MAY CONSIDER?

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Best Execution Committee

- Who measures "best ex"?
- Third party TCA vendors
- Composition of committee
 - Who's on the committee?
- Committee meetings
 - How often?
 - What's covered?
- Record of meetings

Other Conflicts

- Soft Dollars & CSAs
 - 28(e) "safe harbor"
 - Global arrangements
 - Portability of credits
 - Protection of accrued credits
 - Disclosures "bundled" research and services vs. third party
- Directed brokerage
 - Client directed
 - Commission recapture
 - Brokerage for referrals and sales (2013 SEC focus area payments by advisers to entities that distribute mutual funds)
- Trade errors

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Sidebar on ERISA

- Disclosure isn't enough (generally)
- Prohibited Transactions and PTCEs
 - Principal trades (PTE 75-1)
 - Agency trades (PTE 86-128)
 - Cross trades

SPECIAL FOCUS AREAS



Public Equity

- Thinly traded securities
 - Portfolio pumping
- Use of affiliated brokers
- Dark pools IOIs (indications of interest)

- FINRA 2012 inquiry into potential market manipulation

Fixed Income

- Challenges with best price and execution
 - Opacity of issuer and market information
 - Many illiquid investments
 - Fungibility of investments complicates analysis
 - Limited information on best execution across trading venues and participants

Retail Investor Platforms

- Wrap fee programs
 - Sponsor execution capacity
 - Trade aways
- "Institutional" custody and trading platforms
 - Reliance on platform for best execution
 - Platform support services

Private Equity

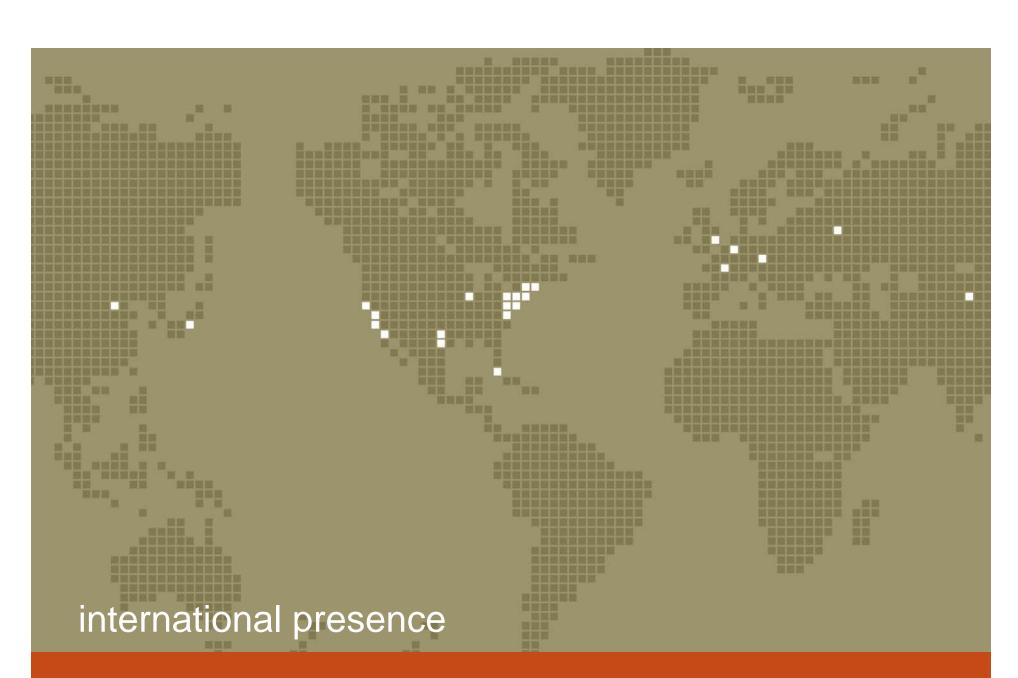
• Best execution is best price

Mechanics / Operations

- Due diligence of trading venues and brokers
 - Current focus on ECNs and ATSs
 - Focus on front running, execution quality and confidentiality
- Measuring best price and execution
- Tape recording
- Trading from home / Remote office / Night trading
- CCO should understand the OMS capabilities, limitations and compatibility with compliance applications

Compliance Watch

- Portfolio pumping
- Window dressing
- Interpositioning
- Use of affiliated brokers
- Fund distribution



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