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Current Trading Issues for Advisers

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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

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?

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**

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 away
- “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



international presence

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London Los Angeles Miami Moscow New York Palo Alto Paris Philadelphia Pittsburgh
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