

Morgan Lewis

together

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Current Best Execution and Trading Issues



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Supervision Of Trading Activities

- Overview of Supervisory Responsibilities
- Achieving Best Execution
 - *Process and Paperwork*
 - *Factors in Best Execution*
- Three Phases
 - *Pre-Trade*
 - *Execution*
 - *Post-Trade*
- Selected Best Execution Issues
- Measurement & Testing

Overview of Supervisory Responsibilities

- Responsibilities under the Investment Advisers Act of 1940
 - *Supervision*
 - *Reasonable Policies and Procedures*
- Standard is one of reasonableness
- Delegation principles
- Active Response to Red Flags

Process and Paperwork

- Focus on process – “Regular and rigorous” review
- Written Best X policy
 - *Factors for selecting brokers*
 - *Criteria to measure these factors*
 - *Consideration of alternative markets*
- Best X committee
 - *Monitor brokers’ performance*
 - *Monitor more than price*
 - *Like market impact and opportunity costs*
 - *Consider evaluation services*
 - *Document steps taken*

Factors in Best Execution

- Execution capability
- Price improvement
- Commission or equivalents
- Accessibility and responsiveness
- Need for speed
- Value of research provided
- Willingness to commit capital
- Assistance in finding liquidity
- Handling of block trades
- Specialization in markets or securities manager is trading
- Electronic order access and trade reporting
- Anonymity
- Financial responsibility
- Low trade errors & willingness to correct their mistakes

Three Phases

- Pre-Trade
- Execution
- Post-Trade

Pre-Trade

- Evaluate desk structure
 - *Sector/Style*
 - *Fund/Product*
- Evaluate trader responsibilities
- Evaluate trading desk workflows to streamline
- Broker selection
 - *Broker Votes*
 - *Trading Desk Independence*

Execution

- Aim – Absolute best price given portfolio manager's objective
 - *Portfolio manager's objective is key to how traders should approach a trade*
- How to assess the prevailing market price?
 - *Market data*
 - *Checking multiple dealers - but how many?*
- Trade sequencing issues
 - *Raises tough trading opportunity questions*
 - *Myriad trading arrangements complicate order placement*
- Trade aggregation and allocation

Post-Trade

- Broker monitoring
 - *Types of services used*
 - *Number of services used*
- Broker Evaluation -- Usefulness of “Dash” Reports?
 - *Rule 605 (formerly 11Ac1-3) reports re: payment for order flow practices*
 - *Rule 606 (formerly 11Ac1-6) reports re: order routing practices*

Selected Best Execution Issues

- Directed Brokerage Arrangements
- Trade Sequencing Issues
- Brokers That Refer Business
- Trade Aggregation
- Trade Allocation
- Agency and Agency-Cross Trades
- Principal Trades
- Cross Trades
- Interpositioning
- Trade and Handling Errors

Directed Brokerage Arrangements

- Cross-subsidization issues
- Sequencing issues
- Due diligence issues
- Disclosure issues

Trade Sequencing Issues

- Raises tough trading opportunity questions
- Myriad trading arrangements complicate order placement
 - *Free trading accounts*
 - *Directed brokerage accounts*
 - *Restricted accounts*
 - *Accounts that say “no” to specific brokers or soft dollars*
 - *Wrap accounts*
 - *“Preferred” accounts*
- Solutions
 - *Step outs*
 - *Rotation*
 - *“Back of bus” with disclosure?*

Brokers that Refer Business

- Referrals & fund sales
 - *SEC & NASD Rule Changes Bar direction for fund sales*
 - *Portfolio Advisory Services, LLC (2002)*
 - *Duff & Phelps (2001)*
 - *Founders Asset Management LLC (2000)*
 - *Fleet Investment Advisors Inc. (1999)*
- High scrutiny
 - *Disclosure may not suffice!*
 - *ERISA issues*

Trade Aggregation

- Statutory framework
 - *1940 Act Sections 17(d) & 17(j)*
 - *Advisers Act Section 206*
- SMC Capital no-action letter (1995)
 - *Aggregation of client orders, including mutual funds and proprietary accounts, allowed under Section 17(d) if funds participate on terms no less advantageous than others*
 - *Aggregation of client orders does not violate Section 206 if*
 - *Adviser discloses aggregation practices in ADV and separately to existing clients*
 - *No advisory account, including a proprietary account, is favored*
 - *Each client participates at the average price, with transaction costs shared pro rata*
- Pretzel & Stouffer no-action letter (1995) & Q&A
- Mass Mutual no-action letter (2000) on Private placements

Trade Allocation

- Raises more difficult issues than trade aggregation
- SMC's suggested procedures
 - *Adviser prepares pre-trade allocation report for each trade*
 - *Shares generally are allocated in accordance with the allocation report*
 - *Exceptions where all accounts receive "fair and equitable treatment" and reason is documented*
 - *Adviser keeps records of its allocation practices*

Trade Allocation

- Tough issues
 - *Proprietary accounts & accounts paying performance-based fees*
 - *Do trades always have to be allocated pro rata?*
 - *Does “fair treatment” mean that one client never can be treated more favorably than another?*
 - *Does each client have to pay the same trade costs?*
- SEC Enforcement examples
 - *Gerson Asset Mgmt (2005)*
 - *Slocum, Gordon & Co. (2002)*
 - *Edward F. Gobora (2002)*
 - *Zion Capital (2001)*
 - *Monetta Financial (2000)*
 - *Nicholas-Appelgate (1998)*

Portfolio Pumping

- Marking the Close to
 - *Enhance performance*
 - *Enhance fees*
- 2001 OCIE Task Force
- Enforcement actions
 - *Schultz Investment Advisors (2005)*
 - *Burton G. Friedlander (2001)*
 - *Oechsle International Advisors, L.L.C. (2001)*

Agency and Agency-Cross Trades

- 1940 Act Section 17(e)
- Advisers Act Section 206(3)
 - *SEC's 1998 interpretive release*
- Rule 206(3)-2
 - *Client must agree in writing*
 - *Affiliated broker must send client*
 - *Trade confirmations*
 - *Annual statement showing total number of agency trades & the total amount of commissions or other remuneration received*
 - *Arrangement must be terminable*
 - *No dual advisory capacity*
- ERISA Prohibited Transaction Class Exemption 86-128
 - *Neither adviser nor affiliate can be a trustee or administrator*
 - *Independent fiduciary must agree in writing*
 - *Arrangement must be terminable*
 - *Broker must send the fiduciary*
 - *3 months before the arrangement, information for the fiduciary to evaluate the arrangement*
 - *Annually, a termination form*
 - *Trade confirmations*
 - *Information, including material changes to brokerage practices & the portfolio turnover ratio*

Principal Trades

- Principal trades
 - *1940 Act Section 17(a)*
 - *Advisers Act Section 206(3)*
 - *Applicability to “riskless” principal trades*

Cross Trades

- SEC Focus
 - *Back Bay Advisors (2002)*
 - *Renberg Capital Management, Inc. (2002)*
- Section 206(3) Standard
- 1940 Act Rule 17a-7
- ERISA prohibited transaction rules
 - *New ERISA legislation*
 - *2002 exception for Index and Model-Driven Funds*
- Areas of concern
 - *Expectation that client trades will hit one-another*
 - *Continuing focus on valuation*
- Inadvertent crosses
 - *“Blind Pool” Exception*
 - Delta Government Options *no-action letter*
 - *ERISA legislative history*
 - *Basic requirements*
 - *Orders must be bona fide*
 - *No pre-arranged terms*
 - *Liquid securities*

Interpositioning

- Interpositioning involves an adviser interposing a broker-dealer between clients and executing broker-dealers
 - *e.g., market makers in OTC principal trades*
- Concerns arise when
 - *Done to generate a commission for the broker-dealer in the middle*
 - *Results in the client paying unnecessary brokerage charges*
- SEC enforcement
 - *Portfolio Advisory Services, LLC (2002)*
 - *Edgemont Asset Management Corp. and Bowling Green Securities Inc. (1991)*

Trade and Handling Errors

- SEC Examination & Enforcement focus
 - *Michael T. Jackson and :*
 - *EGM Capital (2005)*
 - *M&I Investment Management (1992) – failure to supervise*
 - *Dimitri Balatsos (1992) – fraud & recordkeeping*
 - *Jack Allen Pirrie (1991) – use of “Soft Dollars”*
 - *First Capital Strategist (1997) – failure to supervise, misrepresentation of controls & overstating performance*
- What’s a trade error?
- Who should pay for errors?
- De minimis errors, opportunity costs & windfalls
- Disclosure issues
- Policies and procedures
- Dealing with brokers
- Error accounts
- Performance issues
- Insurance

Measurement & Testing

- Established Services
 - *ITG*
 - *Abel Noser*
 - *Elkins McSherry*
 - *Other*
- Transaction Cost Analysis
- SEC Reports

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