

Morgan Lewis

IAA Compliance Workshop
San Francisco, CA

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*Selected Issues in Best Execution
and Trading Practices
November 15, 2007*

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Agenda

- » Achieving Best Execution
 - Regulatory Responsibility
 - Factors in Broker Selection
 - Process and Paperwork
- » Selected Best Execution Issues

Regulatory Responsibility

- » Broker-dealer focus – price at which the client’s order is executed in the marketplace, without consideration of the commission
- » Investment adviser focus - total cost or proceeds in each transaction is the most favorable under the circumstances
 - Includes consideration of transaction cost or commission
 - But, amount of the transaction cost is not the sole determinative factor
 - Consider “full range and quality” of a broker-dealer’s services

Factors in Broker Selection

- » **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

Process and Paperwork

- » Written Best X policy
 - Factors for selecting brokers
 - Consideration of alternative markets
- » Best X committee
 - “Periodically and systematically evaluate the execution [quality] of all broker-dealers executing the adviser’s transactions”
- » SEC Review
 - Names of committee responsible for reviewing and evaluating best x and latest minutes
 - Written documentation substantiating best x review
 - Compliance reports used to monitor best x
 - List of third party vendors who monitor best x and their most recent report

Selected Best Execution Issues

- » Directed Brokerage Arrangements
- » Trade Sequencing Issues
- » Cross Trades

Directed Brokerage

- » Reduction in commission costs – downward pressure on client directed brokerage
- » Focus on directed brokerage arrangements that benefit client (e.g., existing relationship with broker, commission recapture arrangement)
- » Document client direction appropriately
 - No “Qualified” or “Soft” directions - “use your best efforts to direct trades through the recapture program broker/dealers *pursuant to your fiduciary duty to obtain best execution*”
 - Explanation of consequences of client directed brokerage arrangement (potentially higher costs, rotation issues)
 - Eliminate discretion to choose executing broker
- » Disclosure, Disclosure, Disclosure

Directed Brokerage

- » High scrutiny - Any selection of brokers on some basis other than execution factors can be trouble
- » Direction in return for client referrals
 - *Folger Nolan Fleming Douglas Capital Management, Inc.* (August 23, 2007), *Jamison, Eaton & Wood, Inc.* (May 15, 2003)
 - Due diligence – “periodic and systematic review” extends to brokerage arrangements that pre-date advisory relationship
 - “The Commission has repeatedly sanctioned investment advisers that have failed to seek best execution of client trades involving referral arrangements.”
 - *Portfolio Advisory Services, LLC* (2002), *Duff & Phelps* (2001), *Founders Asset Management LLC* (2000), *Fleet Investment Advisors Inc.* (1999)
- » Direction in return for compensation
 - *Callan Associates* (September 19, 2007)
 - Under terms of transaction, Callan disclosed that BNY was its preferred broker for clients interested in commission recapture and soft dollar arrangements, but failed to disclose that Callan was receiving annual payments based on level of commissions sent to BNY
- » Direction in return for fund sales
 - SEC & NASD Rule Changes Bar direction for fund sales

Trade Sequencing Issues

- » Different trading arrangements may create need for disaggregation
 - Free trading accounts (including funds)
 - Directed brokerage accounts
 - Restricted accounts (accounts that do not permit trading with specific brokers, wrap accounts)
- » Problems associated with disaggregation
 - Market impact (first accounts tend to receive a better price)
 - Data leakage (trading activity signals, creates market impact)
 - Need to disclose consequences, including potentially higher commissions

Trade Sequencing Issues

» Simultaneous communication

- Using multiple brokers to execute transactions in same security
- Pros – Equal treatment of clients, administrative ease and avoidance of information leakage
- Cons – Competition in market may negatively affect price, particularly for less liquid securities.

» Rotation

- Pros - Random rotation results in clients being treated fairly and equitably over time

» Rotation (cont.)

- Cons – Puts fund and institutional orders at the mercy of directed orders
- Look at the rotation schedule – ideally, each trade produces a new rotation

» “Back of bus” with disclosure?

- *City of Gainesville*

» Step outs

- Increasingly common option for wrap programs (super brokers)
- Creates cross-subsidization issue

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

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