

Investment Adviser Regulation An A to Z Workshop

Portfolio Trading Compliance

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Overview

» 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***
- » ***Commission or equivalents***
- » Accessibility and ***responsiveness***
- » Need for speed
- » ***Value of research provided***
- » Willingness to commit capital
- » Assistance in finding liquidity
- » Ease of settlement & clearance
- » Block trades
- » Specialization in particular markets or securities
- » 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
- » Soft Dollars

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

Directed Brokerage

- » High scrutiny - Any selection of brokers on some basis other than execution factors can be trouble
- » Direction in return for client referrals
 - 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.”
- » Direction in return for compensation
 - *Callan Associates (September 19, 2007)* – Failure to disclose that Callan was receiving annual payments based on level of commissions sent to BNY
- » Direction in return 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
- Cons – Puts fund and institutional orders at the mercy of directed orders

» “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

- Basic requirements
 - Orders must be bona fide
 - No pre-arranged terms
 - Liquid securities

SEC's 3-Step Analysis

» The investment adviser must determine

- Whether the product or service qualifies as brokerage or research within the meaning of the safe harbor
- Whether the eligible product or service actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities
- In good faith that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer

Research

- » Product or service must constitute advice, analysis or reports
- » Relating to the subject matter of Section 28(e)
 - Advice as to the value of securities, the advisability of investing in, purchasing or selling securities
 - Analysis and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts
- » That reflects the “expression of reasoning or knowledge”

Brokerage

- » Temporal standard that includes products and services that relate to the execution of a trade
 - from the point at which the investment adviser transmits an order to a broker-dealer for execution,
 - through the point at which funds or securities are delivered or credited to the advised account

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