

Financial Research Associates, LLC
Investment Adviser Compliance Forum
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C O U N S E L O R S A T L A W

Best Execution and Brokerage Practices

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Best Execution and Brokerage Practices

- Achieving Best Execution
 - Process and Paperwork
 - Factors in Best Execution
 - Pre-Trade
 - The Execution
 - Post-Trade
 - Challenges
- Selected Best Execution Issues
 - Current Issues
 - Soft Dollars
 - Directed Brokerage Arrangements
 - Trade Sequencing Issues
 - Brokers that Refer Business or Offer Investment Opportunities
 - Trade Aggregation
 - Trade Allocation
 - Agency and Agency-Cross Trades
 - Principal Trades
 - Cross Trades
 - Interpositioning
 - Trade and Handling Errors

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 equivalent rates
- 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

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
- Factors
 - Agency capabilities
 - Capital commitment / VWAP services
 - Electronic trading
 - ECNs and other ATs
 - Soft dollar research and market color
- Newly mandated procedures when executing through selling brokers
- Assessment of the market for the security

The Execution

- Aim – Absolute best price given portfolio manager’s objective
 - Portfolio manager’s objective is key to how traders should approach a trade
- How 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 607 (formerly 11Ac1-3) reports re payment for orderflow practices
 - Rule 606 (formerly 11Ac1-6) reports re order routing practices

Challenges

- Regulatory obstacles
 - Regulatory limits on cross and agency-cross trades
 - Regulatory limits on principal trades
- Client requests to direct trades through specific brokers
 - Cross-subsidization issues
 - Sequencing issues and use of step outs
 - Disclosure issues
 - Due diligence issues
 - Shadow trading concerns
- Information leakage
- Blow outs and transition trades

Current Best Execution Issues

- Soft Dollars
- Gifts and gratuities
- Side-by-Side Trading with Proprietary Accounts & Hedge Funds
- Broker Selection & Broker Votes
- Trading Costs
- Information Leakage
- Joint Trading Desks
- Regulation M issues
- Market Structure Issues

Directed Brokerage Arrangements

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

Trade Sequencing Issues

- Raises tough trading opportunity questions
 - *City of Gainesville v. Montag & Caldwell* litigation (2002)
- 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 or Offer Investment Opportunities

- 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)
- Investment opportunities
 - IPO allocations
- High scrutiny
 - Disclosure may not suffice!

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, does not violate 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 all 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 statement
 - 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 identifying total number of agency trades, and the total amount of commissions or other remuneration received by the broker
 - 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
 - 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 where
 - 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

- Proliferation of error claims prompts insurers to cut coverage
- 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 handling error?
- Who should pay for errors?
- De minimis errors, opportunity costs & windfalls
- Disclosure issues
- Policies and procedures
- Dealing with brokers
- Error accounts
- Performance issues

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