

Morgan Lewis

together

FALL 2007

## Compliance Trading Issues Impacting Institutional Investors



Morgan, Lewis & Bockius LLP

ICI 2007 Equity, Fixed-Income & Derivatives Markets Conference

# 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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