

NRS 22nd Annual Spring Compliance Conference
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Portfolio Trading and Best Execution

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Portfolio Trading and Best Execution

- Changing Landscape
- SEC Exam Focus
- Process and Paperwork
- Factors in Best Execution
- Conflicts in Broker Selection
- Monitor, Measure & Test
- Focus on RIA Trading Platforms
- Trade Aggregation
- Trade Allocation
- Portfolio Pumping
- Agency & Agency-Cross Trades
- Principal Trades
- Cross Trades
- Trade and Handling Errors
- Current Areas of Focus

Changing Landscape

- Economics
- Market practice
- Scrutiny

SEC Examination Focus

- Traditional focus
 - Process – “Periodic and systematic” review
 - Written best execution policy
 - Best execution committee
- Emerging areas of scrutiny
 - Adequacy of procedures
 - Documentation of analytical process
 - Testing
 - Soft dollars

Process and Paperwork

- Focus on process – Should reflect the size and shape of your firm
- 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 outside evaluation services if trading volume merits
 - Consider conflicts
 - Document steps taken
 - Consider the need and adequacy of disclosures to clients
- “Periodic and systematic” review
 - Review the process and results periodically
 - Monitor and test the process, controls and disclosures implemented

Factors in Best Execution

- Execution capability/order handling
- Price improvement?
- Need for speed
- Commission or equivalents
- Ability to execute orders of significant size
- Willingness to commit capital
- Access to markets
- Difficulty of markets and trade management
- Low trade errors & willingness to correct their mistakes
- Familiarity
- Financial stability
- Service
- Value of research provided
- 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

Conflicts in Broker Selection

- Receipt of soft dollar benefits
- Use of brokers that refer business or distribute mutual fund shares
- Preferential access to IPOs and investment opportunities
- Use of affiliated brokers
- Directed brokerage & use of step outs
- Trade sequencing (who goes 1st)

Monitor, Measure & Test

- Monitoring
 - Established services (e.g., Plexus, ITG & Abel Noser)
 - Transaction cost analysis
 - SEC “Dash” reports
- Testing
- Red flags

Focus on RIA Trading Platforms

- Who is responsible for best execution?
- Does the platform support multi-broker executions?
 - Prime Brokerage
 - Step Outs
 - DVP

Focus on Fixed Income

- Beneficial ownership disclosure requirements for convertible securities
- Best execution
- Books and records, and retention
- Contractual arrangements, including ISDA, repo and other master contracts and association rules (EMTA)
- Cross trades (Rule 17a-7 and Section 206(3), etc.)
- Cross market arbitrage
- ERISA issues
- Insider trading issues (including Reg FD, “Chinese Wall” and other confidentiality issues, and communications with issuers, debtors, indenture trustees, etc.)
- Lending issues
- Liquidity issues for mutual funds
- Obtaining soft dollar research on a fixed income transactions, including issues under Section 28(e) (including agency trading to generate soft dollar credits) and issues with new fixed income issues
- Parking and prearranged transactions
- Portfolio pumping (where transparency exists)
- Pricing & valuation
- Reg M issues for convertible securities and corporate non-investment-grade securities
- Risk monitoring
- Money market funds under Rule 2a-7
- Derivatives issues for mutual funds
- Special settlement issues with attached rights and warrants
- Structure of trading desk, including separation of fixed income portfolio managers and traders
- Surveillance (*i.e.*, to avoid Joe Jett/Kidder situations)
- Trade allocation
- Trade errors
- Use of leverage and margin (e.g., under Reg X and 1940 Act Rules)
- Valuation

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 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

- More dicey issue than trade aggregation
- SMC's suggested procedures
 - Prepare pre-trade allocation report
 - Follow pre-trade allocation report
 - Except where all accounts receive “fair and equitable treatment” and reason is documented
 - Adviser documents its allocation practices
- Allocation methods
- Disclosure

Trade Allocation

- Tough issues
 - Proprietary and performance fee accounts
 - 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 & 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

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

Current Areas of Focus

- Information issues
 - Information leakage
 - Insider trading
 - PIPES
- Wrap/SMA trading
- Conflicts & gifts
- Disclosure

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