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C O U N S E L O R S   A T   L A W

# Best Execution, Brokerage Practices & Changes to Soft Dollar Requirements

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# Best Execution, Brokerage Practices & Changes to Soft Dollar Requirements

- 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

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- 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

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- 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

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- 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

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- Broker monitoring
  - Types of services used
  - Number of services used
- Broker Evaluation -- Usefulness of “Dash” Reports?

# Challenges

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- 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

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- Soft Dollars
- Side-by-Side Trading with Proprietary Accounts & Hedge Funds
- Broker Selection & Broker Votes
- Trading Costs
- Information Leakage
- Joint Trading Desks
- Market Structure Issues

# Soft Dollars

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- UK Financial Services Authority
- U.S. Congressional Consideration
  - Fund disclosure of arrangements
  - Board oversight
  - Other changes (or elimination)
- SEC & NASD Sweeps
- NASD Staff Report
- Expected SEC Staff Legal Bulletin

# Soft Dollars - Current Focus of Change “Boiled Down”

- Unbundling cost of research and brokerage embedded in full-service brokerage commissions
  - Should the cost of products and services obtained with commissions be quantified with greater transparency?
- Stricter view of what is research and brokerage
  - Research: Does it have intellectual or analytical content?
  - Role of Providing Broker: Is it actually involved in the trades generating the commissions?

# Five Steps to Adapt to Coming Changes in Soft Dollar Regulation

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- ① Assess current practices and arrangements
- ② Align current practices and arrangements to new requirements
- ③ Confirm revised arrangements with soft dollar brokers
- ④ Assess your contract and ADV disclosure and make any needed changes
- ⑤ Assess your internal and compliance environment in light of SEC recommended practices

# Directed Brokerage Arrangements

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- 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 mutual funds participate on terms no less advantageous than others
  - Aggregation of client orders does not violate Section 206 if
    - Adviser discloses aggregation practices in Form ADV and separately to existing clients
- No advisory account, including a proprietary account, is favored over any other
- Each client participates at the average share price, with all transaction costs shared pro rata
- Pretzel & Stouffer no-action letter (1995)
  - Q&A
  - Section 17j-1 issues
- Mass Mutual no-action letter (2000)
  - Private placements

# Trade Allocation

- Raises more difficult issues than trade aggregation
- SMC's suggested procedures
  - Adviser prepares pre-trade allocation statement for each trade
  - Shares generally are allocated in accordance with the allocation statement
    - Exceptions only where all accounts receive “fair and equitable treatment” and reason for exception is documented
  - Adviser keeps records of its allocation practices
- 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
  - Slocum, Gordon & Co. (2002)
  - Edward F. Gobora (2002)
  - Zion Capital (2001)
  - Monetta Financial (2000)
  - Nicholas-Appelgate (1999)

# 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

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- 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

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- 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 “handling error” claims prompts many 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