

# Investment Adviser Compliance Forum

Best Execution & Brokerage Practices: Soft Dollars, Directed  
Brokerage, May 2004

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# Best Execution & Brokerage Practices

- Current Best Execution Issues
- Broker selection
- Trade aggregation and allocation
- Agency and agency-cross trades
- Principal trades
- Cross trades
- Interpositioning
- Soft dollars
- Directed broker arrangements
- Trade sequencing
- Broker-dealers that refer business or offer investment opportunities
- Trade errors

# Current Best Execution Issues

- Broker Selection & Broker Votes
- Trading Costs
- Information Leakage
- Side-by-Side Trading with Proprietary Accounts & Hedge Funds
- Joint Trading Desks
- Market Structure Issues
  - ITS “Trade Through” Rule
  - Regulation NMS
  - Role of Specialists
  - Market Fragmentation
  - Questions about the SRO Model

# Soft Dollars

- UK Financial Services Authority
  - CP-176 proposal
    - Exclude market pricing & information services
    - Require managers to rebate cost of bundled services
  - PS 04/13
- U.S. Congressional Consideration
  - Fund disclosure of arrangements
  - Board oversight
  - Other changes (or elimination)
- Industry Proposals
  - ICI
  - Fidelity
- SEC initiatives
  - Q&A release - reining in practices?
  - SEC Task force
- NASD Spring 2004 sweep



# 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
  - *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 Management (2001)
  - Monetta Financial (2000)
  - Nicholas-Appelgate (1998)

# 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 plan fiduciary must agree in writing
  - Arrangement must be terminable
  - Broker must send the independent plan fiduciary
    - In the 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)
    - Proposed 2002 rule-making
  - 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 proper valuation
- Inadvertent crosses
  - “Blind Pool” Exception
    - Delta Government Options no-action letter
    - ERISA legislative history
  - Basic requirements
    - Orders must be bona fide
    - No pre-arrangement as to price or 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 “handling error” claims prompts many insurers to cut coverage
- Enforcement focus
  - *M&I Investment Management* (1992) – failure to supervise
  - *Dimitri Balatsos* (1992) – fraud & recordkeeping violations
  - *Jack Allen Pirrie* (1991) – use of “Soft Dollars”
  - *First Capital Strategist* (1997) – failure to supervise, misrepresentation of internal controls & overstatement of 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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