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The Life Cycle of a Trade

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The Life Cycle of a Trade: Current Perspectives and Issues with Investment Adviser Trading

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I. OVERVIEW

A. The past few years have witnessed unprecedented changes in the landscape for trading and in the structure and operation of our capital markets – affecting both buyside and sellside participants. These changes include the evolution of new categories of sellside participants, including proprietary trading firms and hedge funds, and the morphing of buyside firms into sellside firms (and vice versa).

B. These changes also include the emergence of new regulatory schemes in Europe through the European Union's Markets in Financial Instruments Directive (or MiFID) and created a new paradigm for best execution that, in general, treats buyside and sellside firms alike and yet differentiates between firms that merely transmit orders for execution from firms that execute orders, including by selecting among venues. These changes also include initiatives by the UK Financial Conduct Authority and the European Securities and Markets Authority (ESMA), especially recently in the soft dollar context.

C. The changes, plus the past dislocations in the capital markets, prompted the SEC to launch a public reassessment of how our equity capital markets function and ought to be regulated given the SEC's often conflicting mandates under the Securities Exchange Act of 1934 ("Exchange Act"). This effort is reflected in the SEC's ambitious 2010 Concept Release, discussed below, which spans a wide array of current market structure issues, including high frequency trading, order routing, market data linkages, and undisplayed or "dark" liquidity.

D. On June 5, 2014, SEC Chair Mary Jo White gave a speech regarding current equity market structure issues in which she discussed potential regulatory enhancements of the equity markets, including, among other things, with respect to dark pools.[1] Chair White discussed the ways in which dark pools lack transparency, including that they do not publicly display quotes or provide pre-trade price transparency, provide limited information about how they operate, and do not disclose the identities of the participants. Chair White indicated that she has asked the staff for a recommendation "to expand the information about ATS operations submitted to [the SEC] and to make the information available to the public" and stated that the

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[*] Copyright 2015 Morgan, Lewis & Bockius LLP. All rights reserved. Prior versions of this outline were prepared with the help of associates Kaitlyn Piper and Ignacio Sandoval. The portions of this outline on current enforcement actions are drawn from our publications, *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2012 Year in Review,* available at http://www.morganlewis.com/pubs/LIT_2012YearInReview.pdf and *Select Broker-Dealer, Investment Adviser, and Investment Company Enforcement Cases and Developments: 2013 Year in Review,* available at http://www.morganlewis.com/pubs/Securities_LF_2013YearInReview_19feb14.pdf

[1] Mary Jo White, Chair, Secs. and Exch. Comm'n, Remarks Before the Sandler O'Neill & Partners, L.P. Global Exch. and Brokerage Conference: Enhancing our Equity Market Structure (June 5, 2014).

SEC "must continue to examine whether dark trading volume is approaching a level that risks seriously undermining the quality of price discovery provided by lit venues."

E. The SEC has also taken concrete action in a number of areas touching on market structure and operation, including pending proposals dealing with flash orders, non-public trading interest (including dark pools of liquidity), and risk management controls for broker-dealers giving "naked" market access to customers, as well as amendments to Regulation SHO that impose a short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold short. While these actions directly impact sellside market participants, they invariably impact buyside participants like investment advisers, including in how they seek best execution in this changing landscape of trading and market structure. The SEC also adopted in 2014 a series of rules as part of proposed Regulation SCI which, when they take effect, will require certain key market participants, including certain self-regulatory organizations, alternative trading systems and clearing agencies, to have policies and procedures in place surrounding technology, including the design, development, testing, maintenance of technology systems that are integral to their operations.

II. BEST EXECUTION FOR INVESTMENT ADVISERS

A. The Fiduciary Duty to Seek Best Execution. As the landscape for trading has changed in recent years, the trading practices of investment advisers also have changed to adapt. Trading and best execution decisions for advisers pose complex issues, including the choice of broker-dealers to execute trades, venues for execution, information leakage, efforts to gauge transaction costs and conflicts issues that cloud the analysis of best execution and related judgments.

B. Investment Advisers as Fiduciaries. By way of background, neither the Investment Company Act of 1940, as amended ("Investment Company Act") nor the Investment Advisers Act of 1940, as amended (the "Advisers Act") expressly delineate the fiduciary duties of registered investment advisers.[2] However, the U.S. Supreme Court has held that investment advisers are fiduciaries who have an affirmative duty to act in utmost good faith and provide full and fair disclosure of all material facts.[3]

C. The Duty to Seek Best Execution. Under common law, two of the primary duties owed by a fiduciary are the duty of care and the duty of loyalty. As a fiduciary, an investment

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[2] *SEC v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 194 (1963) (citations omitted) ("Capital Gains"). As a general rule, the nature of an investment adviser's fiduciary duties is determined by reference to principles of common law applicable to fiduciaries. Frankel, *The Regulation of Advisers – Mutual Funds and Investment Advisers* at §14.01 (2002 Supp.) ("Frankel"). *See also* Investment Advisers Act Release No. 40 (Jan. 5, 1945) ("It is clear, however, that investment advisers, in addition to complying with the federal law, are subject to whatever restrictions or requirements the common law or statutes of the particular state impose with respect to dealings between persons in a fiduciary relationship."). The extent of an investment adviser's duties, like the duties of other fiduciaries, depends on the expertise they represent themselves to have, their control over clients' assets and investment decisions, and the degree of clients' reliance on the advisers. *See* Frankel at § 13.01[A].

[3] *Capital Gains*: *Transamerica Mortgage Advisers v. Lewis*, 444 U.S. 11, 17 (1979).

adviser has the duty to perform its activities in a competent manner.[4] Principles of agency law provide that, unless otherwise agreed, an investment adviser must act solely for the benefit of the client in all matters connected with the relationship.[5] A specific duty flowing from an adviser's duties of care and loyalty is the duty to seek best execution of client transactions.[6] An investment adviser must seek to execute securities transactions for its clients in such a manner that the client's total cost or proceeds in each transaction – to the extent ascertainable – is the most favorable under the circumstances. In seeking to achieve best execution, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the account under the circumstances. Accordingly, an investment adviser may take into account the full range and quality of a broker's services in selecting broker-dealers including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser, as well as other factors.[7]

D. The Duty of Loyalty – Conflicts of Interest and Disclosure. Inextricably related to the duty of loyalty is that, unless the client otherwise agrees, an investment adviser may not act for persons whose interests conflict with those of the adviser's client or deal with the client as an adverse party in a transaction connected with the adviser's relationship with the client.[8] However, under common law agency principles, an investment adviser is permitted to modify its duty of loyalty through clear disclosure and informed consent. In other words, an adviser can engage in a transaction even when the adviser is faced with a potential or actual conflict of interest, provided that the adviser informs its client in advance and obtains the client's consent.[9] Registered investment advisers, of course, are subject to certain provisions governing specific conflicts of interest that disclosure and consent do not completely resolve, *e.g.*, Section 10(f), Section 17(a) of the Investment Company Act.

E. Best Execution – Brokers and Advisers. All broker-dealers and investment advisers have a legal duty to seek the best execution of their customers' and clients' securities

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4 The duty of care requires a fiduciary to make decisions "only after paying attention, getting the relevant information, and deliberating. This is the basis for the fiduciary duty of care." Frankel at 13-7.

5 *See* Section 387 of the Restatement of Agency (Second) (1958) (the "Restatement").

6 *See, e.g., Disclosure by Investment Advisers Regarding Soft Dollar Practices*, Investment Advisers Act Release No. 1469 (Feb. 14, 1995) (an investment adviser has a "fundamental obligation under the Advisers Act (and state law) to act in the best interest of its clients. This duty requires the adviser to obtain best execution of client transactions."); see also *Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices.,* Investment Company Act Release No. IC-28345 (July 30, 2008) (the "Proposed 2008 Guidance").

7 Exchange Act Release No. 23170 (Apr. 23, 1986) ("1986 Release").

8 *See* Restatement Sections 389 and 394.

9 *See, e.g.*, Restatement Sections 390 and 394. "One employed as agent violates no fiduciary duty to the principal by acting for another party to the transaction if he makes full disclosure of all relevant facts which he knows or should know, or if the principal otherwise knows of them and acquiesces in the agent's conduct.... The agent's disclosure must include not only the fact that he is acting on behalf of another party, but also all facts which are relevant in enabling the principal to make an intelligent determination." Comment b to Restatement Section 392; see also Comment a to Restatement Section 390. *See also* Frankel at § 13.01[B][1] ("the rules of the common law are mostly default rules, which [clients] can waive upon disclosure").

transactions. The general duty to seek best execution for both broker-dealers and investment advisers derives from common law agency principles and fiduciary obligations.[10] Over the years, the best execution obligations for both broker-dealers and investment advisers have developed into multi-element analyses, but some of the elements differ between the two types of entities. For example, a broker-dealer's best execution obligation largely focuses on the price at which the client's order is executed in the marketplace, without considering the amount of commission that the broker-dealer charges.[11] On the other hand, an investment adviser's best execution obligation focuses on the client's total transaction cost, including the commission that the client pays the broker-dealer executing the transaction.

1. Broker-Dealers. In addition to the common law and fiduciary principles, the duty of best execution for broker-dealers has been addressed in SEC releases,[12] judicial opinions,[13] and self-regulatory organization ("SRO") rules.[14] As noted above, commissions are generally not included in the determination of whether a broker-dealer is achieving best execution. However, broker-dealers are subject to separate legal restrictions on the amount of commission that they may charge.

2. Broker-Dealers' Duty of Best Execution.

a. As a general matter, the duty of best execution requires a broker-dealer to seek the most advantageous terms for its customers' orders reasonably available under the circumstances. However, the SEC has recognized that obtaining best execution does not simply mean obtaining the best price or the fastest execution. The SEC has stated that factors other than price and speed may be relevant to best execution, including (1) the size of the order; (2) the trading characteristics of the security involved; (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information; and (4) the cost and difficulty associated with achieving an execution in a particular market center.[15]

b. The determination of whether a broker-dealer is satisfying its best execution obligation does not necessarily require an order-by-order evaluation. In fact, the SEC has recognized that it could be impractical for a broker-dealer that handles a large volume of orders to make execution decisions on each individual order.[16] Accordingly, the SEC has stated

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10 *See, e.g.*, *Hall v. Paine*, 224 Mass. 62 (1916); *see also* Restatement Section 424.

11 The reasonability of commissions or other charges imposed by broker-dealers are governed primarily under self-regulatory organization rules relating to fair prices for services and, in some circumstances, suitability.

12 *See, e.g.*, Securities Exchange Act Release Nos. 49325 (Feb. 26, 2004) ("Regulation NMS Proposing Release") and 43590 (Nov. 17, 2000) ("Execution Quality Release"), and 37619A (Sept. 6, 1996) ("Order Handling Rules Release").

13 *See, e.g.*, Newton v. Merrill Lynch, 135 F.3d 266 (3rd Cir. 1998).

14 *See, e.g.*, FINRA Rule 5310 (providing that broker-dealers must use reasonable diligence to ascertain the best market for a security, and buy or sell the security in such market so that the resulting price to the customer is as favorable as possible under prevailing market conditions)

15 *See* Regulation NMS Proposing Release, Execution Quality Release.

16 *See* Exchange Act Release No. 36130 (Sept. 29, 1995); *see also* Order Handling Rules Release.

that automated routing or execution of customer orders is not necessarily inconsistent with best execution.[17] However, when a broker-dealer does not make execution decisions on an order-by-order basis, the broker-dealer must carry out a regular and rigorous review of the quality of market centers to evaluate its best execution practices, including the determination of the markets to which it routes customer order flow.[18] In conducting that review, the broker-dealer must consider whether different markets may be more suitable for different types of orders or particular securities.[19] In addition, broker-dealers must periodically examine their best execution practices in light of market and technology changes and modify those practices if necessary to enable their clients to obtain the best reasonably available prices.[20]

3. Investment Advisers.

a. An investment adviser's duty to seek best execution involves seeking the best total transaction cost for its clients, including commissions under the circumstances. More specifically, the SEC stated in a 1986 interpretive release that an investment adviser "must execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances."[21] However, the SEC has also stated that the amount of the transaction cost is not the sole determinative factor and that an investment adviser should consider the full range and quality of a broker-dealer's services, including, among other things, execution capability, the value of research provided, commission rates, and responsiveness to the investment adviser.[22]

b. As part of its duty of best execution, an investment adviser must periodically and systematically evaluate the execution performance of all broker-dealers executing the adviser's transactions.[23] The SEC has held that an investment adviser must periodically review the quality of execution of its client's transactions even when the client has an existing relationship with the executing broker-dealer that predates the customer's

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[17] Order Handling Rules Release.

[18] *Id.*

[19] *Id.; see also* NASD Notice to Members 01-22 (Apr. 2001) (stating that "[t]he focus of the [regular and rigorous review] analysis is to determine whether any 'material' differences in execution quality exist and, if so, to modify the firm's routing arrangements or justify why it is not modifying its routing arrangements. This analysis must compare the quality of the executions the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the firm could obtain from competing markets and market centers. Accordingly, a broker/dealer must evaluate whether opportunities exist for obtaining improved executions of customer orders.").

[20] *Newton*, 135 F.3d at 271; *see also* Order Handling Rules Release.

[21] 1986 Release & Proposed 2008 Guidance; *see In the Matter of Jamison, Eaton & Wood*, Investment Advisers Act Release No. 2129 (May 15, 2003) ("Jamison"); *In the Matter of Renberg Capital Management, Inc.*, Investment Advisers Act Release No. 2064 (Oct. 1, 2002); *In the Matter of Portfolio Advisory Services, LLC*, Investment Advisers Act Release No. 2038 (June 20, 2002); *see also In the Matter of Kidder, Peabody & Co., Inc.*, Investment Advisers Act Release No. 232 (Oct. 16, 1968); Rule 206(3)-2(c) under the Advisers Act (recognizing an investment adviser's duty to seek best execution of its customers' transactions).

[22] 1986 Release; *Jamison*.

[23] 1986 Release; *Jamison; In the Matter of Portfolio Advisory Services*.

relationship with the investment adviser.[24] Moreover, while the SEC expressly permits broker-dealers to determine their satisfaction of best execution obligations based on an overall review of execution quality, the SEC staff has implicitly endorsed the notion that both the Investment Company Act and the Advisers Act may require an investment adviser to analyze its execution quality on individual transactions under certain circumstances.[25]

c. An adviser's specific duty to seek best execution varies with individual client trading arrangements because the concept of best execution is, as noted above, circumstantial. Some clients limit their adviser's choice of broker-dealers or the trading arrangements for their accounts. For example, in directed brokerage or commission recapture arrangements, a client directs an investment adviser to use a specific broker-dealer to execute some or all transactions for an advised account. Under these arrangements, known as "directed brokerage arrangements," an investment adviser's duty of best execution is substantially reduced, if not completely obviated, because the adviser's discretion to choose the executing broker-dealer is greatly curtailed, if not eliminated.[26]

F. Proposed Guidance to Fund Boards. In August 2008, the SEC proposed guidance to mutual fund boards for fulfilling their oversight and monitoring responsibilities for advisers' best execution obligations and the conflicts that arise with the use of soft dollar arrangements in particular under Exchange Act Section 28(e) (discussed below).[27] The Proposed 2008 Guidance, which was never adopted, claimed it would not impose any new requirements on fund directors, but rather seeks to provide directors with a flexible framework to evaluate the adviser's best execution obligations. However, the Proposed 2008 Guidance was controversial in the level of detailed scrutiny proposed to be expected of directors. Specifically, the Proposed 2008 Guidance suggested that fund directors ascertain how a fund adviser:

1. Makes trading decisions;

2. Selects broker-dealers;

3. Determines best execution and evaluates execution quality (including how best execution may be affected by the use of alternative trading systems);

4. Negotiates and evaluates commission rates and how transaction costs are measured generally;

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[24] *Jamison*.

[25] *See SMC Capital Inc.*, SEC No-Action Letter (pub. avail. Sept 5, 1995) ("SMC Capital") (granting no-action relief under Section 206, Section 17(d) and Rule 17d-1 to an investment adviser's order aggregation arrangement where the adviser agreed not to aggregate transactions unless it believed that the aggregation was consistent with its duty to seek best execution).

[26] *Jamison* (finding that an investment adviser owed a duty of best execution to a client who executed through a broker-dealer with which it had a previously-established relationship, where the client had not executed a separate writing specifically directing the use of that broker-dealer)

[27] *Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices.,* Investment Company Act Release No. IC-28345 (July 30, 2008) (the "Proposed 2008 Guidance").

5. Evaluates and compares the execution of "execution only" trades;

6. Evaluates the performance of traders and broker-dealers;

7. Oversees and monitors sub-adviser activities;

8. Conducts portfolio transactions with affiliates;

9. Trades fixed income securities;

10. Evaluates trade execution quality with for fixed income and other instruments traded on a principal basis; and

11. Conducts and monitors international trades.

III. SEC CONCEPT RELEASE ON EQUITY MARKET STRUCTURE

A. Overview.

1. While trading issues from buyside and sellside perspectives tend to be viewed and analyzed in different but related ways as reflected in the discussion above, one of the developments having the greatest potential impact on investment advisers and their buyside activities is the prospect of change in the structure and regulation of the equity markets and their participants. In perhaps its broadest conceptual stroke since the SEC's 1994 "Market 2000" Report,[28] on January 13, 2010, the SEC published a release based on the SEC staff's broad review of changes in the current equity market structure and the policy and regulatory implications.[29] The Concept Release, which drew over 400 comments, is still under consideration but has received renewed focus.[30]

2. The purpose of the Concept Release was to communicate the manner in which the SEC is seeking to comprehensively evaluate equity market structure performance and assess whether market structure rules have kept pace with economic conditions, changes in trading technology and practices. The Concept Release spans a wide array of current market structure issues, including high frequency trading, order routing, market data linkages, and undisplayed, or "dark" liquidity. Public comments are due April 21, 2010.

3. The SEC's current review of equity market structure, while conceptual in focus, has already prompted several rulemaking proposals, including:

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[28] SEC Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments* (1994).

[29] *See* SEC, *Concept Release on Equity Market Structure,* Exchange Act Release No. 61358 (January 2010) (the "Concept Release").

[30] *See* Chair Mary Jo White, Speech, Focusing on Fundamentals: The Path to Address Equity Market Structure (Oct. 2, 2013).

a. Flash Orders. One proposal would eliminate the exception for flash orders from Exchange Act quoting requirements.[31]

b. Non-Public Trading Interest. Another would address certain practices associated with non-public trading interest, including dark pools of liquidity.[32]

c. Naked Access. On the same day the SEC issued the Concept Release, the SEC proposed a rule to address the risk management controls of broker-dealers with market access. The SEC proceeded to adopt that rule, Rule 15c3-5, in November 2010.[33]

d. Amendments to Reg SHO. One month later, on February 26, 2010, the SEC adopted amendments to Regulation SHO to impose a short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold short.[34]

B. Framework and Goals Established by the Exchange Act.

1. Five Objectives. Exchange Act Section 11A provides the framework for the SEC's approach to market structure regulation and directs the SEC to facilitate the establishment of a national market system in accordance with certain findings and five specific (though occasionally conflicting) objectives.

a. Economically efficient execution of securities transactions;

b. Fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

c. The availability to brokers, dealers, and investors of information on quotations and transactions in securities;

d. The practicability of brokers executing investors' orders in the best market; and

e. An opportunity, consistent with efficiency and best execution, for investors' orders to be executed without the involvement of a dealer.

2. As the SEC noted in the Concept Release, the five objectives in Section 11A can, "at times, be difficult to reconcile," and the SEC's aim has been to balance various considerations.

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[31] Exchange Act Release No. 60684 (September 18, 2009), 74 FR 48632 (September 23, 2009) ("Flash Order Release").

[32] Exchange Act Release No. 60997 (November 13, 2009), 74 FR 61208 (November 23, 2009) ("Non-Public Trading Interest Release").

[33] *See* SEC, Risk Management Controls for Broker-Dealers with Market Access, Securities Exchange Act Release No. 63241, 75 FR 69792 (November 15, 2010).

[34] Exchange Act Release No. 61595 (February 26, 2010).

a. For example, the objective of maximizing order interaction to match investor orders may conflict with the objective of promoting market competition, which can lead to fragmentation in order flow for a stock that, in turn, inhibits order interaction.

b. Competition among trading venues to provide specialized services for investors also can "lead to practices that may detract from public price transparency" while "mandating the consolidation of order flow" would inhibit competition.

C. Request for Comments. The bulk of the Concept Release asks for industry and public comment on a broad array of issues, including the following, which are extracted from the Concept Release:

1. Fungibility of Securities with Other Products. "Comment is requested, however, on the extent to which the issues identified in this release are intertwined with other markets. For example, market participants may look to alternative instruments if they believe the equity markets are not optimal for their trading objectives. Should the SEC consider the extent to which instruments substitute for one another in evaluating equity market structure?"

2. Globalization. "How does global competition for trading activity impact the U.S. market structure? Should global competition affect the approach to regulation in the U.S.? Will trading activity and capital tend to move either to the U.S. or overseas in response to different regulation in the U.S.? How should the SEC consider these globalization issues in its review of market structure"?

3. Performance of Secondary Markets.

a. Interests on Long-Term Investors versus Professional Traders. "In assessing the performance of the current equity market structure and whether it is meeting the relevant Exchange Act objectives, the SEC is particularly focused on the interests of long-term investors. These are the market participants who provide capital investment and are willing to accept the risk of ownership in listed companies for an extended period of time. Unlike long-term investors, professional traders generally seek to establish and liquidate positions in a shorter time frame. Professional traders with these short time frames often have different interests than investors concerned about the long-term prospects of a company."

(i) "Comment is requested on the practicality of distinguishing the interests of long-term investors from those of short-term professional traders when assessing market structure issues. In what circumstances should an investor be considered a "long-term investor"? If a time component is needed to define this class of investor, how should the SEC determine the length of expected ownership that renders an investor "long-term"? Under what circumstances would a distinction between a long-term investor and a short-term professional trader become unclear, and how prevalent are these circumstances? To the extent that improved market liquidity and depth promote the interests of long-term investors by leading to reduced transaction costs, what steps should the SEC consider taking to promote market liquidity and depth?"

b. Imbalance of Trading Tools Favoring Large Institutions. "[H]as the current market structure become so dispersed and complex that only the largest institutions

can afford to deploy their own highly sophisticated trading tools? If so, are smaller institutions able to trade effectively? Some broker- dealers offer sophisticated trading tools, such as smart routing and algorithmic trading. How accessible are these trading tools to smaller institutions? Are the costs of paying for these tools so high that they are effectively inaccessible? Moreover, to the extent that a competitive advantage flows from these trading tools, does that competitive advantage help to promote and enable competition, beneficial innovation, and, ultimately, enhanced market quality? Is there a risk that certain competitive advantages may reduce competition or lead to detrimental innovations? To what extent is it important for market participants to be allowed to gain competitive advantages, such as by using more sophisticated trading tools?"

c. Variation in Market Performance by Type of Equity Security. "With respect to corporate equities, for example, the SEC is interested in how market structure impacts stocks of varying levels of market capitalization (for example, top tier, large, middle, and small). A vital function of the equity markets is to support the capital raising function, including capital raising by small companies. The Commission recognizes that small company stocks may trade differently than large company stocks and requests comment specifically on how the market structure performs for smaller companies and whether it supports the capital raising function for them."

d. Metrics. "[W]hat are useful metrics for assessing the performance of the current market structure?"

(i) Traditional Factors and Considerations

(a) Spreads

(b) Speed of execution

(c) Depth. "These metrics include fill rates for limit orders, quoted size at the inside prices, the effect of reserve size and undisplayed size at the inside prices or better, and quoted depth at prices away from the inside."

(ii) Focus on Small Orders / Orders for Individual Investors

(a) Affect of Short-Term Volatility. "[S]hort-term price volatility may harm individual investors if they are persistently unable to react to changing prices as fast as high frequency traders. As the SEC previously has noted, long-term investors may not be in a position to assess and take advantage of short-term price movements. Excessive short-term volatility may indicate that long-term investors, even when they initially pay a narrow spread, are being harmed by short-term price movements that could be many times the amount of the spread."

(b) Metrics for Small Orders? "Comment is requested on whether these metrics that focus on the execution of smaller orders continue to be useful. Which metrics are most useful in today's market structure? Are there other useful metrics not listed above? Are there other relevant metrics that reflect how individual investors are likely to trade? For example, a significant number of individual investor orders are submitted after

regular trading hours when such investors have an opportunity to evaluate their portfolios. These orders typically are executed at opening prices. What are the best metrics for assessing whether individual investor orders are executed fairly and efficiently at the opening? Are there other particular times or contexts in which retail investors often trade and, if so, what are the best metrics for determining whether they are treated fairly and efficiently in those contexts as well?"

(iii) Transaction Costs for Institutional Investors.

(a) Hard to Measure. "Measuring the transaction costs of institutional investors that need to trade in large size can be extremely complex. These large orders often are broken up into smaller child orders and executed in a series of transactions. Metrics that apply to small order executions may miss how well or poorly the large order traded overall. Direct measures of large order transaction costs typically require access to institutional order data that is not publicly available."[35]

(b) Usefulness of Data from Trading Analytics Firms. "Comment is requested on these published analyses generally and whether they accurately reflect the transaction costs experienced by institutional investors. Are there other studies or analyses of institutional trading costs that the SEC should consider? Comment is requested in general on other means for assessing the transaction costs of institutional investors in the current market structure. For example, are any of the measures of short-term volatility discussed above useful for assessing the transactions costs of larger orders and, if so, how?"

(iv) Overarching Trends. "With respect to all of the metrics that are useful for assessing market structure performance for long-term investors, the SEC is interested in whether commenters believe they show improvement or worsening in recent years. For example, do the relevant metrics indicate that market quality has improved or worsened over the last ten years and the last five years? Have markets improved or worsened more recently, since January 2009?"

(a) Affect of Regulation. "Which of the recent developments in market structure do you consider to have the greatest effect on market quality? The Commission wishes to hear about any current regulations that may be harming, rather than improving, market quality. Specifically, how could any current regulations be modified to fit more properly with the current market?"

4. Fairness of Market Structure (is it Unfair to Long Term Investors). "The Commission requests comment on whether the current market structure is fair for long-term investors. For example, the speed of trading has increased to the point that the fastest traders now measure their latencies in microseconds. Is it necessary or economically feasible for long-term investors to expend resources on the very fastest and most highly sophisticated systems or otherwise obtain access to these systems? If not, does the fact that professional traders likely

35 Notably, the discussion of transaction costs and the complexities and imprecision of its measurement are thoughtfully considered in the Division of Investment Management, Memorandum to Chairman William H. Donaldson, *Correspondence from Chairman Richard H. Baker, House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises* (June 9, 2003).

always will be able to trade faster than long-term investors render the equity markets unfair for these investors? Or do the different trading needs and objectives of long-term investors mean that the disparities in speed in today's market structure are not significant to the interests of such investors? In addition, what standards should the SEC apply in assessing the fairness of the equity markets?"

5. Usefulness of Rules 605 and 606. "[C]omment is requested on Rules 605 and 606, which were adopted in 2000. Do these rules need to be updated and, if so, in what respects? Do Rule 605 and Rule 606 reports continue to provide useful information for investors and their brokers in assessing the quality of order execution and routing practices? The Commission notes that Rule 606 statistics reveal that brokers with significant retail customer accounts send the great majority of non-directed marketable orders to OTC market makers that internalize executions, often pursuant to payment for order flow arrangements. Do individual investors understand and pay attention to Rule 605 and 606 statistics? If not, what market participants, if any, make decisions based on this data? Are those decisions beneficial to individual investors?"

a. Needs of Institutional Investors. "[A]re there any approaches to improving the transparency of the order routing and order execution practices for institutional investors that the SEC should consider? For example, do institutional investors currently have sufficient information about the smart order routing services and order algorithms offered by their brokers? Would a regulatory initiative to improve disclosure of these broker services be useful and, if so, what type of initiative should the SEC pursue?"

D. High Frequency Trading

1. "One of the most significant market structure developments in recent years is high frequency trading ("HFT"). The term is relatively new and is not yet clearly defined. It typically is used to refer to professional traders acting in a proprietary capacity that engage in strategies that generate a large number of trades on a daily basis."

2. "Other characteristics often attributed to proprietary firms engaged in HFT are: (1) the use of extraordinarily high-speed and sophisticated computer programs for generating, routing, and executing orders; (2) use of co-location services and individual data feeds offered by exchanges and others to minimize network and other types of latencies; (3) very short time- frames for establishing and liquidating positions; (4) the submission of numerous orders that are cancelled shortly after submission; and (5) ending the trading day in as close to a flat position as possible (that is, not carrying significant, unhedged positions over-night). Estimates of HFT volume in the equity markets vary widely, though they typically are 50% of total volume or higher. By any measure, HFT is a dominant component of the current market structure and is likely to affect nearly all aspects of its performance."

3. Questions on Trading Strategies.

a. HFT Strategies in General. "Comment generally is requested on the strategies employed by proprietary firms in the current market structure. What are the most frequently used strategies? What are the key features of each strategy? What technology tools

and other market structure components (such as exchange fee structures) are necessary to implement each strategy? Have any of these strategies been a competitive response to particular market structure components or to particular problems or challenges in the current market structure? Does implementation of a specific strategy benefit or harm market structure performance and the interests of long-term investors? Is it possible to reliably identify harmful strategies through, for example, such metrics as adding or taking liquidity, or trading with (momentum) or against (contrarian) prevailing price movements? Are there regulatory tools that would address harmful strategies while at the same time have a minimal impact on beneficial strategies? Do commenters believe that the overall use of harmful strategies by proprietary firms is sufficiently widespread that the SEC should consider a regulatory initiative to address the problem? What type of regulatory initiative would be most effective? For example, should there be a minimum requirement on the duration of orders (such as one second) before they can be cancelled, whether across the board, in particular contexts, or when used by particular types of traders? If so, what would be an appropriate time period? Should the use of "pinging" orders by all or some traders to assess undisplayed liquidity be prohibited or restricted in all or some contexts? The use of certain strategies by some proprietary firms has, in many trading centers, largely replaced the role of specialists and market makers with affirmative and negative obligations. Has market quality improved or suffered from this development? Is there any evidence that proprietary firms increase or reduce the amount of liquidity they provide to the market during times of stress?"

b. Passive Market Making. "The Commission requests comment on the passive market making strategies of proprietary firms. To what extent do proprietary firms . . . provide valuable liquidity to the market for top-tier, large, medium, and small capitalization stocks? Has market quality improved or worsened as traditional types of liquidity providers have been replaced by proprietary firms? Does the very brief duration of many of their orders significantly detract from the quality of liquidity in the current market structure? For example, are their orders accurately characterized as phantom liquidity that disappears when most needed by long-term investors and other market participants? Or, is the collective result of many different proprietary firms engaging in passive market making a relatively stable quoted market in which there are many quotation updates (primarily updates to size of the NBBO), but relatively few changes in the price of the NBBO? What types of data are most useful in assessing the quality of liquidity provided by proprietary firms?"

(i) Liquidity Rebates. "The Commission requests comment on the volume of high frequency trading geared toward earning liquidity rebates and on the benefits or drawbacks of such trading. Are liquidity rebates unfair to long-term investors because they necessarily will be paid primarily to proprietary firms engaging in passive market making strategies? Or do they generally benefit long-term investors by promoting narrower spreads and more immediately accessible liquidity? Do liquidity rebates reward proprietary firms for any particular types of trading that do not benefit long-term investors or market quality? For example, are there risk-free trading strategies driven solely by the ability to recoup a rebate that offer little or no utility to the marketplace? Are these strategies most likely when a trading center offers inverted pricing and pays a liquidity rebate that is higher than its access fee for taking liquidity? Does the distribution of consolidated market data revenues pursuant to the Plans lead to the current trading center pricing schedules? If so, would there be any benefits to restructuring the Plans and, if so, how?"

c. Arbitrage. "The Commission requests comment on arbitrage strategies and whether they benefit or harm the interests of long-term investors and market quality in general. To what extent do proprietary firms engage in the types of strategies described above? For example, what is the volume of trading attributable to arbitrage involving ETFs (both in the ETF itself and in any underlying securities) and has the increasing popularity of ETFs in recent years significantly affected volume and trading patterns in the equity markets? If so, has the impact of ETF trading been positive or negative for long-term investors and overall market quality? In addition, to what extent are arbitrage strategies focused on capturing pricing differences among the many different trading centers in NMS stocks? For example, do these arbitrage strategies significantly depend on latencies among trading center data feeds and the consolidated market data feeds? Are these strategies beneficial for long-term investors and market structure quality? If not, how should such strategies be addressed?"

d. Structural.

(i) "Some proprietary firm strategies may exploit structural vulnerabilities in the market or in certain market participants. For example, by obtaining the fastest delivery of market data through co-location arrangements and individual trading center data feeds (discussed below in section IV.B.2.), proprietary firms theoretically could profit by identifying market participants who are offering executions at stale prices."

(ii) "Are proprietary firms able to profitably exploit these structural vulnerabilities? To what extent do proprietary firms engage in the types of strategies described above? What is the effect of this trading on market quality?"

e. Directional. "The Commission requests comment on two types of directional strategies that may present serious problems in today's market structure – order anticipation and momentum ignition."

4. Tools.

a. Co-Location Services. The SEC commented that co-location services offered by securities exchanges should be brought within the framework of exchange regulation. Specifically, the SEC stated, "[t]he Commission believes that the co-location services offered by registered exchanges are subject to the Exchange Act. Exchanges that intend to offer co-location services must file proposed rule changes and receive approval of such rule changes in advance of offering the services to customers. The terms of co-location services must not be unfairly discriminatory, and the fees must be equitably allocated and reasonable."

b. Trading Center Data Feeds. In the area of trading center data feeds offered by many exchanges and ECNs, the SEC seeks broad comment: "The Commission requests comment on all aspects of the latency between consolidated data feeds and individual trading center data feeds. What have market participants experienced in terms of the degree of latency between trading center and consolidated data? Is the latency as small as possible given the necessity of the consolidation function, or could plan processor systems be improved to significantly reduce the latency from current levels, while still retaining the high level of reliability required of plan processors? More broadly, is the existence of any latency, or the

disparity in information transmitted, fair to investors or other market participants that rely on the consolidated market data feeds and do not use individual trading center data feeds? If so, should the unfairness be addressed by a requirement that trading center data be delayed for a sufficient period of time to assure that consolidated data reaches users first? Would such a mandated delay adequately address unfairness? Would a mandatory delay seriously detract from the efficiency of trading and harm long-term investors and market quality? Should the SEC require that additional information be included in the consolidated market data feeds?"

E. Undisplayed Liquidity. The Concept Release also addresses – and seeks broad comment – on "dark" liquidity or trading interest that is available for execution at a trading center, but is not included in the consolidated quotation data that is widely disseminated to the public. Specifically, the SEC seeks comment on the following:

1. Individual Investors.

a. "It appears that a significant percentage of the orders of individual investors are executed at OTC market makers, and that a significant percentage of the orders of institutional investors are executed in dark pools. Comment is requested on the order execution quality provided to these long-term investors. Given the strong Exchange Act policy preference in favor of price transparency and displayed markets, do dark pools and OTC market makers offer substantial advantages in order execution quality to long-term investors? If so, do these advantages justify the diversion of a large percentage of investor order flow away from the displayed markets that play a more prominent role in providing public price discovery? If investors were limited in their ability to use undisplayed liquidity, how would trading behavior change, if at all? What types of activity might evolve to replace undisplayed liquidity if its use were constrained?"

b. "Do individual investor orders receive high quality executions when routed to OTC market makers? For example, does competition among OTC market makers to attract order flow lead to significantly better prices for individual investor orders than they could obtain in the public markets? Do OTC market makers charge access fees comparable to those charged by public markets? Does the existence of payment for order flow arrangements between routing brokers and OTC market makers (and internalization arrangements when the routing broker and OTC market maker orders are routed to public markets), would it promote 'competition in the public markets,' lead to narrower spreads, and ultimately improve order execution quality for individual investors beyond current levels? Finally, are a significant number of individual investor orders executed in dark pools and, if so, what is the execution quality for these orders?"

2. Institutional Investors.

a. "To what extent do dark pools meet this objective of improving execution quality for the large orders of institutional investors? Does execution quality vary across different types of dark pools and, if so, which types? If so, does this difference depend on the characteristics of particular securities (such as market capitalization and security price)?"

b. "As noted above in section IV.C., many dark pools execute orders with reference to the displayed prices in public markets. Does this reference pricing create opportunities for institutional investors to be treated unfairly by improper behavior (such as placing a small order to change the NBBO for a very short period and quickly submitting orders to dark pools for execution at prices affected by the new NBBO)? If so, to what extent does gaming occur? Do all types of dark pools employ anti-gaming tools? How effective are such tools? Finally, are institutional investors able to trade more efficiently using undisplayed liquidity at dark pools and broker-dealers than they are using the undisplayed liquidity at exchanges and ECNs? What are the advantages and disadvantages of each form of undisplayed liquidity? If the use of undisplayed liquidity at dark pools and broker-dealers were curtailed in any way, could institutional investors adjust by using undisplayed liquidity on exchanges and ECNs without incurring higher transaction costs?"

3. Public Price Discovery. "Comment is requested on whether the trading volume of undisplayed liquidity has reached a sufficiently significant level that it has detracted from the quality of public price discovery and execution quality. For example, has the level of undisplayed liquidity led to increased spreads, reduced depth, or increased short-term volatility in the displayed trading centers? If so, has such harm to public price discovery led to a general worsening of execution quality for investors in undisplayed markets that execute trades with reference to prices in the displayed markets?"

IV. CURRENT SOFT DOLLAR ISSUES

A. Overview

1. Commission arrangements between money managers and broker-dealers have been the subject of debate ever since the end of fixed commissions. When Congress abolished fixed commission rates in 1975, it enacted Section 28(e) of the Exchange Act, which provides a safe harbor to protect arrangements in which a money manager might pay more than the lowest available commission rate based on the particular products and services it received from the broker-dealer. These arrangements, known as "soft dollar" arrangements, allow a money manager to take into account all of the brokerage and research products and services that it receives from a broker-dealer in directing its clients' securities transactions, rather than simply considering the broker-dealer's commission rates. Similar types of arrangements have developed in other jurisdictions, including the United Kingdom.

2. Twenty years after issuing its last substantive guidance, the SEC updated its views in 2006 to reflect current industry practices. On July 18, 2006, the SEC issued a revised interpretation of Section 28(e),[36] which followed a proposed interpretation of Section 28(e) that the SEC issued for public comment in October 2005.[37]

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[36] Exchange Act Release No. 54165, 71 FR 41978 (July 24, 2006).

[37] Exchange Act Release No. 52635 (October 19, 2005), 70 FR 61700 (October 25, 2005). The SEC's proposal followed recommendations from the NASD's Mutual Fund Task Force in 2004 as well as a rulemaking initiative adopted in 2005 by the United Kingdom's Financial Services Authority ("FSA").

3. As expected, the SEC largely adopted the guidance that it proposed for determining what constitutes "research" and "brokerage" under Section 28(e). However, the SEC substantially revised its prior guidance regarding arrangements involving money managers and broker-dealers, indicating an intention to provide market participants with greater flexibility in structuring arrangements under Section 28(e). The SEC's illustrative guidance on the types of products and services that constitute research and brokerage appears to be final, for now at least. However, the SEC requested additional comment on its interpretation of eligible arrangements involving money managers and broker-dealers, leaving open at least the possibility that the SEC's guidance in that area may be further modified or refined.

4. The SEC's revised interpretation follows a comprehensive effort by the SEC and its Staff to evaluate the application of Section 28(e) from a practical standpoint. In 2004, then-SEC Chairman William Donaldson set up an internal task force to consider revisions to the SEC's interpretation of Section 28(e). Before the SEC issued its proposed interpretation, that task force met with a large number of industry representatives and worked hard to gather a substantial amount of information and gain a thorough understanding of industry practices in this area. The SEC's release clearly reflects that the task force was successful in this regard, as well as understanding challenges the securities industry faces in harmonizing global requirements governing commission arrangements. The SEC's release includes a detailed analysis of the complicated issues that arise in connection with soft dollars, and the revised guidance reflects the dynamic nature of client commission practices and the changes that have occurred in this area since the SEC last considered these issues 20 years ago.[38]

B. Overview Of Section 28(e)

1. Section 28(e) of the Exchange Act provides a safe harbor for persons exercising investment discretion over an account, under which a person will not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of having caused the account to pay a broker-dealer a higher commission for effecting a trade than another broker-dealer would have charged. However, to receive the benefit of the safe harbor, the person must make a good faith determination that the commission paid is reasonable in relation to the value of the brokerage and research services provided by the broker-dealer.

2. Unlike many other provisions of the Exchange Act, Section 28(e) does not provide the SEC with rulemaking authority to set requirements under the safe harbor.[39] As a result, the SEC has issued guidance on the parameters of the safe harbor over the years through interpretive releases. Historically, the SEC's interpretations have focused on the particular products and services that qualify as "research" or "brokerage" under the safe harbor.

[38] The SEC last considered the substantive issues regarding the scope of products, services, and arrangements that qualify under Section 28(e) in a 1986 interpretive release. Exchange Act Release No. 23170 (August 23, 1986), 51 FR 16004 (August 30, 1986). However, in 2001, the SEC issued an interpretation of Section 28(e) to extend the safe harbor to certain riskless principal transactions on the Nasdaq Stock Market. Exchange Act Release No. 45194 (December 27, 2001), 67 FR 6 (January 2, 2002).

[39] Section 28(e) does provide the SEC with limited authority to adopt recordkeeping requirements. However, the SEC has not adopted rules directly pursuant to that authority.

3. The SEC's 2006 release was somewhat broader than its previous interpretations, and provided guidance on a number of general areas relating to Section 28(e) and soft dollar arrangements. However, the release focused most significantly on two particular areas under the safe harbor: (1) eligible research and brokerage products and services; and (2) eligible arrangements involving money managers and broker-dealers.

C. Eligible Research and Brokerage under the SEC's Revised Interpretation.

1. The SEC's revised interpretation largely adopted the standards it proposed in 2006 for determining the applicability of the safe harbor. Under the revised interpretation, a money manager must carry out a three-step analysis to determine whether a particular product or service falls within the safe harbor:

(1) The money manager must determine whether the product or service constitutes brokerage or research services under Section 28(e);

(2) The money manager must determine whether the product or service actually provides lawful and appropriate assistance in the performance of the money manager's investment decision-making responsibilities; and

(3) The money manager must make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.

Ultimately, the Section 28(e) analysis hinges on whether a particular product or service constitutes "research" or "brokerage." The SEC's revised interpretation included new standards for determining whether particular products and services constitute research or brokerage. Those standards are substantially the same as the standards the SEC proposed in 2006.

2. Eligible Research. To be eligible as research under the revised interpretation of Section 28(e), a product or service must satisfy several requirements:

a. First, the product or service must constitute "advice," "analyses," or "reports."

b. Second, the product or service must satisfy the "subject matter" requirements of Section 28(e) (which the SEC stated should be construed broadly to subsume other topics related to securities and the financial markets) by furnishing:

Advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or

Analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.

c. Third, the product or service must reflect "the expression of reasoning or knowledge."[40]

3. Eligible Brokerage. Consistent with its 2006 proposal, the revised interpretation adopted what the SEC calls a "temporal standard" for determining eligible brokerage. Specifically, the temporal standard provides that brokerage begins when the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. The SEC noted further that brokerage services can include connectivity services and trading software (*e.g.*, T1 lines) where they are used to transmit orders to the broker-dealer.[41]

4. Eligible Products and Services under the Revised Interpretation. The SEC's release included extensive illustrative guidance on products and services that are eligible and ineligible under the safe harbor. In many ways, the SEC's illustrative guidance on specific products and services came as little surprise. For example, the SEC reaffirmed that traditional research reports are eligible under the safe harbor, but computer hardware and accessories that deliver research are not eligible. In addition, the SEC took commenters' suggestions into account in its final interpretation of the products and services that constitute research and brokerage under the safe harbor. As a result, the SEC's guidance shifted during the public comment process in several respects. Exhibit A to this article summarizes the SEC's illustrative guidance, but some of the more notable aspects of the SEC's interpretation of eligible products and services include the following:

a. *Order Management Systems*: In the 2006 proposal, the SEC stated that order management systems would not be eligible under the safe harbor as brokerage (the SEC did not address their eligibility as research). However, the SEC's revised interpretation wisely takes a functional approach to these services, and provides that a money manager may use soft dollars to pay for those aspects of its order management system that otherwise qualify as either brokerage or research (*e.g.*, pre-trade and post-trade analytics, order routing services, algorithmic trading services, or direct market access systems).

b. *Mass-Marketed Publications*: In a departure from its 1986 interpretation, the SEC's revised interpretation provided that mass-marketed publications do not constitute research under Section 28(e). Nevertheless, the SEC stated that the safe harbor does apply to publications that are not mass-marketed, including publications that, among other things, are marketed to a narrow audience; are directed to readers with specialized interests in particular industries, products, or issuers; and have high cost.

c. *"Market" Research*: The SEC's revised interpretation provides that certain types of "market research" are eligible for the safe harbor. For example, eligible

[40] As described below, however, the SEC was somewhat flexible in this respect. For example, the SEC indicated that market data constitutes research under Section 28(e) even though data, literally speaking, might not reflect "the expression of reasoning or knowledge."

[41] However, as described below, the SEC indicated that connectivity services do not constitute research under the revised interpretation.

market research under Section 28(e) can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies. In addition, the safe harbor applies to advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that provides these types of market research).

d. *Proxy Services*: The revised interpretation provided that certain proxy products and services that contain reports and analyses on issuers, securities, and the advisability of investing in securities may be eligible research under Section 28(e), subject to a mixed-use allocation. However, the SEC stated that the safe harbor does not extend to proxy services that assist a money manager in deciding how to vote proxy ballots, or services that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes. Many money managers had paid for these services with soft dollars based on the notion that a manager's proxy voting obligations are related to the investment decision-making process.[42]

5. SEC's Functional Approach.

a. On the whole, the SEC adopted a functional approach to determining the products and services that are eligible under Section 28(e). In many cases, this approach has been helpful to market participants by extending the safe harbor to discrete aspects of a product or service that previously might have been evaluated only in the context of the overall product or service. For example, the SEC's guidance on order management systems recognizes the utility of specific aspects of those products, even where the overlying system might not qualify under the safe harbor. Similarly, the SEC recognized the value of market data and electronic research services, even while excluding the computer equipment and accessories used to deliver them.

b. In other cases this functional approach has required that market participants make finer distinctions among products and services than was previously necessary. For example, the SEC stated that "analytical software that relates to the subject matter of the statute before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor." However, the SEC also stated that quantitative analytical software used to test "what if" scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling does not qualify as "brokerage" under the safe harbor because it falls outside the temporal standard. Nevertheless, the SEC also stated that, if money managers use analytical software to test "what if" scenarios related to adjusting portfolios, asset allocations, or portfolio modeling both for research and non-research purposes, the manager may make a mixed-use allocation for the product under Section 28(e). In any event, given the increasingly complex nature of analytical products, money managers often have to consider both

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[42] *See, e.g.*, Rule 206(4)-6 under the Investment Advisers Act of 1940 (requiring investment advisers to establish written policies and procedures that are reasonably designed to assure that advisers vote client securities in the best interest of clients); Rule 30b1-4 under the Investment Company Act of 1940 (requiring registered investment companies to file annual reports containing their proxy voting records).

the function and use of a particular product in determining whether, or to what extent, the product qualifies under Section 28(e).

c. Similarly, the SEC stated that a money manager's legal expenses generally would be considered overhead and therefore would not constitute research under Section 28(e). However, it is not clear that the SEC completely precluded legal expenses from qualifying as research (nor should they). Presumably, money managers might be able to distinguish legal expenses related to how an adviser conducts its business (*e.g.*, corporate legal services), which would be treated as overhead, from legal expenses related to specific investment decisions (*e.g.*, legal advice on antitrust issues affecting a proposed merger or patent advice on a company's technology), which should be treated as research.

D. <u>Arrangements Involving Money Managers And Broker-Dealers</u>.

1. <u>Overview</u>.

a. The SEC's revised interpretation departs significantly from its proposal, and from the SEC's 1986 interpretation, in the area of arrangements between money managers and broker-dealers. Both the SEC and its Staff have indicated that the modifications are designed to provide market participants with greater flexibility in structuring arrangements, but many of the details of the modifications remain subject to interpretation. Perhaps anticipating the need for further guidance, the SEC requested additional public comment on this aspect of the interpretation, and indicated that it may supplement the revised interpretation based on any comments it receives.

b. The SEC's guidance in this area arises from the fact that Section 28(e) expressly provides that the safe harbor is available for commissions paid to a broker-dealer for "effecting" securities transactions based on their relation to the value of the brokerage and research services "provided by" the broker-dealer. This aspect of the safe harbor requires that the broker-dealer providing brokerage and research must also be effecting transactions for the money manager. Additionally, the SEC had previously interpreted Section 28(e) such that a broker-dealer was "providing" research only if it produced a product or service or was legally obligated to pay for a product or service. The SEC's revised interpretation increases flexibility in structuring arrangements by modifying previous guidance on the application of the terms "effecting" and "provided by."

c. In the revised interpretation, the SEC expressly took into account so-called "commission- sharing arrangements" that have been used in the United Kingdom. Under a commission-sharing arrangement, the executing broker agrees that part of the commission it earns will be redirected to one or more third parties, as directed by the money manager, as payment for research services provided to the money manager. These arrangements allow money managers to direct broker-dealers to collect and pool client commissions that may have been generated from orders executed at that broker-dealer, and periodically direct the broker-dealer to pay for research that the money manager has determined is valuable.

2. The "Effecting" Requirement.

a. Historically, soft dollar arrangements involving multiple broker-dealers have been structured as introducing/clearing relationships. For example, a broker-dealer that produces research would "introduce" trades to a "clearing" broker for execution and clearing. In this regard, the SEC had taken the view generally that the safe harbor does not apply to arrangements in which the broker-dealer providing research receives a portion of the client's brokerage commissions without performing any role in the trade. Until 2006, however, the most definitive statement on the level of activity necessary for a broker-dealer to be deemed to be performing a role in a trade came in a 1983 no-action letter in which the SEC Staff stated that the use of the safe harbor was not precluded where a broker-dealer provided research and performed four types of functions.[43]

b. In its proposal in 2006, the SEC had considered formally adopting the Staff's 1983 no-action position by interpreting the term "effecting" to require a broker-dealer's performance of all four functions. However, the revised interpretation provides that a broker-dealer may be considered to be effecting transactions under Section 28(e) if it performs at least one of the following four functions:

(i) Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities);

(ii) Making or maintaining records relating to customer trades required by SEC and SRO rules, including blotters and memoranda of orders;

(iii) Monitoring and responding to customer comments concerning the trading process; or

(iv) Generally monitoring trades and settlements.

The broker-dealer must nevertheless take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement, and in a manner that is fully consistent with their obligations under SEC and SRO rules.

3. The "Provided By" Requirement.

a. Historically, the SEC has required that a broker-dealer be legally obligated to pay for research in order to satisfy the "provided by" requirement, and the SEC reaffirmed this concept in the 2006 proposal. In practice, this interpretation has required that broker-dealers in soft dollar arrangements either provide research directly (*e.g.*, by producing research reports) or be contractually obligated to pay for research prepared by a third-party (*e.g.*, market data services).

b. The SEC's revised interpretation retains this means of satisfying the "provided by" requirement, but also extends the safe harbor to certain arrangements where a

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[43] *SEI Financial Services Company*, Letter from SEC's Division of Market Regulation to Morgan, Lewis & Bockius (December 15, 1983).

broker-dealer is not legally obligated to pay for research. Under the revised interpretation, the "provided by" requirement generally may also be satisfied if a broker-dealer does the following:

(i) Pays the research vendor directly;

(ii) Reviews the description of the research to be provided for "red flags" that indicate the services are not within Section 28(e), and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor; and

(iii) Develops and maintains procedures so that research payments are documented and paid for promptly.

The SEC did not provide specific guidance on complying with the new interpretation of the "provided by" requirement. For example, the SEC did not explain what types of "red flags" broker-dealers should look for in reviewing a research description. In addition, the SEC did not provide specific examples of the types of prompt payment procedures broker-dealers would have to develop and maintain.

4. Structuring Arrangements under the Revised Interpretation. Based on public statements by the SEC and its staff, the SEC's revised interpretation appears to be designed to permit arrangements similar to commission sharing arrangements within the limits of Section 28(e). To that end, the SEC stated specifically in the release that an arrangement involving multiple broker-dealers will satisfy Section 28(e) if at least one of the broker-dealers satisfies the requirements for "effecting" transactions and "providing" research.[44] This aspect of the revised interpretation should permit arrangements that would not have been permitted under the SEC's prior interpretations, including:

a. An executing broker may pay for brokerage or research services at the money manager's direction without being legally obligated to pay for the services. In those cases, the executing broker will have to satisfy the new "provided by" requirement by reviewing research descriptions and establishing policies and procedures for prompt payment of the services.

b. An executing broker may share commissions with a broker-dealer that produces research but does not play an active role in the trading process. In those cases, the second broker-dealer will have to perform one of the four functions that make up the revised "effecting" requirement and allocate the remaining three to the executing broker.

5. While the SEC noted that multi-broker arrangements under Section 28(e) have historically been structured as introducing/clearing arrangements, early indications from the SEC Staff are that the revised interpretation does not, in and of itself, require that broker-dealers use a clearing agreement to allocate performance of the four functions. Similarly, the SEC Staff

[44] Specifically, footnote 182 states that "[i]n Section 28(e) arrangements involving multiple broker-dealers, at least one of the broker-dealers (but not necessarily all) must satisfy the requirements for 'effecting' transactions and 'providing' research."

has indicated that the functions do not necessarily have to be allocated to the executing broker-dealer, and could be allocated to a third broker-dealer.

E. Open Questions. Although the SEC's revised interpretation brought greater clarity to many issues under Section 28(e), it has perhaps generated an equal number of additional questions in practice. In this regard, a number of significant questions remain unanswered in practice, including the following:

1. What obligations do money managers have to verify that broker-dealers are satisfying the new "effecting" and "provided by" requirements?

2. In what circumstances may money managers share research with affiliates under Section 28(e)?

3. How does the SEC's revised interpretation relate to principal transactions in fixed-income securities, which historically have been viewed as outside the safe harbor?[45]

4. Does Section 28(e) permit money managers to transfer commission credits and debits between broker-dealers, including to soft dollar credit aggregators?

5. To what extent will "hard dollar" research arrangements create investment adviser status issues for broker-dealers.

6. Whether and under what circumstances soft dollar credits maintained with a broker-dealer are protected as customer property under Exchange Act Rule 15c3-3 and the Securities Investor Protection Act. The SEC staff had informally taken the view that soft dollar credits could be viewed as customer property for purposes of Rule 15c3-3 where that was consistent with the arrangements between the money manager and the broker-dealer, and the SEC staff has typically sought to interpret the scope and operation of Rule 15c3-3 and the Securities Investor Protection Act so employed a comparable definition of the concept of customer property. However, in the aftermath of the bankruptcy proceedings involving Lehman Brothers, a bankruptcy court in the Southern District of New York ruled that soft dollar credits are not customer property for purposes of Securities Investor Protection Act of 1970 ("SIPA") because the money managers were in essence not customers under that Act.[46] The ruling and the current mismatch in the interpretation of SIPA with Rule 15c3-3 leaves an open issue for money managers seeking to assure that soft dollar credits maintained at a broker are subject to protection.

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[45] In the summer of 2013, the SEC staff issued an interpretive letter making it clear that the Section 28(e) safe harbor could apply to agency transactions in fixed-income securities. *See* Carolina Capital Markets, SEC staff No-Action Letter (July 30, 2013). However, in a separate letter to Carlina Capital Markets, the SEC staff raise questions with an opinion of the company's legal counsel that questioned the analysis concerning the ability of money managers to rely on the Section 28(e) safe harbor in the context of riskless principal transactions in fixed income securities. *See* letter, dated Oct. 25, 2013, from David Blass to Carolina Capital Markets.

[46] *See In re Lehman Brothers Inc.,* No. 08-01420, slip op. (Bankr. S.D.N.Y. Jul. 10, 2012).

F. European Securities and Markets Authority ("ESMA"), Portfolio Manager Use of Client "Dealing Commissions" for Research[47]

1. On December 19, 2014, the European Securities and Markets Authority published its final technical advice to the European Commission to assist it on the content of delegated acts required for the implementation of the Markets in Financial Instruments Directive (MiFID II) and Regulation (MiFIR). Among other things, the Technical Advice addresses the acquisition of research by investment firms for use in managing client assets. The Technical Advice still permits investment firms to acquire research through the use of client assets requires firms to pay for research with their own money or specifically charge clients for the purpose of contributing to a research budget (and prohibits firms from linking these charges to client transactions).

2. Background

a. On October 20, 2011, the European Commission adopted two legislative proposals (a directive and a regulation) for the review of MiFID I. After agreeing on a compromise text on January 14, 2014, the European Parliament and European Council each approved the final legislative texts on April 15, 2014 and May 13, 2014, respectively. On April 23, 2014, ESMA received a formal request from the European Commission to provide technical assistance on the content of various delegated acts required by several provisions of MiFID II and MiFIR. On May 22, 2014, ESMA published a consultation paper in order to present its views and seek comment from interested parties for the purpose of producing the Technical Advice.

3. Consultation Paper

a. Article 24(7)(b) and 24(8) MiFID II generally state that an investment firm that provides investment advice on an independent basis or portfolio management is prohibited from accepting fees, commissions, or any monetary or non-monetary benefits paid or provided by a third party or a person acting on behalf of a third party in relation to the provision of services to clients. Excluded from these provisions, however, is the receipt of minor non-monetary benefits capable of enhancing the quality of service provided to a client that are of a scale and nature such that they could not be judged to impair compliance with a duty to act in a client's best interest.

b. In the Consultation Paper, ESMA took the view that these provisions should be read as prohibiting the receipt of research unless the research qualified as a minor non-monetary benefit. In furtherance of this reading, ESMA proposed to establish an exhaustive list of minor non-monetary benefits and explained in the Consultation Paper the circumstances under which research would be a permissible minor non-monetary benefit. Under the approach outlined in the Consultation Paper, bespoke research, access to research analysts, analytical models, investor field trips, and services linked to research such as corporate access

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47 Final Report, ESMA's Technical Advice to the Commission on MiFID II and MIFIR, ESMA /2014/1569 (December 19, 2014), available at http://www.esma.europa.eu/system/files/2014-1569_final_report_-_esmas_technical_advice_to_the_commission_on_mifid_ii_and_mifir.pdf.

and market services would have not been considered minor non-monetary benefits . As a result, the Consultation Paper if adopted as drafted would have effectively banned the use of dealing commissions to acquire research.

c. The Consultation Paper generated a robust response from stakeholders with 330 formal responses filed. Respondents to the Consultation Paper generally objected to the treatment of research as a non-monetary benefit for purposes of the inducement provisions of Article 24(7)(b) and 24(8) and the proposal for an exhaustive list. While many respondents recognized concerns over conflicts of interest, they also indicated that the use of commission sharing arrangements (CSA) between portfolio managers and brokers was an effective response to these concerns since use of CSAs help ensure that research and execution costs would not necessarily be tied to one another.

4. Technical Advice

a. ESMA conceded the lack of support for an exhaustive list of non-monetary benefits and modified its advice with the recommendation that the list be supplemented via ESMA guidelines. In light of the pushback received, ESMA has modified its initial approach to treating research as a prohibited non-monetary benefit. Under the Technical Advice, ESMA takes the view that the provision of research by third-parties (such as firms executing orders or independent research providers) to investment firms providing portfolio management (or other investment or ancillary services) to clients should not be restricted as an inducement if: (i) Investment firms pay for the research out of their own resources (i.e., hard cash); or (ii) The payments for research are made from a separate research payment account controlled by the investment firm, subject to certain conditions (Research Payment Account), described below.

b. Conditions for Use of Research Payment Account: The use of a Research Payment Account is subject to a number of conditions specified by the Technical Advice, which include: (1) the Research Payment Account being funded by a specific research charge; (2) the investment firm setting and regularly assessing a research budget as an internal administrative measure; (3) the investment firm being responsible for operation of the Research Payment Account; (4) the investment firm regularly assessing the quality of the research obtained; and (5) adequate disclosures to clients.

(i) Specific Research Charge: Under the Technical Advice, a Research Payment Account can only be funded through specific charges to clients. More specifically, the specific research charge: (1) can only be based on a research budget set by the investment firm for the purpose of establishing the need for third party research in respect of investment services rendered to clients; and (2) cannot be linked to the volume or value of transaction executed on behalf of clients. The Technical Advice further states that: (1) the total amount of specific charges received cannot exceed the research budget amount; (2) investment firms must agree with each client on the research charge as budgeted by the firm and the frequency with which the specific research charge is to be deducted from the client's assets over the course of the year; (3) research budgets may only be increased with the client's written consent; and (4) surplus amounts in the Research Payment Account should either be rebated to clients or offset against future specific charges.

(ii) Research Budget: As part of establishing a research budget and agreeing a reasonable charge with clients, the Technical Advice requires firms to set and regularly assess the research budget. In particular, the research budget would have to be: (1) managed solely by the investment firm; (2) based on a reasonable assessment of the need for third party research; (3) subject to appropriate controls and senior management oversight; and (4) the controls would have to include clear audit trails of payments made to research providers and the amounts. Internal research would not be funded from the Research Payment Account.

(iii) Responsibility for Research Payment Account: Although investment firms would be responsible for managing and operating the Research Payment Account, the Technical Advice permits firms to delegate the administration of the research payments to a third party.

(iv) Quality Assessments: Investment firms would have to regularly assess the quality of research purchased based on robust criteria and its ability to contribute to better investment decisions. In this connection, the Technical Advice states that firms should be able to demonstrate these elements in a written policy that can be provided to clients. More specifically, the written policy would have to (1) address the extent to which purchased research may benefit client portfolios; and (2) the approach the firm would take to allocate such costs as fairly as practicable across various clients' portfolios.

(v) Disclosures: The Technical Advice requires that investment firms provide certain disclosures to their clients. In particular, investment firms would have to: (1) disclose the budgeted amount of research; (2) disclose the amount of expected research charge to each client; (3) provide clients with information on an annual basis regarding the total costs that each client has incurred for third party research; and (4) at the request of client (or regulators), provide a summary of the providers who were paid from the Research Payment Account, the total amount they were paid over a defined period, the goods and services received, and how the total amount spent from the Research Payment Account compares to the research budget (noting any rebates or carryover of surpluses).

V. TRADE AGGREGATION AND ALLOCATION

A. Overview. An adviser whose clients include registered and unregistered funds, retail and institutional accounts, or some combination thereof, can face challenging trading issues. The funds generally are "free to trade" accounts, while some institutional accounts may direct brokerage, and wrap fee account trades tend to be placed with the program sponsor. The existence of accounts that direct may effectively force an adviser to break up orders it might otherwise aggregate and send to a single broker.

B. Concerns Associated with Disaggregation. Disaggregating trades may raise concerns. For example:

1. The first accounts to trade may receive a better price than accounts trading down the line, especially with large orders or thinly-traded securities. This is because the first and following trades may tend to "push" the market (that is, create market impact).

2. If the sell-side community understands that the adviser disaggregates orders, the adviser effectively may be "signaling" or "tipping" its executing broker-dealers that larger volume may be forthcoming, and some broker-dealers might use this information to the detriment of the adviser's clients.[48]

3. The adviser's similarly-managed accounts may experience performance dispersion as a result of paying different prices for a security, incurring different transaction costs, or failing to purchase the security due to market impact concerns or limited availability. Disaggregation may also lead to performance dispersion between the adviser's similarly-managed funds, institutional accounts and other accounts.

C. Failure to Aggregate Does Not Result in a Breach of Fiduciary Duty. An adviser does not breach its fiduciary duty to its clients merely by failing to aggregate orders for client accounts. The adviser could, depending on the circumstance, have to disclose to its clients that it will not aggregate and any material consequences of the failure to aggregate, such as potentially higher commissions.[49]

D. Other Procedures for Placing Client Orders Permitted. Using multiple broker-dealers to execute transactions in the same security for fund and non-fund accounts is the reverse of aggregation. In approving procedures that called for *pro rata* allocation among client accounts, the SEC staff observed that there may be other allocation methods that advisers can use without violating Section 206 of the Advisers Act.[50] Advisers should be able to satisfy their fiduciary duties by employing methodologies or procedures, other than aggregating transactions and sending them to a single broker, provided these procedures are disclosed to clients and designed to ensure that clients are treated equitably and fairly over time and that no client account is systematically disadvantaged.

E. Other Types of Procedures. Rather than broadcast orders across multiple brokers simultaneously, an adviser may place orders with one broker and, once those orders have been executed, place orders with the next broker (and so on). Sequential allocation is done to avoid multiple orders from one adviser competing with one another for execution. It also can lessen the "data leakage" problem – the excessive market impact that could result if the market thought that multiple brokers were working orders, although some market impact may occur.[51] These procedures include the following:

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[48] *See Wagner & Glass*, *The Dynamics of Trading and Directed Brokerage*, 2 J. Pension Plan Investing 53, 63 n.21 (1998) ("Wagner"). ("Although not necessarily common, 'worst case' scenarios of broker conduct that managers worry about include a dealer who gets a call from a manager asking for a price quote instead colludes with other dealers to inflate prices; a dealer who gets a manager's call immediately buys up all available stock so that the manager has to buy from the dealer regardless of price; a dealer who gets a manager's call surreptitiously tips off a good client of the dealer who in turn buys up all of the available stock with the intent of selling it back to the manager; and a dealer who gets a manager's call may know of a willing seller but represents to both sides that the other one wants a higher price so as to widen the spread (and the broker's profit).").

[49] *Pretzel & Stouffer*, SEC No-Action Letter (pub. avail. Dec. 1, 1995).

[50] *SMC Capital*.

[51] *See, e.g., Boards Fight Front-Running of Funds*, BoardIQ (March 6, 2007).

1. *Random Rotation*. Many advisers seek to deal with these sequencing issues by implementing a rotational process in which funds and other free to trade accounts and directed accounts take turns going first.[52] Random rotation seeks to ensure that clients are treated fairly and equitably over time, but it can place fund and institutional orders at the mercy of directed orders, especially when the broker-dealer handling the directed accounts takes time to execute a large order. The rotation schedule can be determined on a trade-by-trade basis, preferably through random selection (*i.e*., each trade produces a new rotation) or it can be set in advance, again through random selection (*i.e.*, the rotation is fixed for a set time period or a set number of trades). In the latter case, the adviser will have to determine how to accommodate new client accounts.

2. *Last to Trade*. Where a client explicitly directs that all trades be executed through a particular broker, the adviser may decide to place that client's trades behind those of its clients who have non-directed accounts (i.e., at the "back of the bus").[53] However, accounts that consistently trade last may trade on less favorable terms than clients who trade ahead of them. In any situation in which client accounts are traded last because of the directions, circumstances or arrangements surrounding the clients' accounts, an adviser should disclose the practice to the affected clients together with the possible effects on trade execution.

3. *Percentage of Assets-Based Rotation*. A less widely used methodology is rotation based on percentage of assets. The adviser creates a rotation determined by the percentage of assets, by client type. For example, if fund assets represent 73% of the adviser's assets under management, and institutional accounts and retail accounts present 20% and 7%, respectively, then the fund would trade first 73% of the time, institutional accounts 20% of the time and retail accounts 7% of the time. This approach is sometimes used when an adviser first starts managing non-fund assets, to avoid putting large accounts at the mercy of small ones.

4. *Simultaneous Release*. Advisers often avoid the simultaneous placement of orders for different clients through multiple broker-dealers because those orders may compete with each other for execution, and may present the potential for excessive market impact. However, simultaneous release of all orders may not affect clients if, for example, the order is small or for a liquid security, because the market may absorb multiple orders without significant price movement.

5. *Step-Outs*. A step-out generally involves the adviser's direction that an executing broker-dealer allocate – or "step out" – all or part of a trade to another broker-dealer for clearance and settlement. Step-outs can be attractive to advisers because they may allow the adviser to accommodate client directed trading (*e.g*., commission recapture) arrangements and to

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[52] In a survey of wrap fee arrangement trading practices, 57% of respondents noted that their firms employ a trading rotation to determine where wrap accounts trade in relation to traditional accounts. *2005 Survey of Wrap Trading Practices*, conducted by TraderForum.

[53] *Lemke* at § 2:105. *See also Wagner & Glass* at 63. ("Since managers have an obligation to seek the best possible price for the greatest number of clients, they tend to place (sequence) the blocks of aggregated orders in front of directed trades (which would have been part of the block order but for the [client's] direction). In practice, what this means is that the manager will wait until the block order is completed before even beginning to try to execute the directed order.").

obtain soft dollar credits under Section 28(e) of the Exchange Act. The use of "step outs" may alleviate problems associated with rotational or back-of-the-bus procedures. Brokers may be willing to take on step-out transactions because they will earn the commission on the other side of the trade, or to attract more commission business from the adviser, even though settlement may be more complicated. Step-outs can raise potential thorny "cross-subsidization" or "free riding" issues, because step-out orders are, in essence, executed for free while the adviser's other clients pay their negotiated commissions.[54]

6. *Hybrid Approaches*. Some advisers may use two or more of the procedures described above, including aggregation, in combination.

F. Disclosure. Advisers should have appropriate Form ADV or other disclosure informing clients of their trading practices and any related conflicts. In particular, an adviser should as appropriate disclose the trading process it employs, the circumstances under which it deviates from that process, and the consequences to the clients of employing that process.[55]

VI. SEC INVESTMENT ADVISER ENFORCEMENT ACTIONS

A. Best Execution. The following cases reflect the SEC Staff's continuing scrutiny of the use of affiliated broker-dealers and the potential impact of those arrangements on best execution.

1. *In the Matter of Tilden Louck & Woodnorth, LLC, LaSalle St. Securities, LLC, and Ralph B. Loucks*, Admin. Proc. File No. 3-15081 (Oct. 29, 2012)

a. The SEC initiated administrative proceedings against Tilden Loucks & Woodnorth, LLC ("TL&W"), a registered investment adviser, its affiliated broker-dealer LaSalle St. Securities, LLC ("LaSalle"), and TL&W's former senior vice president, Ralph B. Loucks ("Loucks"), alleging that TL&W obtained undisclosed compensation and violated its best execution obligations by charging increased commissions on trades executed through its affiliated broker-dealer.

b. The SEC alleged that TL&W failed to disclose compensation it received by charging increased commissions on trades through LaSalle by inaccurately telling clients that they received a discount on LaSalle's commissions. TL&W's Forms ADV stated that its clients obtained a significant discount to LaSalle's retail brokerage charges when, according to the SEC, La Salle had no retail brokerage commission schedules and TL&W set LaSalle's

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[54] *See Wagner & Glass* at 64. ("Unfortunately, while step-outs permit a manager to send an entire block trade to one broker (and thereby avoid sequencing delays), they too have some troublesome drawbacks. In particular: [s]tep-outs cannot be used with principal brokers[;] [i]f a significant portion of an order (more than 20 to 25 percent) has to be stepped out, the executing broker, when busy, may prioritize other orders (where it gets to keep all of the commissions) first[;] [i]f a manager is 'working' an order over several days, it needs to be concerned that the recipient of the first day's step out doesn't use that information to front run, or compete, with the manager's subsequent trades.").

[55] *See generally In re Mark Bailey & Co. and Mark Bailey*, Investment Advisers Act Release No. 1105 (Feb. 24, 1988) (SEC outlined a series of disclosures that should have been made by an investment adviser who did not negotiate commissions for certain client-directed transactions.).

commissions to be significantly higher than the commissions LaSalle charged TL&W. The SEC further alleged that TL&W failed to seek best execution and made misleading statements in its Form ADV about its brokerage practices.

c. The SEC alleged that TL&W violated, and Loucks caused TL&W's violations of Sections 206(2) and 207 of the Advisers Act. The SEC sanctioned TL&W, LaSalle and Loucks with cease-and-desist orders and censured TL&W and Loucks. The SEC further ordered TL&W and LaSalle to disgorge $170,320 plus prejudgment interest, and ordered TL&W, LaSalle and Loucks to disgorge $16,288 plus prejudgment interest. Finally, TL&W and LaSalle were ordered to pay civil money penalties of $100,000 each and Loucks was ordered to pay a civil money penalty of $25,000.

d. TL&W agreed to revise its Form ADV and provide a copy of the revised Form ADV and the SEC order to its clients.

2. *In the Matter of Goelzer Investment Management, Inc. and Gregory W. Goelzer*, Admin. Proc. File No. 3-15400 (July 31, 2013)

a. The SEC filed a settled administrative proceeding against Goelzer Investment Management, Inc. ("GIM"), a dually-registered investment adviser and broker-dealer, and Gregory W. Goelzer ("Goelzer"), GIM's Chief Executive Office and Chief Compliance Officer, for allegedly making misrepresentations in its Form ADV about the process of selecting itself as broker for advisory clients. The SEC also alleged that GIM failed to seek best execution for its clients by neglecting to conduct an appropriate analysis to substantiate its decision to place trades for advisory clients through itself as broker.

b. The SEC alleged that GIM's Form ADV stated that transactions for GIM's advisory clients would generally be effected through GIM as broker, "consistent with its obligation to obtain best price and execution" and that GIM's recommendation that clients use GIM as their broker was based on GIM's consideration of several factors, including the products offered, the level of service, the quality of trade execution, the recordkeeping and reporting capabilities, the trading platforms offered, and the ability to meet client needs. The SEC alleged that these statements were misleading because GIM did not take steps to ensure that it was seeking best price and execution for its advisory clients and failed to evaluate brokerage options for its advisory clients in a manner that was consistent with its Form ADV disclosure.

c. The SEC also alleged that GIM failed to seek best execution for its advisory clients because it did not conduct any analysis of its brokerage services that gave it a basis for using itself as broker. The SEC alleged that instead, GIM used itself as broker for its advisory accounts by default rather than as the result of a best execution analysis.

d. The SEC also alleged that GIM failed to adopt and implement policies and procedures reasonably designed to prevent and detect misrepresentations by GIM and that it failed to disclose the negotiability of its advisory fees in its Form ADV.

e. The SEC's settled Order charged that GIM violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder; that Goelzer caused GIM's violations; and that GIM and Goelzer violated Section 207 of the Advisers Act.

f. Pursuant to the settlement, GIM and Goelzer consented to a cease and desist order. GIM agreed to pay disgorgement of $309,994 and $53,799 in prejudgment interest, and to pay a civil monetary penalty of $100,000. Goelzer consented to a civil monetary penalty of $35,000. GIM also agreed to the engagement of a compliance consultant to conduct a comprehensive review of GIM's compliance program.

3. *In the Matter of A.R. Schmeidler & Co., Inc.*, Admin. Proc. File No. 3-15399 (July 31, 2013)

a. The SEC filed a settled administrative proceeding against A.R. Schmeidler & Co., Inc. ("ARS"), a dually-registered investment adviser and broker-dealer, for allegedly failing to seek best execution in breach of its fiduciary duty and allegedly failing to implement policies and procedures reasonably designed to prevent its purported best execution violations.

b. The SEC alleged that ARS' clients generally entered into advisory agreements with ARS, whereby the client authorized ARS, among other things, to select brokers and dealers to execute trades. According to the SEC, unless specifically directed by a client to use a particular broker-dealer, ARS executed trades for advisory accounts in its capacity as an introducing broker. In February 2007, ARS renegotiated its agreement with its clearing firm and increased the percentage of commissions it received on trades for taxable accounts from 80% to 90%. Although the commission rate charged to clients remained consistent at 6 cents per share, the SEC alleged that ARS did not conduct a sufficient analysis to determine whether it properly sought best execution for trades executed on behalf of advisory clients with taxable accounts. The SEC also alleged that although ARS' policies and procedures governed how to discharge ARS' best execution obligations, ARS failed to implement such policies and procedures.

c. The SEC's settled Order charged that ARS violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

d. ARS consented to a cease and desist order, a censure and to pay a disgorgement payment of $757,876.88 and $78,688.57 in prejudgment interest, and a civil monetary penalty of $175,000. ARS also agreed to engage an independent consultant to undertake to assist ARS in developing and implementing policies and procedures reasonably designed to promote compliance with its duty to seek best execution for advisory clients.

4. *In the Matter of Manarin Investment Counsel, Ltd.*, Admin Proc. File No. 3-15549 (Oct. 2, 2013)

a. The SEC filed a settled administrative proceeding against Manarin Investment Counsel, Ltd. ("MIC"), a registered investment adviser, Manarin Securities Corp. ("MSC"), a registered broker-dealer, and Roland R. Manarin ("Manarin"), the founder, owner and President of MIC and MSC. The SEC alleged that MIC and Manarin failed to obtain best execution for three investment funds managed by MIC (including a mutual fund) (the "Funds") by purchasing higher cost mutual fund shares, even though cheaper shares in the same mutual funds were available. As a result, the Funds paid avoidable fees on their mutual fund holdings and passed these fees through to MSC, the affiliated broker-dealer that executed the purchases.

b. According to the SEC, from at least June 2000 through mid-2010, Manarin and MIC breached their fiduciary duties as investment advisers by causing the Funds to buy the Class A shares of underlying mutual funds even when the Funds were eligible to own lower-cost, so-called "institutional" shares of the same mutual funds. As a result, the Funds paid approximately $3.3 million in avoidable 12b-1 fees on their mutual fund holdings, which were passed through to MSC. The SEC alleged that this practice was a violation of MIC's and Manarin's duty to seek best execution and was inconsistent with disclosures in the Fund's offering materials and MIC's Form ADV.

c. The SEC also alleged that, between October 2008 and December 2011, MSC executed transactions in ETF shares on behalf its affiliated mutual fund and charged commissions that exceeded the usual and customary broker's commission for such transactions.

d. The SEC's settled Order charged that MIC and Manarin violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8(a)(1) thereunder, (ii) Manarin violated Section 34(b) of the Investment Company Act, MIC, MSC and Manarin violated Section 17(a)(2) of the Securities Act, and MSC violated Section 17(e)(2)(A) of the Investment Company Act.

e. Pursuant to the settlement, MIC, MSC and Manarin consented to cease and desist orders and censures. MSC and Manarin also agreed, jointly and severally, to pay disgorgement totaling $685,006.90 and prejudgment interest totaling $267,741.72. Further, Manarin agreed to pay a civil penalty of $100,000.

B. Market Manipulation. The following cases illustrate various examples of allegations of investment advisers engaging market manipulation, including the practice of "marking the close" and short sales that violate Rule 105 under Regulation M.

1. *SEC v. RKC Capital Management, LLC, RKC Capital, LLC, and Russell K. Cannon*, Case No. 2:12-cv-00408-BCW (D.C. Utah Apr. 30, 2012)

a. The SEC filed an unsettled complaint against RKC Capital Management, LLC, RKC Capital, LLC (together, "RKC"), and RKC's founder and manager Russell K. Cannon ("Cannon"), alleging that they artificially inflated the value of assets under management of RKC Matador Fund LLC ("Matador"), a hedge fund that RKC and Cannon managed, in order to attract investments and charge excessive advisory fees.

b. The SEC alleged that RKC and Cannon were "marking the close" of a stock that comprised more than 50% of Matador's assets under management. RKC and Cannon manipulated the stock price by placing large purchase orders of the stock at the end of the trading day in order to push the price higher.

c. This activity often occurred on the last trading day of the month, in what the SEC alleged was an attempt to maximize monthly performance returns to increase the management and monthly incentive fees that RKC and Cannon collected.

d. The SEC also alleged that RKC and Cannon instructed Matador's fund administrator to set the price of the stock above the market price when their attempts at marking the close were unsuccessful in driving up the price.

e. As a result of RKC and Cannon's activity, the SEC alleged that the advisory fees received from Matador and Matador's assets under management were both inflated.

f. The SEC alleged that RKC and Cannon's actions constituted a violation of Sections 206(1), (2), and (4) of the Advisers Act and Rule 206(4)-8 thereunder, Sections 17(a)(1), (2), and (3) of the Securities Act, and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

2. *In the Matter of Eric David Wanger and Wanger Investment Management, Inc.*, Admin. Proc. File No. 3-14676 (July 2, 2012).

a. The SEC initiated an administrative proceeding against Wanger Investment Management, Inc. ("Wanger Investment Management"), a registered investment adviser, and Eric David Wanger ("Wanger"), the owner, chief compliance officer and president of Wanger Investment Management, alleging that Wanger "marked the close" for certain securities owned by Wanger Long Term Opportunity Fund II, LP (the "Fund"), engaged in improper principal transactions with the Fund, and failed to timely file Forms 4 with the SEC.

b. The Fund, which Wanger founded and managed, invested heavily in small and microcap companies with very thin trading volume. The SEC alleged that, from January 2008 through September 2010, Wanger executed, at inflated prices, at least 15 trades in thinly traded securities owned by the Fund at the end of the day of the final trading session of a month or quarter. This activity inflated the Fund's performance between 3.6% and 5,908.71% and its value between 0.24% to 2.56%.

c. The SEC also alleged that Wanger, acting through Wanger Investment Management, engaged in numerous improper principal transactions with the Fund, including transferring monies from the Fund's brokerage account to Wanger Investment Management's bank account to pay operating expenses and payroll and transferring securities on numerous occasions between Wanger's individual account and the Fund's account, in each case without providing written disclosure to the Fund or obtaining the Fund's consent.

d. The SEC also alleged that Wanger, who served as a member of the Board of Directors of a company in which the Fund was a 10% owner, failed to timely file the requisite Forms 4 with the SEC regarding at least 8 personal transactions in the company's securities and 40 of the Fund's transactions in the company's securities.

e. According to the SEC, Wanger's conduct constituted violations of Section 17(a) of the 1933 Act, Section 10(b) and 16(a) of the 1934 Act and Rules 10b-5 and 16a-3 thereunder, and Sections 206(1), 206(2), 206(3), and 206(4) of the Adviser Act and Rule 206(4)-8 thereunder.

f. Wanger settled with the SEC, agreeing to a cease-and-desist order, a one year bar from associating with any firm in the securities industry, a $75,000 civil money penalty and payment of prejudgment interest of $122 and disgorgement of $2,269.

3. *In the Matter of Wesley Capital Management, LLC*, Admin. Proc. File No. 3-14962 (July 26, 2012)

a. The SEC instituted settled administrative and cease-and-desist proceedings against Wesley Capital Management, LLC ("Wesley"), alleging that Wesley purchased securities in public follow on offerings by Duke Realty Corporation and Host Hotels & Resorts, Inc. after having sold short the securities of both issuers during the five business days prior to the pricing of the public offerings.

b. The SEC alleged that Wesley realized profits of $142,124 by participating in these offerings.

c. The SEC alleged that these transactions constituted a violation of Rule 105 of Regulation M.

d. The SEC noted that after the alleged conduct, Wesley developed and implemented policies and procedures pertaining to compliance with Rule 105 of Regulation M.

e. The SEC imposed a cease-and-desist order, censured Wesley, and ordered Wesley to pay disgorgement in the amount of $142,124, plus prejudgment interest of $15,165 and a civil money penalty of $75,000.

C. Principal Trading. The SEC filed two cases in 2013 that demonstrate its focus on principal trading by advisers and the advisers' compliance with the disclosure and consent requirements regarding principal trades.

1. *In the Matter of Shadron L. Stastney*, Admin. Proc. File No. 3-15500 (Sept. 18, 2013)

a. The SEC filed a settled administrative proceeding against Shadron Stastney ("Stastney"), a principal of Vicis Capital LLC ("Vicis Capital"), a registered investment adviser, for allegedly breaching his fiduciary duty to the Vicis Capital Master Fund (the "Fund") by failing to disclose a material conflict of interest and engaging in an undisclosed principal transaction with the Fund.

b. The SEC alleged that in late 2007, Stastney hired a friend and outside business partner to help him manage the Fund's illiquid investments. As a condition of employment, Stastney required the friend to divest those of his personal securities holdings that overlapped with the Fund's investments (the "conflicted securities"). To facilitate the divesture, Stastney arranged for the Fund to purchase from his friend approximately $7.5 million in illiquid, conflicted securities. The SEC alleged that Stastney informed two of his partners of the contemplated transaction but did not disclose to them or to the Trustee of the Fund that he would be participating as a principal in the transaction because he had a personal financial interest in

some of the conflicted securities and would receive a portion of the proceeds of their sale to the Fund.

c. The SEC alleged that as a result of the sale, Stastney personally benefited and received over $2.7 million from the sale of the securities to the Fund.

d. The SEC's settled Order charged that Stastney willfully violated Sections 206(2) and 206(3) of the Advisers Act.

e. Pursuant to the settlement, Stastney consented to a cease and desist order, an industry bar, the payment of disgorgement and prejudgment interest of $2,535,095, and the payment of a civil monetary penalty of $375,000. He also agreed, among other things, to cause the Fund to hire, at his personal expense, an independent monitor to monitor his activities relating to the wind-down of the Fund and to forego compensation from Vicis Capital.

2. *In the Matter of Parallax Investments, LLC, John P. Bott, II and F. Robert Falkenberg*, Admin. Proc. File No. 3-15626 (Nov. 26, 2013)

a. The SEC filed an administrative proceeding against Parallax Investments, LLC ("Parallax"), Parallax's owner, John P. Bott, II ("Bott") and Parallax's CCO, Robert Falkenberg ("Falkenberg") , for allegedly engaging in thousands of principal transactions without obtaining client consent, failing to provide investors with audited financial statements in a timely fashion as required under the Custody Rule, failing to have written policies and procedures reasonably designed to prevent violations of the Advisers Act, and failing to maintain a written code of ethics.

b. The SEC alleged that Parallax engaged in at least 2,000 principal transactions that were executed by an affiliated broker-dealer, Tri-Star Financial ("TSF"), without providing prior written disclosure to clients that it would effect the trades on a principal basis and without obtaining prior consent. TSF used its inventory account to purchase mortgage-backed bonds for Parallax advisory clients and then transferred the bonds from the TSF account to the applicable client account. TSF charged advisory clients a mark-up or mark-down for the trades and Bott, who was a registered representative of TSF, received 55% of the sales credit generated by each trade. TSF earned approximately $1.9 million in gross sales credits (mark-ups and mark-downs) and paid approximately $1 million to Bott.

c. Parallax also allegedly failed to comply with the Custody Rule because it did not distribute annual audited financial statements to private fund clients within 120 days of the fund's fiscal year end. In addition, the financial statements, which were delivered more than a month after the deadline, were not audited by a PCAOB-registered auditor and contained fair value disclosures that did not conform to GAAP.

d. The SEC also alleged that for nearly two years after registering as an investment adviser Parallax failed to adopt and implement policies and procedures and a code of ethics. In particular, the SEC alleged that in response to a 2009 state examination, Parallax purchased an "off the shelf" compliance manual that was never tailored to Parallax's business. In addition, Parallax allegedly failed to conduct an annual review of its policies and procedures until after he received notice that the SEC Staff would be performing an examination. Finally,

Parallax apparently never implemented its code of ethics, including, for example, by identifying access persons or obtaining the required written acknowledgements or reporting of securities transactions and holdings.

e. The SEC alleged that Parallax violated, and Bott aided and abetted Parallax's violations of, Sections 206(3), 206(4), and 204A of the Advisers Act and Rules 206(4)-2, 206(4)-7 and 204A-1 thereunder. The SEC alleged that Falkenberg aided and abetted Parallax's violations of 206(4) and 204A of the Advisers Act and Rules 206(4)-2, 206(4)-7 and 204A-1 promulgated thereunder.

f. In a separate administrative proceeding, the SEC brought charges against Tri-Star Advisors, Inc. ("TSA"), a related investment adviser, TSA's CEO, William T. Payne ("Payne") and TSA's President, Jon C. Vaughan ("Vaughan"), alleging that TSA engaged in 2,212 principal trades without obtaining client consent. The principal trades were executed through its affiliated broker, TSF. In addition, TSA's compliance manual purportedly did not contain any policies and procedures addressing principal transactions. The SEC alleged that TSA violated, and Payne and Vaughan caused TSA to violate, Sections 206(3) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.56

D. Soft Dollar Payments. The following related cases involve the use, documentation and disclosure of soft dollar payments.

1. *In the Matter of Instinet, LLC*, Admin. Proc. File No. 3-15663 (Dec. 26, 2013)

a. In a follow-up to the J.S. Oliver matter, discussed below, the SEC filed a settled administrative proceeding against Instinet, LLC ("Instinet") for allegedly paying approximately $430,000 in client commission credits (soft dollars) as requested by its investment adviser customer, J.S. Oliver Capital Management, L.P. ("JS Oliver"), for expenses that JS Oliver had not properly disclosed to its clients, including improper personal expenses of JS Oliver's president. The SEC alleged that Instinet made the payments pursuant to JS Oliver's requests despite the fact that the information JS Oliver provided to Instinet when requesting approval of the payments contained significant red flags that suggested that each payment was improper.

b. The SEC alleged that JS Oliver, through Instinet, used soft dollar credits on brokerage commissions to pay for personal expenses that fell outside of the safe harbor provided under Section 28(e) of the Securities and Exchange Act of 1934 and that were not properly disclosed to clients. For example, the SEC alleged that in June 2009 Instinet, pursuant to JS Oliver's request, paid JS Oliver $329,365 using soft dollar credits for a payment to Mausner's ex-wife based on JS Oliver's representations to Instinet that the payment was for employee compensation. The SEC further alleged that a Instinet employee knew of significant red flags that the payment to Mausner's ex-wife was improper, including that: (i) the recipient of

[56] See In the Matter of Tri-Star Advisors, LLC, William T. Payne and Jon C. Vaughan, Admin. Proc. File No. 3-15627 (Nov. 26, 2013).

the payment was Mausner's ex-wife (ii) the payment was purportedly related to the Mausners' parting ways professionally after their divorce (iii) JS Oliver gave Instinet a series of inconsistent justifications for the payment (iv) despite Instinet's requests, JS Oliver never provided Instinet with the purported employment agreement or a legal opinion from counsel stating that the use of soft dollars for the payment was permissible and (v) JS Oliver provided Instinet an excerpt of the purported employment agreement (that had been materially altered by JS Oliver) and did not indicate that Mausner's ex-wife had conducted any work for JS Oliver in 3 years and did not substantiate the amount paid. The SEC alleged that despite these red flags, the Instinet employee approved the payment.

c. The SEC further alleged that Instinet employees knew of additional red flags relating to the subsequent payment of soft dollars for increased rent on office space located in Mausner's home and for Mausner's personal time-share property in New York City. The SEC alleged that despite significant red flags, Instinet employees approved such soft dollar payments.

d. The SEC's Order charged that Instinet willfully aided and abetted and caused JS Oliver's violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

e. Pursuant to the settlement, Instinet consented to a cease and desist order, a censure and to pay disgorgement of $378,673.76, prejudgment interest of $59,607.66 and a civil monetary penalty of $375,000. Instinet further consented to retain an independent consultant to undertake to review and report on Instinet's policies, procedures and practices relating to the payment of soft dollars.

E. Trade Allocation. In the following cases, the SEC sanctioned advisers for engaging in alleged "cherry-picking" in which they allocated trades improperly to the detriment of their clients.

1. *In the Matter of MiddleCove Capital, LLC and Noah L. Myers*, Admin. Proc. File No. 3-14993 (Aug. 22, 2012)

a. The SEC initiated administrative and cease-and-desist proceedings against MiddleCove Capital, LLC ("MiddleCove") and Noah L. Myers ("Myers"), alleging that Myers, the sole owner of MiddleCove, unfairly allocated profitable trades to his accounts and unprofitable trades to the accounts of his advisory clients.

b. MiddleCove and Myers allegedly placed securities that they purchased in an omnibus account and waited until the end of the day before allocating them. Those securities that appreciated in value were allocated to day-trading accounts belonging to Myers and his family. Securities that depreciated in value during the day were allocated to client accounts.

c. Based on this alleged cherry-picking scheme, Myers realized ill-gotten gains of approximately $460,000 and caused losses in client accounts of more than $2 million

d. The SEC also alleged that Myers only ceased his cherry-picking activities after one of his employees threatened to contact the SEC.

e. In addition to alleging violations of Sections 206(1) and 206(2) of the Advisers Act for the cherry-picking scheme, MiddleCove also allegedly misrepresented its allocation process in its Form ADV in violation of Section 207 of the Advisers Act.

f. Both MiddleCove and Myers consented to a censure. MiddleCove consented to having its license revoked and Myers consented to a bar from association with the securities industry with a right to reapply after Myers met all of his obligations to pay restitution and arbitration awards. MiddleCove and Myers agreed to pay disgorgement of $462,022, prejudgment interest of $26,096, and a civil monetary penalty of $300,000.

2. *SEC v. Dushek*, Case. No. 13-cv-3669 (Oct. 10, 2013)

a. The SEC filed a settled action in Illinois federal court against Charles J. Dushek ("Dushek Sr."), an investment adviser, and his son, Charles S. Dushek ("Dushek Jr.") (collectively, "the Dusheks") and Dushek Sr.'s advisory firm, Capital Management Associates, Inc. ("CMA"). The SEC alleged that the Dusheks and CMA conducted a "cherry picking" scheme to defraud CMA clients of almost $2 million.

b. The SEC alleged that, from 2008 to 2012, the Dusheks entered into securities trades on behalf of clients without designating trades as "client" or "personal" orders or creating any written record distinguishing client trades from personal trades. According to the SEC, the Dusheks typically waited a day, or in many cases, several days to allocate trades to client accounts or personal accounts. In that time, the Dusheks monitored the profitability of these trades and allocated the profitable trades to their personal accounts and the unprofitable trades to client accounts.

c. According to the SEC, the Dusheks placed and allocated more than 13,500 securities trades in the four-year period. More than 75% of the trades that the Dusheks allocated to themselves were profitable at the time of allocation while fewer than 25% of the trades allocated to clients were profitable at the time of allocation. In that same period, the Dusheks earned positive returns in their personal accounts for 17 consecutive quarters and earned almost $2 million in profits, whereas clients earned negative returns for 17 consecutive quarters and lost over $2 million.

d. The Dusheks' preferential allocations were contrary to representations made to clients, including that CMA does not merge or aggregate client and employee orders.

e. The SEC's complaint charged the Dusheks and CMA with violating Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Sections 206(1) and 206(2) of the Advisers Act.

f. The Dusheks consented to an injunction and agreed to disgorgement, prejudgment interest thereon and civil penalties in amounts to be determined by the court.

3. *In the Matter of MiddleCove Capital, LLC and Noah L. Myers*, Admin. Proc. File No. 3-14993 (Jan. 16, 2013)

a. In a settlement of a litigated proceeding filed in August 2012, the SEC settled with MiddleCove Capital, LLC ("MiddleCove"), a registered investment adviser, and its sole owner Noah L. Myers ("Myers"), over a cherry-picking scheme to the detriment of their advisory clients.

b. The SEC alleged that, from approximately October 2008 to February 2011, Myers used an omnibus account (the "Account") to place orders for MiddleCove advisory client accounts and for accounts in which he or family members had a beneficial interest. He would delay allocation of trades until later in the day or the next day, after he was able to see which securities had appreciated in value. When a security appreciated in value on the day of purchase, Myers would often sell the security and disproportionately allocate the purchase and profit to personal/family accounts. When a security depreciated in value on the day of the purchase, Myers would disproportionally allocate the purchase to advisory client accounts where they would be held for longer than one day. The SEC noted that these purchases and sales often involved leveraged and inverse ETFs, products it believed were generally not designed to be held for more than one day and inappropriate investments for many clients.

c. These preferential allocations were contrary to trade allocation policies contained in MiddleCove's Form ADV, which require that batched trades would be allocated fairly and not favor Myers or MiddleCove.

d. The SEC alleged that as a result of this scheme, Myers fraudulently realized over $460,000 in profits and caused his clients more than $2 million in losses.

e. The SEC's Order charged that MiddleCove and Myers both violated Section 10(b) of the Exchange Act and Rule 10(b)5 thereunder and Sections 206(1) and 206(2) of the Advisers Act, and that MiddleCove violated Section 207 of the Advisers Act.

f. Pursuant to the settlement, MiddleCove and Myers consented to a cease and desist order, a revocation of MiddleCove's investment adviser registration, an industry bar for Myers, disgorgement and prejudgment interest of $489,118 and a civil money penalty of $300,000.

F. *In the Matter of Structured Portfolio Management, L.L.C.*, et al., Admin. Proceeding File No. 3-16046 (Aug. 28, 2014)

1. The SEC filed a settled administrative proceeding against Structured Portfolio Management, L.L.C. ("SPM") and its affiliated advisers for failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act concerning trade allocation and the review of investor disclosures.

2. As alleged in the SEC order, SPM disclosed and allowed a trader to trade the same securities across three SPM-advised hedge funds, but without having appropriate controls in place. In one of the funds, the trader's responsibility was to make a profit, while in the other two funds it was to hedge interest rate risk. Although trading

the same securities across the three funds created a conflict of interest, which was disclosed, SPM did not update or modify its policies and procedures. The firm used trade blotters that did not identify the fund for which securities were traded.

3. In addition, SPM did not adopt and implement written policies and procedures reasonably designed to prevent inaccurate investor disclosures, which resulted in offering documents and other disclosures that did not indicate a fund was no longer trading in mortgage-backed securities.

4. The SEC found that SPM violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

5. SPM was censured, ordered to engage an independent compliance consultant, ordered to cease and desist, and ordered to pay a civil penalty of $300,000.

G. *In the Matter of J.S. Oliver Capital Management, L.P., Ian O. Mausner, and Douglas F. Drennan, Admin. Proc. File No. 3-15446 (Aug. 30, 2013)*

1. The SEC filed an administrative proceeding against J.S. Oliver Capital Management, L.P. ("J.S. Oliver"), a registered investment adviser, and Ian O. Mausner ("Mausner"), its founder, president, and sole owner, alleging that they engaged in separate schemes to (i) disproportionately allocate favorable trades to affiliated and/or favored hedge fund clients to the detriment of other clients; and (ii) with substantial assistance from Douglas F. Drennan ("Drennan"), an outside research analyst also named in the SEC's Order, used soft dollar credits from client commission arrangements for personal and other undisclosed and unauthorized purposes.

2. The SEC alleges that from June 2008 to November 2009, J.S. Oliver and Mausner allocated profitable equity trades on a preferential basis to six client accounts, including affiliated hedge funds, to the detriment of three other J.S. Oliver clients. The SEC's Order states that Mausner placed block trades in omnibus accounts at various broker-dealers, which were then reported to J.S. Oliver's prime broker. Thereafter, he allegedly used the prime broker's online platform to allocate the shares among client accounts, often waiting until after the close of trading so that he could determine the value of the securities and allocate to preferred accounts those that had increased in value and to disfavored accounts those that had decreased in value. Where there were multiple trades in the same security on the same day, Mausner allegedly allocated the most favorably priced trades to favored accounts.

3. The preferential allocations were contrary to J.S. Oliver's written policies and procedures and to representations made in client agreements, which required that allocations among clients would be fair and equitable and in proportion to account assets or target percentage levels. In addition, the SEC alleges that J.S. Oliver received performance fees from the favored funds, and Mausner and his family profited at certain clients' expense because they were personally invested in some of the favored funds.

4. The SEC alleges that a separate scheme operated from January 2009 through November 2011 in which J.S. Oliver misused over $1.1 million in soft dollar

credits accrued from trading commissions paid by J.S. Oliver clients. J.S. Oliver disclosed in its Form ADV allowable uses of soft dollar credits, but Mausner, allegedly with substantial assistance from Drennan, misrepresented and falsely documented the purpose of certain payments, which were directed to unauthorized uses such as Mausner's personal expenses and salary and bonus payments to Drennan.

5. Finally, the SEC alleges that J.S. Oliver failed to maintain a memorandum of each order it gave for the purchase or sale of securities and to maintain originals of Mausner's email messages promoting one of the funds that he favored in his cherry-picking scheme.

6. The SEC's Order alleges (i) that J.S. Oliver and Mausner violated Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Sections 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated, and Mausner willfully aided, abetted, and caused J.S. Oliver's violations of Sections 204 and 206(4) of the Advisers Act and Rules 204-1(a)(2), 204-2(a)(3), 204-2(a)(7), and 206(4)-7 thereunder; and (iii) that Drennan willfully aided, abetted, and caused J.S. Oliver's violations of Sections 17(a)(1) and (2) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

7. An initial decision, dated August 5, 2014, found (i) that Drennan willfully aided and abetted and caused J.S. Oliver's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act , Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder; (ii) that J.S. Oliver willfully violated Section 204 of the Advisers Act and Rules 204-5(a)(3) and 204-2(a)(7) thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; (iii) that J.S. Oliver willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, and that Mausner willfully aided and abetted and caused J.S. Oliver's violations; and (iv) that J.S. Oliver and Mausner willfully violated Section 207 of the Advisers Act, and that J.S. Oliver violated Section 204 of the Advisers Act and Rule 204-1(a)(2) thereunder, violations that Mausner willfully aided and abetted and caused.

8. It was ordered (i) that J.S. Oliver, Mausner, and Drennan cease and desist from committing or causing violations of the securities laws; (ii) that J.S. Oliver and Mausner, jointly and severally, pay disgorgement of $1,376,430 plus prejudgment interest, and Drennan, J.S. Oliver, and Mausner, jointly and severally, pay $482,381 plus prejudgment interest; (iii) that J.S. Oliver pay a civil monetary penalty of $14,975,000, Mausner of $3,040,000, and Drennan of $410,000; (iv) that the investment adviser registration of J.S. Oliver be revoked; and (v) that Mausner and Drennan be permanently barred from association with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. The SEC has granted a petition for review of the initial decision.

H. Cross Trading

1. *In the Matter of Western Asset Management Co.*, Admin. Proceeding File NO. 3-15688 (Jan. 27, 2014)

2. The SEC filed a settled administrative proceeding against Western Asset Management Co. ("WAMCO"), a registered investment adviser, in which it found that WAMCO engaged in prearranged dealer-interposed cross trades in which the counterparty dealers purchased fixed-income securities from certain WAMCO clients and then resold the securities to other WAMCO clients.

3. Since many clients involved in the cross trades were investment companies, the SEC found that WAMCO aided and abetted and caused those clients to unwittingly violate Sections 17(a)(1) and (2) of the Investment Company Act. The SEC also found that the cross trading resulted in undisclosed favorable treatment of certain clients over others by cross trading securities at the bid instead of the midpoint between the bid and the ask. Further, the SEC found that WAMCO did not adopt policies and procedures reasonably designed to ensure compliance with the cross trading provisions.

4. The SEC found that WAMCO violated Section 17(a)(1) and 17(a)(2) of the Investment Company Act; Sections 203(e)(6), 206(2), 206(4), and 207 of the Investment Advisers Act of 1940 ("Advisers Act"), and Rules 206(4)-7 and 206(4)-8(a)(2) thereunder.

5. WAMCO was censured, ordered to engage a compliance consultant, ordered to cease and desist, and ordered to pay a civil penalty of $1,000,000.