

Morgan Lewis

PLI's Fundamentals of Investment
Adviser Regulation 2016
July 13, 2016

BROKERAGE AND TRADING PRACTICES

Steven W. Stone

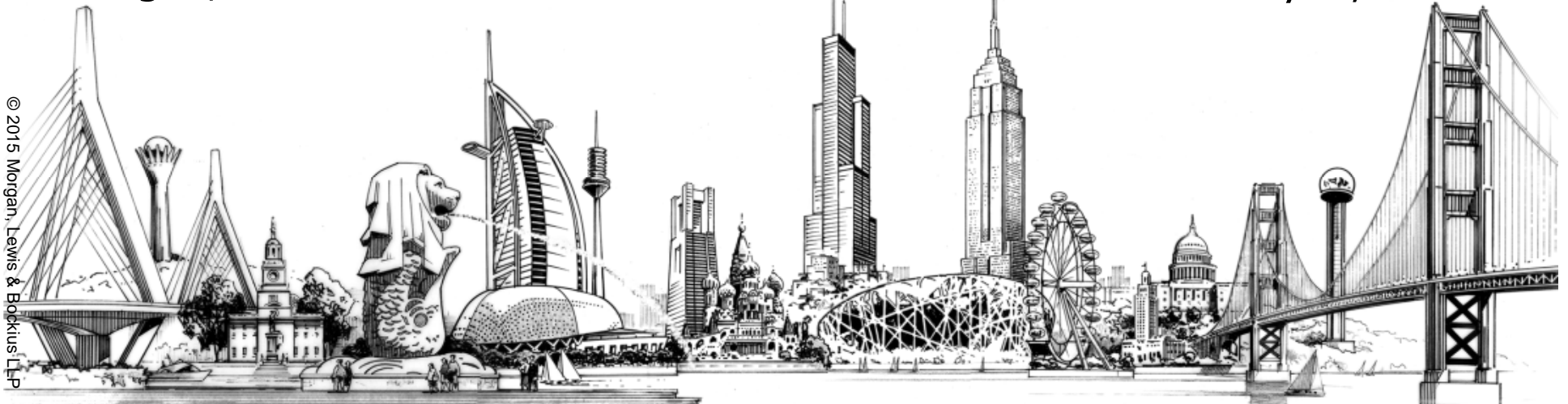
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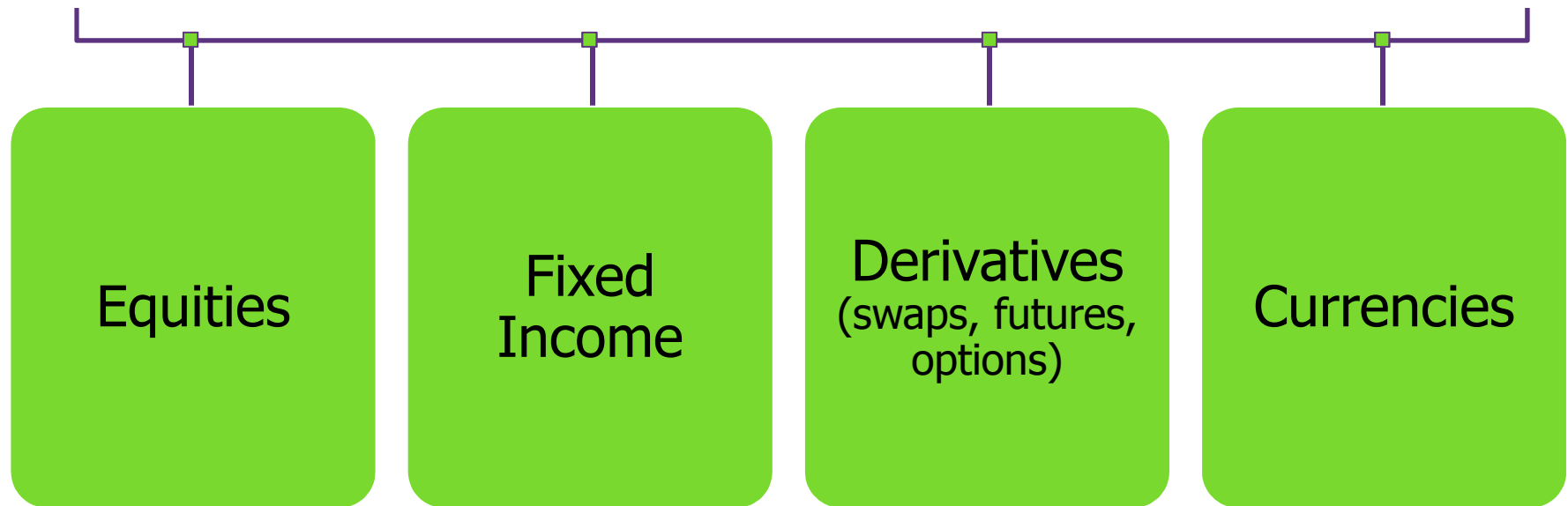
Life Cycle of a Trade

Pre-trade
processes

Post-trade
processes

Trade
errors

Types of Traded Investments



Current Focus



- Best execution is subject of increased SEC focus
 - SEC is better at detecting execution quality and trading issues, which increases the changes that the SEC will actually challenge execution quality on a substantive basis
 - SEC's enforcement and exam units have hired industry experts on trading
 - National Exam Analytics Tool ("NEAT") 4.0
- All of this increases the chances that best execution issues will be a key focus of adviser exams and the subject of criticism in exam comment letters or possible referrals for enforcement action

Bedrock Concepts and Requirements

- Fiduciary obligations
 - Advisers Act
 - ERISA
- Best price and execution

SEC on Best Execution

- In the SEC's view, "[i]nvestment advisers have an obligation to seek best execution of clients' securities transactions [and in] meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients in such a manner that the client's total cost of proceeds in each transaction are the most favorable under the circumstances."

Best Execution

- Quantitative & qualitative factors, including:
 - Net price, including commission, mark-up & down or spreads
 - Execution quality – accurate and timely execution, clearance and error/dispute resolution
 - Soft dollar research/services
 - Reputation, financial strength and stability
 - Block trading and block positioning capabilities
 - Willingness and ability to execute hard trades
 - Willingness and ability to commit capital
 - Access to underwritten offerings and secondary markets
 - Ongoing reliability
 - Nature of the security and available market makers
 - Desired timing and size of trade
 - Market intelligence
 - Confidentiality
 - Other factors

Pre-Trade Processes

Broker Selection

- Due diligence
- Broker vote
- Affiliated brokers (agency, agency cross and principal trades)

Soft dollar arrangements

- Reasonability determinations
- Agreements with brokers and providers

Best Execution Committee

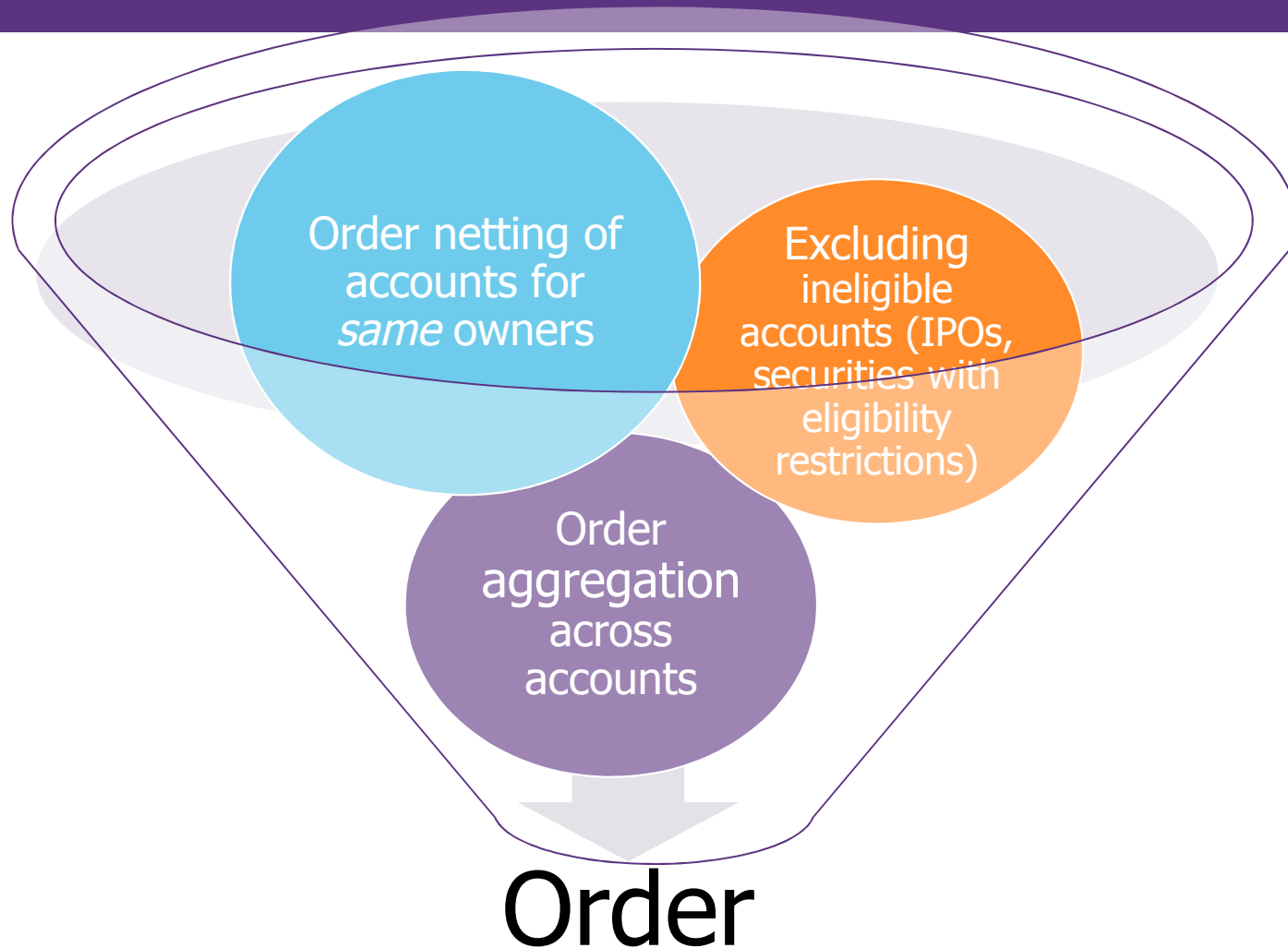
- Who measures?
 - Use of third-party TCA vendors
- Composition of committee
 - Who is on the committee?
 - Include GC or CCO?
- Committee meetings
 - How often?
 - What is covered?
- Records of meetings

Trade Life Cycle

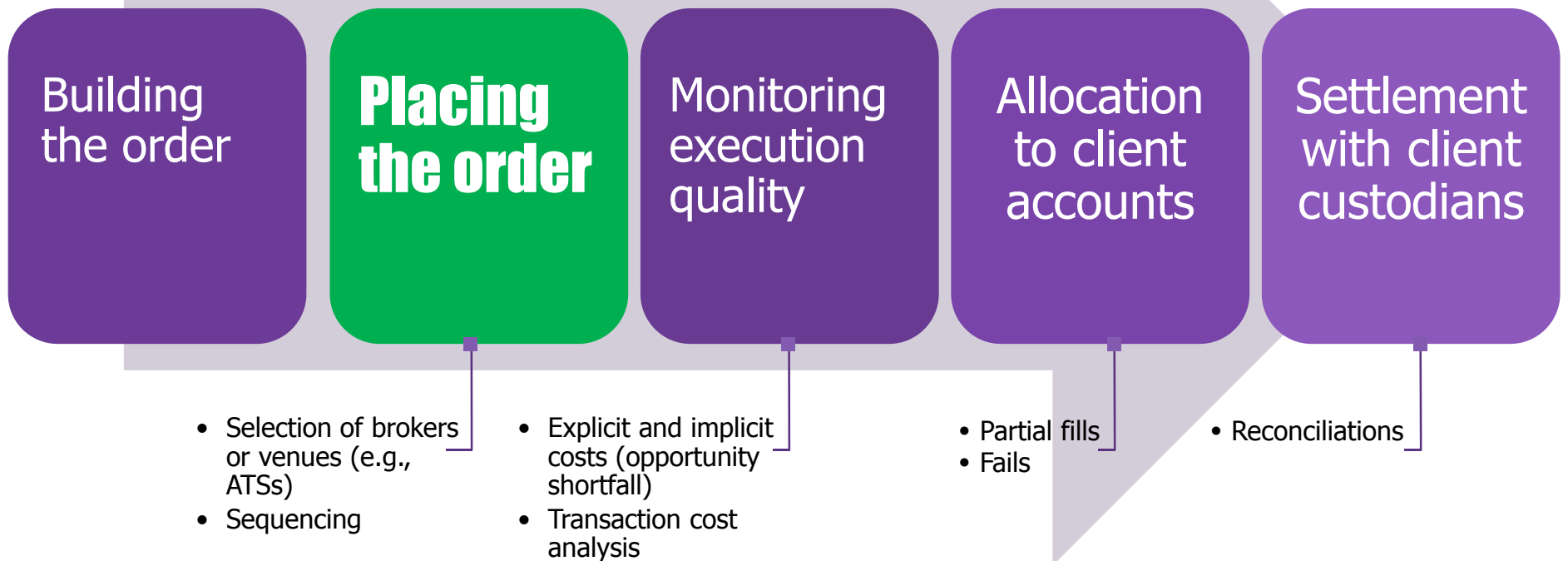


- Selection of brokers or venues

Building the Order



Trade Life Cycle



Conflicts

- Principal and agency trades
- Cross trades
- Fair allocation (including prop. accounts)
- Side by side trading
- Step out trades
- Interpositioning
- Trade errors
- Broker selection

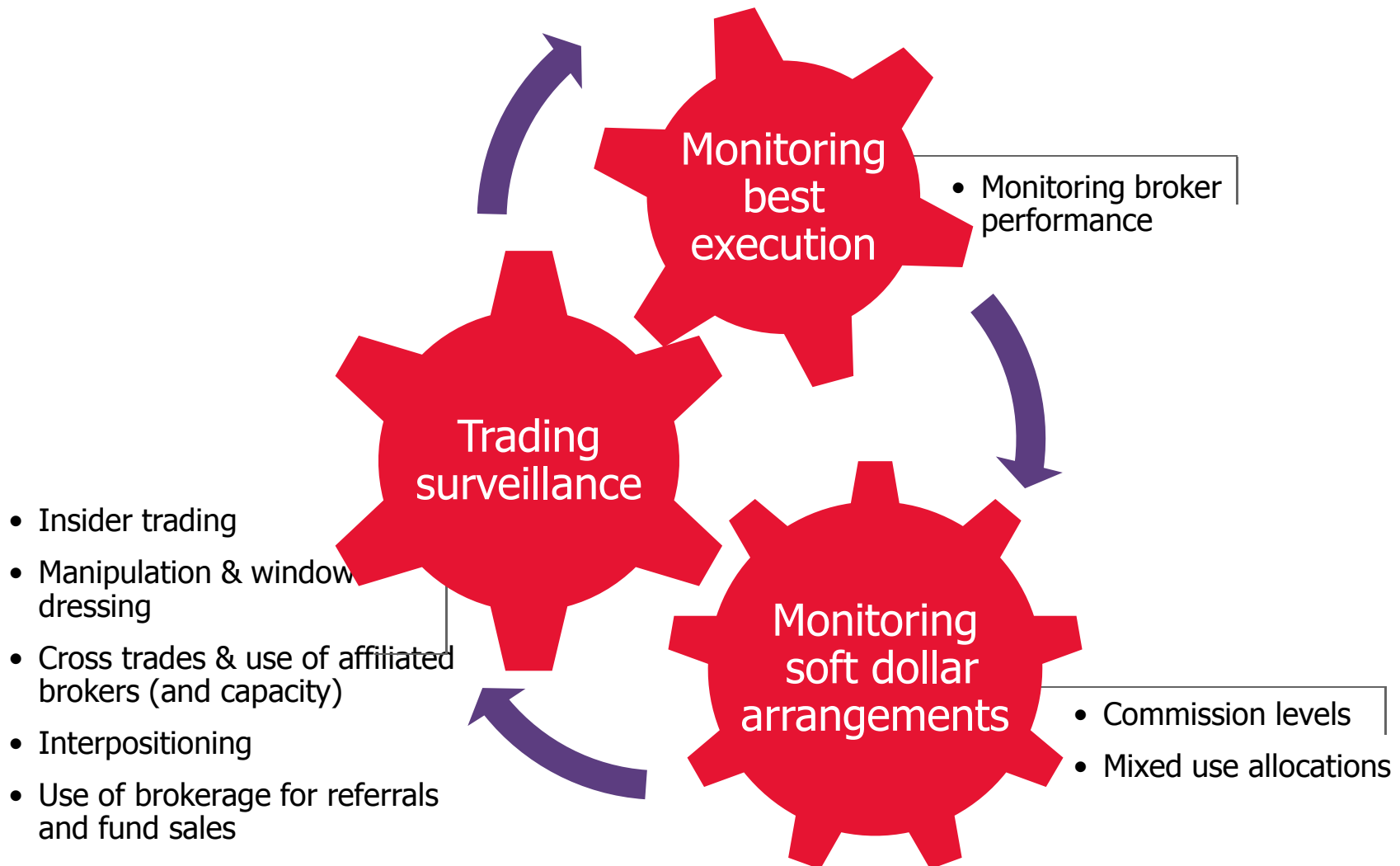
Conflicts

- Soft Dollars and CSAs
 - 28(e) “safe harbor”
 - Portability of credits
 - Protection of accrued credits
 - Disclosures – “bundled” research and services vs. third party
 - Global arrangements & recent FCA changes in UK
 - Limits on “corporate access”
- Directed brokerage
 - Client directed
 - Commission recapture
 - Brokerage for referrals and sales
- Affiliated brokerage
 - Commission levels
 - Research
 - Share class suitability
- Trade errors

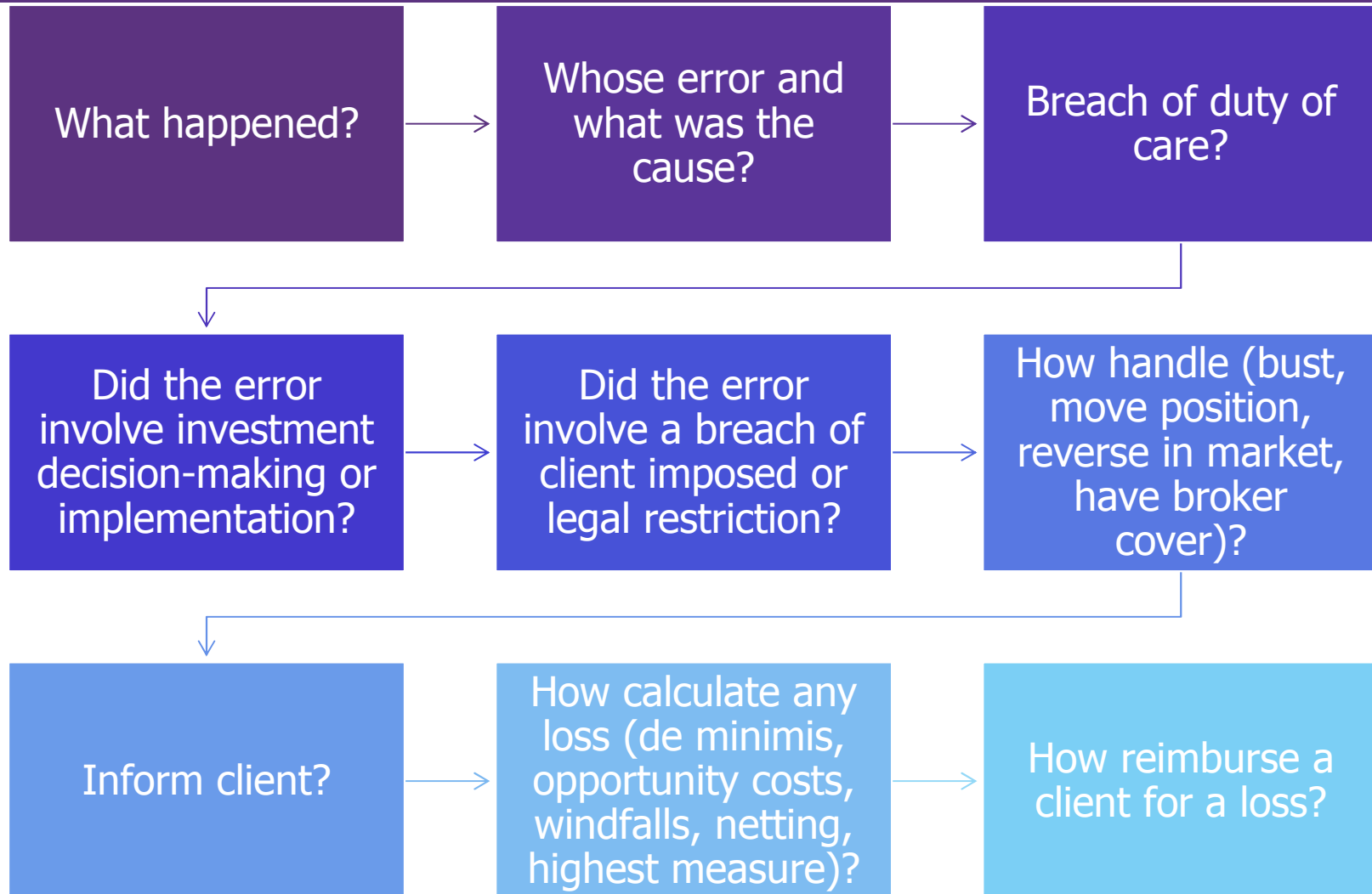
Sidebar on ERISA

- Disclosure is not enough (generally)
- Prohibited Transactions & PTCEs
 - Principal trades (PTE 75-1)
 - Agency trades (PTE 86-128)
 - Cross trades

Post-trade Processes



Trade Errors





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SPECIAL FOCUS AREAS

Fixed Income

- Recent Developments
 - SEC initiatives
 - MSRB & FINRA best ex rules for munis
- Challenges with best price and execution
 - Opacity of issuer and market information
 - Many illiquid investments
 - Fungibility of investments complicates analysis
 - Limited information on best ex across trading venues and participants
 - Shallow nature of dealer “books”
- Challenges with interest rate environment (e.g., high yield)

Retail Investor Platforms

- Wrap fee programs
 - Sponsor execution capacity
 - Trade away and transparency of any added trading costs
- “Institutional” custody and trading platforms
 - Reliance on platform for best execution
 - Platform support services

Recent Enforcement Actions

- Best Execution
 - Tilden Louck & Woodnorth (Oct. 29, 2012)
 - Goelzer Investment Management (July 31, 2013)
 - A.R. Schmeidler (July 31, 2013)
 - Manarin Investment Counsel (Oct. 2, 2013)
 - Pekin Singer Strauss Asset Mgmt. Inc. (June 23, 2015)
- Trade Allocation
 - MiddleCove Capital (Aug. 22, 2012)
 - SEC v. Dushek (Oct. 10, 2013)
 - MiddleCove Capital (Jan. 16, 2013)
 - Welhouse & Assoc. Inc. (Oct. 16, 2015).
- Principal Trading
 - Shadron L. Stastney (Sept. 18, 2013)
 - Parallax Investments (Nov. 26, 2013)
 - Citigroup Global Markets Inc. (Aug. 19, 2015)
- Soft Dollar Payments
 - J.S. Oliver Capital Management (Aug. 30, 2013)
 - Instinet (Dec. 26, 2013)
- Cross Trades
 - Western Asset Management Co. (Jan. 27, 2014)

Heat Map of Trader's Concerns

Source: TraderForum, Top issues facing buy-side traders (February 12, 2010)

Hot

- Too much SEC focus on equity trades, need more scrutiny fixed income trading
- HFT being considered as non-impactful to markets
- Filing miscues
- Effects of gaming
- Challenging process to upgrade/ change best of breed OMS/EMSs
- Efficient Use of Pre-, Post-, and Real-Time TCA
- Finding liquidity
- Counter party risk

Hotter

- Information leakage via execution venues
- Short swing profits
- Best execution
- Drastic increase in non-trading responsibilities
- HFT
- CSAs/ways to reduce executing brokers
- Integrating New Trading Tools/Strategies on the Desk
- Algorithm/high-touch variation of trades
- Measuring performance
- What is the right TCA measure for the group
- Finding meaningful, account specific TCA "apples to apples"

Hottest

- Affording technology needed to compete
- Sourcing natural liquidity
- Insider trading
- Hidden liquidity aggregation
- Monitoring our brokers execution logistics
- Fragmented markets
- Need for more flexible Multi-benchmark TCA
- Managing/Understanding Routing/ Order-Handling Procedures
- Identifying which systems to add/ keep on desk
- Budget/Paying soft dollars and research
- Resource consumption by our PMs and Analysts

THANK YOU

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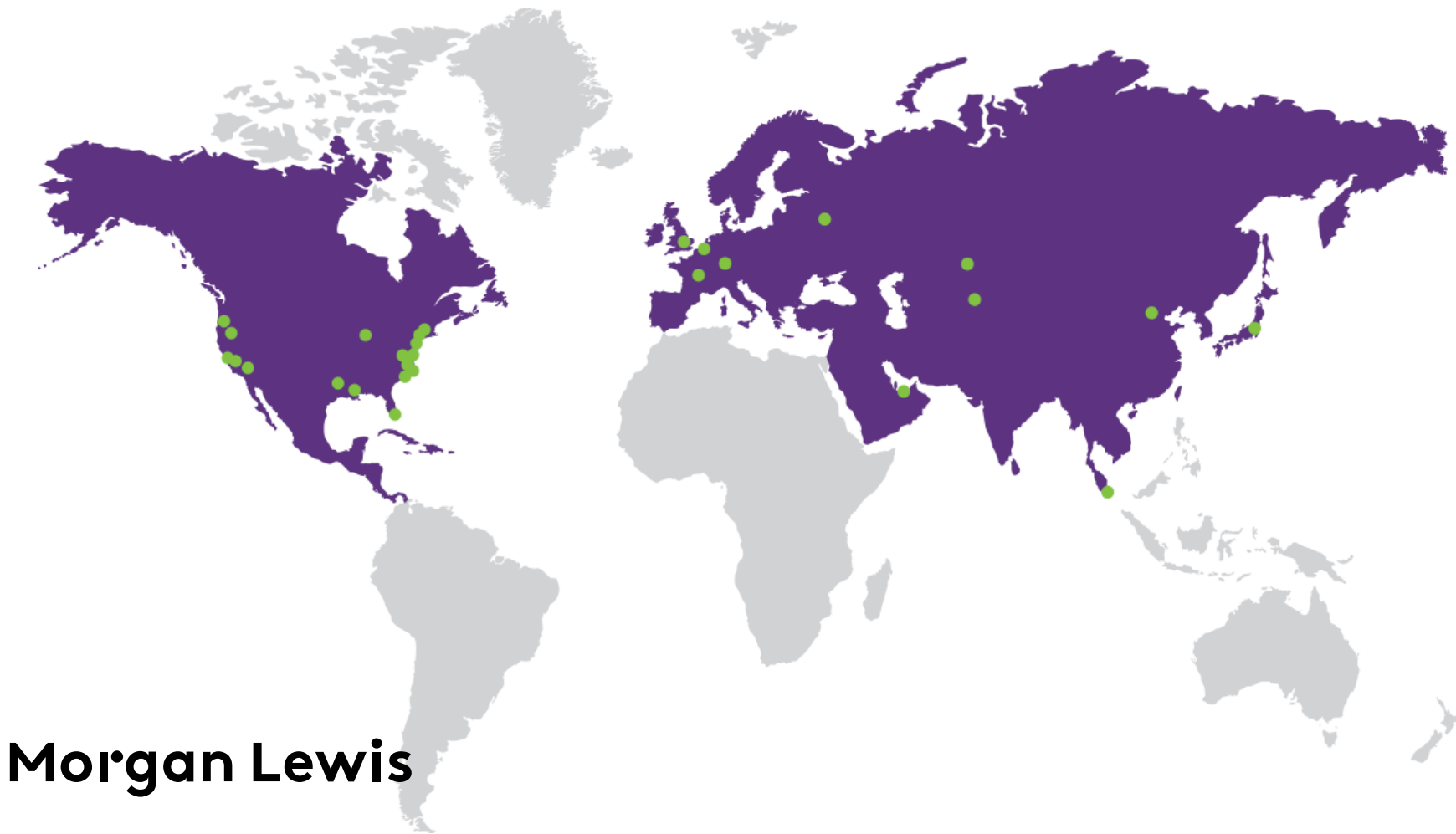
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