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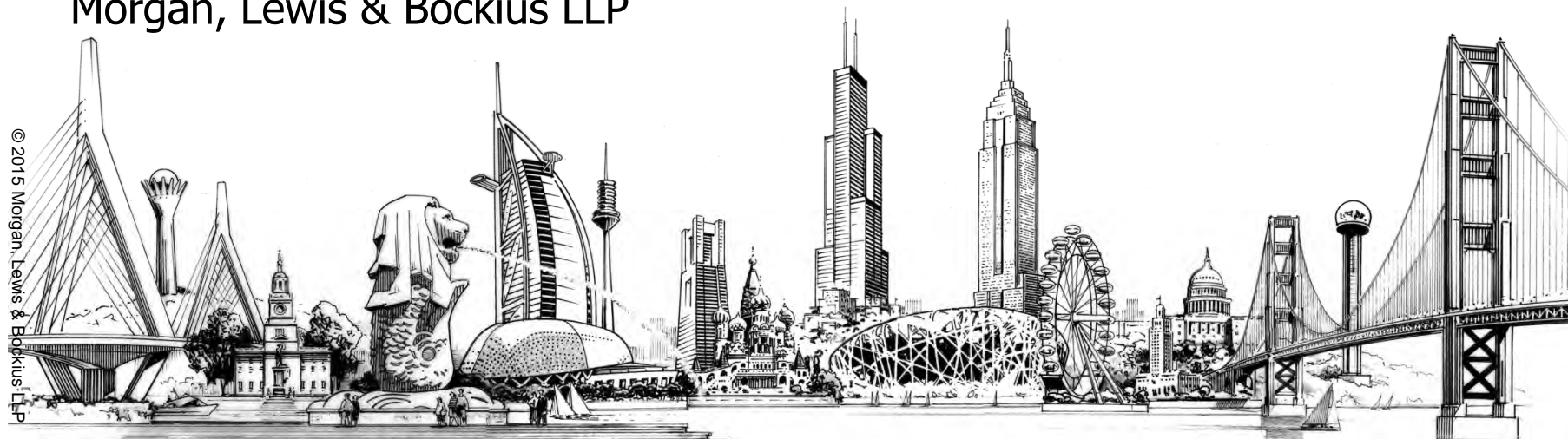
PLI's Fundamentals of Investment  
Adviser Regulation 2015  
July 15, 2015

# **REGULATION OF ADVISERS (PART II): BROKERAGE AND TRADING PRACTICES**

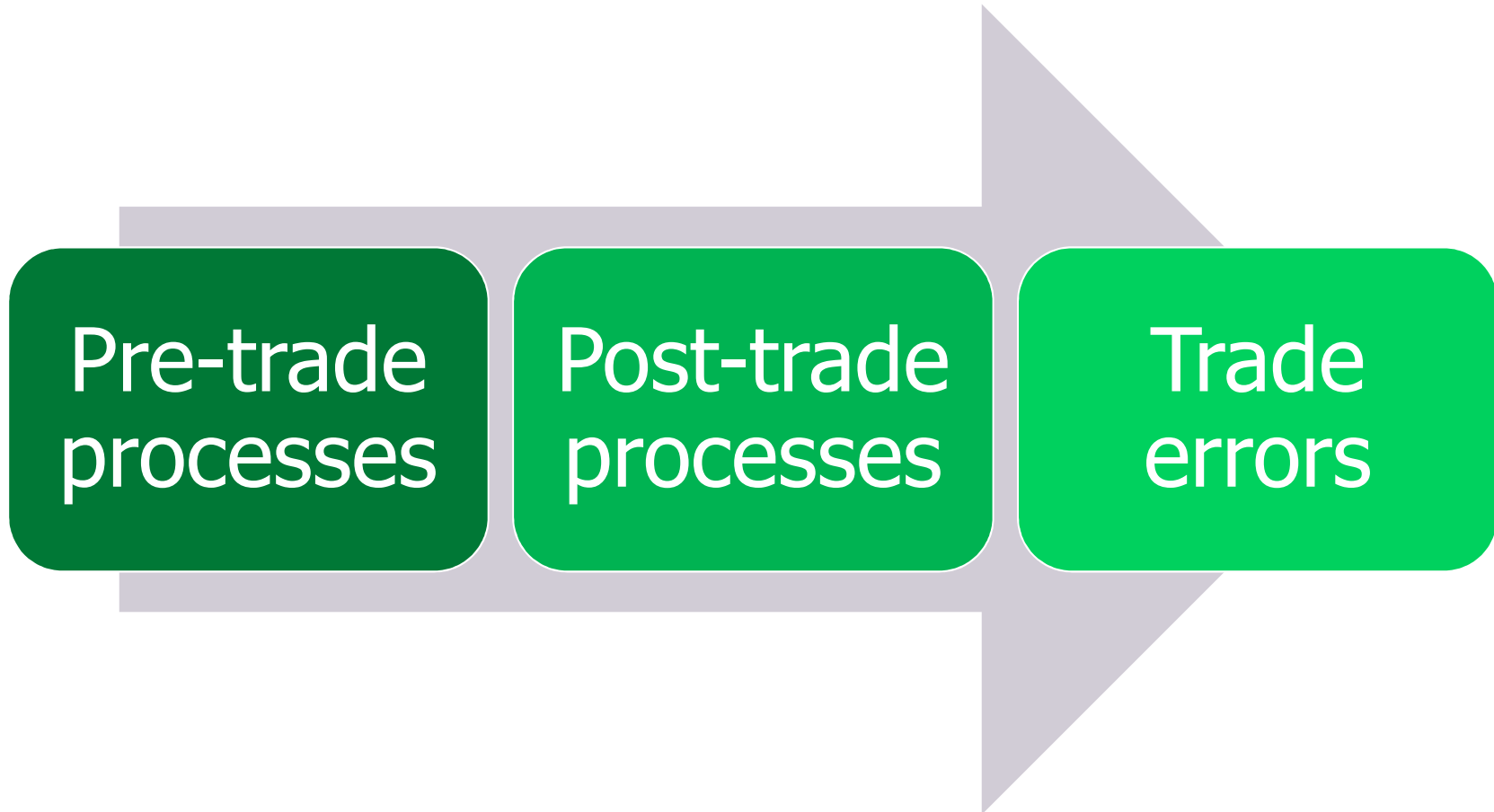
**Steven W. Stone**

Partner

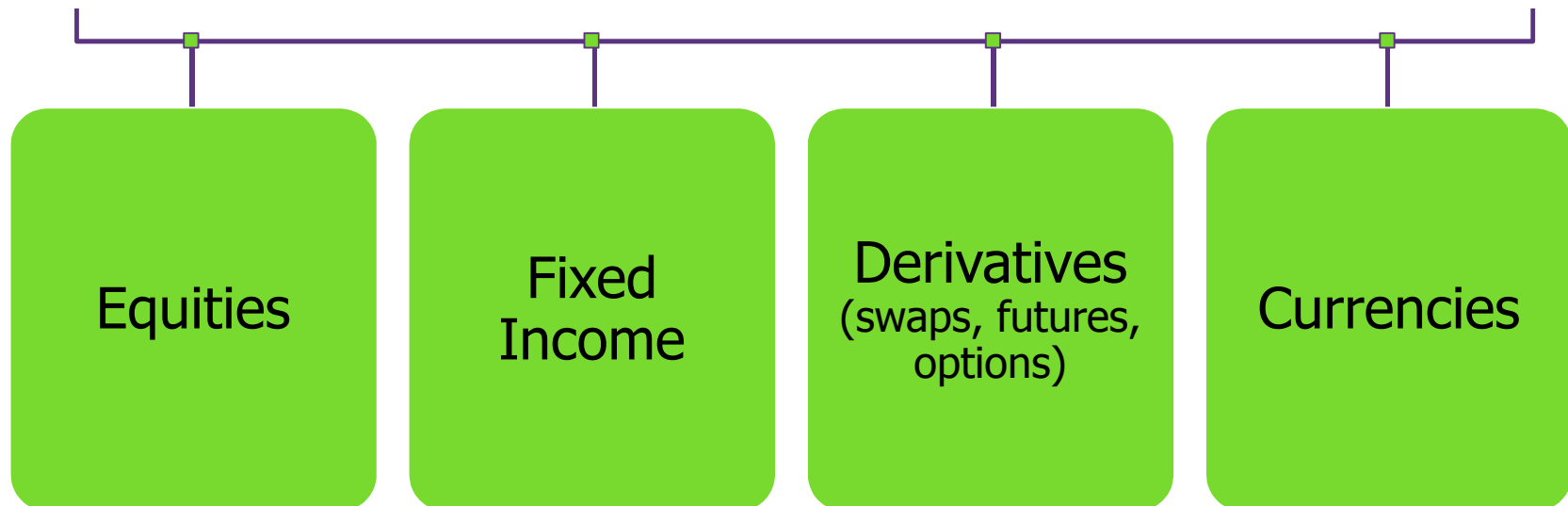
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# Life Cycle of a Trade



# 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”)
- 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."

# 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

- 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



# Best Execution Committee

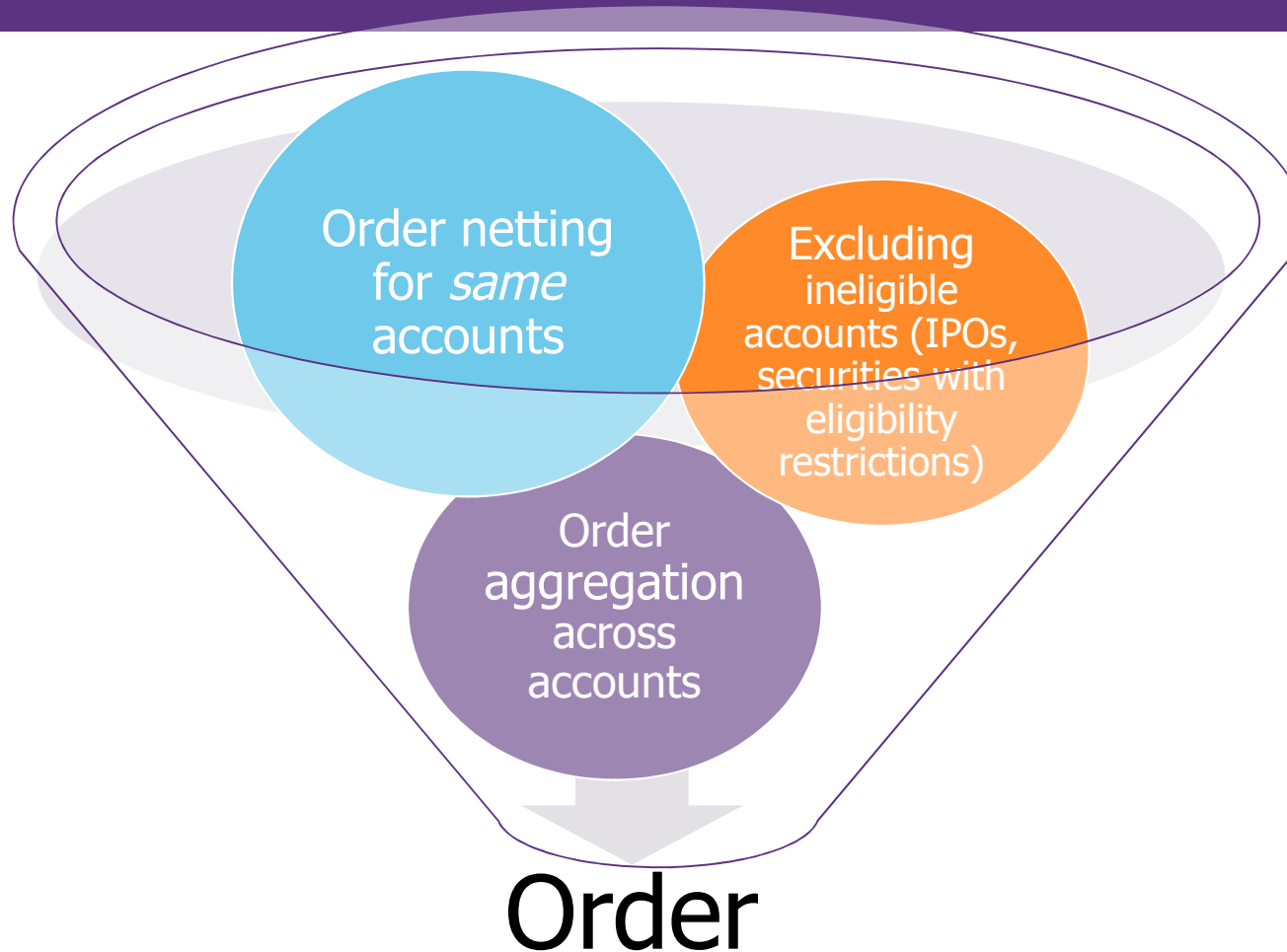
- Who measures?
  - Use of third-party TCA vendors
- Committee meetings
  - How often?
  - What is covered?
- Composition of committee
  - Who is on the committee?
  - Include GC or CCO?
- Records of meetings

# Trade Life Cycle

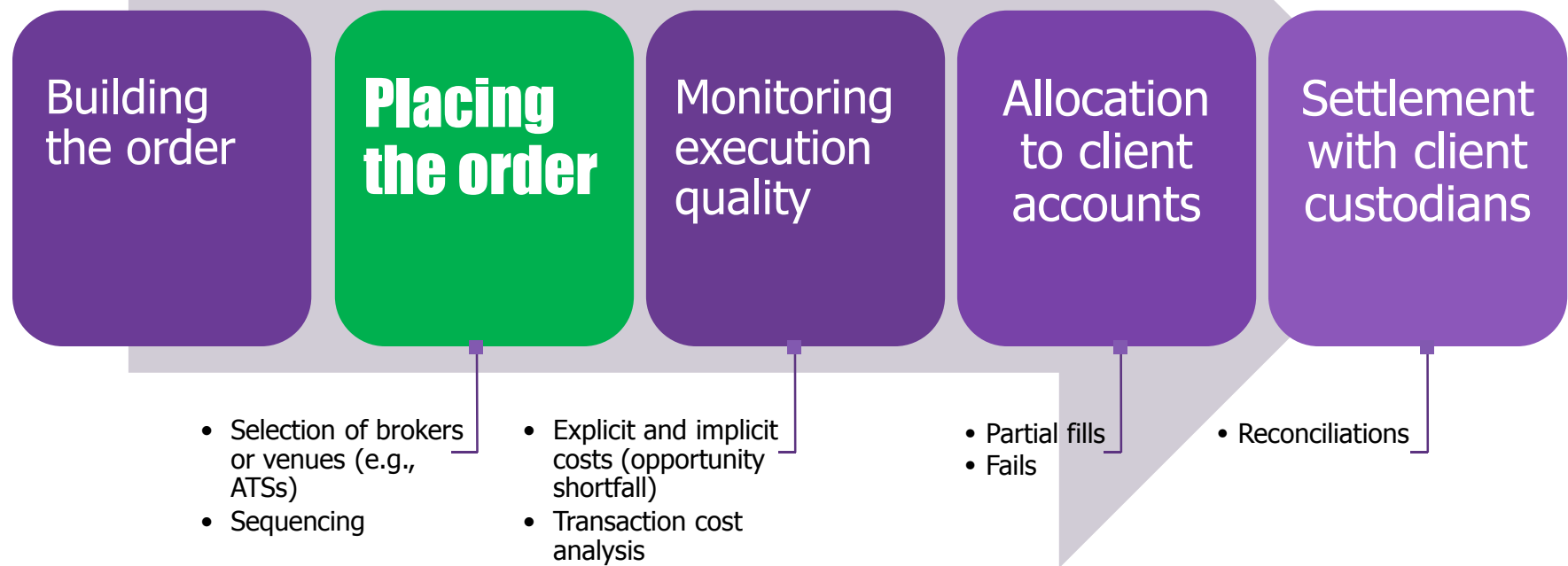


- Selection of brokers or venues

# 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

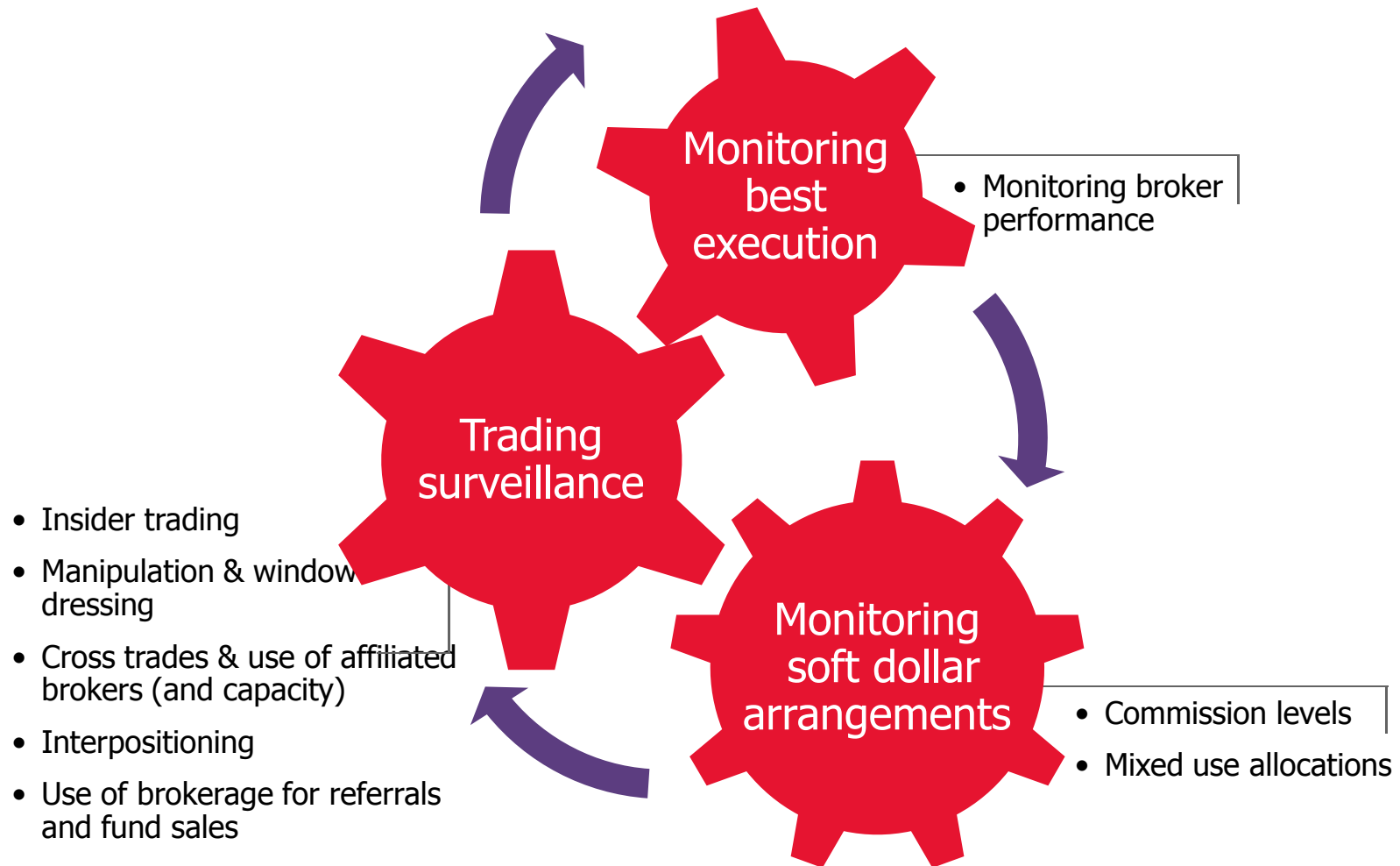
# Conflicts

- **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

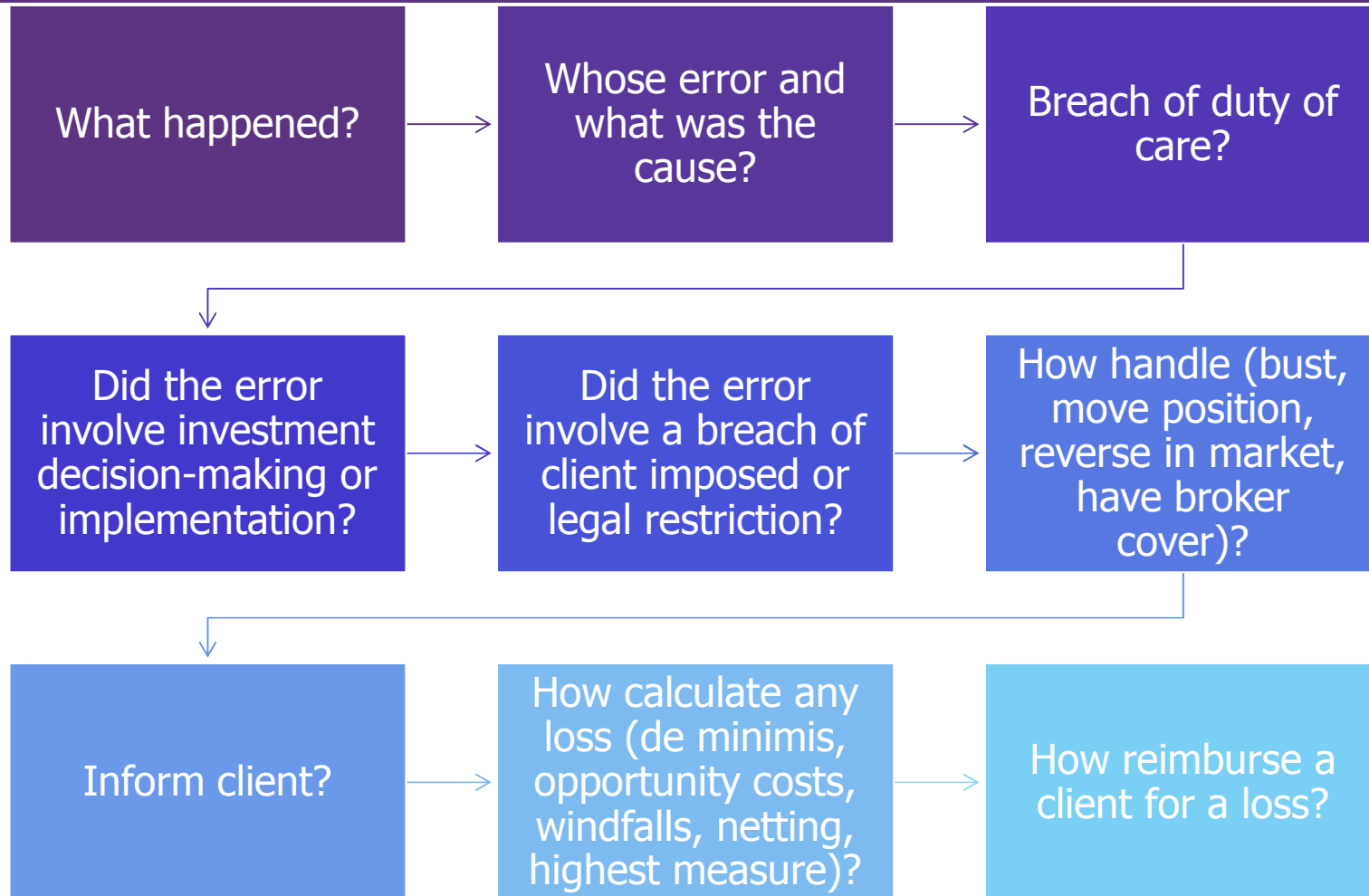
- Disclosure is not enough (generally)
- Prohibited Transactions & PTCEs
  - Principal trades (PTE 75-1)
  - Agency trades (PTE 86-128)
  - Cross trades

# Post-trade Processes





# Trade Errors



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# SPECIAL FOCUS AREAS

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# Fixed Income

- Recent Developments
  - SEC initiatives
  - MSRB proposal for 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

# 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)
- Trade Allocation
  - MiddleCove Capital (Aug. 22, 2012)
  - SEC v. Dushek (Oct. 10, 2013)
  - MiddleCove Capital (Jan. 16, 2013)
- Principal Trading
  - Shadron L. Stastney (Sept. 18, 2013)
  - Parallax Investments (Nov. 26, 2013)
- 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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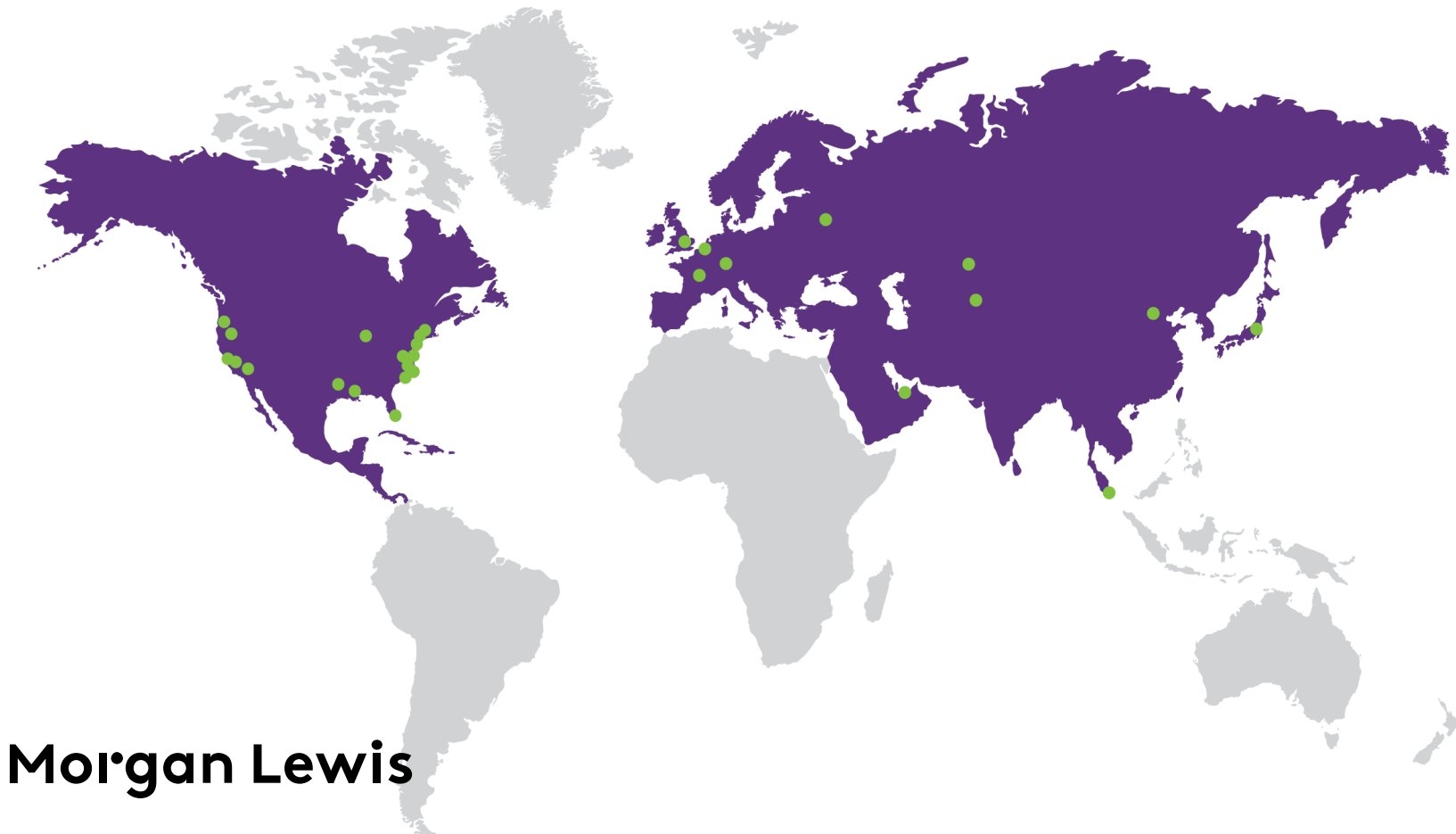
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