

Morgan Lewis

Regulation of Advisers (Part II):  
Brokerage and Trading Practices

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# Current Focus

- Best execution is subject of increased SEC focus
  - SEC's enforcement and exam units have hired industry experts on trading
  - Data Analysis
- SEC is better at detecting execution quality and trading issues in routine exams, which increases the changes that the SEC will actually challenge execution quality on a substantive basis
- All of this increases the changes 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

- Both quantitative and qualitative factors (a partial list)
  - Overall trading costs (i.e., net price paid or received), including commissions, mark-ups & -downs or spreads
  - Quality of execution – accurate and timely execution, clearance and error/dispute resolution
  - Receipt of soft dollar research/services
  - Reputation, financial strength and stability
  - Block trading and block positioning capabilities
  - Willingness to execute hard trades
  - Willingness and ability to commit capital
  - Access to underwritten offerings and secondary markets
  - Ongoing reliability
  - Nature of the security and the available market makers
  - Desired timing and size of trade
  - Market intelligence regarding trading activity
  - Confidentiality
  - Other factors?

# Best Execution Committee

- Who measures “best ex”?
- Third party TCA vendors
- Composition of committee
  - Who is on the committee?
  - How many may there be?
  - How many needed?
  - Is the CCO included?
- Committee meetings
  - How often?
  - What is covered?
- Record of meetings

# 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”
  - Global arrangements
  - Portability of credits
  - Protection of accrued credits
  - Disclosures – “bundled” research and services vs. third party
- Directed brokerage
  - Client directed
  - Commission recapture
  - Brokerage for referrals and sales (2013 SEC focus area – payments by advisers to entities that distribute mutual funds)
- 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

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# SPECIAL FOCUS AREAS

# Public Equity

- Thinly traded securities
  - Portfolio pumping
- Use of affiliated brokers
- Dark pools – IOIs (indications of interest)
  - FINRA 2012 inquiry into potential market manipulation

# Fixed Income

- Challenges with best price and execution
  - Opacity of issuer and market information
  - Many illiquid investments
  - Fungibility of investments complicates analysis
  - Limited information on best execution across trading venues and participants

# Retail Investor Platforms

- Wrap fee programs
  - Sponsor execution capacity
  - Trade aways
- “Institutional” custody and trading platforms
  - Reliance on platform for best execution
  - Platform support services

# Private Equity

- Best execution is best price


# Mechanics / Operations

- Due diligence of trading venues and brokers
  - Current focus on ECNs and ATSS
  - Focus on front running, execution quality and confidentiality
- Measuring best price and execution
- Tape recording
- Trading from home / Remote office / Night trading
- CCO should understand the OMS – capabilities, limitations and compatibility with compliance applications

# Compliance Watch

- Portfolio pumping
- Window dressing
- Interpositioning
- Use of affiliated brokers
- Fund distribution





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