Best execution and trade allocation continue to be among the top regulatory issues cited in public statements by senior staff at the Securities and Exchange Commission (“SEC”). These concepts are not new, but they are receiving renewed emphasis during examinations by the SEC’s Office of Compliance Inspections and Examinations (“OCIE”). Going back to 1999 and 2000 OCIE conducted best execution sweep exams, where the SEC found wide-spread lack of attention to best execution considerations. The SEC continues to find trade allocation issues during exams and has brought several enforcement cases.

Unless written policies and procedures are developed and implemented\(^1\) by advisers to periodically and systematically assess their brokerage selection and placement practices, as well as the results of those practices, a breach of the advisers’ best execution duty will be easy for the SEC to find and hard for the adviser to defend. Existing SEC guidance has long recognized that best execution is fact-specific. Quantitative tools are available to the SEC and to the industry to aid in that fact-driven analysis. Unless investment advisers identify—and disclose to clients—the qualitative factors that significantly influence their brokerage placement practices, advisers risk being judged by the SEC and potential client litigants solely on the cold, hard numbers that these new tools provide.

Viewed from a different perspective, however, there may be an opportunity in those cold hard numbers. When execution data is carefully analyzed, advisers can make better informed brokerage placement decisions that may improve their investment performance. The SEC has

noted wide-spread lack of trading practices disclosure. Using well-crafted disclosures, advisers can better distinguish themselves from their competitors by clearly articulating specific ways in which their clients’ interests are kept at the forefront of the adviser’s mission and motivation.

Enforcement proceedings exemplify the consequences when clients’ best interests are not at the forefront of the adviser’s mission because of other motivations. Many cases are variations on an old theme—personal benefits directly or indirectly derived from clients’ transactions and assets. In many instances, an employee’s improper conduct hurt the employer’s investment performance and, accordingly, the firm’s competitive edge. Making matters worse, besides the bad publicity, those SEC proceedings have included sanctions against the firm for failing to adequately supervise its employees.

Regular compliance-driven assessments of an adviser’s trade execution can serve clients’ interests by identifying ways to increase the clients’ investment returns and thereby improving the adviser’s comparative performance. Good disclosures can help to distinguish an adviser from its competitors. These are positive results that can flow from the blood, sweat, and tears shed in preparation for OCIE’s inevitable visit.

I. Recent Cases

In October 2013, the SEC sanctioned an investment advisory firm and its owner for failing to seek “the most beneficial terms reasonably available when investing in mutual fund shares for three funds that they managed”. The SEC went beyond alleging merely undisclosed conflicts of interest. “Investment advisers must fulfill their fiduciary duty of best execution when selecting mutual fund shares for their clients”, the SEC said in its press release. The owner and his firm “breached that duty by choosing more expensive shares that would pay higher fees to an affiliate when their clients were eligible to own lower-cost shares in the very same mutual funds”, according to the release. Mere conflict disclosure would not avoid the “best execution” violation. The application of best execution principles to mutual fund selection is new regulatory territory.

In July 2013, the SEC sanctioned two investment advisory firms for failing to seek best execution on client trades placed with their in-house brokerage divisions. The SEC found that a dually registered investment adviser and a broker-dealer “failed to reevaluate whether it was providing best execution for its advisory clients when it negotiated more favorable terms with its clearing firm”. In its press release, the SEC said, “The firm failed to implement policies and procedures reasonably designed to prevent its best execution violations.” “These cases send a clear message to dually registered investment advisers and broker-dealers about our expectations in connection with their best execution analysis.” “Investment advisers must carefully analyze whether their clients are obtaining the most beneficial terms reasonably available for their orders, particularly if those orders are executed through affiliated broker-dealers. We will hold accountable those advisers who fail to do so.”

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2 In the Matter of Manarin Investment Counsel, Ltd., Manarin Securities Corp., and Roland R. Manarin, Administrative Proceeding File No. 3-15549, October 2, 2013 (“Manarin”).
In October 2012, the SEC found that an investment adviser obtained undisclosed compensation by charging increased commissions on trades for its clients through its affiliated broker-dealer. Here the adviser and its affiliated broker-dealer not only failed to obtain best execution but also made misrepresentations to clients about what it would do to obtain it. “By setting commission rates that exceeded LaSalle’s charge to execute a trade, Tilden failed to seek best execution for its clients’ securities transactions. Further, Tilden made misleading statements in its Forms ADV concerning the steps it would take to evaluate execution of client trades and ensure that commission rates were reasonable,” according to the SEC’s settlement order. Care must be taken to be sure an adviser complies with both the best execution obligation, as well as representations made about the adviser’s process for fulfilling its best execution obligation.

II. Best Execution

An investment adviser’s fiduciary duty to its client is the heart of the adviser’s duty to seek best execution. Not only does an adviser owe an undivided duty of loyalty to serve its client’s interests and maximize the client’s benefits, but there is growing recognition of the intrinsic value in the control of brokerage placement—an asset created when paid for by the client. An adviser’s compliance violations are typically styled by the SEC as a breach of the anti-fraud prohibitions in Section 206 of the Advisers Act. While having no private right to recover losses under Section 206, clients could assert a breach of fiduciary duty claim to recover losses if asserted within the relevant statute of limitations period.

Best execution obligations arise if the adviser has authority to exercise brokerage placement discretion. In the absence of discretion, an adviser still needs to offer its best professional advice that a client-directed brokerage arrangement may not be in the client’s best interests. Client-directed brokerage effectively precludes the negotiation of brokerage commission rates and the adviser’s utilization of execution alternatives such as electronic communications networks. Clients must be so advised.

The SEC’s emphasis on an investment adviser’s best execution practices cannot be viewed in isolation. The SEC has articulated four interdependent elements as a framework guiding its efforts to better achieve a national market system: (i) competition among markets; (ii) transparency of pricing; (iii) better linkages between market centers; and (iv) best execution of customer orders. (Speech by Arthur Levitt, Chairman, SEC, to the Securities Industry Association, Boca Raton, Florida, http://www.sec.gov/news/speech/speecharchive/1999/spch315.htm (November 4, 1999).) To that end, in November 2000, the SEC adopted two rules under the Securities Exchange Act of 1934, as amended (“Exchange Act”), concerning the disclosure of order routing and execution performance. SEC Rules 11Ac1-5 and 11Ac1-6 became effective in November 2001. Those rules were designed to make available to the public (1) monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis; and (2) basic, uniform measures of execution quality (effective spread, rate of price improvement and disimprovement, fill rates, and speed of execution) by market centers. These

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4 In the Matter of Tilden Loucks & Woodnorth, LLC, LaSalle St. Securities, LLC, and Ralph B. Loucks, Administrative Proceeding File No. 3-15081 (October 29, 2012).
quantitative tools are now available for the SEC and the industry to better assess each broker-dealer’s trade execution performance, as well as the relative performance of markets and market makers. It is clear that the SEC wants this new-found data to be put to good use by the investing public, starting with the professional investment management community.

A. **Best Execution Defined—Relatively Speaking**

The concept of best execution has always been difficult to clearly articulate because it is a subjective “facts and circumstances” analysis. Best execution means different things to different advisers and different clients. According to the SEC, it must be analyzed in terms of specific transactions but viewed in the context of broader considerations. In a 1986 interpretive release addressing the scope and application of soft dollar practices under Section 28(e), the SEC said that:

> As a fiduciary, a money manager has an obligation to obtain “best execution” of clients’ transactions under the circumstances of the particular transaction. The money manager 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 [footnote omitted]. A money manager should consider the full range and quality of a broker’s services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account. In this connection, money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions.


Make no mistake, quantitative considerations are an important part of the analysis. In her remarks to mutual fund directors about their oversight, former SEC Commissioner, Annette L. Nazareth, said:

> As part of its review of portfolio executions, directors should consider the impact of commission rates on best execution. Directors should consider requesting from their advisers reports summarizing commission rates paid to brokers; seek explanations for the commission rates that exceed the customary rate paid; and examine, particularly for liquid securities, the adviser's relative use of alternative execution strategies such as program trading, direct access, and ECNs that can achieve quality executions at reduced cost.
With respect to trades executed by an affiliate of the adviser, directors both should require that the adviser obtain the most favorable commission rate that the affiliated broker-dealer gives comparable clients, and that such affiliate provides the best execution reasonably available under the circumstances to the fund.


Part of the analysis turns upon the characteristics and circumstances of each client. The size of the client’s account, investment objectives, and other client-specific factors all bear upon what is the best execution available to that client. Of course, each client may benefit from the adviser’s services to other clients—most often when the adviser is able to aggregate trades for clients with like objectives for the purpose of obtaining more efficient and effective execution, including lower transaction costs. Trade aggregation is described in later paragraphs.

A number of qualitative factors affecting best execution have been identified by the SEC and by advisers in defense of their brokerage placement practices. Not all of the factors cited are relevant to every adviser. Best execution analysis includes a mix of major factors such as securities price, brokerage commission (compensation), execution speed, and capacity for large transactions. Financial strength, the assurance of liquidity, and a willingness to commit the broker-dealer’s own capital to complete the transaction are important factors. Accuracy in handling orders, transaction/account reporting, and prompt error resolution are also important. Access to initial public offerings, private placements, and other new offerings are important to some advisers’ investment strategies. Block trading, arbitrage capabilities, access to electronic communications networks (“ECNs”), and other markets may be factors. Besides various clearing and settlement capabilities, confidentiality may be an especially important consideration for some advisers and their clients who are acquiring or selling large positions. While transaction costs reflect a short-term consideration, there is also value in the long-term working relationship between the adviser and the broker, though that is harder to specifically articulate.

Qualitative factors will vary among advisers depending upon their business model, services, investment strategies, and affiliate relationships. Qualitative factors will only be persuasive when they are relevant to the adviser. An analysis of qualitative execution must also be honest about an adviser’s own interests. The adviser’s interests must be well-articulated to clients in Form ADV and in other disclosures. For example, a “standard” client disclosure has long been included in many advisers’ Form ADVs to the effect that research and other benefits derived from one client’s transactions may benefit other clients and, in some instances, may not directly benefit the client’s specific transaction which generated the benefit.

**B. Best Execution—The Process**

In view of the range of possible qualitative factors that might be cited by an adviser, the SEC has come to focus its examinations on the process by which the adviser seeks and evaluates best execution, while perhaps judging less stringently the relative merits of those factors to the
specific adviser. The importance of an adviser’s review process is not a new concept either—the SEC has long asserted that a periodic and systematic evaluation of execution performance of broker-dealers is required, as quoted above.

OCIE’s sweep and regular examinations have found advisers often ignoring their best execution obligation or failing to consider execution alternatives. The fact that rerouting orders never occurred at an adviser has exceeded the credulity of some SEC examiners. Many advisers could not articulate qualitative factors that guided their decision-making, leaving the SEC examiners doubting if there were any. Even when qualitative factors could be divined after that fact, the lack of any periodic or systematic analysis of those factors was a major concern because of evolving market structures. Of course, in the absence of mitigating qualitative factors that demonstrated due consideration for the clients’ benefit, there were ever-present factors benefiting the adviser. Recurring conflicts have included, for example, directing brokerage to broker-dealers expressly or implicitly in exchange for new client referrals and soft dollar benefits. Many of those conflicts of interest were not fully disclosed to clients.

1. SEC Statements and Enforcement

The SEC has observed and recommended several steps advisers should consider to improve their best execution practices and evaluation process. (Speech by Paul Roye, Director, Division of Investment Management, SEC, National Symposium on Investment Adviser Regulation, Philadelphia, Pennsylvania, http://www.sec.gov/news/speech/spch512.htm, September 10, 2001.) For example, some advisers have formed committees to take charge of the firm’s brokerage placement decision-making and practices.

Whether or not a committee is formed, the SEC says an adviser should establish quantitative and qualitative criteria and information which can be periodically reviewed. Document the review. Conflicts of interest affecting brokerage placement must be identified, properly resolved, and fully disclosed. Echoing the SEC’s concern about disclosure, industry leaders have underscored the importance of identifying and disclosing conflicts because the flip side of proving that a client consistently received best execution is so difficult. With this in mind, some leaders recommend that advisers be cautious about targeting any more than a small percentage of trades to any broker-dealer so that most trades are placed without regard to rewarding anyone other than the client.

A common conflict is the adviser’s brokerage placement in exchange for referrals. The SEC has implicitly said that, as long as the placement-for-referral practice is fully disclosed, the practice is not itself an issue. OCIE’s letter dated May 1, 2000, to federally registered investment advisers (http://www.sec.gov/divisions/ocie/advlt.htm) cited examples of disclosure failures found during examinations. OCIE noted a violation may be found where the “[a]n adviser allocates client brokerage to a broker in exchange for client referrals without full disclosure of the practice . . . .” Full disclosure would appear to resolve this conflict in the SEC’s eyes, even though the referrals had no benefit to the adviser’s other clients.

Merely giving lip service to an adviser’s best execution practices in Form ADV can compound the violations because, above all, the disclosures must be accurate. In Founders Asset
Management, Release No. 1879, File No. 3-10232 (June 15, 2000), the SEC cited the adviser for material misstatements in its Form ADV, a violation of Section 207 of the Advisers Act, along with violations of Section 206 for non-disclosure of material information. The adviser’s Form ADV said it was the firm’s policy “to seek the best execution of orders at the most favorable prices” and that “[s]ubject to the policy of seeking best execution of orders at the most favorable prices, Registrant may place transactions with brokerage firms which refer investment advisory clients to Registrant.” Consistent with the disclosure, trades were directed to a designated registered representative at a broker-dealer in exchange for client referrals. All things being equal, the disclosure of this placement-for-referrals conflict may not have been an issue for the SEC—but all things were not equal. Trades for the adviser’s smaller accounts (under $2 million) were executed at a 20 cent commission rate while 6 to 8 cent commission rates were charged to the adviser’s larger private and fund accounts. The smaller accounts were also disadvantaged because their trades were not aggregated with the adviser’s larger accounts and were executed by the broker-dealer after the larger accounts’ trades. That adviser paid $590,000 to clients plus a civil money penalty of $150,000—an expensive lesson.

2. CFA Institute Trade Management Guidelines

The CFA Institute (f/k/a the Association for Investment Management and Research or “AIMR”) issued guidelines for trade management practices. The CFA Trade Management Guidelines can be found on the Internet at http://www.cfapubs.org/doi/abs/10.2469/ccb.v2004.n3.4007. Like its Soft Dollar Standards (http://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2004.n1.4005.aspx) and its Global Investment Performance Standards (http://www.gipsstandards.org/Pages/index.aspx), these guidelines will help advisers (and hopefully regulators) grapple with a difficult concept. These are a compilation of recommended practices and not legal requirements. As noted above, factors affecting an adviser’s trade management only make sense when tailored to its own circumstances.

The CFA Institute’s view is that best execution cannot be analyzed trade-by-trade on a meaningful basis. Its guidelines define best execution as the trading process firms should apply that seeks to “maximize the value of a client’s portfolio within the client’s stated investment objectives and constraints”. The CFA Institute acknowledges that its view is somewhat at odds with the SEC’s historical statements about analyzing the circumstances of the particular transaction, but is provided for additional explanation and guidance. In seminar panels some SEC staff have acknowledged, but not commented, on CFA Institute’s perspective.

The CFA Institute’s Trade Management Guidelines offer an excellent view of best execution. CFA Institute refers to best execution as a trading process that seeks to maximize the value of a client’s portfolio given each client’s stated investment objectives and constraints. In CFA Institute’s words, this definition recognizes that best execution:

- is intrinsically tied to portfolio-decision value and cannot be evaluated independently;

5 More recently, see In the Matter of Tilden Loucks & Woodnorth, LLC, LaSalle St. Securities, LLC, and Ralph B. Loucks, Administrative Proceeding File No. 3-15081 (October 29, 2012).
is a prospective, statistical, and qualitative concept that cannot be known with certainty *ex ante* [*i.e., beforehand*];

has aspects that may be measured and analyzed over time on an *ex post* [*i.e., after the fact*] basis, even though such measurement on a trade-by-trade basis may not be meaningful in isolation; and

is interwoven into complicated, repetitive, and continuing practices and relationships.

CFA Institute’s Trade Management Guidelines provide a menu of ideas to assist advisers in developing their own policies and procedures. The Guidelines focus on three areas: processes, disclosures, and record keeping. CFA Institute’s Guidelines are detailed and largely self-explanatory.

### 3. Key Concepts to Apply

SEC examiners have been given specific guidance about the compliance steps the SEC wants to see during an inspection. Key concepts that can be drawn from the SEC’s guidance, CFA Institute’s Guidelines, and common sense include:

- Specifically assigning responsibility for development and for implementation oversight to a committee within the firm. To the extent possible, the committee should include management and people other than those who place brokerage orders.

- Identify all of the factors that may affect brokerage selection and placement decisions. Gather input from all affected personnel in the firm (such as portfolio managers, traders, back office staff, compliance, sales and marketing, and representatives from affiliates).

- Identify a reasonable number of execution alternatives. Obtain information from those broker-dealers and other alternatives. Organize the information so that quality and related costs can be readily compared both currently and from review to review.

- Develop written policies describing the firm’s brokerage selection, placement, and evaluation process, including the decision-making factors and all potential conflicts. Include policies on soft dollar arrangements, trade aggregation and allocation, and other trading practices. Review the policies at least annually and update them as circumstances change.

- Provide the policies to all affected personnel on a periodic basis and, for key personnel, obtain their written acknowledgements (or
at least evidence of their receipt). If the policy is not followed by an employee, the breach is likely to be sufficient grounds for termination—in the absence of a written policy, the employee’s termination may be problematic.

- Develop checks and balances to better control the process. Be mindful of economic incentives affecting the personnel who make brokerage placement decisions.

- Periodically supervise affected personnel for compliance with the policies. Review internal trade data to test for anomalies and violations of policy.

- Provide the policies to clients (excluding any competitive or proprietary information) and summarize the policies in Form ADV. If conflicts are involved, incorporate both disclosure and consent language into the firm’s standard client service contracts.

- If more than one broker-dealer is routinely used (and that is recommended), an approved list of brokerage firms should be developed annually. A “budget” of anticipated brokerage expenditures (starting with last year’s data) can be an effective tool to promote the firm’s objectives and identify anomalies in practice.

- Create a periodic evaluation process that considers both quantitative and qualitative data. Periodically obtain commission and execution performance data from your broker-dealers. Market center performance data is also available, as described below. Periodically survey affected personnel for their qualitative evaluation of the brokerage services with a questionnaire or feedback form.

- Periodically discuss execution alternatives used by your broker-dealer and other broker-dealers, such as electronic communications networks. Document those discussions with a letter or memo with supporting materials.

- Document the evaluation process in the form of committee minutes or a memorandum, including the conclusions and supporting information.

- Retain all of the above documentation related to your trade management (best execution) process.

It cannot be emphasized enough to “do what you say.” Client disclosures become representations. Failure to live-up to those representations will become material misrepresentations
and omissions and violations of Section 207 of the Advisers Act. On-going supervision of employees for compliance with the adviser’s policies and procedures is crucial.

4. **Conflicts of Interest**

In evaluating best execution, bear in mind that there may be a number of potential conflicts of interest to be factored into the analysis and, if applicable, these must be disclosed to clients. Such conflicts may include, for example, affiliation by ownership or control, soft dollar arrangements, IPO allocations, client referral sources, distribution of funds that are managed by the adviser, payment for order flow, and equity interests in market makers or market centers.

C. **Quantitative Data—Help from your Broker-Dealers**

The broker-dealers used by an investment adviser should be in a position to assist in the adviser’s assessment of best execution. Broker-dealers and other market centers are required to regularly publish quantitative data about their trading practices and execution results that can be incorporated into an adviser’s policies, procedures, and methods of analysis. An understanding of the broker-dealer’s best execution obligation will be helpful to an adviser’s own analysis, as well as counseling a client in situations where the adviser does not exercise brokerage discretion and so does not itself have a duty of best execution.

Broker-dealers are subject to their own duty of best execution, which is similar in many ways an investment adviser’s duty. A broker-dealer must “use reasonable efforts to maximize the economic benefit to the client in each transaction.” *(Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F. 3d 266, 270; 1998 U.S. App. LEXIS 1378 (3d Cir. N.J. 1998) (“Newton I”).)* A broker-dealer’s best execution duty has been incorporated into self-regulatory organization (“SRO”) rules (See NASD Rule 2320 and Notice to Members 01-22; NYSE Rule 401 and NYSE Information Memo 97-8). The duty includes an assessment of what execution alternatives are “reasonably available,” which has and will continue to evolve over time. Nondisclosure of material execution practices may serve as the premise of a securities law claim. *(Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 259 F. 3d 154, 173; 2001 U.S. App. LEXIS 17424 (3d Cir. N.J. 2001) (“Newton II”).)*

Because of changes in market structure and technology, today’s execution at the national best bid and offer (“NBBO”) does not necessarily satisfy a broker-dealer’s best execution obligation. *(See Newton I at 271).** Better prices (price improvement) may be available through electronic communications networks such as SelectNet, Instinet, Island, Bloomberg Tradebook, Archipelago, REDIBook, Strike, Attain, NexTrade, Market XT, GFI Securities. *(See the SEC’s Special Study, Electronic Communication Networks and After-Hours Trading, [http://www.sec.gov/news/studies/ecnanfter.htm](http://www.sec.gov/news/studies/ecnanfter.htm) (June 2000).)* Recently effective SEC regulations now generate data that can be used in conjunction with NBBO data, which will have a significant impact on the analysis.

Quantitative trading and execution data is now publicly available under SEC Rules 11Ac1-5 and 11Ac1-6 under the Exchange Act. Pursuant to SEC Rule 11Ac1-5 all market centers (exchange market makers, OTC market makers, alternative trading systems, national securi-
ties exchanges, and national securities associations) must make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. To facilitate comparisons across market centers, the rule adopts basic measures of execution quality (effective spread, rate of price improvement and disimprovement, fill rates and speed of execution) and sets forth specific instructions on how the measures are to be calculated. The statistical information is categorized by individual security, by five types of orders (e.g., market and inside-the-quote limit), and four order sizes (e.g., 100-499 shares and 500-1999 shares). The data can be used to analyze order executions for a particular security or for any particular group of securities, as well as for any size or type of order across those groups of securities. This information must be posted by the market center on the Internet under the phrase “Disclosure of SEC-Required Order Execution.” (See Joint Industry Plan, Release No 34-44177; File No. 4-208, http://www.sec.gov/rules/other/34-44177.htm (April 12, 2001).)

Under SEC Rule 11Ac1-6 all broker-dealers (including introducing firms, but excluding certain small firms) that route customer orders in equity and option securities are required to make publicly available quarterly reports that, among other things, identify the venues to which customer orders are routed for execution. Broker-dealers must disclose to customers, on request, the venues to which their individual orders were routed for orders routed. Quarterly reports should be available for 2002 and subsequent quarters. This data can help to identify potential conflicts of interest between the broker-dealer and its clients.

The obligations of both introducing and clearing firms under these rules have been explained by the NASD in Notice to Members 01-22 (“NTM 01-22”) (http://www.nasdr.com/pdf-text/0122ntm.pdf). NTM 01-22 indicates that the NASD issues “Compliance Report Cards” for best execution to member firms—something that an adviser should request to support the adviser’s own best execution analysis. NTM 01-22 offers the NASD’s recommendations about factors and procedures that should be included in a broker-dealer’s best execution analysis, which may be instructive for advisers. According to the NASD, despite the fact that an introducing broker-dealer may never execute customer orders, it nonetheless has an obligation to ensure that its customer orders are executed in a manner consistent with the duty of best execution. A broker-dealer’s lack of cooperation in providing this information should be a factor in the adviser’s decision-making.

The firm-specific, downloadable data available on the Internet is not easy to use. It will require advisers to create a template to import and display the data. The Joint Industry Plan, cited above, explains the various data fields and file layout. (See the exemplary web pages that accompany this outline.) Third-party vendors may offer this data in a more user-friendly presentation. An adviser should not be reluctant to ask for this information from each broker-dealer with whom the adviser places orders, including relevant parts of the broker-dealer’s own best execution assessment. The SEC’s releases and remarks by former SEC Chairman Arthur Levitt (noted above) make clear that the SEC intends that customers, including their professional advisers, are the intended beneficiaries of this quantitative data.
D. Facing Your Examiners—Responding to their Questions

The SEC’s examiners have access to the quantitative trade and execution data described above. Their use of this new quantitative data remains to be seen in practice. Historically, examiners have also requested downloads of an adviser’s trade blotter in a spreadsheet format for the period covered by the examination. The adviser’s trade data is then easily sorted using different data fields to identify “outlier” transactions which merit closer attention. Sorting on the commissions paid field has been an easy route to identify potential problems. The data may also be sorted by broker, total dollar amounts, and per share rates. The SEC’s Special Report on Soft Dollars Standards, noted above, discusses commission rates and other issues. Armed with the data, examiners will look to the adviser for explanations—and good ones! In anticipation of this type of review, compliance officers should periodically test their data.

III. Allocation of Trades

The SEC continues to encounter trade allocation issues during examinations and the SEC staff frequently highlights the issue in their public comments. These are fiduciary duty issues, so SEC examiners are always keenly focused on them. Trade allocation issues often arise in three contexts: (1) determining which clients will participate in transactions involving initial public offerings or private placements where the supply is limited; (2) transactions in thinly traded securities held by multiple clients; and (3) transactions involving securities with significant intra-day price movements where orders are not batched. Thus, from time to time it may be necessary to allocate one or more limited investment opportunities. An allocation is always necessary when aggregating orders (“bunching,” “block trading,” or “batching”) to improve execution or for administrative convenience.

There is no section of the Advisers Act or any SEC rule that requires an adviser to have allocation policies or procedures. The adviser’s fiduciary obligations have been construed to require that, over time, the adviser “fairly and equitably” allocate investment opportunities among its clients having a similar investment objective. While what is fair and equitable could conceivably be judged with respect to a specific transaction, more likely it will be judged in the context of a course of dealing involving multiple transactions. Allocations must be made such that the adviser does not give preferential treatment to some clients over others. This typically means not allocating investment opportunities or profitable trades to preferred clients. Conversely stated, an adviser cannot discriminate by assigning unprofitable trades to one client and not other similarly situated clients. When orders for a particular security are aggregated into one or more large orders, all participating clients need to participate at an average price and cost for the day.

There is no duty to aggregate orders for clients who trade in the same security on the same day. Indeed, it may be inappropriate to aggregate orders for different types of accounts (e.g., discretionary orders and client directed orders). In *SMC Capital Inc.*, SEC No-Action Letter (Sept. 5, 1995), the SEC noted that an adviser would not violate its duty to seek best execution merely by failing to aggregate orders for client accounts. The adviser should, however, disclose to its clients that it will not aggregate and the potential consequences of the failure to aggregate. Nonetheless, when orders for multiple clients are entered at different times during the day, the sequencing of those orders may become important. A practice of assigning orders to
clients “after the fact” will create regulatory concerns. Serious allocation issues will arise when trading practices demonstrates a consistent pattern of preference.

Thorough disclosure about an adviser’s aggregation and allocation practices may mitigate some, but not all, regulatory concerns. At a basic level, clients need the disclosure to understand whether the adviser’s practices are acceptable or at least tolerable. Disclosure may thus resolve many potential issues among different types of clients. Disclosure will not resolve issues where the preference is given to the adviser’s or employees' proprietary accounts over clients’ accounts. Disclosure cannot resolve a breach of fiduciary duty.

A. SEC Statements and Enforcement

The SEC recently summarized aspects of its no-action position on trade aggregation and allocation:

Generally, our staff has not recommended enforcement action against advisers that aggregate trade orders on behalf of clients, so long as the adviser allocates the trades in a way that treats all clients fairly. E.g., Pretzel & Stouffer, SEC No-Action Letter (Dec. 1, 1995); SMC Capital Inc., SEC No-Action Letter (Sept. 5, 1995). However, advisers violate the Advisers Act’s anti-fraud provisions if they fail to disclose allocation policies that disadvantage a client. See Account Management Corporation, supra note 156 (adviser failed to disclose that it allocated shares in “hot” initial public offerings only to limited number of eligible client accounts); cf. Nicholas Applegate Capital Management, Investment Advisers Act Release No. 1741 (Aug. 12, 1998) (adviser failed to supervise senior trader who allocated profitable day trades to his own personal account rather than to client account).

Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Release No. IA-1862; 34-42620; File No. S7-10-00 (April 5, 2000) at note 178.

In OCIE’s letter dated May 1, 2000, to federally registered investment advisers noted above, the SEC cited several examples of trade allocation issues it has encountered in its examinations:

- An adviser may defraud its clients when it disproportionately allocates hot initial public offerings (“IPOs”) to favored accounts, and does not adequately disclose this practice to all clients. For example, allocations of IPOs may be inequitable when the following types of accounts are favored: proprietary accounts; accounts that pay performance-based fees; accounts that have relatively poor performance; and new investment companies (in order to boost performance to attract additional assets).
An adviser may defraud its clients by waiting to decide how to allocate a trade among its clients’ accounts based on subsequent market movements. The concern is that the adviser could allocate the trade to favored clients if the price movement was favorable and allocate the trade to other accounts if the price movement was unfavorable. This practice is known as “cherry-picking,” and violates the Advisers Act.

An adviser may defraud its clients when it fails to use the average price paid when allocating securities to accounts participating in bunched trades and fails to adequately disclose its allocation policy. This practice violates the Advisers Act if securities that were purchased at the lowest price or sold at the highest price are allocated to favored clients without adequate disclosure.

In SMC Capital Inc., SEC No-Action Letter (Sept. 5, 1995), the SEC took a no-action position where the proposed aggregation of orders would be as follows:

- Policies for the aggregation of transactions would be fully disclosed in the adviser’s Form ADV and separately to SMC’s existing clients and the broker-dealers through which such orders would be placed.

- The adviser would not aggregate transactions unless it believed that aggregation was consistent with its duty to seek best execution (which includes the duty to seek best price) for its clients and was consistent with the terms of the adviser’s investment advisory agreement with each client for which trades are being aggregated.

- No advisory client would be favored over any other client; each client that participated in an aggregated order would participate at the average share price for all the adviser’s transactions in that security on a given business day, with transaction costs shared pro rata based on each client’s participation in the transaction.

- The adviser would prepare, before entering an aggregated order, a written statement (the “Allocation Statement”) specifying the participating client accounts and how it intended to allocate the order among those clients.

- If the aggregated order was filled in its entirety, it would be allocated among clients in accordance with the Allocation Statement; if the order is partially filled, it would be allocated pro rata based on the Allocation Statement.
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- Notwithstanding the foregoing, the order may be allocated on a basis different from that specified in the Allocation Statement if all client accounts receive fair and equitable treatment and the reason for the different allocation is explained in writing and is approved in writing by the adviser’s compliance officer no later than one hour after the opening of the markets on the trading day following the day the order was executed.

- The adviser’s books and records would separately reflect, for each client account the orders of which were aggregated, the securities held by, and bought and sold for, that account;

- Funds and securities of clients whose orders were aggregated would be deposited with one or more banks or broker-dealers, and neither the clients’ cash nor their securities would be held collectively any longer than was necessary to settle the purchase or sale in question on a delivery versus payment basis; cash or securities held collectively for clients would be delivered out to the custodian bank or broker-dealer as soon as practicable following the settlement.

- The adviser would receive no additional compensation or remuneration of any kind as a result of the proposed aggregation.

- Individual investment advice and treatment would be accorded to each advisory client.

The SEC specifically noted that its conclusion that no violation of Section 206 of the Advisers Act would be asserted was based particularly on the following representations: (1) the practice of aggregating orders would be fully disclosed in the adviser’s Form ADV and separately to the adviser’s existing clients, and (2) no advisory client, including those clients in which the adviser or persons associated with the adviser have a direct or indirect beneficial interest, would be favored over any other client and each client who participated in an aggregated order would participate at the average share price with all transaction costs shared on a pro rata basis.

There have been a number of recent SEC enforcement proceedings raising trade allocation issues, primarily involving self-dealing by the adviser or the adviser’s employees to the disadvantage of the firm’s clients. For example, Zion Capital Management LLC, and Ricky A. Lang, Initial Decision Release No. 220, Administrative Proceeding File No. 3-10659 (January 29, 2003); SEC v. Slocum, Gordon & Co., et al., United States District Court for the District of Rhode Island, Civil Action No. 02-367L (August 20, 2002); United States v. Alan Bond, 01-CR-1140 (S.D.N.Y.), Litigation Release No. 17266 (December 12, 2001); In the Matter of Monetta Financial Services, Inc., Robert S. Barcarella, William M. Valiant, Paul W. Henry, and Richard D. Russo, Initial Decision Release No. 162, Administrative Proceeding File No. 3-9546 (March 27, 2000). See also In Re Kemper Financial Services, Inc., Administrative Proceeding File No. 3-8207 (1993) regarding a violation of Section 17(d) of the Investment Company Act of 1940, as
amended, where a portfolio manager gave preference to private accounts over the funds he advised.

B. **Methods of Allocation**

The first step in any trade allocation is a determination of which clients should be included in the transaction. As an initial matter, this turns upon each client’s investment objectives and suitability considerations. This decision-making is greatly facilitated (and later defended if challenged) by using some sort of investment policy statement for each client. The investment policy statement can articulate the investment characteristics that the adviser will rely upon to judge which clients should participate in a proposed transaction and perhaps in what relative amount. Various types of investment limitations may be included. The investment policy statement may thus help the adviser in differentiating among clients when making the initial participation decision, as well as the level of participation in a transaction.

There is no prescribed method of allocation. Recognizing that the allocation practice should be fully and accurately disclosed to clients, what seems “fair and reasonable” may become more self-evident when the adviser knows its clients will be reading it. In practice, variations on a pro rata or sequential (rotational) method are typically used. A random methodology may be objectively fair, but over time might not seem equitable in anybody’s eyes—the coin that always comes up heads may bear closer examination. Whatever method is used, it needs to be documented and should be tested periodically to assure it is achieving its stated purpose.

There are many considerations that overlay a basic pro rata or sequential system or, more likely, a combination of several approaches. Pro rata allocations are generally premised on the relative size of the participating accounts in relation to the total amount of securities in the transaction. Equity securities are, by nature, unique—like real estate. A pro rata allocation of a unique opportunity seems more appropriate. Sequential systems would work better where the security is relatively more fungible, such as broad categories of corporate or municipal fixed income securities. A variety of other factors come into play which, if identified in advance, might come into play to make upward and downward adjustments to an initial pro rata allocation. The size of the base allocation in relation to the size of the account may be a factor. For example, an allocation may be too small to be meaningful to a large account. A de minimis exception rule might exclude large accounts when the base allocation fell below a minimum percentage threshold, so as to reduce transaction costs. An account’s current position in the security may be a factor. Odd lots create additional transaction costs, so a rounding factor may be appropriate. An allocation is necessarily subject to a private placement offering’s minimum investment requirements. As noted above, client-specific suitability factors are a necessary limitation on any allocation. After all of the logical factors have been applied, it may be necessary to “break the ties” with a random lottery, keeping in mind the need to later demonstrate that it was truly random.

When orders are aggregated, the allocation policy should require that all participating clients pay the average price at which all orders were filled during that trading day. All transaction costs should be shared on a pro rata basis. Everything else being equal, personal and proprietary accounts may be included in an aggregated order as long as the price and cost is handled in this
manner. Keep in mind that some types of accounts should not be included in the same aggregated order.

Application of the trade allocation policy will inevitably raise new facts and circumstances that were not anticipated. Track those situations, as well as the exceptions, and revisit the trade allocation policy periodically to assure it is achieving fair and equitable treatment and, wherever possible, to eliminate unnecessary exception reporting in the future.

C. **Timing and Record Keeping Issues**

The adviser’s trade allocation policies must be disclosed to clients, typically in Form ADV or, for a mutual fund, in the fund’s prospectus. Those disclosures must be retained in the adviser’s books and records.

Investment advisers are required under SEC Rule 204-2 to keep true, accurate, and current records of, among other things, orders given for the purchase and sale of a security. Those records must contain the date, amount, and price of each purchase and sale. An adviser may violate the timeliness requirement if it does not promptly record and preserve each trade allocation. Allocations made after the next trading day will likely draw SEC criticism.

Ideally, procedures should require trade allocations to be reduced to writing before an order is placed. This is typically done on an “allocation statement.” If the allocation statement is provided to the broker at the time of the trade, then the risk of post-trade manipulation is reduced. Pre-trade allocations avoid most of the issues that can arise if allocations were made with 20-20 hindsight. When allocations are made after the trade and the prices have moved, it may be difficult to prove that no preference was intended. Pre-trade allocations may not always be possible, but exceptions should be explained and documented before the end of the next trading day. Reallocation after a trade should be avoided but, if an exception arises, it must be thoroughly explained. Write the explanation as though you expected to read about it in the newspaper—you might. In some cases it may be unavoidable to reallocate after the trade where, for example, the order is only partially filled. Again, carefully explain and document the reallocation based on the policies’ enumerated factors.

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*These materials have been prepared to aid in your general understanding of the complexities of federal investment adviser regulations. The application of federal laws and regulations varies depending upon the particular facts and circumstances and may change over time. There also may be state laws, regulations, and policies applicable to the same facts and circumstances. These materials are not intended to convey legal advice. We would be pleased to discuss your questions and specific circumstances at your convenience.*
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