

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a city skyline at night, with lights from buildings and streets creating a bokeh effect.

2016 INVESTMENT MANAGEMENT CONFERENCE

Portfolio Brokerage Practices

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DISCUSSION OVERVIEW

- Best Execution
- Soft Dollars
- Commission Recapture Programs



BEST EXECUTION



DUTY OF BEST EXECUTION

- Generally, best execution is the duty to obtain the best trading results given various quantitative and qualitative factors. Both buy and sell-side institutions are subject to duties of best execution
- The duty derives from common law and the antifraud provisions of the federal securities laws, particularly for investment advisers Section 206 of the Investment Advisers Act of 1940
- *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 (1963):
 - Seminal Supreme Court decision that found a federal fiduciary duty for investment advisers that springs from antifraud provisions of the Investment Advisers Act of 1940
 - Hence, Section 206 of the Investment Advisers Act of 1940 imposes a fiduciary duty on investment advisers
 - Standard is duty of loyalty and duty of care

FACTORS IN EVALUATING EXECUTION QUALITY; NOT JUST PRICE

- Price and price improvement
- Speed
- Certainty of execution
- Responsiveness
- Commission and commission equivalent rates/commission recapture
- Order handling capabilities, such as block and complex trades
- Expertise with relevant markets or securities
- Assistance in finding liquidity and willingness to commit capital
- Access to market centers and other market participants
- Low trading errors and willingness to correct mistakes
- Value of research
- Confidentiality
- Reputation
- Capital adequacy
- Back office capabilities, including automation and trade reporting
- Past experience

ESTABLISHING A COMPLIANCE PROGRAM

- Implement and update written compliance policies and procedures addressing best execution:
 - Broker selection
 - Methods and measures for evaluating execution quality
 - Allocation of desk or trader responsibility for particular funds, investing style and geographic and industry sectors
- Establish a best execution committee with appropriate procedures
 - Committee meetings should be periodic and systematic
 - Minutes should be made and maintained under direction of legal
- Implement and test systems for monitoring executions
 - Determine tools that will be used
 - Broker-dealers' "dash reports" (Exchange Act Rules 605 and 606)
 - Other vendors (e.g., TAG)
- Develop Trade Allocation Practices
- Provide periodic training to relevant personnel

TRADING DESK COMPLIANCE

- Trading desks should have the necessary tools, including an:
 - Effective execution management system
 - Timely and accurate market data as needed to determine the best price of a security
 - Procedures for complying with regulatory requirements relating to cross and agency-cross trades and principal transactions
 - Client account instructions, including account objections, use of soft dollars, commission recapture programs and disallowed brokers
- Systematic trade allocation process and method of documenting deviations from standard trade allocation policy
- Guidance should be provided regarding the number of dealers that should be contacted to obtain a price, particularly for illiquid and thinly-traded securities, or for fixed-income trades seeking “soft dollars” safe harbor

POST-TRADE REVIEW AND ANALYSIS

- Periodic and systematic meetings of the Best Execution Committee to review execution quality
 - Analyze execution quality based on statistical information
 - Review executing brokers, including with respect to the reasonableness of commissions, commission equivalents, soft dollar arrangements, commission recapture, potential conflicts of interest, any credit or other financial issues regarding the broker, news relating to litigation, regulatory investigations and other qualitative factors
 - Desk errors or mistakes
 - Systems issues
 - Available third-party data
- Determine and assign responsibility for pre-meeting preparation
- Assign responsibility for implementing any needed changes based on review
- Make and keep relevant records

FUND BOARD OVERSIGHT

- A fund board has a duty of care and a duty of loyalty prescribed by state common law, which requires a fund director to act in the best interests of the fund and its shareholders.
- A fund board is responsible for reviewing the adviser's portfolio trading practices.
 - Best Executions Analysis and Oversight
 - Use of Client Commissions
 - Use of Affiliates
 - Trade Allocation
 - Crossing Transactions
 - Selection of Trading Venues
- How a fund board satisfies its oversight responsibilities
 - How a fund board satisfies its oversight responsibilities
 - How a fund board satisfies its oversight responsibilities
 - Commission Costs Allocated to Sell-Side Firms
 - Portfolio Turnover Rates



SOFT DOLLARS



OVERVIEW OF SOFT DOLLAR ARRANGEMENTS

- Practice by which investment advisers with investment discretion over client accounts use client commissions, rather than their own resources, to pay for “brokerage and research services” provided by broker-dealers
- Reflects the perceived value of brokerage and research services in managing client accounts, notwithstanding adviser may not pay the lowest price for execution and uses client assets that provide the investment adviser direct benefits
- Inasmuch as client commissions are an asset of the client, the use of soft dollars would ordinarily constitute a breach of fiduciary duty absent the safe harbor of Section 28(e) of the Securities Exchange Act of 1934

SECTION 28(E) SAFE HARBOR

- In 1975, Congress enacted Section 28(e) of the Securities Exchange Act of 1934 to provide investment advisers with a safe harbor from liability for a breach of fiduciary duty because the adviser used client assets for its own benefit and paid more than the lowest commission rate in order to receive “brokerage and research services” provided by a broker-dealer
- The adviser must determine, in good faith, that the amount of the commission is reasonable in relation to the value of the “brokerage and research services” received

ELEMENTS OF THE SECTION 28(E) SAFE HARBOR

- The investment adviser must exercise investment discretion for the account;
- The adviser must determine in good faith that the amount of commissions is reasonable in relation to the value of products or services received;
 - May be for a particular transaction or with respect to overall responsibilities
- Only agency or eligible riskless principal transactions satisfy Section 28(e);
- Generally viewed as applying to trades in equity securities (agency execution) and not trades in fixed-income securities (principal executions), but fixed-income trades structured on an agency basis seek qualification
- The services received must be eligible “brokerage or research services” that provide “lawful and appropriate assistance” to the money manager in the performance of its investment decision-making responsibilities; and
- Commissions must be paid to a broker-dealer that “effects” the trades and/or “provides” the eligible product or service

SECTION 28(E) ELIGIBLE RESEARCH

- Advice 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
- Analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts
- Form is irrelevant – includes paper, electronic and oral discussions
- Must be the “expression of reasoning or knowledge”
- Potentially eligible research includes research reports, market color, investment seminars, meetings and discussions with research analysts and company executives, trade analytics, proxy services that are reports on issuers and securities, certain software and market and economic data services
- Ineligible research includes mass-market publications (WSJ), operational overhead (e.g., salaries, rent, equipment, telephone lines), proxy services relating to the mechanical aspects of proxies, computer hardware and travel

SECTION 28(E) ELIGIBLE BROKERAGE SERVICES

- Programs for securities execution
- Performing functions that are incidental thereto
 - Clearance, settlement and short-term custody related to particular trades
 - Post-trade matching of information
 - Electronic communications related to trades, allocations and settlement
- Temporal standard for determining if services relate to the execution of trades
 - Begins when the adviser communicates with the broker-dealer for the purpose of transmitting an order for execution, and
 - Ends at the conclusion of a trade's clearance and settlement (*i.e.*, when securities or funds are delivered or credited to the advised account)
- Ineligible brokerage services include equipment, portfolio management software, compliance testing, trade financing, long-term custody and prime brokerage services, including stock loan

MIXED-USE RESEARCH AND BROKERAGE SERVICES

- “Mixed use” means that eligible products or services have eligible and non-eligible uses
- An inherent conflict exists because the non-eligible use benefits the adviser and has no protection under Section 28(e)
- The conflict is managed by the adviser making a reasonable allocation of the value of the mixed-use service between eligible and non-eligible uses
- The value of the non-eligible use is allocated to the expense of the adviser for it to cover with its own resources
- Adequate books and records are needed to support allocations

“EFFECTING” TRADES

- A broker-dealer effects a trade if it:
 - Executes, clears, or settles the trade; or
 - Performs one or more of the following four specified functions and allocates the other functions to another broker-dealer:
 - Takes financial responsibility for trades until settlement
 - Maintains records
 - Monitors and responds to customer comments concerning the trading process
 - Monitors trades and settlements

“PROVIDING” RESEARCH OR BROKERAGE SERVICES

- Broker-dealers “provide” “brokerage and research services” if they:
 - Prepare the research;
 - Are financially obligated to pay for the research; or
 - Are not financially obligated to pay for the research, but take reasonable steps to assure themselves that client commissions are used only for eligible “brokerage and research services” (*i.e.*, no red flags)

CLIENT COMMISSION ARRANGEMENTS

- SEC staff guidance has facilitated the use of soft dollar aggregators and service providers that are not registered broker-dealers
 - See Goldman, Sachs & Co., SEC No-Action Letter (Jan. 2007)
- Conditions of the no-action relief:
 - The adviser must independently value the services;
 - The executing broker may not participate in valuing the services;
 - Payments to the service provider must be from a commission pool that the executing broker and adviser have agreed to set aside for obtaining services;
 - Payments may not be conditioned on the execution of transactions in securities that are described in the research; and
 - Service providers cannot perform other functions typically characteristic of acting as a broker-dealer

COMPLIANCE CONSIDERATIONS

- Written policies and procedures, including recordkeeping
- Approval and compliance procedures, including:
 - Confirming the eligibility of research products and brokerage services
 - Reviewing the eligibility of executions (*i.e.*, agency or eligible riskless principal)
 - Evaluating broker-dealers
 - Analyzing brokers' soft dollar reports with internal records
 - Reviewing allocations of mixed-use products and services
 - Evaluating appropriate use of commissions (*e.g.*, use of research and brokerage services paid by commissions generated by indexed funds)
 - Confirming consistency with disclosures and procedures
- Oversight and periodic review of soft dollar arrangements for compliance
- Employee training



COMMISSION RECAPTURE PROGRAMS

COMMISSION RECAPTURE PROGRAMS ARE A FORM OF DIRECTED BROKERAGE

- Directed brokerage involves the investment adviser client of the sell-side firm directing transactions to a particular broker and receiving products or services directly from the broker
- Full and fair disclosure must be provided to advisory clients of:
 - The existence and terms of practice regarding brokerage transactions, and the effect of such practices on commissions
 - The effect of client directed brokerage on the adviser's ability to obtain volume discounts, negotiate commissions or achieve best execution for some transactions
 - The potential for disparities in commission charges
 - The potential conflicts of interest
- Disclosures should be included in Form ADV, fund prospectuses and the investment management contract and updated as appropriate
- Compliance procedures should address the use of directed brokerage
- See *In re Mark Bailey & Co.*, Advisers Act Release No. 1105 (Feb. 24, 1988)

COMMISSION RECAPTURE PROGRAMS

- Sell-side institutions pitch commission recapture arrangements to buy-side institutional clients as an indirect means of lowering client transaction costs
- Because many full-service broker-dealers do not negotiate discounts to their commission charges, they may offer rebates in the form of commission recapture to clients in order to lower other expenses of the client and receive client order flow
- The use of commission recapture is subject to fiduciary standards:
 - For registered investment companies:
 - Section 36 of the Investment Company Act of 1940 establishes a federal fiduciary standard with respect to the use of the fund's assets (e.g., portfolio commissions) by fund insiders, such as the adviser and fund board
 - The SEC has interpreted Section 15(c) of the Investment Company Act of 1940 to require independent fund directors to review the fund adviser's brokerage allocation practices
 - Adviser has a duty to disclose to the independent fund directors commission recapture opportunities (See *Moses v. Burgin*, 445 F.2d 369, 376-77 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1971))
 - No absolute duty to recapture commission costs but a matter for independent directors of a registered investment company to consider for the best interests of the fund (See *Tannenbaum v. Zeller*, *Tannenbaum v. Zeller*, 552 F.2d 402, 417-18 (2d Cir. 1977), cert. denied, 434 U.S. 934 (1977); and *Papilsky v. Brendt*, Fed. Sec. L. Rep. [1976-77 Transfer Binder] (S.D.N.Y. 1976) ¶ 95,627

COMMISSION RECAPTURE PROGRAMS

(CONTINUED)

- For unregistered investment companies:
 - Subject to general antifraud provisions of the Investment Advisers Act 1940 codified in Section 206
- Subject to Best Execution
 - A commission recapture arrangement does not relieve the adviser from its best execution duties; nor does it relieve the sell-side institution from its best execution duties to the buy-side firm, even though the buy-side institution directs order flow to firms providing commission recapture
 - Consideration of negotiated commission rates and net expenses under a commission recapture program versus the commission rates that the adviser may be directly able to obtain outside of the program
 - Determine reputation of sell-side firms participating in the program
 - Participating sell-side firms must be subject to adviser's best execution review and standards
- Program must exclusively benefit the client
- A commission recapture program, must exclusively benefit the client whose commissions are used to generate client portfolio trades
 - Form ADV – Part 1A and Part 2, including any conflicts associated with participation
 - Disclosure in Forms N-1A, N-3, N-3 and N-4
 - Consider disclosure for private funds based on materiality



QUESTIONS?



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