National Society of Compliance Professionals
Midwest Regional Membership Meeting
Regulatory Developments
June 3, 2002
Minneapolis, Minnesota

INVESTMENT ADVISER CONFLICTS

by

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INVESTMENT ADVISER CONFLICTS

I. Introduction

Today, in the normal course of business, investment advisers face an increasing number of potential conflicts of interest between the investment adviser and the client. These conflicts arise in several areas. First, they arise in connection with the placement of brokerage and execution of transactions. In the second instance, they arise in connection with the dramatic increase in investment opportunities such as private placements, hedge funds and a variety of other alternative investments. These conflicts also arise in connection with other activities such as investment banking if an investment adviser is part of or affiliated with a broker-dealer.

II. General

A. Agency and Fiduciary Obligations

In general, an investment adviser is acting as agent for his customer or client. As an agent, an investment adviser has under the common law a duty of due care and a duty of loyalty.[1] The duty of due care requires that an order be executed using reasonable care in accordance with prevailing industry standards.[2] Under the common law, the duty of loyalty of an agent is a quasi-fiduciary duty which requires that the agent not act in conflict with the interest of its principal (the client) unless the agent has the client's consent, express or implied, that the agent may proceed, notwithstanding the conflict. The more serious the conflict, the more explicit that disclosure and consent is required to be. Under the federal securities laws, the United States Supreme Court has gone beyond the common law in legal theory by holding that an investment adviser acts as a fiduciary of his client.[3] In the author's view, this, in practice if not legal theory, is no more than the common law duty of an agent to his principal under the circumstances of the securities business. As in the case of other fiduciaries, the client, as principal, in the advisory agreement creating the relationship, may waive or consent to the agent, the investment adviser, engaging in certain types of activities that might not otherwise be permissible. This consent may be implied or may be express by a written or oral consent. The client consent, whether implied or express, will be effective only if given after suitable disclosure. The more material the conflict, the more

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[1] Restatement (Second) of Agency §1.

[2] Restatement (Second) of Agency §376 & §379.

[3] *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

explicit the disclosure and consent required. For example, as discussed below, consent to certain types of brokerage practices may be implied if there is a disclosure in the Form ADV. The fact that the client signs the advisory agreement acknowledging that he has read the Form ADV may be an express or at least an implied consent to disclosures of conflicts in the Form ADV. However, in the case of certain material conflicts such as directed brokerage, the SEC staff is of the view that such a conflict is so material that written disclosure and express written consent is required. For other material conflicts, an adviser is well advised to obtain express written consent in the advisory agreement or other form of consent after appropriate disclosure.

B. Form ADV

Form ADV has express provisions with respect to disclosures by investment advisers concerning their brokerage and other practices involving potential conflicts, notably Items 12 and 13 of ADV Part II.[4] Knowledgeable counsel advise investment adviser clients to disclose in the Form ADV or other disclosure statement all significant conflicts. Ideally for the greatest protection of the investment adviser, any material conflicts should be disclosed and written consent to them obtained by way of the investment advisory agreement. The SEC has proposed to amend the ADV and to change Part II into the form of a narrative. The proposed disclosure involving conflicts will include additional information concerning brokerage practices and opportunity allocation.

C. Anti-Fraud Provisions and Conflicts

The anti-fraud provisions in Section 206(1) and (2) of the Investment Advisers Act[5] and under the other securities acts[6] specifically prohibit manipulative or fraudulent activities, including those involving conflicts of interest. Failure to disclose a material conflict may involve violation of the anti-fraud provisions of the Investment Advisers Act and if in connection with the purchase or sale of securities, Section 10(b) of the Securities Exchange Act of 1934[7], as amended ("34 Act") or other securities acts.

D. Specific Statutory Provisions to Avoid Conflicts

1. Principal Transactions

Section 206(3)[8] of the Investment Advisers Act prohibits an investment adviser from engaging in a principal transaction with a client except with prior written consent after disclosure of the specific transaction. Section 206(3) states as follows:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly –
> …

[4] Form ADV Part II Items 12 and 13; *see also* Items 7, 8 and 9.
[5] 15 U.S.C. §80b-6(1) & (2).
[6] *See, e.g.*, Section 10(b) and rules thereunder of the Securities Exchange Act of 1934; 15 U.S.C. 78(j).
[7] 15 U.S.C. 78j; Rule 10b-5.
[8] 15 U.S.C. 80b-6(3).

> (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph (3) shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction.[9]

These prohibitions would probably be required in any event under common law, although the method of consent might be different. There has been some indication recently that the SEC is considering allowing a blanket general consent by the client for certain types of riskless principal trades.[10] Recently, the SEC alleviated the principal transaction prohibition to permit certain limited riskless principal transactions to be treated as agency transactions for purposes of the soft dollar safe harbor of Section 28(e) of the 34 Act.[11] *See* Section III.C.3.d below. In that release, the SEC permitted certain eligible riskless principal transactions reported under National Association of Securities Dealers Regulation, Inc. ("NASDR") Rules 4632, 4642 or 6420 to be treated as agency transactions. These NASDR rules require riskless principal transactions with both legs executed at the same price. The trades are then treated as agency transactions exclusive of any mark up, mark down, commission or other fees. The fees are distinguished in the SEC release from fees paid on traditional riskless principal transactions and traditional principal transaction involving dealer's inventory which are not covered. The essence of this release is that for purposes of Section 28(e), the riskless principal transactions meets the requirement of the Act because they would be treated as de facto agency transactions.

2. Crosses

Like principal transactions, cross transactions require consent before the transaction is settled.[12] Rule 206(3)-2[13] states as follows:

> An investment adviser, or a person registered as a broker-dealer under section 15 of the Securities Exchange Act of 1934 [15 U.S.C. 78o] and controlling, controlled by, or under common control with an investment adviser, shall be deemed in compliance with the provisions of sections 206(3) of the Act [15 U.S.C. 80b-6(3)] in effecting an agency cross transaction for an advisory client, if:
>
> (1) The advisory client has executed a written consent prospectively authorizing the investment adviser, or any other person relying on this rule,

[9] 15 U.S.C. §80b-6(3).
[10] *See*, "Priorities in Investment Adviser Regulation" Remarks of Paul F. Roye, Division of Investment Management, at the IA Compliance Summit and Best Practices Update, (April 8, 2002), available at http://www.sec.gov/news/speech/spch549.htm.
[11] 15 U.S.C. §78bb(e); Securities Exchange Act Release No. 34-45,194 [Current] Fed.Sec.L.Rep. (CCH) ¶86,613 (Dec. 27, 2001).
[12] Rule 206(3)-2; 17 C.F.R. 275.206(3)-2.
[13] 17 C.F.R. 275.206(3)(2).

> to effect agency cross transactions for such advisory client, provided that such written consent is obtained after full written disclosure that with respect to agency cross transactions the investment adviser or such other person will act as broker for, receive commissions from, and have a potentially conflicting division of loyalties and responsibilities regarding, both parties to such transactions;
>
> (2) The investment adviser, or any other person relying on this rule, sends to each such client a written confirmation at or before the completion of each such transaction, which confirmation includes (i) a statement of the nature of such transaction, (ii) the date such transaction took place, (iii) an offer to furnish upon request, the time when such transaction took place, and (iv) the source and amount of any other remuneration received or to be received by the investment adviser and any other person relying on this rule in connection with the transaction. *Provided, however*, That if, in the case of a purchase, neither the investment adviser nor any other person relying on this rule was participating in a distribution, or in the case of a sale, neither the investment adviser nor any other person relying on this rule was participating in a tender offer, the written confirmation may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer.

In a 1998 release, the SEC staff clarified and reversed some of the prior positions of the Division of Investment Management regarding crosses under Section 206(3).[14] Prior to that time, the staff had taken the position that prior to execution of the transaction, the customer must consent to the transaction after disclosure of the details of the transaction. The release changed that to provide that the disclosure must be in writing to the client before completion of such transaction. The completion of the transaction was interpreted to mean settlement. The interpretation only applies if the investment adviser is acting as an agent for both parties and receives no commission or other fee for the transaction. The release required that the adviser disclose facts necessary to alert the client to the investment adviser's potential conflicts of interest in the principal or agency transaction. A generic disclosure which is provided to the client at the time of signing the advisory agreement would be sufficient, but it would need to be supplemented for each transaction. The staff appears to permit pre-execution consent provided that the execution price and final commission or charges are disclosed before settlement. One of the problems is, however, the release appears to permit the client to refuse to consent after receiving the execution price, leaving the investment adviser holding the bag. This staff interpretation is based on the investment adviser not acting as a broker, *i.e.*, not receiving any sort of commission or compensation for effecting the transaction. In such case, the investment adviser would be acting as a broker and be required to register as a broker-dealer.

[14] Investment Advisers Act Release No. 1732, Fed.Sec.L.Rep. (CCH) ¶56,375 (July 17, 1998).

3. Investment Company Act of 1940 Conflict Provisions

The Investment Company Act of 1940[15] contains many conflict provisions applicable to investment advisers to investment companies. These include anti-conflict provisions regarding principal transactions, joint transactions, transactions underwritten by affiliates, transactions in which certain interested parties have an material interest and a variety of other provisions involving potential conflicts.[16] In addition, Section 17(j) requires codes of conduct for investment advisers and their access persons and affiliates.[17] While a discussion of these provisions is beyond the scope of this article, they are noted to indicate the numerous statutory conflict provisions applicable to investment advisers to investment companies.

III. **Brokerage Allocation**

A. General

Numerous conflicts arise in connection with the placement of brokerage by investment advisers on behalf of clients. If the investment adviser receives any emolument, consideration, services or benefits from placing brokerage with a particular broker-dealer, including affiliates, a conflict is present. For example, if an investment adviser rewards a broker-dealer who refers clients to the investment adviser by directing brokerage back to the broker-dealer, the SEC considers this a breach of investment adviser duties as an agent and fiduciary. However, clients may direct an investment adviser to place brokerage with one or more particular broker-dealers and this occurs frequently. However, the investment adviser must clearly disclose the possible disadvantages and advantages and obtain the client's written consent before placing brokerage as directed by a client.

B. Best Execution

As an agent and a fiduciary, an investment adviser has an obligation to obtain best execution for its client with respect to all brokerage transactions except as otherwise permitted by Section 28(e) which provides a safe harbor for soft dollars, as discussed below in Section C. The SEC has expressed its views vehemently that all investment advisers need to have procedures and policies regarding best execution. While a precise definition of best execution is elusive, it is safe to say that best execution requires, in the view of the SEC, a minimum of "rigorous and regular" examination of order routing and brokerage practices.[18] The head of the SEC Office of Compliance Inspection and Examination ("OCIE") has articulated the obligation of an investment

[15] 15 U.S.C. 80a-1 *et seq.*

[16] For example, see Section 17 dealing with transactions of certain affiliated persons and underwriters. 15 U.S.C. 80a-17. *See also* Section 12 dealing with the functions and activities of investment companies. *See* rules under Section 17 and rules under Section 10. For example, Rules 10b-1, 10f-1, 17a-1 through 17a-9, Rules 17d-1 through 17d-3, Rule 17e-1, 17f-1 through 17f-7, Rules 17j-1; 17 C.F.R. 270.10b-1, 10f-1, 17a-1-9, 17d-1 to 17d-3, 17e-1, 17f-1 to 17f-7, 17j-1. These rules minutely regulate activities of investment companies and their affiliates, including investment advisers engaging in various types of transactions involving conflicts or perception of conflicts.

[17] 15 U.S.C. 80a-17(j).

[18] *See, e.g.,* "Valuation, Trading and Disclosure: Three Compliance Imperatives," Remarks of Lori A. Richards, Director, Office of Compliance Inspection and Examination, at the 2001 Mutual Fund Compliance Conference, Investment Company Institute, (June 14, 2001), available at http://www.gov.sec/news/speech/spch499.htm.

adviser's duty as requiring periodic and systematic evaluation of the quality of execution services received from broker-dealers that are used to execute trades, including:

1. Obtaining the best price (for large trades in blocks with the least amount of market impact);

2. Speed of execution;

3. Certainty of execution; and

4. Commission rate or spread.

All alternative executions should be explored. Of more importance, an OCIE sweep found that investment advisers were not analyzing execution quality factors, including conflicts of interest and trade placements such as directed brokerage, soft dollar payments and other considerations and emoluments which are discussed below. Further, the scrutiny of investment advisers will increase as a result of the SEC's order execution disclosure requirements for markets under Rule 11Ac1-5 and order routing disclosure requirements for broker-dealers under Rule 11Ac1-6.[19]

The SEC has repeatedly articulated that, in connection with soft dollars, the money manager must "execute securities transactions for clients in such a manner that the clients total costs or proceeds in each such transaction is the most favorable under the circumstances.[20] As explained below, the investment adviser in a Section 28(e) of the 34 Act[21] transaction is permitted to cover the full range and quality of broker-dealer services including placing brokerage, including among other things, the value of research provided as well as execution capability, commission rate, financial responsibility and responsiveness. However, the inclusion of research and execution success is in the context of Section 28(e) of the 34 Act inherently involve a conflict of interest as discussed below.

C. Section 28(e) Soft Dollars, Conflicts and Best Execution

1. Introduction

The acceptance of research materials and other services by an investment adviser from a broker-dealer with whom the investment adviser has placed client brokerage creates an inherent conflict of interest. However, Congress has provided an exemption from such conflict provided one meets all the specific requirements of Section 28(e) of the 34 Act.

[19] 17 C.F.R. 204.11Ac1-5 & 6.
[20] *See, e.g.*, Securities Exchange Act Release No. 34-23170; Fed.Sec.L.Rep. (CCH) ¶26,577 at p. 19,722 (April 23, 1986).
[21] 15 U.S.C. §78bb(e).

2. Background

Prior to May 1, 1975, brokerage commissions were fixed by various stock exchanges. Commencing May 1, 1975, fixed commissions were abolished by legislation. At that time, Section 28(e), an amendment to the 34 Act, became effective.[22]

Prior to the abolition of fixed rates, brokers could not compete for business by offering lower rates. Brokers therefore sought to obtain order flow by providing various additional services and equipment at no additional cost to customers, including money managers such as investment advisers. These services provided by broker-dealers included research related services, research related hardware, execution equipment, such as direct lines, quotation machines, order entry equipment, order confirmation equipment and a variety of other types of materials. Once it became clear that fixed rate commissions would be eliminated, there was concern that certain money managers might be deemed in violation of their fiduciary duty if they failed to select the lowest cost broker to execute transactions. The established broker-dealers who had provided research services and other types of services to obtain order flow sought to protect that business by allowing investment advisers and customers to pay higher commission, part of which would presumably compensate the broker-dealer or its affiliate for research services or equipment. Thus, the passage of Section 28(e) was vigorously supported by the broker-dealer community.

Section 28(e) provides a safe harbor to investment advisers and broker-dealers who provide, for a combined fee, transaction "execution and research" services and material within the meaning of Section 28(e). Section 28(e) provides as follows:

> No person using the mails, or any means or instrumentality of interstate commerce, in the exercise of investment discretion with respect to an account shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law unless expressly provided to the contrary by a law enacted by the Congress or any State subsequent to the date of enactment of the Securities Acts Amendments of 1975 solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange broker, or dealer, would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer, viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion. This subsection is exclusive and plenary insofar as conduct is covered by the foregoing, unless otherwise expressly provided by contract. Provided, however, that nothing in this subsection shall be construed to impair or limit the power of the Commission under any other provision of this title or otherwise.

[22] 15 U.S.C. §78bb(e).

(2) A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commission that will be paid for effecting securities transactions, at such times and in such manner as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(3) For purposes of this subsection, a person provides brokerage and research services insofar as he

(A) furnishes advice, either directly or through publications or writings, 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;

(B) furnishes analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or

(C) effects securities transactions and performs functions incidental thereto (such as clearance, settlement and custody) or required in connection therewith by rules of a Commission or a self-regulatory organization of which such person is a member or person associated with a member or in which such person is a participant.[23]

The SEC has issued an extensive release and numerous no action and interpretive letters regarding Section 28(e), the most important being the Section 28(e) Release.[24]

3. <u>The Basic Elements of Section 28(e)</u>

a. <u>The Elements</u>

The safe harbor of Section 28(e) has a number of requirements which are the following:

i. A securities transaction;

ii. Investment discretion by the adviser;

iii. Agency transaction by the broker;

iv. Brokerage and research services from the broker;

[23] 15 U.S.C. §78bb(e).
[24] Fed.Sec.L.Rep. (CCH) ¶26,579A (April 23, 1986).

v. Reasonable commission for combined brokerage and research;

vi. Full disclosure of the arrangement.

b. Security Transaction

The safe harbor of Section 28(e) applies only to agency securities transactions.[25] It does not apply to futures transactions or certain principal transactions. It does apply to certain riskless principal transactions that are treated as agency transactions. See Section (d) below.

c. Investment Discretion

The safe harbor is available only if the adviser is exercising investment discretion. Investment discretion is defined as follows in Section 3(a)(35) of the 34 Act.

> "[a] person exercises 'investment discretion' if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have the responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this title and the rules and regulations thereunder."[26]

The question of whether an investment adviser is exercising investment discretion is a question of fact. The existence of a power of attorney is good evidence of discretion, but is not definitive. Even absent a power of attorney, there may be de facto discretion if most or all of the recommendations are generated by the investment adviser and accepted by the client. The issue is who generates the ideas. Ultimately, the question turns on who is generating the ideas for transactions, the adviser or the client?

d. Agency Transaction

The SEC takes the position that only agency transactions qualify for the safe harbor. However, certain counsel dispute this contention because Section 28(e) references services provided by a "broker" or "dealer", inferring that principal transactions are covered. Nevertheless, except for certain riskless principal transactions discussed below, the SEC is

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[25] Letter from Richard Ketchum, Director of Division of Market Regulations, to Charles Lerner, Department of Labor, July 25, 1990.

[26] 15 U.S.C. §78c(a)(35).

unequivocal that Section 28(e) does not apply to a principal transaction.[27] Recently the SEC has taken the position that certain riskless principal transactions will qualify as agency transactions for purposes of Section 28(e) provided both legs of the transaction are executed at the same price and the execution is subject to reporting to a self-regulatory organization price reporting and monitoring system.[28] See Section III.C.4.a below for a further discussion.

e. Brokerage and Research Services from the Broker

The definition of brokerage and research services is very broad and includes both research and transaction execution services and materials. Section 28(e) includes within the term "brokerage and research services"

i. furnishing advice through writings or publication as to the value of securities, advisability of investment and purchasing securities and the availability of securities;

ii. furnishing an analysis and reports concerning issuers, industries, securities, economic factors, portfolio strategy and the performance of accounts;

iii. services in effecting securities transactions and performing functions incidental thereto, such as clearance, settlement and custody.

It must be emphasized that research, within the meaning of Section 28(e), includes brokerage execution services, reports, and services and materials that are incidental thereto.

If a product has both permitted and non-permitted functions, a reasonable allocation of the cost of the product or service according to its use must be made by the investment manager. Only the portion relating to permitted product or services may be paid with soft dollars. The non-permitted portion must be paid in hard dollars by the adviser. The investment adviser has the burden of proving that he used good faith in his allocation procedures.[29] To demonstrate good faith, an investment adviser must maintain current and adequate records, and should not make a retroactive allocation.

It is important to note that the research must be provided by the broker. A broker may provide research services to or by paying a third party. The broker may acquire the research services or product from a third party, pay for it and furnish it to an investment adviser. It is clear, however, that the adviser may not contract to pay for research services and then

[27] Hoenig & Co., Inc. SEC No-Action Letter, [1990-91 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶79,639 (1990); Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lerner, Department of Labor (July 25, 1990); Duff and Phelps, Inc., SEC No-Action Letter [1976-77 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶80,821 (Sept. 27, 1976).

[28] Securities Exchange Act Release No. 34-45194 (December 27, 2001); Fed.Sec.L.Rep. (CCH) ¶86,613 (Dec. 27, 2001).

[29] Section 28(e) Release at 19,727.

forward bills to the broker. Thus, the adviser may not incur liability to the third party provider.[30] The Section 28(e) release states: "Section 28(e) might, under appropriate circumstances, be applicable to situations where a broker provides a money manager with research provided by third parties."[31] In another report, the SEC stated:

> "It is not necessary that a broker produce the research services 'in house' in order to obtain the protection afforded by Section 28(e)….It is necessary, however, in order to satisfy the statutory requirement, that the research services be 'provided by' the broker. While a broker may, under appropriate circumstances, arrange to have research materials or services provided by a third party, it is not 'providing' such research services when it pays obligations incurred by the money manager to the third party."[32]
>
> In another matter, the SEC stated:
>
> "The Commission believes that a broker-dealer may be deemed to have provided third party research when it has incurred a direct legal obligation to a third party producer to pay for the research (regardless of whether the research is then sent directly to the broker's fiduciary customer by the third party, or instead is sent to the broker who then sends it to his customer….The Commission does not believe, however, that Section 28(e) would apply where the broker was merely used as an alternative means of paying obligations incurred by the fiduciary in its direct dealings with the third party….In that regard, a broker-dealer may be deemed to have provided third party research that it is legally obligated to pay for even if its fiduciary customer participates in the selection of the research services or products to be provided to it by the broker-dealer."[33]

f. <u>Commissions Must Be Reasonable in Relationship to the Value of Brokerage and Research on a Combined Basis</u>

Section 28(e) provides the safe harbor only if the commissions are reasonable in relationship to the value of the permitted brokerage and research services under Section 28(e). An understanding of best execution is critical to understanding Section 28(e). For purposes of Section 28(e), best execution requires that a money manager make a good faith attempt to "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."[34] Section 28(e)

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[30] Section 28(e) Release at 19,728.
[31] Section 28(e) Release at 19,728.
[32] Investors Information, Inc. [1979-80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,481 at p. 83,011 (Mar. 19, 1980).
[33] In the Matter of the National Association of Securities Dealers, Inc. [1980 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,705 at p. 83,858, n. 54 (Dec. 12, 1980).
[34] Section 28(e) Release at 19,733, quoting from Securities Fund Monitoring Services [1979 Transfer Binder] Fed.Sec.L.Rep. (CCH), ¶81,913 (1978). Exchange Act Release 9598 [1971-1972 Transfer Binder] Fed.Sec.L Rep.

permits the value of research to be considered as part of best execution. The investment adviser "is not required to seek the services which carries the lowest cost so long as the difference in cost is reasonably justified by the quality of the service offered."[35]

Best execution also includes execution price paid for the security, the commission, if any, and a host of other factors affecting the full range and quality of a broker's execution services, such as credit worthiness of the executing broker, order execution capability, ability to execute the type of order, past history of execution of such orders, access to market information, past promptness in execution of orders, promptness and accuracy of oral and hard copy reports of execution, ability and willingness to correct errors, promptness and accuracy of confirmation and a host of other factors. The value of research is ultimately in the eye of the beholder. The value of research can sometimes be measured by its cost if it is priced and firms subscribe to it.[36] Of course, the value of research to the investment adviser regardless of the subscription cost may vary between nothing to a great deal depending upon its use by the adviser. When research is not market priced, the broker's cost to generate the research could be considered, but even this is extremely difficult and certainly not available to an adviser.[37] All in all, evaluating the reasonableness of the value of research is difficult. However, the SEC has recently begun to question research value to the advisers as a whole.

In the past, the SEC has brought a number of cases against investment advisers and broker-dealers where the broker-dealer paid for products or services that were not viewed as within the definition of research and execution services permitted by Section 28(e). SEC cases concentrated on cases where soft dollar credits were used to pay for obvious personal or business expenses of the investment adviser or individuals associated with the investment adviser with no real benefit to the adviser's clients. As a result of the recent order routing and execution disclosure requirements for market centers and broker-dealers,[38] there will be an abundance of information with which to value the routing and execution of transactions for purposes of Section 28(e). With the new order execution and routing disclosures, the SEC has started to shift its focus to cases against broker-dealers as well as investment advisers involving the quantitative value of research and the quantitative value of execution. The statistical evidence available from such disclosures will also make it much easier for the SEC to prove that either or both the investment adviser and broker-dealer violated its best execution obligations or that the broker-dealer aided and abetted an investment adviser in violating best execution.

Investment advisers will need to be certain that broker-dealer routing and execution systems are reasonable and that commissions, including the value of research, are fair. The NASDR would also likely pursue broker-dealers in the event that the value of research and the executions are not reasonable under the general principles of fair commission and markups required by NASDR Rules 2430 and 2440.

(CCH), ¶78,776 (1972); *see also* In re: Investment Information, Inc. [1976-77 Transfer Binder] Fed.Sec.L.Rep. (CCH), ¶80,816 (1976).

[35] Section 28(e) Release at 19,730 at Footnote 35.

[36] Section 28(e) Release at 19,727 at Footnote 11.

[37] Section 28(e) Release at 19,733.

[38] Rules 11Ac1-5 and 11Ac1-6; 17 C.F.R. 240.11Ac1-5 and 11Ac1-6.

g. Disclosure

The safe harbor of Section 28(e) is clearly conditioned upon full disclosure by a money manager of its commission and soft dollar research practices and their allocation to customers. Section 28(e)(2) states:

> A person exercising investment discretion with respect to an account shall make such disclosure of his policies and practices with respect to commissions that will be paid for effecting securities transactions, at such times and in such manner as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors.[39]

Form ADV, Part II, Items 12 and 13, require specific disclosures related to commissions and soft dollar practices and arrangements relating thereto. ADV disclosure, alone, will not, in some cases, be adequate disclosure. Because of the SEC's order handling routing disclosures by broker-dealers and markets, the SEC expects advisers to expand and to be able to justify their disclosures where soft dollar materials or services are received from broker-dealers.

4. Special Issues for Section 28(e)

a. Principal or Riskless Principal Trades

For many years, the SEC's position was that the safe harbor does not apply to principal or riskless principal trades even when the markup is the equivalent of a commission.[40] However, recently this position has been modified somewhat by the SEC. The SEC now interprets commission in Section 28(e) to include "a markup, markdown, commission equivalent or other fee paid by the a managed account to a dealer for executing a transaction where the fee and transaction price are fully and separately disclosed on the confirmation and the transaction is reported under conditions that provide independent and objective verification of the transaction price subject to self-regulatory organization oversight."[41] The SEC stated that fees paid for eligible riskless principal transactions reported under NASDR Rules 4632, 4642 or 6420 fall within the interpretation. NASDR Rules 4632, 4642 and 6420 require a riskless principal transaction in which both legs of the transaction are executed at the same price. These trades are treated as an agency transaction exclusive of any markup, markdown, commission or other fee equivalent. The fees also are distinguished by the SEC in its release as the SEC's release from fees paid on traditional riskless principal transactions as well as traditional principal transactions involving the dealer's inventory.

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[39] 15 U.S.C. §78bb(e)(2).
[40] Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lerner, Department of Labor (July 25, 1990); Duff and Phelps, Inc. SEC No-Action Letter [1976-77 Transfer Binder] Fed.Sec.L. Rep. (CCH) ¶80,821 (Sept. 27, 1976).
[41] Securities Exchange Act Release No. 34-45194 Fed.Sec.L.Rep. (CCH) ¶86,613 (Dec. 27, 2001).

b. Introducing Broker Transactions

The SEC has made it clear that the safe harbor of Section 28(e) is available when an individual adviser uses an introducing broker who clears its transactions with a clearing firm.[42]

c. Prime Brokerage

An executing broker in a prime brokerage relationship who gives up an order for clearance by another firm can also be protected. However, in this case, the introducing broker must do no more than merely receive commissions, and is responsible for paying the clearing broker whatever fees are charged by the clearing broker.[43]

d. Futures Transactions

Since Section 28(e) applies only to securities transactions, it does not cover futures transactions, including futures on treasury bonds or financial indices.[44] This is a problem because many advisers use financial futures as an integral part of a securities investment. Financial futures are used in a variety of ways to hedge portfolios, anticipate cash flows, or to liquidate part of a portfolio. Today, many broker-dealers are also futures commission merchants and the futures commission dollars are de facto considered in furnishing research. Since futures transactions are agency exchange execution transactions, an adviser must be careful not to pay up for "research" using futures commissions.

e. ERISA

To the extent applicable, Section 28(e) preempts the Employee Retirement Income Security Act, as amended ("ERISA").[45] However, if a soft dollar transaction is outside of the safe harbor, ERISA's standards apply. ERISA requires a fiduciary (such as a broker-dealer or adviser with discretion over plan assets) to use plan assets for the exclusive benefit of the plan's beneficiary.[46] Thus, if a soft dollar arrangement is outside of Section 28(e), a broker-dealer or, if applicable, an adviser must be able to demonstrate that the services and research received actually benefited the specific client who pays the commissions for the soft dollar services and research. Section 28(e), however, has a lesser standard in that the broker-dealer or adviser need only demonstrate that the services or research received by the adviser benefited some clients over all. Thus, it is extremely important that if an a broker effects transactions for ERISA clients, all transactions involving the ERISA plan be within the safe harbor.

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[42] SEI Financial Services Co., SEC No-Action Letter [1984 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶77,631 (Nov. 14, 1983) Becker Securities Corp. [1976-77 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶80,641 (1976).
[43] Data Exchange Securities, SEC No-Action Letter [1981-82 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶77,016 (Apr. 20, 1981).
[44] Letter from Richard Ketchum, Director of Division of Market Regulation, to Charles Lerner, Department of Labor (July 25, 1990).
[45] ERISA §2, *et seq*.
[46] ERISA §§403, 404 and 406.

If an adviser receives services for which the investment manager is obligated to pay from fees charged the client, the adviser may violate the various provisions of ERISA.[47]

D. Conflicts Regarding Directed Brokerage and Referral of Clients

Brokerage in return for clients is a material conflict and is prohibited without the consent of a client after full disclosure. This issue presents one of the bigger conflicts compliance problems for investment advisers. In the usual course when an account executive refers a new client to an investment adviser, the account executive will, in the course of human nature, want to receive brokerage for the transactions executed by the investment adviser for the referred client. This is particularly true with respect to individual clients but also applies to institutional clients. Client referral is not protected by Section 28(e). However, if a client, after specific disclosures of the disadvantages and advantages to the extent that there are some, consents to directed brokerage, an investment adviser may follow a client's direction. Directed brokerage consents should be in writing and written disclosures with respect to various disadvantages of directed brokerage should be in written form and acknowledged by the client.

The SEC expects that the adviser inform the client, preferably in writing, that better commissions may be obtained elsewhere by the adviser, if such is the case. If the client is disadvantaged by reason of its order being executed later than non-directed orders, such disadvantage must be disclosed. Absent disclosure and client direction, trades would not be appropriate unless best price and execution were obtained. However, where the client receives other services or materials from the broker, the client may have other reasons to direct brokerage and pay a higher commission. Full service brokerage sweep accounts, custodial services, check writing and other services are valuable to a client and may more than offset the cost of a higher commission rate. Since custody services have various fees of $5,000 to $10,000 per account, this service is also not inconsequential and important to many clients.

In some cases, an institutional client may direct an adviser to direct its institutional brokerage orders to a particular broker-dealer who may provide services or materials directly to the institutional client or purchase them for the institutional client from third parties. Large institutions often obtain custody, research, software or other services by a directing that its orders be executed at a specific broker-dealer. Since the client has directed the adviser to place the orders with one or more broker, services and materials may be any services and materials whether or not permitted by Section 28(e).

E. Rebates from a Broker

A cash rebate or order flow payment from a broker to an investment adviser without express client consent after full disclosure would violate the investment adviser's agency fiduciary obligation to the client. It is clear that any such rebate is outside the scope of Section 28(e). If an investment adviser receives and retains cash or order flow rebates resulting from client brokerage, the investment adviser would violate its agency fiduciary obligation. Further, the adviser would also be a "broker" required to register under Section 15 of the 34 Act. However, if the cash or

[47] ERISA §§403(f)(i), 404(a)(i), 406(g).

order flow rebate is passed on to a client directly by the adviser or by the broker, the investment adviser will not be considered a broker required to register under the 34 Act. Further, such a rebate to the client would not violate an adviser's fiduciary duty. However, the rebate must relate only to the brokerage for the specific client whose brokerage generates the rebate.

Institutional investors sometimes require investment advisers to arrange for rebates directly from the broker or to a third party to pay for research and services that are obtained by the institutional investor. Although these transactions are not covered by Section 28(e), they do not raise a problem as long as the services are obtained by the investor and paid for by the brokerage for the specific investor. The client may direct the use of a particular broker and receive cash or other services, or the client may direct the broker to pay for research or other services that the client as opposed to the adviser receives.

F. Order Flow Payments

Payments are made by market makers and specialists for order flow in over-the-counter and certain exchange markets. Generally, the arrangement provides that the broker that is referring the transaction to the market maker or specialist will be guaranteed executions for its customers at the national best bid or offer ("NBBO") or better. In return for the order flow, the broker that is introducing the transaction to the market maker or specialist will receive a rebate, usually 2 or 3 cents per share. The SEC has made clear that execution at the NBBO by itself is no longer sufficient to full best execution obligations and that both the adviser and broker-dealer must attempt price improvement by various means. If the introducing broker receives order flow payments, the usual Section 28(e) analysis will apply. However, the order flow payments may not be paid under any circumstance to the adviser and in most cases should not be paid to an affiliate absent express consent from the client. If the introducing broker receiving the order flow payments from a market maker or specialist is an affiliate of the adviser, there is a question as to whether the order flow payments received from the affiliated broker-dealer violates the agency obligation of the adviser absent client consent. Clearly, any such conflict or payment should be disclosed and specific client consent obtained. SEC Rule 10b-10 requires disclosure of receipt of the cash rebate by the retail broker from the dealer.[48]

G. Order Errors

For many years, common practice in the securities industry was for order errors to be settled between the party giving the order and the party receiving the order by some sort of accommodation or a compromise. However, it is clear that the SEC condemns such practice if additional client brokerage is to be provided to the broker by an investment adviser. The SEC condemns such practice because it is a clear conflict of interest. The SEC staff takes the position that an investment adviser may not settle an error by providing additional client brokerage business to a broker-dealer. Further, a broker-dealer would become an aider and abettor by accepting such.[49] As a result, broker-dealer compliance policies should provide that either the broker-dealer

[48] Securities Exchange Act Release No. 16,679, [1981 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶82,481 (Mar. 19, 1980).

[49] Letter from Richard Ketchum, Director of Division of Market Regulation to Charles Lerner, Department of Labor [1988 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶78,871 (Oct. 25, 1988).

accepts the error for the account or the adviser settles the error out of its own account, not by using client brokerage or funds.

H. Practice Tips, Including Best Execution, Brokerage Allocation, Principal and Cross Transactions

1. Supervisory Procedures

Each firm should have written supervisory procedures and policies covering the following areas:

a. brokerage allocation and soft dollars;

b. best execution;

c. directed brokerage, including rebates and order flow payments;

d. principal transactions, including riskless principal transactions; and

e. cross trades.

In many cases, the procedures with respect to best execution, brokerage placement and soft dollars will be combined procedures. The procedures should provide for identification of all soft dollar research arrangements and provide for a method of evaluating quality of execution of transactions and order routing on a regular basis, at least quarterly. In most firms this is done by a committee that reviews the recommendations with respect to needed research, the order routing procedures, the quality of executions received and the commissions paid. Records of the committee's deliberations and decisions should be maintained to demonstrate compliance with the above principals. The procedures should clearly provide for a review of the services and materials received to be certain that they qualify as research and brokerage services within the meaning of Section 28(e). The procedures should also provide for allocation of part of the cost to the firm in the event that materials or services have a mixed use, as explained above. *See* item 4, documentation of soft dollar arrangements below for further detail.

2. Directed Brokerage

Investment adviser compliance procedures should have policies and procedures regarding directed brokerage compliance. If an individual broker is receiving a significant amount of brokerage from an investment adviser, particularly for individual clients but also for institutional clients, the firm should be certain that directed brokerage letters have been signed by the customer consenting to the directed brokerage arrangement. Copies of the disclosures to the customer and the customer's consent to directed brokerage should be maintained.

Compliance procedures should also cover the review of materials or services furnished directly to a client of an investment adviser at the request of the adviser. This should include cash rebates or order flow rebates. In any case, the specific written consent of a client receiving the services or materials, whether the services or materials are permitted under Section 28(e) or not, should be documented. The investment adviser should obtain from the client a written representation that the orders are being directed by the client and obtain from the client a specific direction with respect to payment of the rebate or the furnishing of material or services to the client.

3. Order Flow Payments

If a broker-dealer is making order flow payments directly to a customer whose assets are managed by an investment adviser, the arrangement should be documented and a file maintained. Investment adviser compliance procedures should prohibit payment of order flow payments to the investment adviser without express consent of a senior official and the client. Such consent should be given only if it is demonstrated that the order flow payments are directed to the specific client whose brokerage transactions result in the order flow payment.

4. Documentation of Soft Dollar Arrangements

a. Agreements

The investment adviser's compliance procedures should provide for documenting all soft dollar arrangements with respect to the terms and conditions. There should be a central file maintained where these agreements are retained. The compliance procedures should provide for periodic review of soft dollar arrangements to determine if the terms of the agreement are being followed.

b. Appropriate Research Services or Materials

As explained above, only certain materials are within the Section 28(e) definition of research services or materials. The supervisory procedures should provide for approval of services or materials to be furnished by broker-dealers or by third parties to the investment adviser pursuant to any soft dollar arrangement and a record of the same should be maintained. The approval should be by a senior level supervisor who has a very good knowledge of the SEC Section 28(e) Release defining what is appropriate research and execution services. In the event that the services and materials have a joint use, there should be an allocation and recapture of the cost for the services and materials to the extent used by the investment adviser for its own purposes and not for the purposes of clients. Records of the above should be maintained.

c. Third Party Research or Materials

A broker-dealer should be certain that it does not pay invoices for materials or services contracted by an adviser. As discussed above, Section 28(e) allows a broker-dealer to pay only for third party services or material within the definition and for which the broker-dealer itself contracts to pay. The compliance procedures should provide a review procedures for all invoices for third party research or material to be certain that the broker-dealer and not the adviser contracted for and paid for the materials or services.

5. Order Errors

Investment advisers should have in their trading compliance procedures a specific provision providing that traders and other personnel of the firm are prohibited from resolving errors with investment advisers by obtaining future brokerage from the investment adviser.

6. Cross Trade Procedures

As explained in the section discussion cross trades, any cross trade involves a conflict of interest. In order to comply with the requirements of Section 206(3), it is necessary that the adviser have clear procedures and policies on when and how a client is notified. Pre-transaction disclosure of a general conflicts of interest could be made in the Form ADV or in the advisory agreement or both and the client's consent to cross trades may be obtained in advance. However, the SEC release makes it very clear that that is not enough. The investment adviser must also disclose execution price, best price in the market and commission for the specific transaction prior to settlement and obtain the client's concurrence. However, the procedures should note that the client retains the right to disavow. Procedures should cover all of the above, including documentation and approval of such transactions.

7. Principal Transactions

Unlike cross transactions, the SEC has not issued a release in case of principal transactions. Client consent to principal transactions between the adviser or its affiliates and the client must be obtained. The adviser should have clear procedures for obtaining the client's consent for principal trades prior to their being effected. Procedures should clarify and spell out the differences and the conditions that must be met.

IV. Conflicts in Allocation of Investment Opportunities

A. General

Investment advisers have a host of investment opportunities. The existence of these investment opportunities frequently present conflicts as to which clients will be offered the investment opportunities. In many cases, the opportunity is limited, for example, in connection with an initial public offering ("IPO"). In many cases, an investment opportunity suitable for one client will not be suitable for the investment objectives of another client. For example, certain private placement opportunities are inappropriate for many smaller clients, but may be a good fit for a sophisticated investor or an institution. In some cases, allocation by the investment adviser will be restricted by law. For example, a trust may not permit investment in certain types of securities. In other cases, the risk would be too high for the risk tolerance for the particular client. In other cases, while it would be an excellent opportunity, it would be contrary to the diversification and asset allocation principals.

Faced with these varying opportunities, investment advisers must have reasonable policies and procedures to fairly allocate investment opportunities. The procedures should assign particular responsibility to specific supervisors and the implementation should be documented.

B. Priority of Research Recommendations and Opportunities

Investment advisers, when they develop a research recommendation or investment opportunity, generally allocate the opportunity to all clients for whom the recommendation is suitable based on the client's investment objectives, diversification and available funds. However, for a number of reasons, a particular investment opportunity or recommendation may not be suitable or otherwise appropriate for particular clients. For example, the client's accounts may not have the funds to participate or the securities may be too speculative. Consequently, investment advisers must have policies on the priority and allocation of investment opportunities and research to clients. These methodologies should be disclosed in general terms in the Form ADV and if a particular exclusion or methodology has unusual features, the methodology and allocation procedures should be disclosed in general terms in the Form ADV and client consent obtained with respect to the same. For example, many investment advisers may provide research recommendations to clients for which the firm has discretionary authority before providing research recommendations to other clients. Many firms do not want to make their research recommendations known outside the firm until they have been completely implemented for discretionary accounts to prevent the investment opportunities becoming available to the public to the detriment of discretionary clients. Likewise, some firms publish their recommendations to the general public, but only after implementing those recommendations for both their discretionary and non-discretionary clients. In other cases, if the firm has investment company clients, its policy may be to implement the research recommendations for the investment companies prior to implementing the recommendation for other types of clients. In all cases, the Form ADV or another disclosure statement should disclose the method and priority of allocation of research. It is also recommended that a provision be included in the investment advisory agreement, both disclosing and obtaining the specific consent of the client to the methodology of research allocation.

C. Personal Trading by the Investment Adviser and its Employees and Affiliates

Trading ahead of or in conflict with a research recommendation by an investment adviser, its employees or affiliates is an anti-fraud violation. All firms should have personal trading policies and procedures to prohibit activities which discriminate against clients to the benefit of the investment adviser itself, its employees or its affiliates and personal trading procedures to prevent misuse of non-public material information. These personal trading procedures are generally implemented by requiring all trades for employees and their households to be disclosed to the investment adviser. The investment adviser compliance officials or supervisors review all trades for possible conflicts of interest. These policies also include prohibitions against trading ahead of client and against trading ahead of research recommendations by the firm or its employees. Attached is a detailed article by the author prepared for the National Society of Compliance Professionals 2000 Annual Meeting describing in detail personal trading policies and provisions.

In many cases, investment adviser personnel or the firm's profit sharing or pension plan, may desire to participate with clients in investment opportunities. Generally, this is permitted under limited circumstances with appropriate disclosure and consent by clients, but in all cases, the client's interest must proceed that of the firm, the investment adviser and its personnel.[50] An investment adviser or its affiliate (such as a profit or pension sharing plan) and employees, may participate in a block trade with clients provided they pay the same brokerage and receive the same treatment as clients. This would mean that all clients for whom the particular research recommendation is suitable participate in the transaction. If the block transaction is not fully implemented, the clients receive allocation prior to the firm, its employees or affiliates.

D. Block Allocations

In connection with implementation of research recommendations, firms should have a policy for allocation of block trades. The policy should have a methodology so that all clients for whom a particular type of trade is suitable at the time may participate in the block. In the event the full block amount is not executed, there should be a system by which the trades are allocated. The system does not necessarily have to be a pro rata application. The system can be a system of allocation by random so that clients participate equally on a random statistical basis in blocks of transactions. The system can be by account number (*i.e.*, those not participating in a particular block will participate in the next block and so on). Some of these systems are quite sophisticated, particularly where the firm has a diverse clientele and where many trades would be unsuitable for certain clients.

If the investment adviser, its affiliates or employees are participating in a block, most firms provide that the firm, its affiliates and employees will not participate if the block is not completely completed or will participate only to the extent that recommended amounts for clients are completed.

The system of allocation should be described in general terms in the Form ADV Part II. In certain cases where allocation system is unusual, it is recommended that it be described in general terms in the advisory agreement and client consent obtained, that disclosure and consent mechanism be obtained in a separate document.

E. Special Types of Transactions

1. Underwritten Transactions, Including Initial Public Offerings

In the case of underwritten transactions, both IPOs and secondary offerings, an investment adviser may be allocated a limited number of shares. The question then becomes to which clients will the allocated securities be assigned. Again, if the firm is going to participate in underwritten securities transactions where the amount allocated may be less than requested for all clients, the firm must have procedures so that all clients for whom the securities are suitable will participate fairly over a period of time. This does not necessarily mean a pro rata allocation, but there must be a methodology of allocation that is fair. As in the case of block trades, it may be

[50] SMC Capital, Inc., SEC No-Action Letter [1995 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶77,049; 1995 WL 529274 (September 5, 1995).

done randomly, by name, by account number or by any other system as long as it meets the basic test of fairness.

Some investment advisers have a policy of not handling IPOs for their clients because they believe that they are too volatile and present very difficult allocation problems. Even if the firm uses a fair system of allocation, clients continually complain that they do not receive enough shares. Further from the investment adviser's perspective, receiving only a limited number of shares in a new company is many times not worth following the company if only a few clients hold the shares. For that reason, a number of investment advisers have policies that they will not recommend or execute transactions for initial public offering shares for their clients. As discussed in the paper attached dealing with personal trading policies, many investment advisers do not allow their employees and affiliates to participate as investors in IPOs or other hot issues for a variety of reasons. In the event the firm does not allow participation in IPOs by either clients or its employees, it should be disclosed in the Form ADV. In the event the firm, employees or affiliates are going to participate in IPOs, either with or without clients, there should be a clear disclosure regarding the same in the Form ADV. Further, it is recommended that in such case the policy be disclosed in the advisory agreement and consent obtained.

2. <u>Private Placements</u>

Private placements, real estate ventures, hedge funds and a variety of other types of private placement investments will not be suitable for many clients because of their limited marketability. Nevertheless, many investment advisers do recommend private placements to sophisticated clients with significant assets and sufficient liquidity so that illiquidity is not an issue. Since private placements generally have a limited number of investors, it is obvious that not all clients, even those who have the means and investment objectives necessary to make such investments, will be able to participate. Consequently, a fair method of allocation must be developed.

Because of the number of limited participations in a private placement and the illiquidity of such private placements, many investment advisers specifically provide in their Form ADV that they will not review or recommend private placements to clients. Any such policy should be disclosed in the Form ADV. Even if the firm will not recommend private placements to clients. If the firm or its employees or affiliates will participate in private placements with clients, it should clearly be disclosed in the Form ADV and consent obtained in the advisory agreement.

3. <u>Investment Opportunities and Types of Securities Which Will Not Be Offered by an Investment Adviser</u>

If an investment adviser does not offer a particular type of security or investment opportunity to its clients as a matter of policy, such should be disclosed in Form ADV.

F. NASDR Rule 2711 and NYSE Rule 475

1. Background

The NASD and the New York Stock Exchange have recently adopted in record time NASDR Rule 2711 and NYSE Rule 475 regulating conflicts regarding research by analysts affiliated with broker-dealers. These rules are also applicable to investment advisers that are part of or are affiliated with broker-dealers. However, these rules are applicable only if the broker-dealer uses and publishes within the meaning of the rule research provided by an investment adviser. The literal wording of the rules would not cover research from affiliates, but it is the author's understanding from conversations with the NASDR staff that the NASDR staff believes the rule applies if a broker-dealer receives research recommendations from an affiliate and publicizes them within the meaning of the rule.

Conflicts resulting between research recommendations and the other activities of an affiliated broker-dealer, such as investment banking, market making and its proprietary trading, have been a long-standing issue in the securities industry. Because of the Enron debacle, reforms resulting from these issues are at the forefront of the agenda of Congress, the SEC and the self-regulatory organizations. Notwithstanding the current publicity, these issues have been under consideration for the last several years. However, because of the Enron debacle and its resulting publicity, and because of Congressional, SEC and industry pressure, the NASDR has developed and submitted to the SEC in record time Rule 2711, a new rule with respect to research conflicts. The newly proposed Rule 2711 is far more encompassing than the proposals to amend NASDR Rule 2210 set forth in Notice to Members 01-45 last year. The pressures in this area are so great that the proposed new NASDR Rule 2711 was not submitted to members of the NASDR for approval but was approved by the Board of the NASD and filed on February 8, 2002. The NYSE filed a similar rule at the same time. These rules were promptly approved by the SEC.

This outline discusses the NASDR Rule 2711. The parallel NYSE rule is similar, but there are differences which the Securities Industry Association has requested be eliminated so that the industry operates with a uniform rule.

2. New NASDR Rule 2711 in Concept

The new rule pending before the SEC has the following concepts imbedded in the Rule:

a. Significant restrictions on an investment banking firm relationship with the firm's research department.

b. Significant restrictions on review of a research report by the subject issuer or company.

c. Prohibition on certain forms of research analyst compensation.

d. Prohibition on a promise of any favorable research report to issuer.

e. Imposition of quiet periods in which a firm may not publish a research about a subject company.

f. Significant restrictions on personal trading by research analysts.

g. Notwithstanding current Rule 2210, additional disclosure requirements regarding ownership, conflicts of interest, receipt of compensation, position as an officer or director, meaning of ratings, distribution of ratings, price charts, price targets, market making, and prominence of disclosures.

h. Adoption and implementation of written supervisory procedures.

3. <u>The Rule's Definitions</u>

The rule broadly defines "investment banking department", "investment banking services", "research report", "subject company" and "research department". "Research report" is broadly defined to mean any type of written or electronic communication that will be distributed or has been distributed with reasonable regularity to customers or the general public and which presents an opinion or recommendation concerning an equity security. With respect to an analyst, a "research analyst" is defined as a person who is principally responsible for and any other associated person who directly or indirectly reports to such analyst in connection with preparation of the substance of a research report, regardless of job title. The "research analyst account" means any account in which the research analyst or any member of the person's household has a beneficial interest or over which the analyst or household member has discretion or control other than an investment company registered under the 1940 Act. The household includes individuals whose principal residence is the same as the research analyst's principal residence. "Public appearance" is broadly defined to include any participation in a seminar forum, including interactive electronic forum, radio or television interview, or public speaking activity in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

4. <u>Restriction on Investment Banking Department Relationships with the Research Department</u>

Research analysts cannot be subject to the supervision or control of any employee of a firm's investment banking department. Further, no employee of an investment banking department may review or approve a research report of a member before its publication with one exception. Investment banking personnel may review a research report before publication to verify the factual accuracy of information or any potential conflict of interest, but only under the following conditions:

a. Any written communication between the banking and research department must be made through an authorized legal or compliance officer of the member firm with a copy to such person; and

b. Any oral communication between banking and research departments concerning a research report must be documented and made either through an authorized legal or compliance official acting as an intermediary or in a conversation conducted in the presence of such official.

These restrictions are rather strict, but are probably necessary from a political standpoint in view of the temper of the public and the United States Congress. What this means is that it will be highly unlikely that there will be communication of any significant amount. Firms will need to institute supervisory procedures to facilitate such communications where necessary. It is likely that most firms will tape any oral conversations.

5. <u>Restrictions on Review of a Research Report by the Subject Company</u>

"Research report" is very broadly defined but is limited in the sense that a member must have distributed or proposed to distribute it with reasonable regularity to its customers or the general public and present an opinion or recommendation concerning an equity security. Generally, Rule 2711 prohibits a member from submitting a research report to a subject company before its publication. However, there are two exceptions. The first exception permits submitting a research report to the subject company to verify factual accuracy of information, but only if:

a. the part of the research report submitted to the subject company does not contain a summary, rating or price target;

b. a complete draft of the report is provided to the legal or compliance department before sections of the report are submitted to the subject company;

c. if after such submission to the subject company the research department intends to change the proposed recommendation rating or price target, it must provide written justification and receive written authorization from the legal and compliance department for the change;

d. copies of all drafts and the final version of research must be retained for three years after publication.

The other exception permits a member to notify the subject company of a change in rating of the company's securities provided the notification is no earlier than the day before the announcement of the rating change after the close of trading in the principal market for the company's securities. Submitting pieces of a research report to a subject company for verification of accuracy will require a great deal of care. Many factual statements are in fact factual conclusions and may involve judgment. Hopefully the definition of "research summary" means ultimate research recommendation as opposed to certain factual conclusions. For example, is a statement factual if it states that the debt of the company imposes a significant burden and will require a specific amount of dollars to liquidate on an annual basis having a negative impact effecting the company's cash flow? The author would consider such a statement factual that might need verification. The rule is unclear as to whether this would be permitted.

6. Prohibition of Certain Forms of Research and Analyst Compensation

Rule 2711 explicitly prohibits the payment of any bonus, salary or other form of compensation to a research analyst based upon specific investment banking services transactions. The rule apparently does not prohibit an analyst from receiving compensation based upon general revenues of investment banking generated by transactions. However, to the extent that specific investment banking service transactions are part of the general revenues, there is a question as to whether compensation of the analyst tied in any way to the investment banking department's revenues would be permitted. However, it appears to be permitted because the disclosure requirement requires the member to disclose the general compensation received by the analyst as a result of investment banking department revenues.

7. Prohibition of Promise of Favorable Research

The rule explicitly prohibits the direct or indirect offer of favorable research, a specific rating or price target or threaten to change any research rating or price target to a subject company as consideration for an inducement of receipt of business or compensation.

8. Imposition of Quiet Periods

Research reports may not be published by a manager or co-manager of an underwriting of an initial public offering ("IPO") for forty days following the date of the offering, or in the case of a secondary offering ten calendar days following the date of the offering. However, subject to prior authorization by the legal and compliance department, a research report may be issued during the quite periods if it concerns the effects of significant news or a significant event on the subject company during the quiet period. The determination of significant news or a significant event is certainly something that companies will have to be careful in evaluating and in many cases it is likely that the legal or compliance department, in the exercise of caution, will prohibit the dissemination of a research report although it may be of importance to the public to change a prior recommendation. In such cases, any research report that is outstanding would have to be withdrawn with no comment as to why.

9. Restrictions on Personal Trading by the Research Analyst

The restrictions on the purchase or sale of securities by research analysts are again relatively dacronian. The rule prohibits a research analyst from purchasing or receiving any securities before an IPO if the issuer is principally engaged in the same type of business as companies that the research analyst follows. Research analysts may purchase or sell a security issued by a company that the research analyst follows or any option or derivative of any such security provided it is purchased or sold prior to thirty calendar days before and ending five calendar days after the publication of a research report concerning the company or any change in a recommendation, rating or price target. Notwithstanding such restrictions, a member firm may:

a. permit a research analyst to sell all of the securities that are issued by a company that the research analyst follows within thirty calendar days after the research analyst began following the company;

b. permit a research analyst to purchase or sell any security issued by a subject company within thirty calendar days before the publication of a research report, change in rating or price target due to significant news or a significant even concerning the company provided the legal or compliance department pre-approves the research report and any change.

A research analyst account may not purchase or sell any security, option or derivative of a security inconsistent with the research analyst recommendation as reflected in his most recent report that has been published by the member.

A member's legal or compliance department may authorize a transaction that is otherwise prohibited during the blackout period or that may not be purchased or sold because it is inconsistent with the research report based upon significant personal financial circumstances of the beneficial owner or owners of the research analyst account. This relief, however, is subject to a number of conditions as follows:

a. The legal or compliance department must authorize the transaction before it is entered.

b. Each exception granted must be in compliance with supervisory procedures and policies adopted by the member reasonably designed to ensure that the transactions do not result in a conflict of interest between the professional and personal activities of the analyst.

c. The member must retain written records concerning the transaction and the justification for a period of three years following the date on which the transaction is approved.

The prohibitions on securities transactions by the analyst do not apply to the purchase or sale of securities of:

a. investment companies registered under Section 5(b)(1) of the Investment Company Act of 1940;

b. any other investment fund over which neither the research analyst nor a member of the analyst's household has any investment discretion or control provided:

i. the analyst's account collectively owned an interest representing no more than one percent of the assets of the fund;

ii. the fund invests no more than twenty percent of its assets in securities of issuers principally engaged in the same type of business as companies that the research analyst follows; and

iii. the investment fund does not distribute securities in kind to the research analyst or household member before the issuer's initial public offering.

10. Specific Disclosure Requirements

The specific disclosure requirements, as noted below, are in addition to NASDR Rule 2210 and are extremely detailed. Also as explained below, they must be set forth conspicuously at the front of the research report or there must be a reference on the front page to where the disclosure will be found.

a. Ownership and Material Conflicts of Interest Disclosure

In all research reports members must disclose and in all appearances research analysts must disclose:

i. Any interest of the analyst or member's household member in the securities of subject company and the nature of the financial interest;

ii. Whether the member or its affiliates beneficially own one percent or more of any class of common equity securities of the subject company (as of five days before the publication of a research or public appearance);

iii. Any other material conflict of interest which the member or analyst knows or has reason to know at the time of publication or public appearance;

iv. Any other material conflict of interest which the member knows or has reason to know at the time of the publication of the research or which the analyst knows or has reason to know at the time of a public appearance.

The rule filing by NASDR with the SEC indicates that in the event that disclosures are edited out of television or other pre-recorded programs, that the analyst would not be responsible from being certain that it is included.

b. Receipt of Compensation

Research reports must disclose the following:

i. Compensation received by an analyst that is based upon the member's investment banking revenues;

ii. If the member or its affiliates receive compensation for the company that is the subject of the research reports within twelve months prior to the report or reasonably expects to receive compensation within three months following publication of the research report;

iii. In public appearances whether the analyst knows or has reason to know that any subject company which he discusses is a client of the member or its affiliates.

c. Position as an Officer or Director

In research reports and appearances, there must be a disclosure if the research analyst or a member of the analyst's household serves as an officer, director or advisory board of a company about which a report is presented.

d. Meaning of Ratings

A member must define in its research reports the meaning of each rating used by the member in its rating system. The definition must be in plain English and be consistent with its plain meaning.

e. Distribution of Ratings

Research reports must disclose the following concerning distribution of ratings:

i. The percentage of all securities rated by the member to which the member would assign a buy, hold or sell rating.

ii. The percentage of subject companies within each of these three categories for whom the member has provided investment banking services within the last twelve months.

iii. The rating information must be current as of the end of the most recent calendar quarter or second most recent calendar quarter if the publication date is less than fifteen calendar days after the most recent calendar quarter.

f. Price Charts

If a research report concerning an equity security has had a rating assigned to that security for at least one year, the report must contain a line graph of the security's prices for the period that the member has assigned any rating or for a three year period, whichever is shorter. The graph must show:

i. the dates on which the member assigned or changed the rating;

ii. each rating or price target is assigned or changed on those dates; and

iii. be current as of the most recent calendar quarter (or second most recent calendar quarter if the publication date is less than fifteen calendar days after the most recent calendar quarter).

g. Price Targets

A member must disclose in research reports the valuation method used to determine price targets. The rule requires that price targets have a reasonable basis as defined under NASDR rules and most importantly be accompanied by a disclosure concerning the risks that may impede the achievement of price targets.

The disclosure of risk that might impede achievement of price targets will be a formidable undertaking for most firms. Some firms may attempt to use boilerplate language which includes a great variety of circumstances, but that is not what the NASDR and SEC have in mind. The disclosures must be specific to the subject company and its operations. Because of a potential liability and regulation, recommendations regarding price targets will need to fall within the safe harbor for disclosure of soft information which will lengthen research reports and make them considerably more complex.

h. Market Making

Any market making activity in the subject company securities must be disclosed at the time the research report was published. This is a long time NASDR requirement in Rule 2210.

i. Prominence of Disclosures

The disclosures must be presented on the front page of research reports or the front page must refer to the page on which the disclosures are found. Disclosures and references to disclosures must be clear, comprehensive and prominent. In the comments accompanying the rule filing, the NASDR specifically states that disclosures that the firm "may" or "might" have market making activities or receive compensation are not satisfactory for purpose of disclosure. The disclosures have to be explicit and state whether the firm is a market maker or was a market maker and the periods of time. Likewise with respect to investment banking compensation, the disclosures have to be specific and may not be qualified using words such as "could", "might", or "may".

11. Supervisory Procedures

As indicated above, although probably not necessary, the rule requires supervisory procedures designed to ensure that the member and its employees comply with the provisions of the rule. It, however, contains a further element that a senior officer of such member must attest on an annual basis to the NASD or that the member has adopted and implemented the required supervisory procedures.

The provision in the supervisory procedures section of the proposed rule requiring the annual attestation by a senior official that the procedures are in place and adequate imposes a significant personal burden on the senior official who must so certify. Many firms senior officials will not be actually involved with the procedures because the person is a senior official with other responsibilities. For that reason it will be hard, if not impossible, for most senior officials to conscientiously give the attestation. The responsibility should be the firm as a whole or the official but not necessarily a senior official closely involved in monitoring the procedures.

12. Some Practical Considerations

a. Each firm will have to carefully consider the adoption of procedures and policies to implement Rule 2711. The procedures and policies will necessarily be complex and have to be adopted to the firm's operation. Fire wall procedures will have to be a careful review between investment banking and research.

b. Firms will need to change their personal trading policies to conform to the requirements of Rule 2711. Personal trading policies will now need to track carefully not only purchase and sale of transactions by individuals that fall within the definition of research analysts and any accounts of the research analyst, including those of the household members. This would best be accomplished by receiving confirmations with respect to all transactions or requiring an identified analyst and his household members to effect transactions through the firm's own brokerage operation for ease of tracking. Trading departments will need to be informed that transactions for analysts will need to be pre-cleared in most cases. The order execution desk will generally not have the capability to ascertain whether or not a particular transaction will qualify within the rather Byzantine provisions of Rule 2711. Consequently, clearance will probably have to be handled by the compliance department for ease of compliance. Firms will probably develop broader, more general prohibitions on purchase and sale transactions than those required by the provisions of Rule 2711 which may create a trap for the unwary.

c. Firms will have to carefully monitor and institute compliance procedures to track whether the firm and its affiliates have one percent or more of the outstanding shares within the meaning of the proposed rules. The rules would propose to use the broad definitions of ownership under Section 13(d) and 13(g) of the 34 Act. 15 U.S.C. in (d) and (g). *See* *also,* Rule 13d-3; 17 C.F.R. 240.13d-3. It is unclear as to whether the term “affiliates” include officers, directors and employees under common control which is an interpretation the SEC has taken in the past.

d. The NASDR comments in the SEC rule filing seeks comment on whether the beneficial owner concept should include any accounts over which an analyst has discretion but no beneficial ownership. This would severely restrict a number of firms and appears not to be in the public interest. In any event, it would create further compliance complication for many firms where research analysts do have discretion over certain accounts, particularly small and medium size firms. Not only would the discretionary accounts have to be identified, but their trading would have to be monitored because it would considered personal trading by the research analyst.

e. The broad definition of compensation in the proposed rule will include not only cash compensation but other arrangements for any kind of investment banking services. Firms will need to set up a procedure to track all agreements, formal or informal, with issuers for which they provide investment, banking or other services.

f. Many firms today have fire walls between their research analysts who make recommendations and their investment banking departments. The amended rule will require that these fire walls be breached to a certain extent because disclosures with respect to the firm’s holdings as well as compensation for investment banking services must be made thereby bringing to the attention of the analysts the firm’s interest in the compensation received for investment banking services. These fire walls may still need to be maintained for purposes of avoiding use of inside information or other material undisclosed information in connection with recommendations, but their purpose with respect to walling off the research analyst from the firm’s own interest will be impaired.

g. In public appearances, particularly on talk shows and similar appearances, the recitation of disclosures will be cumbersome and difficult. However, it appears that it will become a part of public life. Obviously, it will reduce the spontaneity and eventually result in boilerplate disclosures on such shows as *Wall Street Week* and other prominent shows which will eat up significant amount of time unless edited out by the procedures. How much effect it will have remains to be seen.

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