FS Regulatory Brief

SEC's current views related to trade allocation practices

Introduction

The manner in which advisers allocate investments among client and other managed accounts is a high-risk compliance area. Currently, the SEC is highlighting certain problematic investment allocation practices by investment advisers. These practices include, for example, allocating profitable trades to proprietary or other accounts that the adviser may wish to favor (e.g., accounts with a higher fee structure) or, conversely, "dumping" unprofitable trades in less favored accounts without proper disclosure to advisory clients. Another issue was advisers' failure to keep proper books and records with respect to trade orders and allocations. In addition, the SEC has scrutinized management's supervision of investment advisers' trading activities and allocation practices.

One of the more common practices that has caught the SEC's eye is "cherry-picking." Cherry-picking involves delaying an allocation of securities (purchased or sold) until *after* the order is filled and the transaction price has been determined, or reallocating trades at the end of the day (i.e., once the trade price has been established). This practice allows an adviser to allocate a disproportionately higher percentage of favorable (or unfavorable) trades to one account over another. This ultimately could result in noticeable performance dispersion between accounts. It is noteworthy that a cherry-picking scheme could involve the allocation of favorable trades to certain accounts to increase profits as well as to minimize losses.

These investment allocation issues continue to be a high priority for the SEC, as evidenced by its current examinations and enforcement actions. This article analyzes the specific allocation practices challenged by the SEC and provides guidance on how investment advisers may fortify their investment allocation practices by:
(1) implementing and following effective written allocation policies and procedures; (2) ensuring proper disclosure of allocation practices to clients and investors; and (3) keeping proper books and records with respect to trade orders and allocations.

Applicable rules and regulations

Generally, an investment adviser has a fiduciary duty to act in the utmost good faith with respect to its clients and to provide full and fair disclosure of all material facts. The SEC has often relied on Section 206 of the Investment Advisers Act of 1940 (Advisers Act) and Section 10(b) of the Securities Exchange Act of 1934 to bring allocation and other conflicts of interest or market manipulation cases against investment advisers. An adviser may also violate Rule 204-2(a)(3) by not keeping proper trade order memoranda.

Finally, Section 203(e)(6) of the Advisers Act allows the SEC to censure or suspend the activities of a person who fails to reasonably supervise another person with a view towards preventing violation of certain rules and regulations. In addition, inadequate allocation policies and procedures or the failure to properly supervise inappropriate employee activities relating to allocations may violate Rule 206(4)-7. The specific requirements of these rules are discussed in the Suggested Allocation Practices section below.

Points to consider

Levels of allocation

An investment adviser's duty to allocate trades fairly and equitably usually exists at more than one level. Often, investment advisers manage multiple funds that participate in different investment strategies with some overlapping commonality. In addition, advisers frequently manage commingled funds as well as separately managed accounts (SMAs) that invest pari passu (on equal footing) with the commingled funds subject to certain investment restrictions.

As an illustration, assume an investment adviser manages a global multi-strategy fund with no restriction (Fund A), a credit-focused fund (Fund B), and a separately managed account (SMA Account), which trades pari passu with Fund A.

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In this example, the investment adviser must consider allocation issues at both the strategy and client levels. First, the investment adviser must determine how a particular *credit* investment should be allocated between the multi-strategy clients (Fund A and SMA) and the credit fund (Fund B). In doing so, the investment adviser may consider various factors including to what extent, if any, the credit fund should be given preference over the other clients given its credit-specific focus. For instance, should the credit fund systematically receive a higher fixed percentage of all credit investments with the remainder to be shared among the two multi-strategy funds? The answer depends on numerous factors including the size of the accounts involved, the size of investment opportunities, the availability of credit investment opportunities in general and the disclosures made to clients and investors. Once a determination has been made at the strategy level, the adviser must consider how the investment should be allocated between the clients that participate in the same strategy (i.e., Fund A and SMA Account). Such determinations also require consideration of various factors including the size of the investment, client specific restrictions and available cash flow.

The investment adviser must also consider the allocation implications around the sale of investments. In instances where the investment sold is in an illiquid name or operates in a distressed market, for example, the investment adviser may need to determine how to most equitably relieve its funds' positions in the event that the sell order is only partially executed. Using the same set of facts previously described, an investment is purchased on behalf of all the funds – Fund A, Fund B, and the SMA Account – and equally distributed into each fund's portfolio. If the investment adviser subsequently decides to sell the position, whether it is to reduce exposure in the investment or to create liquidity in a fund for a redemption request, the investment adviser must determine how to equitably relieve the position in each fund. There are various factors that play a role in the adviser making a decision. The investment adviser must be conscious of the investment profile of each fund, the principal's and the client's interest in each fund, and, if applicable, which fund and who is making the redemption request.

The SEC expects investment advisers to make all such determinations in a fair and equitable manner without favoring any particular client(s) unless such a practice is clearly disclosed to all clients and investors.

Suggested allocation practices

The current enforcement cases brought by the SEC serve as a reminder of certain basic rules that investment advisers should follow when allocating investments:

- Avoid "cherry-picking" or other undisclosed inequitable allocation practices.
- Determine and document the allocation method before executing trades or, in very limited cases, immediately thereafter but before settlement.
- Ensure that allocation methods and practices are consistent with investor disclosures.
- Maintain proper written records with respect to all allocations, including any post-trade modifications and cancellations.
- Review any deviations from allocation guidelines, both individually and in the aggregate, for evidence of any inappropriate favoritism.

The following guidelines and suggested practices may assist investment advisers with respect to allocation practices:

Implement or review allocation policies and procedures

An investment adviser should implement or review existing written allocation policies and procedures and ensure that the allocation policy addresses the specific risks and issues associated with the adviser's investment programs. Specifically, the methodology and timing of the allocation should be considered.

1. Allocation methodology

An integral part of an allocation policy is the methodology used to allocate investments among numerous clients. The methodology should be specific, systematic and address the needs of different investment programs administered by the adviser. In addition, the policy should provide guidelines to handle situations where the methodology may not be practical or efficient.

Investment advisers often allocate trades pro rata based on client assets under management (AUM). However, allocation based on client size may be complicated in certain circumstances (e.g., certain investment products such as derivatives) and may not allow the adviser to capture the variances in investment objectives among clients. For instance, in the example previously described, a pro rata allocation may not be efficient for the credit fund, which requires more enhanced credit exposure than the multi-strategy clients. Accordingly, the investment adviser in that situation may choose not to use a methodology based on client size. Instead, the adviser may decide to allocate a fixed percentage of all credit investments to the credit fund while dividing the remaining investment among the two multi-strategy clients pro rata based on AUM.

Often, the effectiveness of an allocation methodology depends on various factors, including: (1) different goals and requirements of client investment programs (i.e., investment restrictions, focus or concentration); (2) availability of account capital and size (i.e., a new client or a client with significant new subscriptions may require additional allocations whereas a fund with significant redemptions may require smaller allocations); (3) the nature of the investment opportunity (i.e., the size and scarcity of the position); and (4) in the event of a sale, the nature of the investment itself (i.e., the illiquidity of the investment).

Going back to the previous example, suppose that the investment adviser decides to allocate all credit investments 50/50 at the strategy level (i.e., 50% to the credit fund and 50% divided pro rata between the two multi-strategy funds). This allocation may work well while the credit fund builds up its portfolio, but it may lead to an over-allocation once it has reached its full capacity or if it experiences significant redemptions that are not offset by subscriptions. The efficacy of the 50/50 allocation may also depend on the size of each investment opportunity.

Similarly, the pro rata allocation at the portfolio level (i.e., between Fund A and SMA Account) may also be affected by external factors such as the size of each client or the size of the investment. For example, the 50/50 allocation at the strategy level and a subsequent pro rata allocation at the client level may result in a negligible position size for one or more of the multi-strategy clients (or, if the investment is very small, all three clients – Fund A, Fund B and the SMA Account).

An adviser may avoid such an outcome by frequently reassessing its allocation program, anticipating the various factors that could influence an allocation determination, and building certain preapproved exceptions or deviations into the allocation methodology. Such exceptions may address issues such as small positions, cash flow considerations or specific types of investments (e.g., derivative products that make pro rata allocation difficult or bank debt that requires certain minimum ownership). For instance, in our example, the investment adviser may deal with the small investment issue (e.g., allocation methodology leading to negligible investment size for one or more of the clients) by applying a predetermined rotational system (i.e., alphabetical) or altering the usual 50/50 strategy level allocation by applying a de minimis threshold for each client. This would help ensure that all qualifying clients have some minimum but meaningful exposure to the investment. However, over time, such methods may lead to significant performance dispersion, which may require enhanced disclosure and documentation procedures.

Finally, allocation methodologies should apply to both purchases as well as sales of investments and should specifically address the allocation methodology for partial fills (e.g., the amount ultimately purchased or sold is less than the aggregate order amount).

If we refer back to the previous example regarding the sale of an illiquid investment, suppose that an order to sell the entire position of the investment across all funds is only partially filled. The investment adviser is challenged with deciding how to allocate the relief of the position in each fund. Common methods may include pro rata or rotational. The pro rata method would leverage the proportional size of each position across all funds when the positions were established and use those same proportions when relieving the position across the funds. A rotational method would establish an order of relief by fund, and each fund would take its turn in relieving the position. These methods ensure that the process is objective in nature. The investment adviser should establish a method or formula for these scenarios, then prepare a policy that clearly describes the process. If the investment adviser chooses to deviate from the methodology outlined in the policy and decides to relieve the fund's position based on its investment profile, the investment adviser should carefully document the rationale for deviating from the policy and explain how the transaction was performed in the best interest of all exposed clients.

2. Timing of allocation

An allocation policy also should address who within the investment adviser has authority to make allocation decisions and when such decisions should be made. Except for very limited instances, all allocation determinations should be made and documented *prior* to execution. Examples of instances when allocation decisions may be made after execution include modifying a previously allocated trade due to error (e.g., an investment was erroneously allocated to an unsuitable client), if a client has insufficient capital to fund the allocated investment, or if the allocation would result in a de minimus difference in allocation.

Books and records – required documentation

A registered investment adviser must keep an accurate order ticket or trade memorandum (memorandum) for the purchase or sale of any security. Each memorandum must include, among other information, the terms and conditions of the order, trade instruction, any modification or cancellation of the original order, the person who recommended the transaction, the person who placed the order, the account(s) for which the transaction is entered, the date of the order entry, the executing bank, broker or dealer, and, if applicable, whether the order was entered pursuant to exercise of discretionary power (Rule 204-2(a)(3) of the Advisers Act).

The SEC has referred to several actions (and inactions) by investment advisers that have led to violations of the books and records requirements. The following guidelines may assist investment advisers in keeping valid books and records with respect to trade orders and allocations:

- For each trade order, keep an accurate order memoranda that reflects all applicable information required by Rule 204-2(a)(3).
- An order ticket for an aggregated order should reflect the allocation determinations (made pursuant to a predetermined allocation methodology) *at the time* of placing the order.
- An order ticket should indicate the allocation methodology used and any deviations from standard allocation methodology (including reasons for such deviations).
- An order ticket should accurately reflect any modifications or cancellations of trade orders or allocations made at any time (i.e., after execution, before settlement, after settlement, etc.).
- Do not discard any order ticket after execution.

Proper disclosure

It is important that an investment adviser's disclosures of allocation practices be accurate and fully consistent with actual practice. Investment advisers often describe their allocation practices in various documents, such as fund offering documents (i.e., private placement memorandum), due diligence questionnaires, investment management agreements, compliance manuals and, for registered advisers, in Form ADV. These documents are collectively referred to as "disclosure documents."

To ensure accurate disclosure of allocation practices, an allocation policy should include procedures for identifying all relevant disclosure documents and reviewing them periodically to ensure that the disclosure documents accurately and consistently describe the firm's actual allocation practices. The review should be undertaken by members of the legal and compliance teams as well as representatives of the investment team who are involved in the day-to-day allocation practices (e.g., portfolio managers and traders).

Effective surveillance/compliance program[1]

Another integral part in ensuring a fair and equitable allocation practice is to design and implement an effective surveillance program. The program should include periodic testing or reperformance of select trades to identify any patterns of favoritism among clients or material deviations from predetermined allocation methodologies. While forensic testing measures are not required, they are often used by the SEC examination staff during inspections and may serve as effective tools in identifying undisclosed or unauthorized allocation practices. Examples of tests that can be performed include performance dispersion testing, IPO allocation testing, profitable trades testing, allocation exceptions testing, and order memoranda testing.

Performance dispersion testing

A surveillance program for trade allocations should include a review and analysis of significant

[1] *CCOutreach* National Seminar - Forensic Measures for Funds and Advisers (November 14, 2007).

performance dispersions among client accounts. The testing should cover a meaningful period of time – typically one year or longer – in order to identify discernable patterns in allocation practices. As part of the testing, an investment adviser should review monthly performance returns among clients and proprietary accounts with similar investment objectives and strategies, and then investigate the reasons for any significant dispersions. While cash flows and investment restrictions may explain notable dispersions, they also may be caused by undisclosed favoritism toward certain accounts. Particular attention should be paid to allocations made to (or performance dispersions involving) accounts with high fee structures, proprietary accounts or accounts in which the adviser's principals have made large investments.

IPO allocation testing

For those clients that participate in initial public offerings (IPOs), performance of all IPO-eligible accounts should be reviewed over a period of time (one to two years) to look for any account whose performance is notably higher than the average for all IPO-eligible accounts. Significant performance dispersions should be scrutinized for allocation practices involving undisclosed favoritism.

Profitable trades testing

A review of profitable trades in both client and proprietary accounts may also be useful to identify unfair allocation practices. This testing involves calculating the number of profitable trades in each client account over a period of time (e.g., previous 12 months) and comparing each client's number against the average number of profitable trades for all clients. This testing is particularly helpful in identifying cherry-picking among clients with overlapping investment objectives.

Allocation exceptions testing

A review of all exceptions made to existing allocation policies may be useful to ensure that all exceptions are consistent with the policy. This review can indicate instances where exceptions were made that resulted in preferential treatment of an account or accounts over time.

Order memoranda testing

A surveillance program also should include periodic review and comparison of order memoranda against actual trade allocations made to clients to ensure accurate documentation of trade allocations. Such testing should include reviewing cancellations and modifications of allocations noted in order memoranda – particularly those made after trade settlements – to ensure that such cancellations or modifications were made for valid and authorized purposes.

Supervisory oversight

The SEC considers it an integral part of a compliance program to have members of the senior management team oversee the implementation of compliance policies and procedures. The SEC also has shown it will hold senior management accountable for compliance-related violations.

Summary

The manner in which advisers allocate investments among client and other accounts is a high-risk compliance area that continues to be a high priority for the SEC, as evidenced by its current examinations and enforcement actions. Given the complexities and differences among investment advisers and investment programs, it is difficult to create a one-size-fits-all solution for trade allocation practices. However, most investment advisers would benefit from certain key practices. These include: (1) establishing detailed, written allocation policies and procedures catered to the adviser's investment programs; (2) ensuring proper and timely documentation of all trade orders and allocations in accordance with the books and records requirements; (3) implementing a robust post-trade monitoring process to detect any inappropriate or inadvertent patterns over time; (e.g., creating a documented rationale related to performance dispersion); and (4) accurately disclosing allocation practices to investors and clients.

Additional information

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