ICI MUTUAL **RISK MANAGEMENT STUDY**

Managing Risks in Trade Allocation

Fiduciary, Regulatory, and Practical Considerations

ICI Mutual

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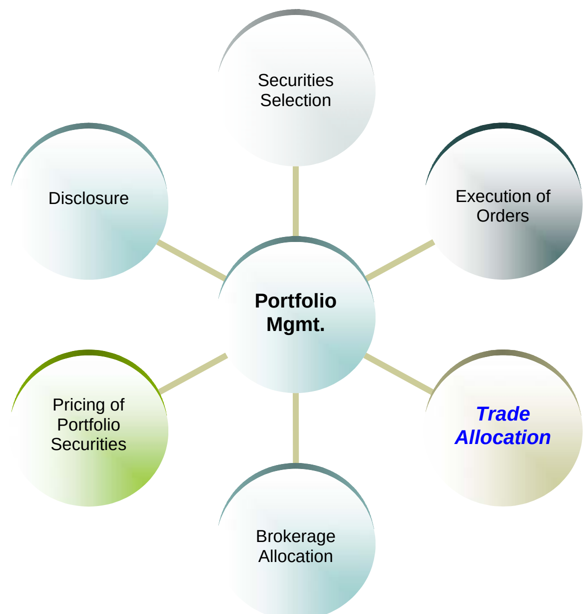
Introduction and Executive Summary

Fund advisers must regularly determine how to apportion securities trades ordered contemporaneously on behalf of multiple funds or non-fund clients, a determination generally referred to as *trade allocation*. Errors, biases, or affirmative misconduct on the part of individual advisory personnel, or biases or flawed methodologies on the part of the advisory organization itself, can lead to unfairness in results achieved for clients in trade allocations, both in individual trades and in trades conducted for clients over time. Trade allocation is a core portfolio management function, and advisers are expected to perform this function so as to avoid unfairness and ensure an equitable balancing of competing client interests.



Fund advisers are increasingly involved in new investment activities that may complicate trade allocation determinations. Thus, for example, the introduction of hedge funds and other new "non-fund" investment products may, in some instances, increase the risk of real or perceived conflicts of interest for advisers in making trade allocation decisions.[1] Meanwhile, increased regulatory attention is being focused on the core obligations of fund advisers as fiduciaries and on the appropriate discharge of these obligations.[2] Trade allocation, by its very nature, invites regulatory inquiry into questions that are fundamental to the role of an adviser as a fiduciary: Are the interests of the adviser being placed before the interests of funds or other advisory clients? Are certain funds or clients being given preferred treatment relative to other funds or clients? Is adequate information being provided to fund boards and fund shareholders regarding any inherent conflicts between the interests of funds (and their shareholders) and the interests of the adviser?

Given such questions, it is not surprising that trade allocation is among the areas receiving increased regulatory scrutiny. In this regard, the Securities and Exchange Commission ("SEC") and its staff have specifically identified trade allocation as a risk area to be considered by advisers in assessing their compliance programs (both at inception of such programs and periodically thereafter).[3] The SEC staff has also made trade allocation a common focus area in SEC examinations.[4]

As demonstrated during the mutual fund trading scandal of 2003-2004, industry practices and procedures that may be generally accepted in one era can be challenged in another, and judgments of regulators, and perceptions of shareholders and advisory clients, as to what constitutes appropriate fiduciary behavior in a particular area may change over time.[5] In light of the developments outlined above, fund advisers may conclude that it is an opportune time to review their established programs for managing trade allocation risks.[6] Such reviews may lead some advisers to conclude that modifications to their current programs should be made, while others may conclude that no modifications are necessary. Regardless of the results, advisers are likely to find that there are organizational benefits to the review process itself. These benefits include re-sensitizing advisory personnel to the nature and importance of the risks inherent in the trade allocation process, and developing tangible evidence – useful in the event that future problems should arise – that the adviser has shown good faith and diligence in devoting organizational time and attention to its risk management efforts.

This report is designed to assist fund advisers in this effort. Specifically, this report provides a general introduction to relevant concepts and issues associated with trade allocation, including a review of the basic fiduciary principles underlying an adviser's allocation responsibilities, and a description of the types of legal proceedings to which advisers are most likely to be subject. This report also includes case studies illustrating how individual advisers have chosen to address selected trade allocation issues, along with a list of selected regulatory materials that may assist advisers in evaluating (and, as appropriate, in revising or supplementing) the specific trade allocation policies and procedures that are currently in place for their own organizations. Designed primarily for compliance and legal personnel, this report may also be of interest to senior management, portfolio management personnel, and fund boards.

The observations in this report are derived from ICI Mutual's interviews with selected fund groups, from analysis of claims reported to ICI Mutual over its twenty-year history, and from a review of publicly available information. This report is not intended to – and does not – recommend any single structure or set of "best practices" for managing trade allocation risks. Given the diversity of the investment management industry, it is not practical or advisable to seek a one-size-fits-all approach to managing risks in this area.

This report joins a library of past ICI Mutual risk management studies, including *Preparing for a Pandemic* (2007), *Independent Director Litigation Risk* (2006), *The Two Faces of Identity Theft* (2006), *Managing Defense Costs* (2004), *Computer Security Lite* (2003), *Understanding Bond Fund Risks* (2002), *Investment Management Compliance Risks* (2002), and *Managing Risks in Processing Corporate Actions* (2001). As with the previous studies, nothing in this report should be considered legal advice; rather, advisers, funds, and fund boards should look to their respective counsel for such advice.

Managing Risks in Trade Allocation

Trade allocation issues may arise in a number of contexts. Allocation is commonly required where the *quantity* of a given security is limited (as, for example, where a security cannot be purchased or sold in amounts sufficient to satisfy the original orders of all clients). Allocation may also be required with respect to the *pricing* of trades (as, for example, where market movement affects the purchase or sale price of a security during the trade execution process, requiring the adviser to determine how to apportion the various prices among clients ordering that security), and the *filling* of trades (as, for example, where market conditions delay the completion of trade execution by hours or days, requiring the adviser to determine how to apportion purchases or sales of the security as they are effected during the trade execution process). In addition, allocation issues may sometimes arise in the pre-order *selection* of investments (as, for example, where multiple clients of a single portfolio manager are eligible to trade in a security whose market is or is likely to be limited, but the portfolio manager determines to place purchase or sale orders only for some of them).

Effective risk management programs for trade allocation seek to ensure that allocation decisions are made in conformance with *basic fiduciary principles*, so as to ensure fair and equitable treatment by advisers of the competing interests of managed funds and other advisory accounts. In the future, as in the past, *regulatory examinations and investigations* in the trade allocation area are likely to focus on allocation practices that may be viewed as violating one or more of these basic principles. While specific techniques used by individual advisers to ensure adherence to these principles vary, effective risk management programs in the area of trade allocation tend to have certain *common characteristics*. These topics are addressed below, and are followed by *case studies* which describe how individual advisers have addressed selected trade allocation issues.

I. Basic Fiduciary Principles

The status of an adviser as a fiduciary to its advisory clients is well established. Indeed, it has been more than forty years since the U.S. Supreme Court recognized "the delicate fiduciary nature of an investment advisory relationship,"[7] and the fiduciary status of fund advisers has been characterized by the Director of the SEC's Division of Investment Management as "[p]erhaps the most fundamental principle in the fund business."[8] Thus, programs to manage trade allocation risks should seek to ensure that advisers, in making trade allocation decisions, adhere to their fiduciary obligations. For guidance in this regard, an adviser should consider applicable fiduciary principles –

both under common law,[9] and as applied by federal courts and the SEC under the Investment Advisers Act of 1940 ("Advisers Act").[10]

Two fiduciary principles that are particularly relevant to the trade allocation process (both of which have been recognized by the U.S. Supreme Court as applicable to registered investment advisers under the Advisers Act) are the duties of *loyalty*[11] and *disclosure*.[12] A third relevant principle derives from common law: *impartiality* on the part of a fiduciary as among multiple clients.[13]

- *Loyalty*: Long recognized by courts, the duty of loyalty obligates a fiduciary to act solely in its clients' interests and, in particular, to refrain from placing its own financial or reputational interests, or the interests of its affiliates or unrelated third parties, above the interests of clients.[14]

- *Disclosure*: Sometimes viewed as an extension of the duty of loyalty,[15] the duty of disclosure (as applied by courts pursuant to the Advisers Act) requires an adviser to provide its clients with "full and fair" disclosure of all material facts, including especially any conflicts of interest to which the adviser may be subject.[16] Senior officials at the SEC have characterized this disclosure requirement as among the major fiduciary responsibilities owed by advisers, and have cautioned that "an adviser's disclosures to clients must be appropriately updated to reflect the evolving nature of the adviser's conflicts."[17]

- *Impartiality*: While courts do not appear to have expressly recognized a "duty of impartiality" under the Advisers Act,[18] courts have recognized such a duty under common law.[19] Sometimes viewed as an extension of the duty of loyalty,[20] the precise contours of the principle of impartiality are not especially well defined.[21] It seems clear that impartiality does *not* equate to "equality" in the sense of requiring a fiduciary, in balancing the competing interests of competing clients, to assign identical weight to the interests of each of them. On the other hand, a fiduciary should avoid mistakenly ignoring the interests of some beneficiaries, or being influenced by favoritism (or antagonism) towards particular clients.[22] In some cases, uniform application of an objective methodology may be indicative of impartiality.[23]

II. Regulatory Examinations and Investigations

Trade allocation may require an adviser to make sophisticated judgments, based on complex facts, as to how to achieve an appropriate balance of the competing economic interests of multiple clients.

Application of the broad fiduciary principles discussed above to the specifics of allocation determinations can raise numerous questions for an adviser. Thus, for example, when, if at all, should an adviser's duty of loyalty preclude it from allocating a portion of a limited opportunity trade to a client paying a higher management fee? When, if at all, should an adviser's duty of impartiality preclude it from using standard allocation methodologies that may, in individual cases, disparately affect the economic interests of advisory clients of certain types or sizes? When, if at all, will "full and fair" disclosure to clients permit an adviser to effect allocations that might otherwise raise concerns over the adviser's loyalty or impartiality?

Unfortunately, the answers to these types of questions are not always clear. That being said, past SEC no-action letters and enforcement proceedings provide some guidance on specific allocation practices. In recent years, for example, the SEC staff has made available information regarding documents and information requested, analyses performed, and deficiencies commonly found, by SEC examiners in the trade allocation area. The SEC staff has also developed a list of questions for use by advisers in conducting compliance risk assessments on trade allocation.[24] Appendix A to this Study provides a list of these publicly available resources. Close analysis of this regulatory guidance may assist advisers in assessing whether their existing policies and procedures for trade allocation are likely to withstand regulatory scrutiny.

Common Deficiencies Relating to Trade Allocations*

(As identified by the SEC staff)

Policies and procedures

Examples:

- Firms lacked sufficient policies and procedures to adequately address their trade allocation practices.
- Firms did not implement adequate monitoring and testing procedures to ensure that trade allocations were fair and did not favor or discriminate against any client or account.
- Firms did not follow their allocation policies and procedures consistently and frequently departed from their initial allocation decisions for inappropriate reasons.
- Firms did not document their allocation decisions and reviews.

Trade allocations

Examples:

- Certain accounts received preference over others in receiving the most desirable investment opportunities at time of purchase.
- Securities were sold out of favored accounts first to obtain superior prices or secure limited selling opportunities.
- Wrap fee, directed brokerage, and sub-advised accounts were consistently placed at the end of the order-entry queue.
- Profitable trades were allocated to proprietary or favored accounts.

* *See* CCOutreach 2007 Regional Seminars, at 14-18, http://sec.gov/info/cco/information2007.pdf

With the introduction by fund advisers of new investment products and techniques, future regulatory enforcement actions (and civil lawsuits) in the trade allocation area may differ in their particulars from those of the past. Yet as in the past, future proceedings appear most likely to involve perceived violations of one or more of the basic fiduciary principles discussed above, and thus appear likely to fall within one of the following broad categories:

- *Special Financial and/or Reputational Benefits*: A number of past proceedings have challenged trade allocation methodologies that seemingly conferred special financial and/or reputational benefits on advisers or their affiliates. Thus, in some cases, the trade allocation methodologies at issue allegedly provided *direct* financial benefits to advisers or their affiliates, as, for example, where methodologies seemed to favor (i) accounts paying higher fees, (ii) personal accounts of officers or directors, or (iii) in-house retirement accounts for advisory employees.[25] In other cases, the methodologies at issue appeared to provide only reputational and/or *indirect* financial benefits to advisers or their affiliates, as, for example, where methodologies seemed to favor "incubator" funds or other accounts in which performance results could be magnified by allocation decisions (so as to promote future investments by others in such accounts).[26]

- *Inadequate Disclosure*: Whatever the *perception* of inequities in the trade allocation process, it can be difficult for regulators to establish *proof* of inequities sufficient to establish a substantive violation of law. Perhaps as a result, a number of past regulatory proceedings have focused less on inequities themselves, than on alleged failures by advisers to fully and appropriately *disclose* relevant information regarding trade allocation practices to their clients. Examples include proceedings focused on the adequacy of disclosure relating to the effect of allocations on different clients or groups of clients, or to alleged conflicts of interest of the adviser in making trade allocation decisions.[27]

- *Rogue Employees*: Fund groups are not immune to losses from rogue behavior by portfolio managers, currency traders or other employees in positions of significant authority. Indeed, from time to time, deliberate misconduct by such individuals in allocating trades has resulted in significant reputational and financial damage for fund groups.[28] As with other types of "rogue trading" in the financial institutions sector generally, such losses typically do not involve direct forms of illicit financial reward to the employee.[29] Rather, the employees responsible, to the extent that their motivations can be derived, appear more frequently to be motivated by a desire to demonstrate successful performance, to enhance their individual reputations, or to inflate their own sense of self-worth.[30]

III. Common Characteristics of Effective Risk Management Programs

Effective programs for managing trade allocation risks, while they may vary in their particulars, tend to share certain characteristics: i.e., a thoughtful *process* for making trade allocation decisions; vigorous *testing* to ensure that the process is achieving fair and equitable results over time; thorough *documentation* of both the trade allocation process itself and of the individual allocation decisions that are made as part of that process; and appropriate *disclosure* to clients of relevant information on trade allocation, including discussion of any material conflicts of interest to which the adviser may be subject. A focus on these four areas can assist an adviser to reduce and manage trade allocation risks, and can play a critical role in the event that an adviser's trade allocation determinations are challenged in a regulatory investigation or civil lawsuit. In such an event, the adviser's prior focus on these four areas can be expected to provide tangible and contemporaneous evidence that an adviser has acted in good faith and with due care in the fulfillment of its fiduciary responsibilities.

- *Process:* The centrality of process to the fiduciary role is widely recognized and often emphasized.[31] In an area as permeated with fiduciary concerns as trade allocation, an insistence on process is critical to an effective risk management effort. Indeed, as noted in one influential law journal, "the decision-making process may be almost as important as the decision itself, at least for purposes of determining [a fiduciary's] responsibility."[32] The processes used by advisers in the trade allocation function vary in their particulars, but commonly include the following general components: (1) careful consideration and selection of *default methodologies* for use in allocating certain types of trades and/or trades for certain types of clients;[33] (2) evaluation of the legitimacy of any *exceptions* to default methodologies that may be permitted in particular cases, and appropriate supervisory approval of the use of any such exceptions;[34] and (3) contemporaneous *review* of trade allocation decisions.[35]

- *Testing:* Separate and apart from the contemporaneous review of trade allocation decisions, comprehensive testing of trade allocation results can help to ensure that clients are treated fairly and equitably. In recent years, *forensic testing* has emerged as an important mechanism for assessing whether individual or institutional biases, or flaws in allocation methodologies, are systematically affecting allocations over time.[36] The SEC staff is advocating the use of forensic testing by fund advisers, especially as part of their annual compliance reviews,[37] and is actively encouraging fund boards to ask questions of advisers regarding the conduct of such testing as well as the results.[38]

Documents and Information Examiners Frequently Request and Analyses Frequently Performed with Respect to Trade Allocations

(As identified by the SEC staff)

- **A list of all initial public offerings in which clients (including registered and unregistered funds), proprietary accounts, or access persons participated (i.e., purchased shares)**
  - ➢ Determine which clients received shares of the IPO allocation and whether the IPOs were consistent with client investment objectives.
  - ➢ Compare the performance of accounts with similar objectives to determine if IPOs were allocated consistently.
  - ➢ Determine whether certain accounts (e.g., accounts paying an incentive fee) may have been favored.
  - ➢ Determine if proprietary or access person accounts received IPO allocations and whether these allocations were consistent with the firm's disclosures and code of ethics.
  - ➢ Review the net gain or loss on IPOs and determine whether any accounts appeared to receive an inordinate number of "hot" IPOs.

- **Performance returns for each client account for a specified period (e.g., one year)**
  - ➢ Compare performance among accounts to look for performance disparities. This could be an indication of favoritism or inequitable allocations. For example, compare the performance returns on:
    - Accounts with similar objectives;
    - Accounts with incentive-based compensation arrangements to those with asset-based compensation;
    - Accounts that received the 10 most profitable trades to other accounts with similar objectives.
  - ➢ Compare performance of personal, related, or proprietary accounts versus the performance achieved by clients. This could be an indication of favoritism towards insiders.
  - ➢ Calculate and compare the percentage of profitable trades in client accounts and personal, related, or proprietary accounts.

- **A list of shareholders owning 1% or more of Fund shares**
  - ➢ Review the allocation of investment opportunities among funds and clients to determine if funds substantially owned by insiders received more favorable allocations.

See SEC, CCOutreach 2007 Regional Seminars, http://sec.gov/info/cco/information2007.pdf; SEC, CCOutreach 2006 National Seminar (Nov. 14, 2006), http://www.sec.gov/info/cco/ccons2006examareas.pdf.

➢ *Documentation:* Advisers typically require careful and contemporaneous documentation of trade orders[39] and trade allocations,[40] both to accord with applicable law and regulation and to facilitate their implementation and oversight of trade allocation determinations. Documentation also plays a critical role in the event of regulatory investigations or civil lawsuits challenging trade allocation decisions. Because such proceedings, by their very nature, involve examinations of *past* events and an adviser's *past* judgments, regulators and plaintiffs' attorneys, as well as judges and juries, tend to rely on two broad types of evidence in reconstructing and assessing an adviser's past conduct and decisions: (1) contemporaneous writings (such as recorded procedures, trade tickets, memoranda, and individual e-mails), and (2) after-the-fact recollections and explanations by defendants and witnesses, as elicited through sworn testimony during the course of litigation. A focus on properly constructed documentation helps to ensure the existence of a contemporaneous, accurate, and unambiguous record, in the event that the deliberations, judgments, or actions of either an adviser or its personnel become subject to subsequent legal challenge.

- *Disclosure:* As discussed above, regulatory enforcement actions in the trade allocation area frequently focus on alleged failures by advisers to fully and accurately disclose relevant information to their clients, including information on any conflicts of interest that may affect their fiduciary judgments. Given the importance of disclosure to the management of trade allocation risks, advisers typically focus significant effort on ensuring that discussion of trade allocation in fund prospectuses and other client documents is fully consistent with actual allocation practices, and that any material conflicts of interest are identified and appropriately described.[41] It is common for legal and compliance personnel, including chief compliance officers, to be involved in reviewing both trade allocation practices and associated disclosure. Advisers also frequently require portfolio managers to review trade allocation disclosure on a regular basis.

A focus on ***process***, ***testing***, ***documentation***, and ***disclosure*** helps to ensure that:

- appropriate operational and management personnel are in a position to evaluate – fully and in advance of allocation determinations being made – the investment, legal, compliance, and other implications of particular allocation methodologies;
- the competing interests of participants in the trade allocation process (whether the interests of the adviser vis-à-vis its clients, or of clients vis-à-vis one another) are recognized and duly considered;
- actual allocation determinations are made and implemented in a deliberate manner and in accordance with pre-established compliance rules or guidelines;
- allocations, or patterns of allocations, that may raise compliance concerns are detected and are brought promptly to the attention of appropriate supervisory personnel; and
- clients are fully informed of issues that may be relevant to their investment decisions.

Conclusion

Trade allocation has been – and remains – a core portfolio management function. As fund advisers increasingly engage in new activities that may complicate trade allocation determinations, and as trade allocation is among the areas undergoing increased regulatory scrutiny, fund advisers may wish to review their established programs for managing trade allocation risks, so as to avoid unfairness and achieve an equitable balancing of competing client interests in the trade allocation process, and so as to ensure that trade allocation decisions are made in conformance with advisers' basic fiduciary duties. While effective risk management programs in the area of trade allocation tend to focus on process, testing, documentation, and disclosure, specific techniques used by individual advisers vary.

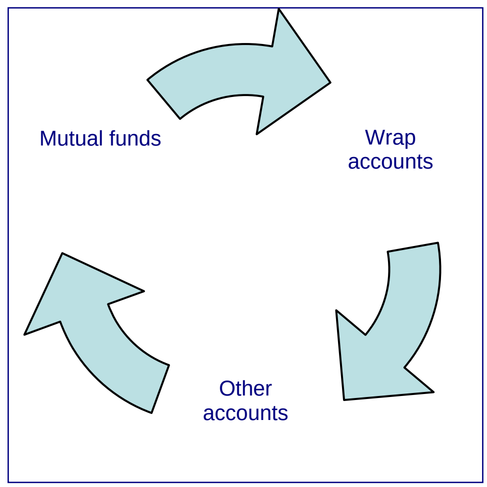
The following case studies illustrate how individual advisers have chosen to address selected trade allocation issues, specifically in the areas of limited discretion accounts and foreign IPOs. Following the case studies, this report also includes a list of selected regulatory materials that may assist advisers in evaluating their existing trade allocation policies and procedures.

Case Study 1: Limited Discretion Accounts

Summary of Issue: In assessing how to allocate securities among multiple clients so as to achieve an appropriate balance of their competing economic interests, advisers may face the issue of how to allocate securities as between clients that have granted their advisers full discretion to select brokers to effect trades ("full discretion accounts"), and clients that have placed restrictions on their advisers' selection of brokers ("limited discretion accounts"). This case study discusses how this issue has been addressed by one adviser, in the context of allocations involving two types of limited discretion accounts – wrap accounts and "pure" unified managed accounts ("UMAs").[1]

Original Allocation Methodology: The adviser generally uses a "rotational" allocation methodology, under which participating clients are categorized into groups, with each group given priority in trades on a rotating basis. In any given trade, orders of the priority group are filled first, with any overage then made available to the group next in order of priority. For purposes of allocating certain types of equity securities, the adviser has divided clients into three groups: mutual funds, wrap accounts, and other accounts (including UMAs).

Original Allocation Methodology



Concerns over Original Allocation Methodology: Experience led the adviser to conclude that its rotational methodology was problematic, primarily because of the adviser's limited ability to influence trading strategies used by limited discretion accounts. In particular, the adviser was troubled by (1) the relative frequency of delayed executions in trades effected by sponsors of its wrap account clients, and (2) the relative insensitivity of brokers charged with effecting trades for pure UMAs to the impact of their trades on the overall market for the security at issue. The adviser became concerned that under its rotational methodology, trading for wrap accounts and pure UMAs was having adverse, spillover impacts on the timing and/or pricing of trades for those groups subsequent in priority.

Resolution: As regards wrap accounts, the adviser has determined to maintain a rotational methodology, but, where feasible, to "step out" trades for wrap accounts in order to facilitate their prompt execution.[2] The adviser has also determined that where step outs are not feasible, it will *not* wait for trade executions by all participating wrap account sponsors to be completed before initiating trades for the client group next in order of priority. The adviser discloses in its Form ADV that limited discretion accounts, including wrap accounts, may be disadvantaged in trade allocations and trade execution vis-à-vis full discretion accounts.

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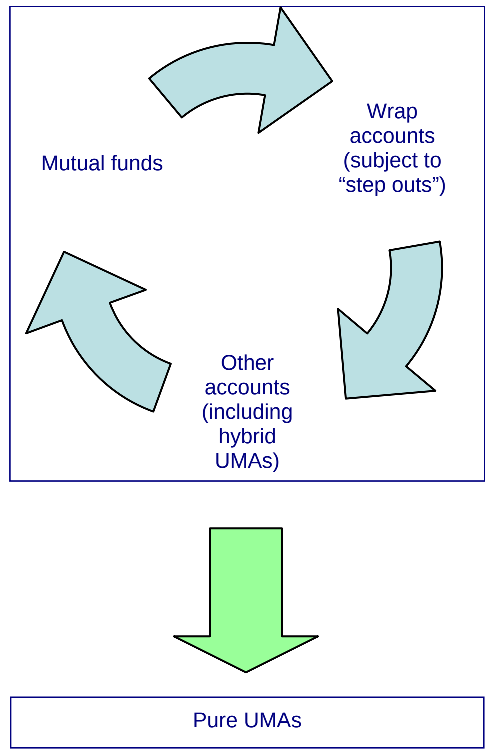
[1] In both wrap accounts and UMAs, the sponsors (typically, broker-dealers) engage advisers to manage all or a portion of the assets in one or more accounts. The sponsors charge clients asset-based annual fees for their services (including brokerage services). In UMAs, advisers create "model" portfolios, and based on these models, may periodically direct the sponsors to effect trades on behalf of the UMAs. Under "pure" UMA arrangements, advisers have no discretion to select brokers to effect trades; under "hybrid" UMA arrangements, by contrast, advisers may have such discretion.

[2] In "step out" transactions, the adviser arranges for trades to be executed through a broker other than the wrap sponsor. To address potential concerns over best execution, the adviser ensures that no additional fees and/or commissions are incurred by clients in such transactions.

As regards UMAs, the adviser has modified its rotational methodology. The adviser now places pure UMAs at the end of the trade rotation, such that trades for pure UMAs are now always effected after associated trades for other groups.[3] This disparate treatment of pure UMAs is fully disclosed in the adviser's Form ADV.

Revised Allocation Methodology



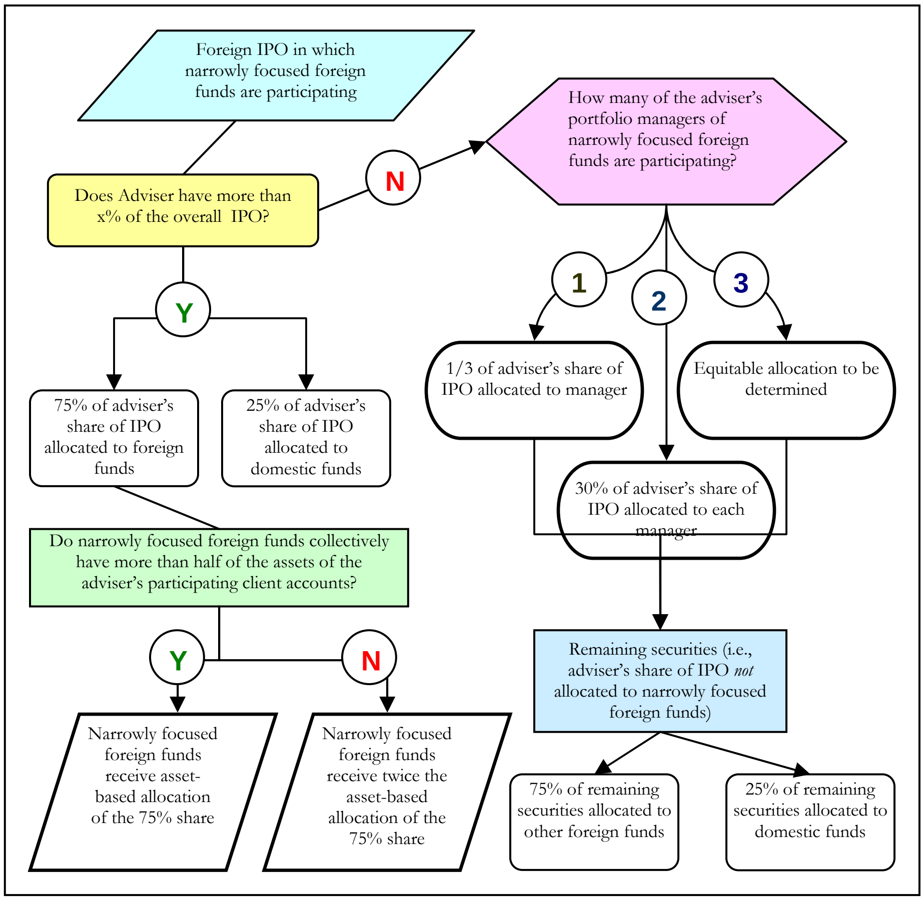
[3] By contrast, hybrid UMAs remain in the normal trade rotation, provided that the adviser has discretion to select brokers for these UMAs for the particular trade at issue.

Case Study 2: Foreign IPOS

Summary of Issue: In assessing how to allocate securities among multiple clients so as to achieve an appropriate balance of their competing economic interests, advisers may face the issue of how clients with narrower investment focuses should be treated relative to clients with broader investment focuses. This case study discusses how this issue has been addressed by one adviser, in the context of allocating securities issued by foreign issuers in initial public offerings ("IPOs").

Original Allocation Methodology: The adviser's generally uses a "pro rata" methodology, under which trades are apportioned based on the assets of participating clients. The adviser has reasoned that use of its default methodology in foreign IPOs could be inequitable to funds with narrower investment focuses, because such funds are not eligible to participate in many IPOs available to funds with broader investment focuses. Accordingly, the adviser developed a methodology for allocation of foreign IPOs that permitted participating narrowly focused funds to receive allocations greater than would otherwise be available to them under a pure asset-based pro rata allocation.

Original Allocation Methodology

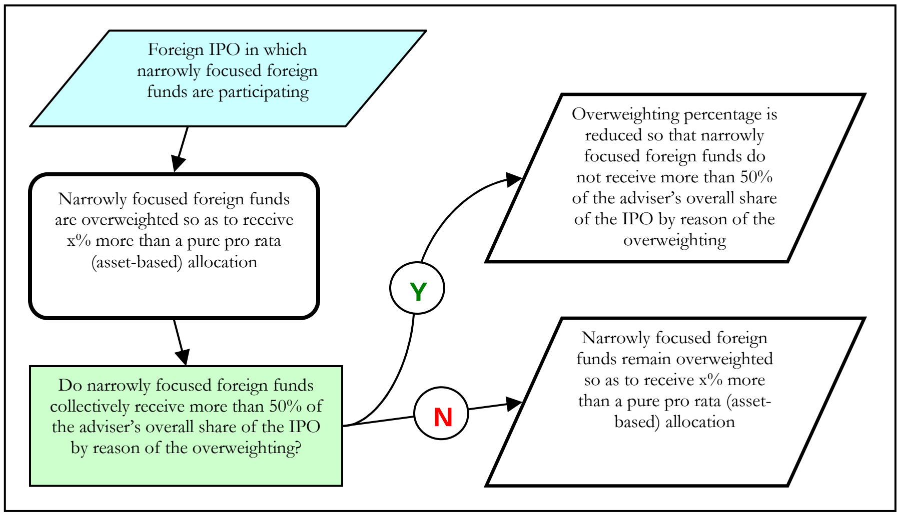


As originally developed, the adviser's methodology established different allocation formulas based on various factors, including (1) the overall share of the foreign IPO available to *all* of the adviser's clients, and (2) the number of portfolio managers of narrowly focused funds participating in the allocation. A flowchart depicting this original methodology is provided above.

Concerns Over Original Allocation Methodology: Experience led the adviser to conclude that its original methodology was cumbersome to apply in practice and that modest variations in underlying circumstances were yielding allocation results that appeared disproportionate to the nature and extent of the variations. For example, in certain cases, a slight increase in the adviser's overall share of a foreign IPO could require use of an entirely different allocation formula. In considering how to address these concerns, the adviser sought to preserve its original objective – to overweight allocations of foreign IPOs to more narrowly focused funds – while simplifying its allocation methodology. The adviser formulated several potential alternative methodologies and back-tested them against the results of prior trade allocations.

Resolution: The adviser has adopted a new methodology that returns to a pro rata (asset-based) methodology, but which overweights by a fixed percentage the assets of participating narrowly focused funds, thus permitting such funds to receive foreign IPO allocations greater than would otherwise be available to them under a purely asset-based pro rata allocation methodology. However, in order to preserve meaningful participation in foreign IPOs by *broadly* focused funds, the new methodology further provides that the overall allocation to narrowly focused funds may not exceed a predetermined threshold by reason of the overweighting. A flowchart depicting the new methodology is provided at right.

Revised Allocation Methodology



The adviser reports that its new methodology has resulted in simplified administration and oversight and more consistent results – in the sense that modest variations in underlying circumstances are not leading to results disproportionate to the nature and extent of the variations. The adviser also reports that portfolio managers are satisfied that the new methodology treats their clients fairly and equitably over time.

APPENDIX A

No-Action Letters, Regulatory Proceedings, and Other Guidance

No-Action Letters

SMC Capital Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 695 (Sept. 5, 1995).

Pretzel & Stouffer, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 911 (Dec. 1, 1995).

Banque Indosuez Luxembourg, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 923 (Dec. 10, 1996).

Mass. Mut. Life Ins. Co., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 759 (Jul. 28, 2000).

Mass. Mut. Life Ins. Co., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 666 (Jun. 7, 2000).

Regulatory Proceedings

Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1387 (Oct. 20, 1993); Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1494 (Jun. 6, 1995); Thomas H. Richards, Investment Advisers Act Release No. 1495 (Jun. 6, 1995).

Michael L. Smirlock, Investment Advisers Act Release No. 1393 (Nov. 29, 1993).

Account Mgmt. Corp., Investment Advisers Act Release No. 1529 (Sept. 29, 1995).

SEC v. Frederick Augustus Moran, 922 F. Supp. 867 (S.D.N.Y. 1996).

McKenzie Walker Inv. Mgmt., Inc., Investment Advisers Act Release No. 1571 (Jul. 16, 1996).

Nicholas-Appelgate Cap. Mgmt., Investment Advisers Act Release No. 1741 (Aug. 12, 1998).

Van Kampen Inv. Adv. Corp., Investment Advisers Act Release No. 1819 (Sept. 8, 1999).

Dreyfus Corp., Investment Advisers Act Release No. 1870 (May 10, 2000).

F.W. Thompson Co., Ltd., Investment Advisers Act Release No. 1895 (Sept. 7, 2000).

Bond, SEC Litigation Release No. 17099 (Aug. 10, 2001).

Suisse First Boston Corp., SEC Litigation Release No. 17327 (Jan. 22, 2002).

Slocum, Gordon & Co., SEC Litigation Release No. 17688 (Aug. 20, 2002).

Roberson Stephens, Inc., SEC Litigation Release No. 17923 (Jan. 9, 2003).

Zion Cap. Mgmt. LLC, SEC Initial Decisions Release No. 220 (Jan. 29, 2003).

Monetta Fin. Servs., Inc., Investment Advisers Act Release No. 2136 (Jun. 9, 2003).

John McStay Inv. Couns. L.P., Investment Advisers Act Release No. 2153 (Jul. 31, 2003).

Gerson Asset Mgmt., Inc., Investment Company Act Release No. 27176 (Dec. 2, 2005).

Other Guidance

Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003).

Secs. & Exch. Comm'n, *Common Examination Areas: Documents and Information Examiners Request and How Advisers Can Use This Information to Enhance Their Compliance Programs* (Nov. 14, 2006), http://www.sec.gov/info/cco/ccons2006examareas.pdf.

Secs. & Exch. Comm'n, *Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs* (2006), http://www.sec.gov/info/cco/adviser_compliance_questions.htm.

Andrew J. Donohue, Dir., Secs. & Exch. Comm'n, Keynote Address at 2007 Mutual Funds and Investment Management Conference (Mar. 26, 2007), http://www.sec.gov/news/speech/2007/spch032607ajd.htm.

Andrew J. Donohue, Dir., Secs. & Exch. Comm'n, Keynote Address at the Practicing Law Institute Investment Management Institute (Apr. 12, 2007), http://www.sec.gov/news/speech/2007/spch041207ajd.htm.

Lori A. Richards, Dir., Secs. & Exch. Comm'n, Remarks at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), http://ftp.sec.gov/news/speech/spch022706lar.htm.

Robert J. Moran & David A. Sturms, *Why and How to Design and Implement Trade Allocation Procedures* (May/Jun. 1995) (available from Vedder, Price, Kaufman, & Kammholz, P.C.).

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ACA Compliance Group, *2007 Investment Management Compliance Testing Survey* (Sept. 4, 2007), http://www.acacompliancegroup.com/documents/Survey%20Report9-4-07.pdf.

PricewaterhouseCoopers, *Strengthening internal control through forensic testing* (July 2007), http://cfodirect.pwc.com/CFODirectWeb/Controller.jpf?ContentCode=MSRA-778M4G&rss=true.

ENDNOTES

[1] *See* Beagan Wilcox, *SEC Official Urges Sharper Side-by-Side Oversight*, BOARD IQ, Aug. 7, 2007 ("With a growing number of investment advisors offering hedge funds or hedgelike mutual funds alongside more traditional mutual funds, a top SEC official is urging boards to ask advisors about related conflicts of interest that could harm their shareholders …."); Gjergji Cici et al., For Better or Worse? Mutual Funds in Side-by-Side Management Relationships with Hedge Funds 1 (Dec. 14, 2006), http://ssrn.com/abstract=905600 ("Given the structural differences in fees between mutual funds and hedge funds, one might expect management firms' incentives to transfer performance from mutual funds to hedge funds to be at least as great as across mutual fund family members.").

[2] Illustrative of this increased attention are public remarks of a senior SEC official who advised that "the application of fiduciary duty is not as embedded in many [advisory] firms' cultures as it could be," and called for a "return to first principles" in this area. Lori A. Richards, Dir., Secs. & Exch. Comm'n, Remarks at the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), http://ftp.sec.gov/news/speech/spch022706lar.htm. Another senior SEC official has remarked, "[p]erhaps the most fundamental principle in the fund business is that fund advisers are fiduciaries, which means the client comes first." Andrew J. Donohue, Dir., Secs. & Exch. Comm'n, Keynote Address at 2007 Mutual Funds and Investment Management Conference (Mar. 26, 2007), http://www.sec.gov/news/speech/2007/spch032607ajd.htm.

[3] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,716 (Dec. 24, 2003) [hereinafter Compliance Programs Release] (identifying trade allocation as among the issues that registered advisers should address in formalizing their compliance policies and procedures pursuant to SEC Rule 206(4)-7); Secs. & Exch. Comm'n, Questions Advisers Should Ask While Establishing or Reviewing Their Compliance Programs (2006), http://www.sec.gov/info/cco/adviser_compliance_questions.htm [hereinafter SEC, Questions Advisers Should Ask] (compiling questions, including questions regarding trade allocation, to assist advisers in conducting their risk assessments).

[4] Secs. & Exch. Comm'n, Common Examination Areas: Documents and Information Examiners Request and How Advisers Can Use This Information to Enhance Their Compliance Programs 2-4 (Nov. 14, 2006), http://www.sec.gov/info/cco/ccons2006examareas.pdf (providing insight into the examination process for trade allocation).

[5] The dozens of scandal-related investigations and scores of scandal-related civil lawsuits initiated from 2003-2005 challenged the conduct of investment advisers and their affiliates in various areas, including market timing practices, revenue sharing arrangements, and receipt of advisory fees. Yet most of these proceedings shared a common underlying theme – namely, allegations that advisers failed in one way or another to meet their obligations as *fiduciaries* to funds and fund shareholders, by placing their own interests before those of funds and fund shareholders, by treating certain funds and fund shareholders unfavorably relative to other funds or institutional clients, and/or by failing to advise funds and fund shareholders of inherent conflicts between the interests of funds and fund shareholders and the interests of the adviser. Most of the regulatory investigations initiated during the scandal period have now been concluded, but not before a number of regulatory settlements were reached involving very large payments – in the form of penalties, disgorgements, and/or future fee reductions – by various fund advisers and affiliated entities. Many of the scandal-related civil lawsuits have likewise been concluded, following either dismissal by the courts or settlements entered into by advisers and affiliated entities, although a large number remain pending. *See generally* 5 ICI MUT. INS. CO., INVESTMENT MANAGEMENT LITIGATION NOTEBOOK (2007) (compiling, among other things, scandal-period lawsuits and regulatory settlements). Fund advisers and their affiliates have collectively devoted enormous time and expense (estimated in the hundreds of millions of dollars) to defend themselves in these matters.

[6] This report focuses on *trade allocation.* Issues relating to *order aggregation* (which is typically a trading department function) are outside the scope of this report. Thus, this report does not address how certain types of trading

strategies – including short sales (e.g., as utilized by long-short funds and so-called "130/30" funds) and quantitatively driven trading – may complicate order aggregation decisions for fund advisers. Similarly, while the issues and observations in this report may bear on risks faced by advisers in other related or analogous areas (e.g., cross trades of securities between managed accounts, allocation of brokerage commissions), none of these other areas is a focus of this report.

[7] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963) (internal quotation marks omitted).

[8] Donohue, *supra* note2; Andrew J. Donohue, Dir., Secs. & Exch. Comm'n, Keynote Address at the Practicing Law Institute Investment Management Institute (Apr. 12, 2007), http://www.sec.gov/news/speech/2007/spch041207ajd.htm. Similarly, the current Director of the SEC's Office of Compliance Inspections and Examinations has noted that "all advisory firms, whatever their size, type or history in the business, owe their advisory clients a fiduciary duty," and has advised that "understanding 'fiduciary duty' is critical, because it is at the core of being a good investment adviser." Richards, *supra* note 2.

[9] In *Capital Gains*, the Court relied in part on the content of common-law fiduciary duty. Specifically, in holding that the SEC could require investment advisers to disclose to their clients a practice known as "scalping" (whereby an adviser deals in recommended securities just before and after the issuance of its recommendations), the Court reasoned that (1) it was unnecessary, "in a suit against a fiduciary … to establish all the elements required in a suit against a party to an arm's-length transaction," and (2) courts "have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients." 375 U.S. at 194 (footnotes omitted).

[10] *See, e.g.*, Secs. & Exch. Comm'n, Information for Newly-Registered Investment Advisers, http://www.sec.gov/divisions/investment/advoverview.htm#P6_207 ("As an investment adviser, … [y]ou cannot use your clients' assets for your own benefit or the benefit of other clients, at least without client consent. Departure from this fiduciary standard may constitute 'fraud' upon your clients (under Section 206 of the Advisers Act).").

[11] Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006) ("In *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court held that this provision [§ 206(2)] created a fiduciary duty of loyalty between an adviser and his client.") (citation omitted).

[12] SEC v. Wash. Inv. Network, 475 F.3d 392, 404 (D.C. Cir. 2007) ("In *Capital Gains*, the Supreme Court noted that investment advisers, as fiduciaries, have 'an affirmative duty of … full and fair disclosure of all material facts ….'").

[13] Under common-law trust principles, a trustee has a duty, "when there are two or more beneficiaries, to deal impartially with them." Williams v. Sec. Nat'l Bank, 358 F. Supp. 2d 782, 799 (N.D. Iowa 2005); *accord* Zim Isr. Navigation Co. v. 3-D Imports, Inc., 29 F. Supp. 2d 186, 192 (S.D.N.Y. 1998) ("Among the many fiduciary obligations of a trustee is the duty to deal impartially with the beneficiaries of the trust …."); UNIF. TRUST CODE § 803 (amended 2005) ("If a trust has two or more beneficiaries, the trustee shall act impartially in investing, managing, and distributing the trust property, giving due regard to the beneficiaries' respective interests."); *cf.* Andrew J. Donohue, Dir., Secs. & Exch. Comm'n, Keynote Address Before IA Week's 6th Annual Fall Compliance Conference (Sept. 25, 2006), http://www.sec.gov/news/speech/2006/spch092506ajd.htm ("As soon as an investment adviser accepts a second client, an adviser's conflicts become more complex. The adviser then has to institute appropriate trade allocation practices, disclosure strategies, and other procedures.").

[14] 2A AUSTIN W. SCOTT, JR. & WILLIAM F. FRATCHER, TRUSTS § 170, at 311 (4th ed. 1987) ("The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty…. It is the duty of a trustee to administer the trust solely in the interest of the beneficiaries …."); *accord* GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543 (rev. 2d ed. 1980) ("Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interest and all consideration of the interests of third persons.").

[15] *See*, *e.g.*, Kalda v. Sioux Valley Physician, Inc., 481 F.3d 639, 644 (8th Cir. 2007) ("The duty of loyalty requires a fiduciary to disclose any material information that could adversely affect a participant's interests."); Huber v. Taylor, 469 F.3d 67, 82 (3d Cir. 2006) ("[I]n this case disclosure was necessary to fulfill the duty of loyalty.").

[16] *See*, *e.g.*, Fin. Planning Ass'n v. SEC, 482 F.3d 481, 490 (D.C. Cir. 2007) ("The overall statutory scheme of the [Advisers Act] addresses the problems identified to Congress in two principal ways: First, by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined, and second, *by requiring full disclosure of all conflicts of interest*.") (citation omitted) (emphasis added); Vernazza v. SEC, 327 F.3d 851, 860 (9th Cir. 2003) ("The [SEC] correctly determined that the petitioners [partners in a registered investment adviser] had a duty to disclose any potential conflicts of interest accurately and completely…."); Amendments to Form ADV, Investment Advisers Act Release No. 2711, 73 Fed. Reg. 13958, 13958 (Mar. 14, 2008) (noting that "investors have the responsibility for … evaluating their advisers' conflicts" and that "[t]herefore, it is critical that clients and prospective clients receive sufficient information about the adviser and its personnel to permit them to make an informed decision about whether to engage an adviser, and having engaged the adviser, how to manage that relationship").

[17] Donohue, *supra* note 13.

[18] As noted in the text, courts do not appear to have expressly recognized a "duty of impartiality," as such, under the Advisers Act. *But cf.* Owen v. SoundView Fin. Group, Inc., 54 F. Supp. 2d 305, 324 (S.D.N.Y. 1999) (holding that trustees of a pooled investment fund (a 401(k) and profit-sharing plan) had to take into account "not only the interests of the particular participant receiving the benefit, but the interests of all plan participants and beneficiaries"), *aff'd*, 208 F.3d 203 (2d Cir. 2000). However, courts interpreting the statute have in the past considered general common-law fiduciary principles, *see*, *e.g.*, *supra* note 9, such that the fiduciary principle of impartiality (i.e., managing assets in a manner that is impartial with respect to one's various clients) provides additional guidance with respect to an adviser's approach to trade allocation.

[19] *See supra* note 13.

[20] *See*, *e.g.*, RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b (Tentative Draft No. 4, 2005) ("The duty of impartiality is an extension of the duty of loyalty …."). (*Restatements* are influential treatises published by the American Law Institute that describe the law in a given area and guide its development.)

[21] *Id.* § 79 reporter's note on cmts. a, b ("Over the years, the nature and implications of the duty of impartiality have been little explained in cases, regulations, rulings, and literature, and vaguely defined at best ….").

[22] As regards the meaning of impartiality, a *Restatement* comment is instructive.

> It would be overly simplistic, and therefore misleading, to equate impartiality with some concept of "equality" of treatment or concern – that is, to assume that the interests of all beneficiaries have the same priority and are entitled to the same weight in the trustee's balancing of those interests. Impartiality does mean that a trustee's treatment of beneficiaries or conduct in administering a trust is not to be influenced by the trustee's personal favoritism or animosity toward individual beneficiaries, even if the latter results from antagonism that sometimes arises in the course of administration. Nor is it permissible for a trustee to ignore the interests of some beneficiaries merely as a result of oversight or neglect, or because a particular beneficiary has more access to the trustee or is more aggressive, or simply because the trustee is unaware of the duty [of impartiality] . . . .
>
> It is not only appropriate but required by the duty of impartiality that a trustee's treatment of beneficiaries, and the balancing of their competing interests, reasonably reflect any preferences and priorities that are discernable from the terms … and purposes of the trust and from the nature and terms of the beneficial interests. Thus, unfortunately, it is often the case that the implications of the duty of impartiality are complicated by the difficulties of determining, and the

vagueness of, some relevant aspects of the settlor's intentions and objectives – much of which is left to interpretation and inference.

Therefore, in short, it is the trustee's duty, reasonably and without personal bias, to seek to ascertain and to give effect to the rights and priorities of the various beneficiaries or purposes as expressed or implied by the terms of the trust.

RESTATEMENT, *supra* note 20, § 79 cmt. b.

[23] *See* Owen v. SoundView, *supra* note 18 (holding that trustees' valuation of a participant's benefit under 401(k) plan satisfied the trustees' duty of impartiality to other participants in part because the trustees' valuation methodology was "an objective and easily administrable method that could be, and was, applied uniformly to all participants").

[24] Secs. & Exch. Comm'n, CCOutreach 2007 Regional Seminars, at 14-18, http://sec.gov/info/cco/information2007.pdf; SEC, Questions Advisers Should Ask, *supra* note 3.

[25] *See*, *e.g.*, Kemper Fin. Servs., Inc., Investment Advisers Act Release No. 1387 (Oct. 20, 1993); McKenzie Walker Inv. Mgmt., Inc., Investment Advisers Act Release No. 1571 (Jul. 16, 1996); F.W. Thompson Co., Ltd., Investment Advisers Act Release No. 1895 (Sept. 7, 2000); Monetta Fin. Servs., Inc., Investment Advisers Act Release No. 2136 (Jun. 9, 2003).

[26] *See*, *e.g.*, McKenzie Walker, *supra* note 25; Account Mgmt. Corp., Investment Advisers Act Release No. 1529 (Sept. 29, 1995).

[27] *See*, *e.g.*, Van Kampen Inv. Adv. Corp., Investment Advisers Act Release No. 1819 (Sept. 8, 1999); Zion Cap. Mgmt. LLC, SEC Initial Decisions Release No. 220 (Jan. 29, 2003).

[28] *See*, *e.g.*, Kemper, *supra* note 25; Nicholas-Appelgate Cap. Mgmt., Investment Advisers Act Release No. 1741 (Aug. 12, 1998).

[29] *See*, *e.g.*, *French trader under investigation*, BBC NEWS, Mar. 12, 2008; *available at* http://news.bbc.co.uk/1/hi/business/7211796.stm ("[T]here has been no suggestion since the story broke that Jerome Kerviel had tried to take the money out of [Société Générale S.A.'s] coffers and put it into his own pocket."); *French Bank Says Rogue Trader Lost $7 Billion*, N.Y. TIMES, Jan. 25, 2008, *available at* http://www.nytimes.com/2008/01/25/business/worldbusiness/25bank.html ("Mr. Kerviel made no money personally."); *Ex-Currency Trader Sentenced To Seven and a Half Years*, N.Y. TIMES, Jan. 18, 2003, *available at* http://query.nytimes.com/gst/fullpage.html?res=9402E1DF1730F93BA25752C0A9659C8B63&sec=&spon=&pagewanted=print ("Mr. Rusnak [the trader who allegedly hid trading losses at Allfirst Financial] did not directly profit from the losses.").

[30] *Cf.* JAMES T. TURNER & MICHAEL G. GELLES, THREAT ASSESSMENT: A RISK MANAGEMENT APPROACH 131-45 (2003) (discussing risk management considerations relevant to addressing the threat presented by insiders).

[31] *See, e.g.,* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 948 (2005) ("Good trust administration is suffused with process values – having competent persons follow intelligent procedures in managing, investing, auditing, and distributing trust assets; subjecting operational decisionmakers to internal review and oversight; and keeping careful records of these steps.") (footnote omitted); Stuart Ober, *Fiduciary Responsibility*, J. FIN. PLANNING, Nov. 1, 2005, at 54 ("The key to fiduciary liability is basic: It's not whether you win or lose, but how you play the game …. Being a fiduciary is about process prudence and not about performance. This ultimately may be the most important lesson for those who have the legal responsibility for managing someone else's money."); *see also* Lori A. Richards, Dir., Secs. & Exch. Comm'n, Remarks before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006), http://www.sec.gov/news/speech/2006/spch101906lar.htm ("One of the key ways that compliance professionals can help to foster a strong culture of compliance is to help create strong compliance programs. Strong compliance programs will have an identifiable process. The process of compliance is important, because if

structurally sound, the compliance process will serve to help the firm avoid violations, and help the firm to detect violations and deal with them effectively.”).

[32] *See, e.g.,* Langbein, *supra* note 31, at 948 (internal quotation marks omitted).

[33] In order to address potential concerns over loyalty and impartiality, many advisers employ one or more default methodologies for most, if not all, of their trade allocation decisions. Use of default methodologies reduces the risk that allocations of oversubscribed trades will be made on an ad hoc basis, or that conflicts of interest will influence individual allocation decisions. Pro rata allocation – in which securities purchased or sold are allocated among advisory clients in proportion to pre-established criteria, such as their respective order amounts and/or relative net assets – appears to be the most commonly used default methodology used by advisers. Other default methodologies (e.g., random allocation, rotational allocation) are also sometimes used, particularly where use of a pro rata methodology may be impractical. Thus, for example, the difficulty of “fractionalizing” trades in many fixed-income securities may have the effect of limiting the overall number of clients who can participate in an allocation, such that a pro rata methodology may not be feasible.

[34] Many advisers find that rigid adherence to default methodologies may from time to time threaten to result in allocations that may be viewed as unfair or inequitable to particular clients or groups of clients. To address these concerns, advisers sometimes permit exceptions to default methodologies to be used under designated circumstances. For example, use of some default methodologies may result in *de minimis* amounts or odd-lots of a security being allocated to certain clients, for whom the administrative inconvenience and cost of such holdings (e.g., brokerage costs in subsequent sales) may outweigh any associated benefits. To address such cases, it is not uncommon for advisers to establish exceptions to prevent such results. Recognizing that exceptions may in some cases raise issues regarding an adviser’s loyalty and impartiality, advisers generally seek to have exceptions reviewed and approved by appropriate supervisory personnel, in order to ensure that their use does not systematically disadvantage individual clients or groups of clients. Many advisers require such approvals to be in writing and to be obtained prior to trade execution, or within a short period of time thereafter.

[35] In order to ensure that trade allocation procedures are being properly followed and that allocation decisions are yielding appropriate and defensible results, advisers typically review trade allocations on a pre-trade and/or post-trade basis. On a day-to-day basis, some advisers – typically larger advisory organizations with greater resources – assign review obligations to a committee or department, while others assign the obligation to a single individual. Advisers report that portfolio managers also frequently perform their own informal reviews of trade allocation decisions, adding additional checks and balances to the process. As one in-house legal counsel reported, portfolio managers are “collegial but competitive” and are quick to discern – and voice their concerns over – any perceived inequities in allocation decisions.

[36] “Forensic testing” generally refers to compliance tests that analyze information over time to identify unusual patterns or trends. *See* PricewaterhouseCoopers, *Strengthening Internal Control Through Forensic Testing* (Jul. 2007), http://cfodirect.pwc.com/CFODirectWeb/Controller.jpf?ContentCode=MSRA-778M4G&rss=true; ACA Compliance Group, *2007 Investment Management Compliance Testing Survey* (Sept. 4, 2007), http://www.acacompliancegroup.com/documents/Survey%20Report9-4-07.pdf; *see also* Lori A. Richards, Dir., Secs. & Exch. Comm’n, Remarks before the National Society of Compliance Professionals National Membership Meeting (Oct. 25, 2005), http://www.sec.gov/news/speech/spch102605lr.htm (“A good forensic test has three characteristics. First, it provides a real test. In other words, it does more than simply repeat things you already do. Second, it helps you answer the question: what am I missing? In other words, it covers new material to test and validate the material you usually work with. Third, it adds current value. You can use it in your everyday program.”).

[37] *See* SEC, Questions Advisers Should Ask, *supra* note 3; Gene A. Gohlke, Secs. & Exch. Comm’n, Examiner Oversight of “Annual” Reviews Conducted by Advisers and Funds (Apr. 7, 2006), http://www.sec.gov/info/cco/ann_review_oversight.htm (describing typical questions that SEC examiners will ask advisers and funds about CCO reviews); Wilcox, *supra* note 1. The SEC staff has specifically suggested that an adviser’s compliance testing include an analysis of the comparative performance of similarly managed accounts (to detect favoritism,

misallocation of investment opportunities, or other breaches of fiduciary responsibilities). *See* Compliance Programs Release, *supra* note 3, at 74,716 n.15.

[38] *See* Wilcox, *supra* note 1.

[39] Rule 204-2(3) under the Advisers Act requires an adviser to maintain, in relevant part:

> A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

Similarly, under Rule 31a-1(b)(5) under the Investment Company Act of 1940, a fund is required to maintain a record of each trade order given by or on behalf of such fund. This information must include, among other things, order time or cancellation, execution time and price, broker name, and the name of the person placing the order on the fund's behalf.

[40] Trade allocation determinations are generally maintained in writing. *See* SMC Capital Inc., SEC No-Action Letter, 1995 SEC No-Act. LEXIS 695 (Sept. 5, 1995); Pretzel & Stouffer, SEC No-Action Letter, 1995 SEC No-Act. LEXIS 911 (Dec. 1, 1995).

[41] *See* Secs. & Exch. Comm'n, Form N-1A, Item 15(a)(4), http://www.sec.gov/about/forms/formn-1a.pdf (last visited Apr. 24, 2008) (requiring, among other things, a description of "material conflicts in allocation of investment opportunities between the Fund and other accounts managed by the Portfolio Manager"); *see also* Secs. & Exch. Comm'n, Form ADV, Part II, Item 12, http://www.sec.gov/about/forms/formadv-part2.pdf (last visited Apr. 24, 2008).

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