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# Compliance Review

**Ongoing Compliance Updates for Independent Investment Advisors**

IN THIS ISSUE

I. Introduction . . . . . . . . . . 1
II. What Is Best Execution and Why Does It Matter? . . . . . . . . 1
III. Soft Dollar Arrangements: What You Need to Know . . . . . . 6
IV. Other Trading Compliance Hot Topics . . . . . . . . 9
V. Conclusion . . . . . . . . . . 11

# Trading Compliance

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## I. Introduction

Investment advisors face a high level of regulatory scrutiny, and advisors' trading practices are an area of particularly heightened attention. This article provides a detailed look at two trading practices for which advisors' fiduciary duties are paramount: best execution and soft dollar arrangements. We also highlight three of the current hot topics related to trading practices: insider trading, personal trading, and the large trader report. Advisors' policies and procedures manuals must address "[t]rading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ('soft dollar arrangements'), and allocates aggregate trades among clients."[1] Advisors subject to state regulation should adopt similar policies and procedures. Regulators at both the federal and state level view adequate policies and procedures in this area as indicators of a culture of compliance within the firm.

## II. What Is Best Execution and Why Does It Matter?

### A. Investment Advisors' Fiduciary Duty

It is well known that investment advisors owe a fiduciary duty to their clients. The fiduciary duty that advisors are held to is an exacting one. As fiduciaries, advisors must act in the best interest of their clients in all matters connected with the advisor-client relationship, and not for their own personal interest. This duty requires scrupulous good faith and candor. Advisors must act in complete fairness and never exert any influence or pressure, take selfish advantage, or deal with clients in such a way that it benefits them or prejudices the client.

This stringent duty has been interpreted by regulators to place specific obligations on advisors, including the requirement that they seek "best execution" of their clients' securities transactions. The Securities and Exchange Commission (SEC) has stated that advisors must "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances."[2]

Advisors might assume that the duty of best execution requires them to obtain the lowest commission costs for their clients. This, however, is not the case. The duty requires advisors to undertake a qualitative review to determine whether the transaction represents the best execution for the particular client, at the particular time, and under the particular circumstances.[3]

According to a statement by senior SEC staff:

> Best execution encompasses a number of factors, starting with the price of the execution and the opportunity for price improvement—that is, finding a better price somewhere in the open market. Other factors include speed and likelihood that the order will actually be executed. For institutional investors, anonymity and liquidity might be overriding concerns. In any case, the quality of the execution must be viewed from the investor's perspective—not the firm's.[4]

**Analyzing Best Execution**

Factors advisors should consider in analyzing best execution include not only the price of the security and commission amount but also:

- ✓ Execution speed
- ✓ Confidentiality
- ✓ Market depth
- ✓ Capital commitment
- ✓ Recent order flow
- ✓ Knowledge of the other side of the trade

Although most frequently discussed in the context of equity trades, the duty of best execution applies to all securities, including fixed income and derivatives. The less transparent and less centralized nature of fixed income and derivative securities markets, however, presents additional challenges for the fulfillment of advisors' best-execution obligations.

In sum, best execution is not based solely on a set of particular points. Instead, it is measured on a variety of factors and circumstances, which may evolve with changes in the business and advances in industry technology. Consequently, best execution is often cited by regulators as a primary area of inspection and enforcement where deficiencies are frequently noted.

### B. Demonstrating Best Execution

An advisor's fiduciary duty requires it to make sure that the costs associated with its selection of a broker-dealer do not benefit the advisor in a way that prejudices the client. Advisors, therefore, must have systems in place to ensure that the costs of executing securities transactions, as well as the indirect benefits the advisor receives as a result of choosing a particular broker-dealer, are fair to the client.

#### 1. Implement Effective Policies and Procedures

The first step toward achieving best execution is to establish an effective process for evaluating the quality of execution that the advisor receives for its clients. The SEC has stated that investment advisors must "periodically and systematically evaluate the execution performance of broker-dealers executing their transactions."[5]

In developing policies and procedures for evaluating best execution, advisors should ask two overlapping questions: (1) Are the current broker-dealers they are using for transactions the best available? (2) Are there alternatives that would be better for the client? These ultimate questions may drive the processes used to evaluate best execution.

Importantly, best execution cannot be determined on a trade-by-trade basis. Rather, advisory firms (small and large) must establish policies and procedures that focus on seeking best execution in the aggregate for their clients. There is no one-size-fits-all program for evaluating best execution. Each firm must develop policies and implement procedures that make sense for its business and for the corner of the advisory world it occupies. Firms can put into action a range of best practices and specific procedures to satisfy their fiduciary obligations. A firm's size and actual business practices will determine which of these policies are implemented.

## Best Execution Practical Tips

- ✓ Consider a best-execution committee.
- ✓ Develop a best-execution policy.
- ✓ Develop and implement best-execution surveillance tools customized to the firm's business model.
- ✓ Document all best-execution reviews and recommendations.

### Establish a Committee

Although not necessary or suitable for every advisory firm, if the size of the firm warrants it, create a best-execution committee. This committee should meet on a regular basis to evaluate the firm's overall trade management policies and procedures and any relevant industry and technological changes that affect trade execution. The committee can then issue recommendations to the firm's management to improve or change best-execution policies and procedures as appropriate. The committee should carefully document its meetings and recommendations.

> Show your firm's culture of compliance: Document your best-execution policy and make the policy available to your clients upon request.

### Develop Firmwide Best-Execution Policies

The first job of the best-execution committee, or the firm's chief compliance officer (CCO), should be the development of an overall best-execution policy that emphasizes the firm's fiduciary responsibilities to seek to maximize client portfolios within the constraints of the client's investment objectives. The policy should address some or all of the following, depending on the exact nature of the advisor's business model:

- The execution capabilities of the broker(s)
- The confidentiality provided by the broker(s)
- Availability of technological aids to process trade data
- Opportunity for price improvement
- The promptness of execution of securities transactions
- Competent block-trading coverage ability, if necessary
- Capital strength and stability
- Reliable and accurate communications and settlement capabilities
- Administrative ability
- Commissions and trading costs
- Knowledge of other buyers and sellers
- The broker's ability and willingness to position a portion of the order
- Research provided (and other soft dollar considerations—see below)
- Breadth of services provided to clients
- Availability of information regarding the most favorable market for executing the trade
- Conflicts of interest with the broker and conflicts that may result from trading activity
- Whether to allow client-directed brokerage
- Whether to limit client transactions to a list of preapproved brokers

> In addition to implementing policies and procedures for best execution that take brokers' block-trading coverage into consideration, the advisor should also establish internal policies and procedures for its aggregation and allocation of trades.

### Implement Procedures and Surveillance Tools to Test Best Execution

Once the best-execution policy is established, the next step is creating surveillance tools and implementing procedures to monitor and test for best execution. Initial procedures should consist of a review of executed transactions and the preparation of a report showing the information and data analyzed. Results from this report should be reviewed by the best-execution committee or the CCO. The committee should provide recommenda-

tions, as necessary, which should be implemented and reviewed on a periodic basis to measure effectiveness. Depending on the size of the firm and the frequency of its trading activity, the review can occur on a monthly, quarterly, or annual basis. Reviews performed annually would be appropriate only for firms whose trading activity is extremely infrequent.

> The first step in addressing conflicts of interest with the selection of a broker is asking yourself a simple question: "Am I using this broker-dealer because it is best for my client, or because of other considerations?" The answer should be because it is best for the client.

Analysis of trading practices should focus on the various best-execution factors the firm has identified in its policy, which may include commission costs, promptness of execution, block-trading coverage ability, evaluation of price per share, services rendered by brokers, conflicts of interest with the broker(s), ability to allocate trades, and soft dollar benefits received. The supporting documentation to be reviewed should include broker trading reports, commission summaries, transaction reports, and failed trades. Depending on the level and complexity of trading activity, the review can also involve sampling and forensic testing. Once the firm reaches a certain threshold of activity, it may need to purchase and implement software that allows it to systematize the review. The review should also include interviews with employees who have contact with the broker, including traders, portfolio managers, and back-office and client service personnel, who can provide qualitative feedback on broker capabilities and service. Based on the analytics, the CCO or committee can then consider whether it is appropriate to amend the type or kind of brokers used. Another useful procedure involves comparing projected brokerage commissions at the outset of the brokerage relationship with actual commissions charged over time. Any significant variance between the projected and actual can then be evaluated to determine whether there are opportunities for the firm to gain additional trading value for its clients and whether there have been exceptions to the firm's policies. In addition to reviewing the actual transactions, advisors should undertake an analysis of other available brokerage alternatives on a periodic basis. Again, the designated reviewer should focus on the same qualities identified in the firm's policy and provide a report of his or her findings to the CCO or the best-execution committee.

> Advisors can compare broker-dealers by periodically reviewing their Rule 606 reports. These reports are required for broker-dealers and provide various uniform statistical measure of the broker-dealer's execution quality.

**Document the Review**

Documenting the analytical review and recommendations is key for future best-execution reviews. As the reviewer is completing the process, he or she should draft a report describing how the review was undertaken, the findings of the review, any necessary changes that result from the findings, and the steps that were (or will be) taken to make any necessary change. The document that is prepared should be dated, signed by the CCO (or a designee of the committee), and filed (along with any backup documentation) as part of the advisor's books and records. Further, the review and the format of the

## Ensure That Policies Are Adhered to By All Affected Employees

Policies are of little benefit if employees are not made aware of them and trained in how to comply with them. To help ensure that the firm's trading policies and procedures are communicated down the lines, the firm should conduct appropriate training:

- ✓ Discuss the policies at the firm's annual compliance meeting.
- ✓ Educate firm personnel on trading policies and procedures and require an attestation by employees to confirm their receipt and understanding.
- ✓ Inform personnel of updates and modifications to existing trading controls.

reporting should be consistently applied, and the information should be presented in a way that facilitates forensic testing over time so that comparisons can be made (1) from period to period, (2) against peers, and (3) by trading method.

Remember: If the procedure is not documented, in the regulator's eyes it never occurred!

**2. Disclosures to Clients**

In addition to implementing appropriate policies and procedures internally, firms must adequately disclose their trade management practices on Form ADV and ensure consistency between internal policies and practices and their public disclosures. Though not addressed by a specific item in the disclosure brochure, best execution is an important aspect of Item 12 (Brokerage Practices) and can also be relevant to Item 10 (Other Financial Industry Activities and Affiliations). In the disclosure brochure, advisors should discuss:

- **Broker selection practices.** Include a general description of the firm's broker selection policies and procedures. For example, list the qualities the firm considers in its evaluation of transactions.[6]
- **Conflicts of interest.** Advisors must clearly disclose and adequately explain their actual and potential conflicts of interest with respect to trading practices, including:
  - The use of an affiliated broker on an agency or principal basis
  - Soft dollar benefits
  - Any trade aggregation and allocation policies
  - Relationships with market makers or market centers

Consistency is key. Brokerage practices that conflict with disclosures made to clients can constitute a fraudulent misrepresentation.

If client-directed brokerage is permitted, explain that clients who choose their own brokers can be subject to higher trading costs and less optimal execution.

**3. Books and Records Requirements**

As noted above, documentation (and recordkeeping) is the key to compliance success. You might have procedures in place to ensure that your clients are receiving best execution, but if you don't have the documentation to show those procedures have been performed, your compliance program will fail you in the regulator's eyes. Your documentation should show:

- The processes the firm uses to select brokers and to oversee broker performance, including the characteristics and qualities of the brokers that led to the selection, the post-trade analysis of the selected brokers (and retention of all backup documentation reviewed and prepared in the process), and any steps that are taken to improve the selection process over time
- The processes the firm uses to evaluate conflicts of interest
- Records that support the firm's negotiation of brokerage commissions, and retention of all client agreements and any other client instructions that might interfere with the firm's ability to receive the best commission rate (e.g., client-directed brokerage)

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In addition to documenting the procedures used to test best execution, advisors must also periodically evaluate the effectiveness of their test procedures. This evaluation can be done as part of the advisor annual review and should also be documented and maintained for the requisite time period.

Federally registered advisors should maintain their records related to best execution for five years (for the first two years, the records should be stored in the firm's offices; thereafter they may be stored off-site). State regulations vary, so advisors should be sure to review the relevant statutes and regulations and implement corresponding procedures for record retention.

## III. Soft Dollar Arrangements: What You Need to Know

### A. What Are Soft Dollars?

A specific aspect of best execution, and one that advisors frequently have questions about, is soft dollars. Generally speaking, soft dollars are benefits (primarily investment research and brokerage services) that investment advisors receive in exchange for directing trade activity to a particular brokerage firm. From this definition, the overlap with the advisor's best-execution fiduciary duties is likely clear: The advisor's receipt of soft dollar benefits cannot come before, or in any way be detrimental to, the interests of his or her clients.

### B. Laws and Regulations Governing Soft Dollars

To avoid claims that their receipt of these so-called soft dollar benefits constitutes a breach of their fiduciary duties, advisors may rely on a statutory safe harbor under Section 28(e) of the Securities Exchange Act of 1934 ("'34 Act"). The 28(e) safe harbor allows advisors that use commission dollars generated by transactions in client accounts to pay for research and brokerage services if the advisor determines in good faith that the amount of the commission paid by its clients is reasonable in relation to the value of the brokerage and research services received.[7] Section 28(e) was passed after the abolition of fixed commission rates in 1975. The safe harbor was a direct result of concerns expressed by advisors that if they paid more than the very lowest available commission rates, they would be exposed to charges of breaching the exacting fiduciary duty standards described above.

In 2006, the SEC issued a comprehensive interpretive release that provides advisors with more specific guidance on what research and brokerage services can fall within the statutory safe harbor.[8] The 2006 release gives advisors a framework consisting of three essential questions advisors should ask in evaluating soft dollar benefits:

**1. Is the product or service *eligible research* or *brokerage service* under the statute?**

Under the statute, **eligible research** is defined as "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" and "analysis and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."[9]

The 2006 release explains that this definition includes research only if "it reflects the expression of reasoning or knowledge."[10] Traditional research reports analyzing the performance of a particular company or investment are the classic example of eligible research. Other eligible research includes:

- Meetings with corporate executives who provide oral reports on the performance of a company
- Seminars or conferences, but only if they truly provide substantive advice
- Software that provides analysis of securities portfolios
- Corporate governance research and corporate governance rating services if they bear on an issuer's performance
- Market research, e.g., advice from broker-dealers on order execution

The SEC release also provides specific guidance on four additional research areas where the use of soft dollars may or may not fall within the safe harbor: (1) mass-market publications, (2) inherently intangible products and services, (3) data, and (4) proxy services. “Mass-market publications,” such as *The Wall Street Journal*, *The New York Times*, and *Money* magazine, are not eligible research. The SEC release sets forth three specific indicators that a publication is “mass market,” and therefore not eligible for the safe harbor: circulation to a wide audience, a publication that is intended for a wide audience, and low costs. On the flip side, indicators for eligible non-mass-market publications are those marketed to a narrow audience and directed to readers with specialized interests in particular industries, and those that have a high cost.

Second, like mass-market publications, “inherently tangible products and services” *are not eligible* under the safe harbor. The release provides as examples in this category meals, travel, and entertainment; office equipment; salaries; computer hardware; and software that assists with administrative functions. Third, market or economic data is eligible if it contains substantive content, e.g., stock quotes and company financial data. And finally, proxy services are eligible only if they provide substantive information concerning securities; proxy services that deal solely with the mechanical aspects of voting are not eligible.

**Eligible brokerage services** are defined as effecting “securities transactions and perform[ing] functions incidental thereto (such as clearance, settlement, and custody) or required in connection therewith.”[11] The SEC release provides advisors with a temporal standard to evaluate brokerage services: Eligible brokerage services begin when the advisor communicates with the broker-dealer for the purposes of transmitting an order and ends when the funds or securities are delivered or credited to the account. Under this standard, services related to the execution, clearing, and settlement of securities transactions are eligible under the safe harbor. These services include connectivity services between the advisor, the broker-dealer, and other parties to the transaction, and trading software used to route orders. Because they fall outside the temporal standard, hardware such as telephones and computer terminals and software used for recordkeeping and administrative purposes are not eligible for the safe harbor.

**2. Does the product or service actually assist the advisor in his or her provision of investment advice?**
Even if the research and brokerage services are “eligible,” the safe harbor is available for research only if it assists the advisor in making investment decisions. Likewise, brokerage services fall within the safe harbor only if they assist the advisor in carrying out its responsibilities. The analysis here is straightforward—to qualify under the safe harbor, research and brokerage services must benefit the advisor’s clients. If the research or brokerage service is used to provide a benefit to the advisor—e.g., for marketing purposes—the safe harbor will not apply.

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**3. Finally, if the product or service is both eligible and assists the advisor appropriately, is the amount of client commissions paid for the product or service reasonable?**

Once the first two questions are answered in the affirmative, the advisor must then determine whether the commissions its clients pay are reasonable in light of the value of the research and brokerage services received. This final question in the analysis brings the advisor back to the duty of best execution. In order for the safe harbor to apply, the advisor must determine the benefits it receives so that it can compare that benefit with the cost to its clients.

The advisor's evaluation of the reasonableness of the services gets particularly complicated when the product or service obtained with the client's commission has "mixed uses"—that is, when the research or brokerage service has other functions that are not sufficiently related to the investment advisor's provision of advice to fall within the safe harbor. In these circumstances, the advisor must make a reasonable allocation of the cost of the product according to its use. The percentage of the service, or its specific component, that falls outside the safe harbor must be paid for directly by the advisor and not with soft dollars.

### C. Evaluating Soft Dollars and Mixed-Use Items

How does an advisor make a reasonable allocation of costs between eligible and noneligible uses for mixed-use items? This is a challenging area for advisors. As with best execution, the key to evaluating soft dollar arrangements is adequate documentation. The SEC's 2006 release specifically states that advisors "must keep adequate books and records concerning allocations so as to be able to make the required good faith showing."

To make the allocation, the advisor must first determine the cost of the mixed-use item, and then evaluate what portion of the use falls within the eligibility standards discussed above. This evaluation will vary based on each advisor's business. For example, an advisor may receive the Bloomberg Service and a Bloomberg terminal. If this advisor uses the terminal strictly as a research tool for its investment decision-making process for its client accounts, the entire benefit could be appropriately allocated to soft dollars.

## Soft Dollar Disclosures and Conflicts of Interest

As with best execution, an advisors' receipt of soft dollar benefits must be clearly disclosed on Form ADV Part 2A under Item 12, Brokerage Practices, and such disclosures must be consistent with the firm's actual practice. In addition to disclosing its soft dollar practices—e.g., whether the firm receives soft dollar benefits and what those benefits are—the firms must also adequately explain the conflicts of interest that are created by its receipt of soft dollar benefits.

The instructions to Form ADV Part 2A provide advisors with an excellent road map for their soft dollar disclosures. The Form requires that advisory firms disclose all soft dollar benefits received, including both proprietary research (created by the broker-dealer) and research created by third parties. Additionally, the instructions clarify that advisors receiving soft dollar benefits must disclose:

- ✓ That when client brokerage commissions are used to obtain research or other products or services, the *advisor* receives a benefit because it does not have to produce or pay for these things
- ✓ That the advisor has an incentive to select or recommend a broker-dealer based on its interest in receiving the research or other products or services, rather than based on the client's interest in receiving the most favorable execution
- ✓ If applicable, that the commissions paid by the client are higher because the advisor receives soft dollar benefits
- ✓ Whether soft dollar benefits are used to service all of the advisors' accounts or just those accounts that pay for the benefits, and whether the advisor allocates soft dollar benefits in proportion to the soft dollar credits the client account generates
- ✓ The procedures used by the firm to direct client transactions to a particular broker-dealer in return for soft dollar benefits

Another advisor, however, might use Bloomberg both for appropriate investment decision making and to provide clients with access to financial information. In this case, the service and terminal would have a mixed use, and the advisor must determine what percentage can be properly allocated to soft dollars and what cannot. This determination should be documented and based on the actual uses. In other words, if the service and terminal are used 50% of the time for research that informs the advisor's decisions, 50% of the cost can be attributed to safe harbor purposes and paid for with soft dollars, while the other 50% must be paid for with hard dollars by the advisor directly.

In every instance, the advisor should document the costs, the allocation, and the rationale for the allocation to demonstrate to the regulator that the determination of what was allocated to soft dollars is reasonable and made in good faith.

## IV. Other Trading Compliance Hot Topics

In addition to best execution and soft dollars, advisors should be aware of a number of other trading areas and their regulatory compliance considerations. These areas include personal trading, insider trading, and the SEC's new large trader rule.

### A. Personal Trading

SEC Rule 204a-1 requires advisors to adopt a written code of ethics, which must require the advisor's "access persons" to periodically report their personal securities transactions and holdings to the firm's chief compliance officer (or another designated person). Access persons are defined by the rule as supervised persons who have "access to nonpublic information regarding any client's purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund" or who are "involved in making securities recommendations to clients, or who [have] access to such recommendations that are nonpublic." Further, if the firm's primary business is providing investment advice, all its "directors, officers and partners are presumed to be access persons."

> Employees who are in a position to exploit information about client securities transactions or holdings must report their personal trading, and those reports must be reviewed by the firm's chief compliance officer.

In turn, the rule mandates that the code of ethics require those reports be reviewed to identify improper trades or patterns of trading. Like the advisors' best-execution duties, these requirements provide a mechanism for advisors to ensure that advisory personnel do not place their own interests above those of the advisor's clients. In addition to adopting a code of ethics, advisors should take care to include procedures to ensure that the code of ethics is adhered to and that the personal trading reports submitted by access persons are actually reviewed.

### B. Insider Trading

Another area related to the code of ethics requirement of Rule 204a-1, and one of great concern for regulators, is the responsibility of advisory firms to establish policies and procedures to prevent insider trading. Section 204A of the Investment Advisers Act of 1940 specifically requires advisors to:

> establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment advisor's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser.[12]

The SEC has recently highlighted insider trading as a top area of focus for the agency's investment advisor examiners and has made known that its examiners are focused on:

- Whether a firm has identified the source and type of nonpublic information that they and employees may be privy to
- Whether the firm has crafted and implemented adequate procedures to maintain the confidenti-

ality of that information, and is implementing those procedures

- Whether the firm has guidelines with respect to when and to whom it will provide information—for example, information about its portfolio or its trading

When developing insider trading prevention policies, advisors should ask themselves:

- How could my employees come into possession of material nonpublic information?
- How could this information be abused?
- What procedures can I put in place to prevent it?
- What tests can I employ to determine whether there are indications of insider trading at my firm?

### C. Large Trader Rule

The large trader rule, Rule 13h-1, and its accompanying Form 13H, was adopted by the SEC in 2011 to compile data on those deemed by the SEC to "conduct a substantial amount of trading activity, as measured by volume or market value in the U.S. Markets." The rule has two components: the reporting requirement for "large traders" (discussed

## SEC's Code of Ethics Rule—Rule 204a-1

The Code of Ethics Rule (Rule 204a-1) mandates two specific types of reporting for all access persons of an RIA firm:

**Holdings reports.** These reports must contain the access person's current securities holdings and must be provided to the CCO (or other designee): (1) within 10 days of the individual becoming an access person and (2) at least once during each 12-month period. The holdings reported must be current within 45 days of the report and must, at a minimum, provide:

- ✓ The title and type of security, and as applicable the exchange ticker symbol or CUSIP number, number of shares, and principal amount of each reportable security in which the access person has any direct or indirect beneficial ownership
- ✓ The name of any broker, dealer, or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit
- ✓ The date the access person submits the report

**Transaction reports.** These reports must contain specific information about each reportable security transaction in which the access person acquired direct or indirect ownership in the reporting period. The reports must be provided to the CCO (or other designee) within 30 days of the end of a quarter and must cover all transactions during the quarter. Each report must also contain:

- ✓ The date of the transaction, the title, and as applicable the exchange ticker symbol or CUSIP number, interest rate and maturity date, number of shares, and principal amount of each reportable security involved
- ✓ The nature of the transaction (i.e., purchase, sale, or any other type of acquisition or disposition)
- ✓ The price of the security at which the transaction was effected
- ✓ The name of the broker, dealer, or bank with or through which the transaction was effected
- ✓ The date the access person submits the report

Rule 204a-1 excludes five types of securities from these reporting requirements:

1. Direct obligations of the U.S. government
2. Bankers' acceptances, bank certificates of deposit, commercial paper, and high-quality short-term debt instruments, including repurchase agreements
3. Shares issued by money market funds
4. Shares issued by open-end funds other than reportable funds
5. Shares issued by unit investment trusts that are invested exclusively in one or more open-end funds, none of which are reportable funds

here) and recordkeeping, reporting, and monitoring requirements for broker-dealers that hold accounts for large traders.

The rule defines a large trader as any person who:

> (i) directly or indirectly … exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the identifying activity level; or (ii) voluntarily registers as a Large Trader.[13]

Generally, an "NMS security" refers to exchange-listed equities and options. The "Identifying Activity Level" is broken down into two thresholds: either two million shares or shares with a fair market value of $20 million during a calendar day; or either twenty million shares or shares with a fair market value of $200 million during a calendar month. The identifying activity level includes every transaction regardless of which side of the market it is on (though certain limited transactions are exempted) and specifically prohibits disaggregation (offsetting transactions) for the purpose of avoiding large trader status.

If an advisor satisfies the large trader criteria, it must file Form 13-H through the EDGAR filing system. The initial filing must be made "promptly" within meeting the large trader criteria, which the SEC has indicated means within 10 days. Large traders then must make annual Form 13-H filings within 45 days of the end of their fiscal year and amended filings if the information contained on the form becomes inaccurate. The information required by Form 13-H is fairly general (type of business engaged in by the filer, whether it files other forms with the SEC, whether it is regulated by the CFTC or any foreign regulator, specific information on its affiliates, governance information, and the identity of broker-dealers it uses), and the contents of the filing are not made publicly available by the SEC.

Advisors who meet the large trader definition, or anticipate they will meet the definition, should adopt internal policies and procedures to ensure that filing requirements under Rule 13h-1 are satisfied.

## V. Conclusion

The best advice for any advisory firm is to always keep the interests of the firm's clients in mind. Each area of the firm's operations, particularly areas like trading that are at the heart of the advisor-client relationship, must be closely monitored. This is accomplished by developing appropriate policies and implementing systematic procedures to ensure that those policies are adhered to. Use this article as a tool to help your firm meet its compliance obligations with respect to trading practices.


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[1] Investment Advisers Act Release No. 2204, Dec. 17, 2003, available at sec.gov/rules/final/ia-2204.htm.

[2] *In re Oakwood Counselors, Inc., et al.*, Investment Advisers Act Release No. 1614, Feb. 10, 1997.

[3] Securities Exchange Act Release No. 34-23170, April 28, 1986 (“1986 release”), available at sec.gov/rules/interp/34-23170.pdf.

[4] Gene Gohlke, associate director of the Office of Compliance Inspections and Examinations, ICI Securities Developments Conference, Dec. 7, 2001.

[5] 1986 release.

[6] “Sample Disclosure Language for Form ADV” on SchwabAdvisorCenter.com > News & Resources > Compliance > Hot Topics. Sample language helps RIAs disclose use of the Schwab Advisor Services platform.

[7] 15 U.S.C. §78bb(e).

[8] SEC Securities Exchange Act, Release No. 34-54165, July 18, 2006 (“2006 release”), available at sec.gov/rules/interp/2006/34-54165.pdf.

[9] 15 U.S.C. §78bb(e)(3)(a) and (b).

[10] 2006 release.

[11] U.S.C. §78bb(e)(3)(c).

[12] 15 U.S.C. §80b-4a.

[13] 17 C.F.R. §204.13h-1.

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