The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE
Washington, DC // Brussels // London // www.ici.org

Comment Letter on Proposed AIMR Trade Management Guidelines, February 2002

February 12, 2002

Association for Investment Management and Research
Professional Standards & Advocacy Department
560 Ray C. Hunt Drive
P.O. Box 3668
Charlottesville, Virginia 22903-0668

Re: Proposed AIMR Trade Management Guidelines

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on the Association for Investment Management and Research's ("AIMR") proposed Trade Management Guidelines ("Guidelines").[2] As the Guidelines note, the issues relating to the obligations that investment management firms have to clients regarding the execution of trades and the management of the trading function are very complex. We generally believe that the Guidelines can be a useful tool to assist investment management firms in developing and implementing processes relating to best execution. The Institute has several concerns, however, regarding their application,[3] as well as several recommendations regarding the proposed processes, disclosures and recordkeeping. Our specific comments follow below.

I. Application of the Guidelines

As the Guidelines recognize, the concept of best execution is complex. It is therefore extremely important that each firm tailor the processes relating to best execution to its specific circumstances. We therefore urge AIMR to revise the Guidelines, as recommended below, to ensure that they provide appropriate flexibility.

Given the complexities surrounding the concept of best execution, we also believe it is critical that the Guidelines' recommendations not be construed as mandatory. While a number of recommendations in the Guidelines may be useful to certain advisers, in many cases they would not necessarily be considered "best practices" by most industry participants. Rather, they are among many possible approaches.[4] In this regard, the introductory language notes the voluntary nature of the recommendations.[5] There are instances throughout the Guidelines, however, where the language suggests otherwise. The Institute therefore recommends that AIMR use a more flexible term than "should," such as "may" or "could," to describe the practices and procedures firms may consider adopting.

Finally, the Guidelines recognize that the concept of best execution does not lend itself to a precise definition or quantifiable measurement. Nevertheless, there seems to be much emphasis throughout the Guidelines on the use of statistical measurements to determine best execution. For example, the Guidelines state that the proposed definition of "best execution" recognizes that it "is a prospective, statistical concept ...." We recommend that the Guidelines clarify that best execution is not a quantifiable concept and that statistical measurements can be only one part of the overall assessment that firms may make in examining best execution.

II. Trade Management Processes

The Guidelines recommend that firms establish formal trade management policies and procedures relating to best execution based upon their size, structure and organizational complexity. The Guidelines further recommend that firms establish trade management oversight committees that would have responsibility for developing, evaluating, and changing (when necessary) firm trading practices.

The Institute supports the concept of the establishment of a trade management oversight committee as an option for firms, but we are concerned that the responsibilities set forth by the Guidelines for such a committee may be too extensive. As a result, it may be unreasonable to expect such a committee to be able to carry out all these responsibilities effectively. For example, one of the responsibilities of the trade management oversight committee would be to evaluate a firm's capability to deliver best execution to its clients by assessing the firm's trading skills, equipment, and information resources. Such a committee, however, may not always be the appropriate entity to make these assessments; for some firms, other personnel may be better suited for this task.[6] We believe a more appropriate role for the trade management oversight committee would be to oversee and assist a firm in developing, evaluating and changing (when necessary) the firm's trading practices, rather than having the sole or primary responsibility for actually performing each of these functions.

The Guidelines also recommend that a firm develop trade management procedures that adopt the AIMR Soft Dollar Standards. The Institute strongly objects to this recommendation. The Guidelines should be unbiased recommendations to assist firms in the development of best execution processes; they should not contain a recommendation that all firms adopt specific standards with respect to any practices. This is particularly true in the case of the Soft Dollar Standards, which have not been widely accepted in the investment management or securities industry. We therefore urge AIMR to eliminate this recommendation from the Guidelines.

Finally, the Guidelines recommend that firms establish controls to monitor and evaluate broker performance and execution quality, including compiling and reviewing, among other things, information adequately illustrating the broker's financial condition, including a broker's audited financial statements. The Institute opposes this recommendation, as it is unnecessary and could prove unduly burdensome for some firms. Under the federal securities laws, brokers are subject to minimum capital requirements and other regulations intended to ensure financial stability. In addition, a broker's financial condition would likely be considered by a firm prior to the initial decision to utilize that broker to execute trades. Moreover, it is unclear what type of, and how extensive, a review of a broker's financial statements would be considered appropriate. For these reasons, the Institute believes that AIMR should clarify that this recommendation is but one approach for firms to consider and defer to the adviser's discretion as to whether such a review is necessary.

III. Disclosures

The Guidelines recommend that firms disclose their trade management practices as well as their actual and potential trading related conflicts of interest to all current and prospective clients. The Institute generally supports disclosure that would improve the quality of information provided to clients and prospective clients.[7] However, we do not believe that it is necessary for the Guidelines to include disclosure recommendations, inasmuch as registered investment advisers are already subject to similar, and in some cases more extensive, disclosure requirements under the Investment Advisers Act of 1940.

In particular, much of the Guidelines' recommended disclosures are already required in SEC Form ADV.[8] In addition, the SEC recently proposed amendments to Form ADV to increase the disclosures required of registered investment advisers.[9] We therefore oppose the disclosure recommendations as superfluous. Moreover, as the SEC's disclosure requirements evolve over time, the potential for inconsistency between SEC requirements and the Guidelines would grow. The better approach would be for the Guidelines to make a strong affirmation of advisers' obligations to adhere to all applicable disclosure requirements of the SEC and other regulatory bodies.[10]

In addition, the list of conflicts of interest to be disclosed contains principal trades. Under Section 206(3) of the Advisers Act, an investment adviser is prohibited from acting as principal without disclosing this to and obtaining the consent of its client. We therefore question the necessity of disclosing these types of trades, as prior disclosure is already required. As noted above, a better approach for the Guidelines to take would be to emphasize the advisers' obligations to adhere to applicable regulatory disclosure requirements.

Finally, the Institute notes that several of the recommended disclosures appear to involve potential conflicts for a broker and not an adviser. We therefore question the value or applicability of these disclosure recommendations. For example, the internalization of orders by a broker is not a conflict of interest for an adviser. It is therefore unclear why an adviser should have to disclose this information to its clients and prospective clients.[11]

IV. Recordkeeping

The Guidelines contain several recommendations relating to the maintenance of trading records. In line with our comments above on the need for appropriate flexibility in the Guidelines, we believe that the Guidelines' recordkeeping recommendations are far too rigid and detailed in nature. In addition, the Advisers Act already imposes extensive recordkeeping requirements on advisers. Those advisers that advise investment companies or pension plans have still further recordkeeping requirements under the Investment Company Act of 1940 or the Employee Retirement Income Security Act of 1974. The Guidelines' recordkeeping recommendations

therefore could prove burdensome and add unnecessary expense for firms. For these reasons, we believe that the Guidelines should only recommend that advisers maintain records consistent with applicable regulatory recordkeeping requirements.

It also is unclear whether the recordkeeping is to be performed on a trade-by-trade basis. This would be extremely time consuming and burdensome for firms. A standard that contemplates the maintenance of records on anything other than a periodic basis could upset the normal flow of a firm's trading operations. We therefore recommend that, if AIMR determines that the Guidelines should contain recordkeeping recommendations, it clarify that firms are not expected to maintain records on a trade-by-trade basis for purposes of those recommendations.

* * *

The Institute appreciates the opportunity to comment on AIMR's proposed Trade Management Guidelines. Any questions regarding our comments may be directed to the undersigned at 202-326-5824 or to Ari Burstein at 202-371-5408.

Sincerely,

Amy B.R. Lancellotta
Senior Counsel

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes9,040 open-end investment companies ("mutual funds"), 487 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.952trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders. The Institute also represents the interests of investment advisers. Many of the Institute's investment adviser members render investment advice to both investment companies and other clients. In addition, the Institute's membership includes 341associate members which render investment management services exclusively to non-investment company clients. A substantial portion of total assets managed by registered investment advisers is managed by these Institute members and associate members.

[1] Proposed AIMR Trade Management Guidelines (November 12, 2001).

[3] As a preliminary matter, it does not appear that fixed-income instruments are covered by the Guidelines. The Institute agrees with limiting the scope of the Guidelines to include only equity securities transactions as the processes used in determining best execution for fixed-income transactions are very different, and in many cases much more complex, than those a firm may implement for most equity securities. We therefore seek clarification that fixed-income instruments are not covered by the Guidelines.

[4] For example, the Guidelines recommend that each firm establish a brokerage target allocation plan that would project annual trading activity and compensation for each broker on the firm's approved brokers list. It is our understanding that due to the difficulty in quantifying broker targets, many firms do not set such targets.

[5] Similarly, we urge the Securities and Exchange Commission to view the Guidelines as potentially helpful measures for firms and not require or imply, such as through its examination process or other pronouncements, that firms should adopt any or all of the Guidelines' recommendations.

[6] If the trade management oversight committee contains personnel with the proper expertise, it may be appropriate for the committee to make this evaluation. However, a firm should not be expected to place personnel on the committee with such expertise in order to satisfy the Guideline's recommendation.

[7] See, e.g., Letter from Amy B.R. Lancellotta, Senior Counsel, ICI, to Jonathan G. Katz, Secretary, SEC, dated June 13, 2000 (Comment Letter on Proposed Revisions to Form ADV and Related Rules).

[8] Regarding the disclosure of actual and potential conflicts of interest, the current Part II of Form ADV requires disclosure of other financial industry activities or affiliations, participation or interest in client transactions, brokerage discretion, and information relating to soft dollar arrangements.

[9] Investment Advisers Act Release No. 1862 (April 5, 2000). Unlike the disclosure in the current form, the disclosure proposed to be required by the new Form ADV would have to be in a narrative format and actually describe the control procedures the adviser uses to address actual and potential conflicts of interest.

[10] If AIMR determines that disclosure recommendations are necessary, we recommend that AIMR eliminate from the Guidelines the recommendation that firms disclose information beyond that required under federal law. Similarly, the frequency of the disclosure

required by the Guidelines should conform to that under federal law. As currently drafted, the Guidelines recommend that disclosure "be made ... not less frequently than once a year." By contrast, Rule 204-3 under the Advisers Act only requires that an adviser offer to deliver the required disclosure annually. We recommend that the Guidelines be revised to conform to the requirements of Rule 204-3.

[11] Similarly, the terms "preferencing of orders" and "order flow arrangement" are typically used when discussing the practices of brokers. The Guidelines, however, use these terms in connection with arrangements between an investment management firm and a broker. In addition, the Guidelines recommend that firms disclose their "order-routing practices" to all current and prospective clients. It is unclear from the Guidelines, however, what the term "order-routing practices" describes or refers to. In particular, this term can mean different things for investment management firms and broker-dealers. The Institute therefore recommends that, if disclosure regarding order-routing practices is recommended in the Guidelines, AIMR clarify this term.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.