October 31, 2024

Fool Me Once: A Reminder of Sound Trade Allocations Practices in Light of Recent SEC "Cherry Picking" Actions

EXECUTIVE SUMMARY

- Although trade allocation is a topic that has received considerable attention by the SEC and industry registrants for decades, 2024 has proven the SEC continues to focus intently on the topic, and that investment managers remain susceptible to problematic practices – in particular, "cherry picking."
- Regulatory standards surrounding investment managers' trade allocation practices are not new and center on four key pillars: fair and equitable treatment, adequately designed and effectively implemented policies & procedures, accurate client disclosures, and adequate policy & procedure testing & oversight.
- In light recent SEC enforcement actions and the SEC's ability to monitor investment managers' trade allocation practices outside of the examination context, investment managers should take a fresh look at their trade allocation practices, policies & procedures, disclosures, and Compliance testing to assess whether they are reasonably designed to detect and prevent "cherry picking" by firm personnel.
- There is little reason investment managers shouldn't feel confident that their trade allocation policies & procedures meet regulatory standards expressed by the SEC, reflect actual practices and are consistent with client disclosures, and are subject to testing and certain types of forensic analyses to assess their efficacy.

INTRODUCTION

Dating back to August, I suspect all of us have seen a healthy dose of headlines related to the asset exodus happening at Western Asset Management Company ("Wamco"), approximately $37 billion since then. The cause of this exodus, as a variety of news outlets reports, stems from a Wells Notice Wamco's ex-Co-CIO, Ken Leech ("Leech"), received from the SEC, indicating the SEC is considering bringing an enforcement action for an alleged "cherry picking" scheme in US Treasury derivatives allocations across an undisclosed number of Wamco accounts. Wamco is under a parallel probe, and the Justice Department is also investigating.

"Cherry picking" – allocating more profitable trades to favored or preferred clients or accounts over others – is nothing new. Plenty has been written on the topic by the SEC, industry trade groups, and law firms alike, and what constitutes sound allocation practices has reached a level of general industry normalization over the past 30 years. Interestingly, however, we continue to see registrant missteps and malfeasance on this time-worn topic. *Fool me once*, as the old saying goes. Four "cherry picking" enforcement actions have

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surfaced in various forms this year (inclusive of the Wells Notice to Leech), two of which were publicized just last month. In September, the SEC settled an enforcement action with an investment adviser representative that alleged "cherry picking" violations, imposing a $750,000 civil penalty and barring the representative from the industry; the SEC also settled an enforcement action against two investment managers for similar "cherry picking" violations, imposing a $200,000 civil penalty. In March of this year, another "cherry picking" enforcement action against an investment adviser firm was concluded with a corresponding $300,000 penalty.

In light of these recent "cherry picking" actions, it seemed worthwhile to devote this month's essay to the topic of trade allocation generally. Accordingly, this essay is intended to do the following:

- ❖ Provide a refresher on SEC standards and expectations relating to trade allocation practices **(p. 3)**;
- ❖ Identify the problematic practices at play in the most recent SEC enforcement actions **(p. 4)**; and
- ❖ Distill any new learnings that may serve to refine your own firm's trade allocation monitoring practices as a result **(p. 6)**.

FOOL ME ONCE

The regulatory standards relating to what constitute appropriate trade allocation practices by an investment manager date back nearly 30 years, with periodic guidance and insights provided by the SEC at various points along the way. The standards and expectations the SEC has expressed over the past three decades provide investment managers with a reliable framework on which to base their trade allocation practices even today.

Standards prescribing acceptable trade allocation practices are not codified in the Investment Advisers Act or Investment Company Act. Rather, the standards the SEC has held and continues to hold investment managers to today can be traced back to a 1995 no-action letter issued by the SEC in 1995. At that time, an investment manager had requested the SEC Staff's assurance that the Staff would not recommend enforcement action to the SEC if the manager aggregated orders for the purchase or sale of securities on behalf of a number of different types of clients.

In granting the investment manager's no-action request, the SEC Staff considered a number of trade allocation practices the manager represented it would employ when aggregating client orders. 12 years later in 2007, SEC Staff issued guidance highlighting common deficiencies it had been finding when examining investment managers' trade allocation practices, and in 2008, it further supplemented this guidance based on other observations. These noted deficiencies were informed by the original standards on which the SEC based its registrant-specific 1995 no-action relief. Collectively and consistently, SEC expectations and standards for sound trade allocation practices can be summarized in the table on the following page.

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SEC TRADE ALLOCATION GENERAL STANDARDS

Favortism	• No advisory client account (including proprietary accounts) may be favored over any other client. • Each client who participates in an aggregated order should generally participate at the average share price with all transaction costs shared on a pro rata basis. o Other practices (e.g. random allocations, account rotations, highest price to largest account, etc.) may be employed but should be documented and be able to be justified as treating all clients fairly and equitably. • Securities should not be sold out of favored accounts first to obtain advantageous pricing or secure limited selling opportunities. • Favored accounts should not receive preference over others for receiving the most desirable investment opportunity at time of purchase.
Compensation	• An investment manager should receive no additional compensation or remuneration of any kind as a result of a proposed aggregation and allocation.
Pre-Trade Allocation	• Before entering an aggregated order, an investment manager should document and specify the participating client accounts and how it intends to allocate the aggregated order among those clients. • If an aggregated order is filled in its entirety, it should be allocated among clients in accordance with a pre-allocation statement; if the order is partially filled, it should be allocated pro rata based on the allocation statement.

Post-Trade Allocation	• Notwithstanding pre-trade allocation instructions and intentions, an order may be allocated on a basis different from that specified originally if:
	  o All client accounts receive fair and equitable treatment,
	  o The reason for the different allocation is explained in writing (e.g. a client account may need a minimum lot size for a certain security purchase for the purchase to make sense, but after submitting an order, the availability of the securities sought is insufficient to meet such client's originally intended pro rata share); AND
	  o The post-trade allocation is approved by Compliance.

Policies & Procedures	• An investment manager should have policies & procedures governing its trade allocation practices, as well as adhere to and monitor for adherence to such policies & procedures. • Monitoring for adherence to policies & procedures should be designed to detect whether any client accounts were favored or discriminated against relative to other accounts.
Disclosure	• An investment manager should disclose its trade allocation policies and practices in its Form ADV Part 2A (Brochure). • Other client disclosures (e.g. private placement memoranda, subscription agreements, etc.) should also be consistent with the investment manager's underlying allocation practices.
Books & Records	• Allocation decisions and reviews should be documented and retained.

As you can see, the SEC's standards and expectations are relatively straightforward and clear. Furthermore, they are principles-based and do not prescribe a particular, absolutist methodology for investment managers to employ when allocating trades among client accounts. If managers are able to evidence fair and equitable allocation decisions and treatment, have policies and procedures that are designed to ensure fair and equitable treatment, follow and monitor for compliance with such policies and procedures, and disclose their allocation policies and practices in their Form ADV Part 2A and similar disclosure documents, they should be on reliable path toward meeting fiduciary obligations and regulatory expectations alike.

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FOOL ME TWICE

Notwithstanding well-settled regulatory standards regarding sound trade allocation standards, investment managers continue to find themselves in the SEC's crosshairs.

As noted at the outset, four "cherry picking" actions have arisen or resolved in some shape or form this year alone. Although the Wamco matter is still in-process and publicly available information is limited, based on what is available, the allegations appear consistent with the types of conduct observed in the other three actions from this year. These 2024 actions have the following characteristics generally in common (which are also the same types of characteristics the SEC Staff noted in its 2007 and 2008 guidance as discussed in the prior section):

COMMON CHARACTERISTICS: 2024 SEC "CHERRY PICKING" ACTIONS

Wait-and-See	• Investment adviser representatives place a block/aggregated trade, but wait until later in the day to provide the broker(s) allocation instructions once the investment adviser representative has the opportunity to observe price movements – favorable trades are allocated to the investment adviser representatives' favored client or own personal accounts, and unfavorable trades are allocated to other accounts.
Statistical Significance	• The return differences between an investment adviser representatives' favored accounts versus other accounts are statistically significant; the probability of the differences occurring by chance was nearly zero.
Policy & Procedure Inefficacies	• Investment managers have policies & procedures governing their trade allocation practices; however, such policies & procedures are not followed and/or not being monitored for compliance. • Investment managers' policies & procedures are inconsistent with what the managers disclose in their Form ADV Part 2A Brochures regarding their trade allocation practices
Misleading & Inaccurate Disclosures	• Although investment managers' Form ADV Part 2A Brochures may disclose such managers' trade allocation practices and policies, such disclosures are inaccurate and misleading given the stated practices are not in fact occurring or being monitored.

Included as an Appendix to this essay is a table that provides the greater particulars of the SEC's "cherry picking" actions concluded thus far this year, including details of the underlying conduct/allegations, along with the outcomes of each action (to the extent applicable).

GREAT ARTISTS STEAL

Given the SEC's relatively consistent historical treatment of trade allocation practices and "cherry picking" behavior, and given the type of information that is available to investment manager's own Compliance personnel and the SEC alike, it is feasible for a manager to be reasonably positioned to prevent and detecting "cherry picking" by its personnel. In fact, it is essential given the SEC is watching on its own.

SEC "Spec Ops." One notable aspect to the three enforcement actions that concluded this year is the role the SEC's Market Abuse Unit ("MAU") within the SEC's Enforcement Division played in detecting and investigating the misconduct. The MAU was established within the SEC's Enforcement Division in 2010 and was and continues to be viewed as the SEC's "spec ops" unit. The MAU uses quantitative and statistical

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analysis to identify securities law violations latent in large data sets, and its charge is to focus on detecting and investigating a number of different types of market abuse trading practices, including "cherry picking." Without getting too far afield but simply to share some interesting anecdotes, the MAU has been comprised of FBI agents, quantitative analysts trained in applying statistical metrics to trading data, trading strategies experts, index arbitrage and ETF specialists, market structure experts skilled in analyzing latent compliance and regulatory risks in market centers, broker dealer analysts, high-frequency trading experts, and experienced accountant investigators.

Beginning in 2015, the SEC's Enforcement Division initiated a targeted data-driven initiative to identify "cherry-picking" specifically. Investigators began analyzing large volumes of investment managers' trade allocation data to identify instances where it appeared a manager was disproportionately allocating profitable trades to favored accounts. Per the Enforcement Division, this is done by identifying specific custodians that provide services to investment managers and their clients and leverage their trading records and other data to efficiently target preferential trade allocations occurring outside the detection of even the most observant clients. Although no further detail has been provided, presumably the information being looked at is that which brokers are required to report pursuant to the National Market System Plan Governing the Consolidated Audit Trail Plan adopted by the SEC ("CAT NMS Plan"). The CAT NMS Plan requires brokers to provide allocation reporting that contains: (a) a firm designated ID for any account(s), including subaccount(s), to which executed shares are allocated and provides the security that has been allocated; (b) the identifier of the firm reporting the allocation; (c) the price per share of shares allocated; (d) the side of shares allocated; (e) the number of shares allocated to each account; and (f) the time of the allocation.

As one can see, the SEC has access to data via brokers that it can and does use to detect problematic allocation practices by investment managers. Accordingly, it is imperative for managers' Compliance programs to have their own mechanisms and practices in place to do the same.

The Steal. For whatever mystique the MAU may have, the good news is that it doesn't have access to any more information regarding an investment manager's allocation practices than a manager already has itself. Another piece of good news is that historically, the SEC has shared not just the types of information it typically seeks from registrants during examinations on the topic of trading practices, but what it looks within that information. These shared insights, coupled with data that is already at the fingertips of investment managers, position a manager to conduct forensic testing that has the potential to reasonably approximate the testing of the MAU. The table on the following page identifies the types of forensic analyses the SEC often performs during exams, as well as other analyses investment managers can employ that both mirror SEC practices and potentially augment them.

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"CHERRY PICKING" FORENSIC TESTING & ANALYSES

IPOs	• Determine which clients received shares of the IPO allocation and whether the IPOs were consistent with client investment objectives. • 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 Dispersion	• Compare the performance of accounts with similar objectives to determine if investment opportunities were allocated consistently.
1%+ Fund Shareholders	• Review the allocation of investment opportunities among funds and clients to determine if funds substantially owned by insiders received more favorable allocations.
Allocation Exclusions & Non-Pro Rata Allocations	• Review a sampling of allocations over a designated time period and determine whether certain accounts are regularly being excluded from or receiving non-pro rata allocations.
Profitable vs. Unprofitable Trades	• Calculate the percentage of trades allocated to client accounts that were profitable versus unprofitable and assess whether such variations are statistically significant.

And of course, in addition to an investment manager performing various forensic testing and analysis, managers should annually validate that their Form ADV Part 2A Brochures and other disclosures regarding trade allocation practices match corresponding policies and procedures. Relatedly, managers should be testing such policies & procedures periodically to the extent such testing may be in addition to forensic analyses discussed above (e.g. testing designed to ensure that a Compliance approval requirement was adhered to for certain allocations, etc.).

PARTING THOUGHTS

Without question, not every investment manager will have the resources to perform the same type of data analytics the SEC performs with respect to "cherry picking" detection. In certain respects, a manager may well need to hire data scientists to perform certain types of analyses. I'm not sure the SEC would expect that even, nor would that level of analysis necessarily be warranted depending on the nature of registrant's business. That said, an investment manager should at least be cognizant of the types of practices and deficiencies that have given rise to recent and historic "cherry picking" enforcement actions. An investment manager should also be aware of how extensive forensic analyses can be so that, as a manager's business grows or changes, its Compliance program is able to keep pace. For the Wamco and Leech matter, it will be interesting to see how its resolution or conclusion compares to the other 2024 actions discussed in this paper. Of particular interest will be how Leech's role as both a portfolio manager and Co-CIO (with organizational oversight responsibility) factors into the matter's outcome. I suspect it will be touched upon in some fashion at least, at which point perhaps a sequel to this paper may be written.

Thanks for reading . . .

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APPENDIX – 2024 SEC "CHERRY PICKING" ACTIONS

ADVISER & OUTCOME	KEY FACTS/ALLEGATIONS
❖ **Registrant:** First Allied/Cetera ❖ **Result:** $200k fine ❖ **Date:** September 2004	• Two investment adviser representatives both held their personal and client accounts at a broker-dealer and had discretion over such accounts. • The investment adviser representatives purchased stocks in their personal accounts and then, later in the day and after the opportunity to observe price movements, allocated shares among personal and clients' accounts • One representative's personal accounts obtained average first-day returns of approximately 0.50% on equity trades, while the his clients' accounts obtained average first-day returns of approximately −2.10% on equity trades; similarly, the other representative's personal account obtained average first-day returns of approximately 0.50% on equity trades, while his clients' accounts obtained average first-day returns of approximately −0.40% on equity trades. • The difference between the investment adviser representatives' allocations of profitable trades and unprofitable trades was statistically significant; the probability of these results occurring by chance was nearly zero. • The investment managers had policies and procedures in place concerning "aggregation of client trades" that stated that "IARs [investment adviser representatives] are required to make a preliminary allocation before execution," and must transmit a "pre-trade allocation statement" to the trade desk "prior to the trade being entered." In addition, investment adviser representatives "[were] not permitted to modify the allocation for any reason" without "approval from the Compliance department," and "may include their personal accounts in an aggregated order as long as such inclusion [did] not materially diminish the benefits that clients would receive if the [adviser's] accounts were not included." However, these were not followed or enforced. • In their firm brochures filed pursuant to Part 2A of Form ADV between July 2020 and March 2022, the investment managers stated, "Our IARs [investment adviser representatives] are not permitted to disadvantage clients while trading their own accounts." However, the investment adviser representatives' cherry-picking schemes rendered this statement false and misleading. • In addition, the investment managers stated in their brochures, "Our supervised persons are not permitted to recommend or use discretionary trading authority on behalf of clients at or about the same time that the IAR . . . buys or sells the same securities for their own account(s)." In reality, the investment adviser representatives regularly bought and sold the same securities for their own accounts at or about the same time as for their clients' accounts, and the investment advisers had compliance policies and procedures specifically permitting investment adviser representatives to include their own trades in aggregated orders with clients' trades.
❖ **Registrant:** Raymond DiMuro ❖ **Result:** Industry bar; $750k fine ❖ **Date:** September 2024	• An investment adviser representative disproportionately allocated winning trades to some favored accounts (the "Favored Clients") and losing trades to other disfavored accounts (the "Unfavored Clients"). As a result of these trade allocations, the Favored Clients received substantial trading profits and the Unfavored Clients suffered substantial trading losses.

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ADVISER & OUTCOME	KEY FACTS/ALLEGATIONS
	• During the Relevant Period, the investment adviser representative placed over 30,000 trades in a block trading account, which accounted for, in terms of the amount traded, about 99% of all his option trades and 65% of all his equity trades. • Using the block trading account, the investment adviser representative placed large securities trades and then later allocated portions of the block trades among the investment adviser's advisory clients. The investment adviser representative placed the block trades throughout the trading day but did not allocate most of them until the last two hours before market close. This delay allowed the representative to consider whether the traded security had gone up or down in price from the time the block trade was executed to the time he was determining how to allocate the block trade. • As a result of cherry- picking, the Favored Clients received $785,381 in day-of-trade profits from the allocated trades, and the Unfavored Clients suffered $1,007,248 in day-of-trade losses from the allocated trades, Absent cherry-picking, and assuming the Favored and Unfavored Clients would have received the average returns of all clients, the Favored Clients would have instead sustained $221,867 in day-of-trade losses (not $785,381 in day-of-trade profits), and the Unfavored Clients would have suffered only $40,746 (not $1,047,994) in day-of-trade losses. • Based on a statistical analysis of the subject trades, trade allocations, and day-of-trade investment returns, the likelihood that the Favored Clients' and Unfavored Clients' disparate investment returns resulted from random chance, as opposed to the investment adviser representative's conduct, was, at best, less than one in a million.
❖ **Registrant:** Advisor Resource Council ❖ **Result:** $300k fine; independent consultant required ❖ **Date:** March 2024	• An investment adviser representative disproportionately allocated option trades with positive returns between the time of the trade and the time of allocation to his personal account, to an account in name of his mother and three other favored client accounts, while disproportionately allocating option trades with negative first-day returns to other clients (the "Disfavored Accounts"). The representative received ill-gotten gains of approximately $207,902 in excess first-day returns. • The investment adviser representative's scheme was halted when the custodian for the accounts he managed detected suspected cherry-picking by allocating trades to his clients according to performance and terminated his access to the investment adviser's block account. • The investment manager failed to adopt and implement policies and procedures reasonably designed to ensure that its investment adviser representatives used the firm's block account appropriately and that allocations were fair to clients. The investment manager's compliance manual required the firm to "designate on the trade ticket the number of shares of the block trade to be allocated to each specific account prior to placing the order," but the firm did not implement this policy. The compliance manual also stated that all allocations would be reviewed to "verify that no client account was systematically disadvantaged by the allocation." The investment manager did not perform those reviews for clients. • The investment manager failed to adopt and implement an adequate supervisory system and procedures reasonably designed to prevent violations of the Advisers Act. For example, the investment manager required new investment adviser representatives to complete an "Investment Process Review" form describing their portfolio management

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ADVISER & OUTCOME	KEY FACTS/ALLEGATIONS
	processes, but failed to conduct sufficient reviews to ensure that investment adviser representatives were actually following their stated processes. • The investment manager's Form ADV Part 2A brochure stated: "We and our employees avoid any circumstances that might adversely affect, or appear to affect, our duty of loyalty" and that the firm's "allocation procedure seeks to be fair and equitable to all clients with no particular group or client being favored or disfavored over any other." Given the cherry-picking scheme alleged above and the firm's failure to adopt and implement policies and procedures reasonably designed to prevent cherry-picking, each of these statements was false. By allowing winning trades to be allocated to the Favored Accounts and losing trades to the Disfavored Accounts, the investment adviser and investment adviser representative did not allocate trades fairly or equitably, and permitted some clients to be disfavored.

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