UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

December 1, 1995

Act 1CA
Section
Rule 17d-1
Public
Availability 12-1-95

Ms. Christine E. Leone
Pretzel & Stouffer
One South Wacker Drive
Suite 2500
Chicago, IL 60606-4673

Dear Ms. Leone:

We are in receipt of your letter dated May 25, 1995 asking a number of questions regarding the rules and regulations governing an investment adviser's ability to aggregate orders for the purchase or sale of securities on behalf of its clients, and the proper allocation of those trades among the clients. You have also asked a number of questions relating to the procedures to be employed in placing orders, and in executing these trades. This response has been prepared jointly by the Division of Investment Management, which is responsible for the regulation of mutual funds and investment advisers, and by the Division of Market Regulation, which is responsible for the regulation of broker-dealers.

The Division of Investment Management recently issued a no-action letter to SMC Capital, Inc. (pub. avail. Sept. 5, 1995) (the "SMC Letter"), a copy of which is enclosed, in which the staff stated that the mere aggregation of orders for advisory clients, including collective investment vehicles in which the adviser, its principals or employees have an interest, would not violate section 17(d) of the Investment Company Act of 1940 ("Investment Company Act") or section 206 of the Investment Advisers Act of 1940 ("Advisers Act") if the adviser implements procedures designed to prevent any account from being systematically disadvantaged by the aggregation of orders. 1/ While the Division believes that the procedures described in the SMC Letter should be adequate for this purpose, the letter notes that there may be other allocation methods that advisers can use without violating section 17(d) or section 206. 2/

In response to your specific questions:

1. *Are mutual fund managers allowed to trade futures for publicly traded mutual funds, as well as their employer's ERISA plans, such as profit-sharing plans?*

Whether or not a fund manager may trade futures for a mutual fund depends upon the investment policies of the fund, as disclosed in the fund's prospectus and statement of additional information. In addition, section 18 of the Investment Company Act restricts the extent to which an investment company may issue "senior securities," including debt. The Division of Investment Management has taken the position that obligations evidenced by

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1/ We discuss section 17(d), rule 17d-1 thereunder, and section 206 in response to question 2.

2/ See the SMC Letter at n.11.

futures and options contracts may constitute "indebtedness," and thus these transactions may give rise to the issuance of senior securities. The Division has stated, however, that it will not recommend enforcement action to the Commission under section 18 if an investment company appropriately "covers" its options and futures positions by holding or having the right to acquire the assets that the fund is obligated to deliver under the contract or by holding cash or high-grade liquid debt securities in a segregated account on the books of its custodian bank in an amount that, when combined with the amount of initial margin paid, 3/ is at all times sufficient to fulfill its obligations. 4/

We are unable to advise you whether a manager may trade futures for an employee benefit plan subject to the Employee Retirement Income Security Act of 1974, as this question is within the jurisdiction of the Department of Labor, the agency that administers ERISA.

2. *If yes, what laws pertain to segregation of assets, allocation of trades and/or, trading procedures?*

As discussed in response to question 1, the Division of Investment Management takes the position that an investment company must appropriately "cover" its options and futures positions, or place cash or high-grade liquid debt securities in a segregated account in an amount that is at all times sufficient to fulfill its obligations. The Commission has stated that only liquid assets, such as cash, U.S. government securities or other appropriate high-grade debt obligations, should be placed in such segregated accounts. The value of the assets in the account should be marked-to-market daily, and additional assets should be placed in the segregated account whenever the total value of the account falls below the amount required. 5/

Neither the Investment Company Act nor the Advisers Act directly addresses the issue of allocating client orders. Section 17(d) of the Investment Company Act may be implicated, however, by an adviser's allocation of trades among a registered investment company and other clients that may be "affiliated persons" of the registered investment company (or affiliated persons of such persons), including clients in which persons

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3/ To enter into a futures contract or write a commodity option, investors deposit a specified amount of assets or cash as initial margin. Currently, investment companies must maintain their initial margin deposits in special accounts with a third party custodian bank, rather than directly with the futures commission merchant ("FCM"). The Commission has proposed a rule that would permit investment companies to use FCMs and commodity clearing organizations as custodians of their assets and effect their commodity trades in the same manner as other market participants under conditions designed to ensure the safekeeping of investment company assets. *See* Investment Company Act Release No. 20313 (May 24, 1994).

4/ Dreyfus Strategic Investing (pub. avail. Mar. 30, 1987) (copy enclosed).

5/ *See* Investment Company Act Release No. 10666 (Apr. 18, 1979), 17 SEC Docket 319.

associated with the adviser have an interest. 6/ Section 17(d) provides that the Commission may adopt rules restricting participation by a registered investment company in joint transactions with affiliated persons for the purpose of preventing or limiting participation by the company on a basis different from or less advantageous than that of any other participant. Rule 17d-1, in relevant part, provides that no affiliated person of a registered investment company, and no affiliated person of an affiliated person, may participate in any joint enterprise, arrangement, or profit-sharing plan, as defined in the rule, with the investment company without first obtaining an exemptive order from the Commission. As we stated in the SMC Letter, however, we do not believe that the mere aggregation of orders on behalf of a registered investment company and other advisory clients would violate section 17(d), provided that the investment company participates on terms no less advantageous than those of any other client. If a portfolio manager allocates trades in such a way as to disadvantage a registered investment company, however, a joint enterprise or arrangement raising the concerns section 17(d) was designed to address may result. 7/

The anti-fraud provisions of the federal securities laws also would apply to transactions that are allocated in order to benefit certain accounts over others. In particular, section 17(j) of the Investment Company Act and rule 17j-1(a) thereunder, in relevant part, generally prohibit any principal underwriter for a registered investment company or any affiliated person of the company, its investment adviser or its principal underwriter from defrauding the company in connection with the purchase or sale by such person of a security held or to be acquired by the registered investment company. Rule 17j-1 also requires each registered investment company and each investment adviser and principal underwriter of such company to adopt a code of ethics governing personal trading by fund officers and directors and other persons who have access to information regarding fund purchases and sales of portfolio securities. Under a fund's code of ethics, personal securities trades by such persons must be reported no less frequently than quarterly. Many codes of ethics also set forth other restrictions on personal trading, and may prohibit such trading under some circumstances. Of course, to the extent that trades for the account of an affiliated person of a fund are aggregated with trades for the fund itself in reliance on the SMC Letter, such trades still must comply with all reporting and other requirements set forth in applicable codes of ethics.

Section 206 of the Advisers Act imposes a fiduciary duty on an investment adviser to act in the utmost good faith with respect to its clients, and to provide full and fair disclosure of all material facts. 8/ An adviser that aggregates client orders must do so in a manner

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6/ Section 2(a)(3) of the Investment Company Act defines an affiliated person of another person to include, among other things, any person directly or indirectly owning, controlling, or holding with power to vote, five percent or more of the outstanding voting securities of the other person, any person five percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote by the other person, or any investment adviser of an investment company. Under some circumstances, funds that share a common investment adviser may be deemed to be under common control. In re Steadman Security Corp., 1974-75 Fed. Sec. L. Rep. (CCH) ¶80,038 (Dec. 20, 1974).

7/ *See, e.g.,* In re Kemper Financial Services, Inc., Investment Advisers Act Release No. 1387, Fed. Sec. L. Rep. (CCH) ¶ 85,237 (Oct. 20, 1993).

8/ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 184 (1963).

consistent with its duty to seek best execution of the orders, and must ensure that all clients are treated fairly in the aggregation and allocation. Additionally, an adviser must disclose to its clients its policies with respect to the aggregation of orders.

3. *When must an order ticket be completed by the manager's trader, at the time the order is placed or at the time the fill is reported?*

Trade tickets are generally completed and faxed or otherwise delivered to the client's custodian bank no later than the close of business on the trade date. 9/ In the case of an investment company, this generally permits the custodian and the pricing agent to record the trades by the next trading day, which is when the fund's trading activity must be reflected in the calculation of its net asset value.

Neither the Investment Company Act nor the Advisers Act specifies precisely when an order ticket must be completed in relation to a trade. However, recordkeeping rules under each Act require that records be kept on a current basis. The Commission has instituted, and simultaneously settled, an administrative proceeding against the chief investment officer and head of the fixed-income desk of a registered investment adviser for violations of rules 204-2(a)(3) and 204-2(c)(1) and (2) under the Advisers Act for failing to write trade tickets until two to nine business days after the trades were executed. 10/ The failure to write trade tickets and allocate the transactions in a timely manner caused the investment adviser's records to be inaccurate and not current.

4. *When must the manager decide which accounts the trade will be allocated to? Must this be done and recorded prior to the trade being placed? If yes, may the manager change the initially allocated trades? If yes, what parameters, procedures and/or constraints must he use in changing the allocation?*

While neither the Investment Company Act nor the Advisers Act specifically addresses the issue of allocation procedures, the procedures outlined in the SMC Letter stated that the allocation of aggregated trades would be made, and memorialized in writing, prior to placing the order. Under these procedures, the allocation could be changed for good cause after the order had been placed, 11/ and any deviation from the original allocation would be explained in writing, and approved in writing by the adviser's

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9/ *See* Financial Reporting Codification § 404.03.a. (interpreting Accounting Series Release 118).

10/ In the Matter of Michael L. Smirlock, Advisers Act Release No. 1393 (Nov. 29, 1993). Rules 204-2(a)(3) and 204-2(c)(1) and (2) require advisers to make and keep accurate and current records showing, among other things: (1) the securities purchased and sold for each client and the dates of those purchases and sales; (2) for each security held by a client, information from which the adviser can determine the client who owns that security and the current amount owned by that client; and (3) the terms and conditions of each purchase and sale order and the accounts for which they were entered.

11/ For instance, it may be appropriate to deviate from the original allocation when, subsequent to entering the trade but before the final allocation, the adviser determines that the security in question would be unsuitable or inappropriate for one of the clients designated in the original allocation.

compliance officer no later than one hour after the opening of the markets on the trading day following the day the order was executed. As noted above, there may be procedures other than those specified in the SMC Letter that advisers can use without violating section 17(d) or section 206.

5. *If the allocation may be done after the trade versus prior to placing the trade, how must the trades be allocated? What rules assure that trades are allocated properly, and fairly?*

In general, an adviser has an obligation to treat all of its clients fairly and equitably. Please see the SMC Letter and our response to question 4.

6. *Must managers that manage two or more mutual funds or accounts allocate similar trades to assure that each fund receives a certain average cost? If yes, how is that allocation done? Is there a special method or methods that must be utilized? Must the allocation be compared to the intended initial allocation?*

Although we are uncertain what you mean by "similar trades," we note that an adviser does not violate its fiduciary duty to its clients merely by failing to aggregate orders for client accounts. The adviser would, as a general matter, have to disclose to its clients that it will not aggregate and the consequences of the failure to aggregate, such as potentially higher commissions. As to your questions regarding the procedures or methods to be utilized for allocating aggregated client orders, please see our response to question 4 and the SMC Letter.

7. *When must the manager's traders time stamp the trade tickets? Should they be stamped when the order is phoned into the broker-dealer? Should they be stamped when the broker-dealer calls back with a fill?*

Rule 31a-1(b)(5) under the Investment Company Act requires registered investment companies to maintain a record of each brokerage order given by or on behalf of the investment company (whether executed or not). This record must include, among other things, the time of entry or cancellation of the order and the time of receipt of the report of execution. While "time-stamping" is not specifically required, therefore, as a practical matter, most advisers of investment companies time-stamp to fulfill their obligations under rule 31a-1(b)(5). 12/

12/ Rule 204-2(a)(3) under the Advisers Act requires that records of securities transactions reflect the date of entry of an order (but not the time).

8. *What happens if the order is filled throughout the day because it is so large that it can't be filled in one transaction? When is the trade ticket time stamped? When does the broker-dealer call the manager's trader to confirm the fill? Does the broker-dealer call to confirm portions of the fill, or does he wait until the order is completely filled?*

From the investment adviser's viewpoint, the adviser must (in the case of a trade for the account of an investment company) record the time that the order is entered with a broker-dealer and the time that the adviser receives a report that the order has been executed. If a broker-dealer fills a single order by executing a number of trades, the adviser need not record the time that notice of each trade's execution was received, but must simply record the time that notice is received that the entire order has been executed. A broker-dealer's practices with respect to when it will call its customer to confirm that an order has been executed typically will be governed by the internal procedures of the particular broker-dealer.

Section 17a-3 of the Securities Exchange Act of 1934 ("Exchange Act") sets forth requirements for books and records that broker-dealers must make and keep current. Rule 17a-3(a)(6) requires a broker-dealer to make and keep current a memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The rule further specifies that such memorandum show the time of entry of the order or instructions and, to the extent feasible, the time of execution. The rule specifies that the term "time of entry" is deemed to mean the time when the broker-dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received.

In addition, rule 17a-3(a)(8) under the Exchange Act requires a broker-dealer to make and keep current copies of confirmations of all purchases and sales of securities.

The Commission has interpreted the "make and keep current" provisions of rule 17a-3(a)(6) to require broker-dealers to prepare memoranda of brokerage and principal transactions at the time of the transactions. 13/ The Commission has also interpreted the "make and keep current" provisions of rule 17a-3(a)(8) to require broker-dealers to prepare and mail confirmations on the day of the transactions or the following business day. 14/

In addition, rule 10b-10(a)(1) under the Exchange Act requires a broker-dealer, at or before completion of a transaction with or for the account of a customer, to give or send the customer written notification of the date and time of the transaction (or the fact that the time of the transaction will be furnished upon written request to such customer) and the identity, price, and number of shares or units (or principal amount) of a security purchased or sold by such customer.

13/ *See* Statement Regarding the Maintenance of Current Books and Records by Brokers and Dealers, Exchange Act Release No. 10756 (Apr. 26, 1974) (the "SEC Release") (copy attached).

14/ *See* SEC Release.

9. *Does the broker-dealer have to call back and report the fill by a specific time? Example: if the trade is placed at 10:00 A.M., and happens to be filled at 11:00 A.M., how long may the broker-dealer wait to report the fill? May he wait an hour? Two hours? May he call after the market closes?*

When a broker-dealer reports to its customer that an order has been filled will typically be governed by the internal procedures developed by that broker-dealer. As indicated in the response to question 8 above, rule 17a-3(a)(8) under the Exchange Act sets forth specific requirements with respect to making and keeping current copies of confirmations of all purchases and sales of securities. As noted above, the Commission has interpreted the "make and keep current" provisions of rule 17a-3(a)(8) to require broker-dealers to prepare and mail confirmations on the day of the transactions or the following business day.

As additionally indicated in the response to question 8 above, rule 10b-10(a)(1) under the Exchange Act requires a broker-dealer, at or before completion of a transaction with or for the account of a customer, to give or send the customer written notification of the date and time of the transaction (or the fact that the time of the transaction will be furnished upon written request to such customer) and the identity, price, and number of shares or units (or principal amount) of a security purchased or sold by such customer.

10. *If yes, how does the manager (who we will assume for the moment is day trading) sell his position, if he is unaware of when he was filled?*

The manager should inquire of each broker-dealer used to determine its business practice with respect to notification of orders being filled. If necessary, the manager could try to negotiate that notice be given within a certain period of time after an order has been executed. For a general discussion of the books and records requirements of the Exchange Act, please see our responses to questions 8 and 9 above.

11. *Does the broker-dealer time stamp his trade ticket (the broker-dealer's ticket, not the manager's trader's ticket)? If yes, when? Does he stamp it when he receives the order over the phone and/or when he fills the order and/or when he reports the fill to the manager's trader?*

As indicated in the response to question 8 above, rule 17a-3(a)(6) under the Exchange Act requires a broker-dealer to make and keep current a memorandum of each brokerage order, specifying the time of entry of the order and, to the extent feasible, the time of execution. The rule specifies that the term "time of entry" is deemed to mean the time when the broker-dealer transmits the order or instruction for execution or, if it is not so transmitted, the time when it is received.

In addition, rule 17a-3(a)(7) requires a broker-dealer to make and keep current a memorandum of each purchase and sale for the account of such broker-dealer showing, to the extent feasible, the time of execution. Where such purchase or sale is with a customer other than a broker-dealer, rule 17a-3(a)(7) further specifies that a broker-dealer must make and keep current a memorandum of each order received, showing the time of receipt.

The Commission has interpreted the "make and keep current" provisions of rules 17a-3(a)(6) and 17a-3(a)(7) to require broker-dealers to prepare memoranda of brokerage and principal transactions at the time of the transactions. 15/

12. *When does the broker-dealer NEED to know the identity of the account that did the transaction? The broker-dealer needs to place the trade into someone's account at the end of the day. If the manager's trader doesn't tell him whose account until the following day, where does the trade end up?*

Rule 17a-3(a)(7) under the Exchange Act requires a broker-dealer to make and keep current a memorandum of each purchase and sale for the account of such broker-dealer. Where the purchase or sale is with a customer other than the broker-dealer, rule 17a-3(a)(7) further specifies that a broker-dealer must make and keep current a memorandum showing the account in which the order was entered.

As noted above, the Commission has interpreted the "make and keep current" provision of rule 17a-3(a)(7) to require broker-dealers to prepare a memoranda of brokerage and principal transactions at the time of the transactions.

As a practical matter, an investment adviser must instruct the custodians of the accounts participating in the transaction how funds or securities should be allocated. Please see our response to question 3 regarding when trade tickets are generally completed and delivered to an investment company's custodian.

13. *If several trades are placed without identifying the accounts into which the trade will be allocated ahead of time, what prevents the manager from allocating the trades however he feels is appropriate after the trade is filled? Example - a manager buys 500 S&P 500 futures, but doesn't identify the accounts prior to the trade. He manages two different mutual funds. The trade is filled, and he allocated immediately upon receiving the fill - how do we know the allocation was legitimate? If Fund A received 30% of the trades and Fund B 70% of the trades? If the 500 were filled at different prices, which fund gets which prices?*

Please see the SMC Letter and our response to question 4.

14. *If it is a very busy day and these same trades are not allocated until after the close (at which point the manager already knows the gain or loss in each trade), what prevents him from allocating the losing trades to one account and the winning trades to another?*

Please see our responses to questions 2 and 4. In addition, we emphasize that if a portfolio manager allocates trades in such a way as to disadvantage a registered investment company, a joint enterprise or arrangement raising the concerns section 17(d) was designed to address may result. 16/ Similarly, if a portfolio manager allocates trades in such a way as to disadvantage *any* client, the adviser may violate section 206 of the Advisers Act.

15/ *See* SEC Release.

16/ *See* Kemper, *supra*, note 7.

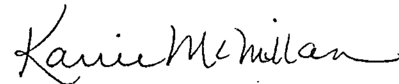
15. *Does the broker-dealer (not the manager or the trader) have to document the TIME he is notified of the allocation of the trades?*

Rules 17a-3 and 17a-4 under the Exchange Act set forth general record keeping obligations for broker-dealers with respect to the documentation of transactions. These rules generally do not mandate specific procedures to be followed by individual representatives of the broker-dealer; it is the responsibility of the entity registered with the Commission as a broker-dealer to maintain compliance with the applicable rules.

This letter sets forth our responses to the general questions you have asked. However, the application of the statutory provisions and Commission rules to specific business practices may vary depending on the particular facts and circumstances. When establishing its procedures, an advisory firm may wish to consult with an attorney who is familiar with the regulation of investment advisers and broker-dealers.

I hope that the above information is helpful. If you have any additional questions, or need further assistance, please feel free to call me at (202) 942-0660.

Sincerely,



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JUN 9 1995
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May 25, 1995

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PLEASE REFER TO OUR FILE NUMBER
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JUN 9 1995
DIVISION OF MARKET REGULATION

To Whom It May Concern:

We are investigating a bond claim for an insurance company. As part of the investigation, we are analyzing an "allocation of trades" scheme. We are in search of specific rules and regulations pertaining to the following types of issues/questions.

1. Are mutual fund managers allowed to trade futures for publicly traded mutual funds, as well as their employer's ERISA plans, such as profit-sharing plans?

2. If yes, what laws pertain to segregation of assets, allocation of trades and/or, trading procedures?

3. When must an order ticket be completed by the manager's trader, at the time the order is placed or at the time the fill is reported?

4. When must the manager decide which accounts the trade will be allocated to? Must this be done and recorded prior to the trade being placed? If yes, may the manager change the initially allocated trades? If yes, what parameters, procedures and/or constraints must he use in changing the allocation?

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allocation be compared to the intended initial allocation?

7. When must the managers traders time stamp the trade tickets? Should they be stamped when the order is phoned into the broker? Should they be stamped when the broker calls back with a fill?

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9. Does the broker have to call back and report the fill by a specific time? Example: if the trade is placed at 10:00 A.M., and happens to be filled at 11:00 A.M., how long may the broker wait to report the fill? May he wait an hour? 2 hours, may he call after the market closes?

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11. Does the broker time stamp his trade ticket (the brokers ticket, not the managers traders ticket)? If yes, when? Does he stamp it when he receives the order over the phone and/or when he fills the order and/or when he reports the fill to the managers trader?

12. When does the broker NEED to know the identity of the account that did the transaction? The broker needs to place the trade into someone's account at the end of the day. If the manager's trader doesn't tell him whose account until the following day, where does the trade end up?

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the accounts prior to the trade. He manages two different mutual funds. The trade is filled, he allocated immediately upon receiving the fill - how do we know the allocation was legitimate? If Fund A received 30% of the trades and Fund B 70% of the trades? If the 500 were filled at different prices, which fund gets which prices?

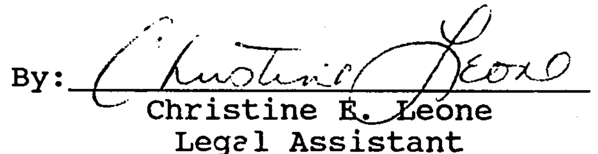
14. If it is a very busy day and these same trades are not allocated until after the close (at which point the manager already knows the gain or loss in each trade), what prevents him from allocating the losing trades to one account and the winning trades to another?

15. Does the broker (not the manager or the trader) have to document the TIME he is notified of the allocation of the trades?

Any information you can provide with regard to this matter would be appreciated. Please contact me if you have any questions. Thank you in advance for your cooperation.

Very truly yours,

PRETZEL & STOUFFER, CHARTERED

By: 

Christine E. Leone
Legal Assistant

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