Trade Allocation: Fair Dealing and Disclosure
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The U.S. Securities and Exchange Commission (SEC) continues to focus its enforcement efforts on trade allocation issues. In the most recent enforcement action involving trade allocation practices, In the Matter of McKenzie Walker Investment Management, Inc. and Richard McKenzie, Jr., the SEC censured and fined a registered investment advisor for failing to disclose its trade allocation practices. However, the SEC order in the McKenzie Walker matter makes clear that the firm’s trade allocation practices themselves came under scrutiny.

The SEC found that McKenzie Walker did not prescribe any objective procedures or formulas for allocating trades among clients or maintain any internal control mechanism to ensure that portfolio managers allocated trades fairly. Instead, the firm allocated trades on an ad hoc basis according to clients’ needs and objectives, the profitability of the trade, the type of client account, and in some instances, the client’s relationship with the firm or its principal. Neither McKenzie Walker’s compliance officer nor anyone else at the firm was required to review trade allocation practices to assess whether all accounts received an equitable allocation of trades consistent with their internal objectives.

According to the SEC, in allocating trades, McKenzie Walker significantly favored the firm’s performance-based fee accounts over its asset-based fee accounts. The firm used profitable equity trades as well as hot initial public offerings (IPOs) to boost the performance of performance-based accounts in general and certain accounts in particular. The performance-based fee accounts received profitable equity trades (trades that resulted in a gain during the time interval between the execution of a trade and its allocation to an account at the end of the day) at approximately twice the rate of the asset-based fee accounts. The asset-based fee accounts received only 2 percent of the approximately $910,000 gross trading profits that McKenzie Walker earned for its clients by trading hot IPOs in the calendar year 1992. The asset-based accounts were also allocated all of the trading losses for poorly performing IPOs, which resulted in net losses for those accounts. In contrast, the performance-based fee accounts received 98 percent of the gross IPO trading profits and no trading losses. Among the performance-based fee accounts, the firm favored certain clients, including a former colleague and a former business partner of Richard McKenzie, Jr., and one of the firm’s lawyers.

The SEC found that McKenzie Walker failed to disclose its practice of favoring its performance-based fee clients in the allocation of equity trades and hot IPOs. The SEC concluded that McKenzie Walker willfully violated Section 206(2) of the Investment Advisers Act of 1940 by “failing to disclose to its clients, current or prospective, that it engaged in a practice of generally favoring its performance-based fee clients in the allocation of equity trades and hot IPOs, and specifically favoring certain of its performance-based fee clients over such clients.” The SEC censured the firm, ordered that the firm disgorge $224,683 plus $35,974 in prejudgment interest, and pay a $100,000 civil fine.
It is interesting to note that McKenzie Walker was not censured for the firm’s trade allocation practices per se but, rather, for failing to disclose its trade allocation practices.

Under CFA Institute’s Standards of Professional Conduct, however, in addition to fully disclosing their procedures, members must also adopt trade allocation procedures that treat clients in an equitable manner.

CFA Institute Professional Conduct Standard III.B., Fair Dealing, states that members must deal fairly and objectively with all clients. To fulfill these duties, members must draft and adhere to allocation procedures that ensure that investment opportunities are allocated to all clients in an appropriate and fair manner. All clients for whom a new issue or secondary offering is suitable should have an opportunity to participate in the offering if they so choose. Members or their firms should adopt an objective formula or procedure for allocating investments to all customers for whom the investments are appropriate.

The CFA Institute Standards of Practice Handbook suggest steps to ensure that adequate trade allocation practices are followed. CFA Institute members and their firms are encouraged to

- obtain advance indications of client interest for new issues,
- allocate new issues by client rather than by portfolio manager,
- adopt a pro rata or similar objective method or formula for allocating trades,
- treat clients fairly in terms of both trade execution order and price,
- execute orders timely and efficiently,
- keep accurate records of trades and client accounts, and
- periodically review all accounts to ensure that all clients are being treated fairly.

Without adequate trade allocation procedures, members and their firms risk breaching the fiduciary duties owed to their investment management clients. CFA Institute Standard of Professional Conduct III.A, Loyalty, Prudence, and Care, states that members have a duty of loyalty to their clients and must place clients’ interests above their own. Members should strive to avoid all real or potential conflicts of interest. Allocating hot IPOs to selected clients in the hopes of receiving additional future business or increased fees creates an obvious conflict of interest and breaches members’ duty to clients. Such practices are detrimental to the interests of those clients not given the opportunity to participate in the offering. The establishment of objective allocation procedures assists members in complying with their fiduciary duties.
Once trade allocation procedures are established, they must be disclosed. As the SEC stated in its order in the *McKenzie Walker* case, a reasonable investor would consider it important to know these allocation procedures. Disclosure must be sufficient to give the client or potential client full knowledge of the procedures and enable the client to make an informed decision regarding the handling of his or her account.

In summary, full and fair disclosure of a firm’s allocation procedures is a minimum step toward meeting the goal of fair dealing. Disclosure of unfair allocation procedures does not, however, relieve CFA Institute members of their duties of fair dealing and fiduciary trust to all clients.