



**Periodic Best Execution (FINRA Rule 2320)
1st Half 2011 Review
Advisors Asset Management, Inc.**

I. Introduction

FINRA Rule 2320 requires firms to employ policies and procedures to use reasonable diligence to ascertain the best inter-dealer markets for buy and sell orders so that the resultant price to the customer is as favorable as possible under prevailing market conditions.¹ AAM maintains such policies and procedures², listed herein, designed to be in compliance with the requirements of Rule 2320. This report is designed to fulfill the requirements of Rule 2320 as well as the “Regular & Rigorous” review requirements.³

AAM regards the concept of Best Execution as an ongoing process in which AAM bond transactions are reviewed semiannually. The results of the comparisons are summarily presented in a chart that depicts the efficiency of each AAM transaction compared to those in the general markets.

II. What are the AAM requirements?

- a. Orders to Buy Bonds** - AAM requires its trading staff to adhere to the AAM Best Execution Policy when executing both orders to buy bonds as well as orders to sell bonds for the firm’s customers. On orders to buy bonds on behalf of a customer, the trader must check at least one national inter-dealer bond listing service. This allows the trader to check the order and order size against listings of bonds for sale from numerous dealers. These listing services are made available by AAM to its traders and may include Bloomberg systems and inter-dealer markets, Valubond Internet Platform, Broker’s Broker Interdealer Internet Platforms, Private Dealer Internet Platforms, quotations from offering dealers or the services of a licensed Broker’s Broker. Executions with any offering dealer may include negotiations as to price and size in order to gain a better price improvement.

This process does not insure the best possible price execution; rather that AAM has used reasonable diligence to obtain the best possible pricing given the nature of the order, the inter-dealer availability of the offering, and the condition of the markets at the time of execution among other things. It is important to understand that the bond market is generally an over-the-counter market where dealers independently make markets in individual bonds. There are some services that attempt to aggregate bond offerings from different dealers; however these services are limited in practical use to the accuracy of the data displayed. Many dealers do not make inter-dealer markets yet provide markets for their own customers. These markets are not visible

¹ FINRA Rule 2320

² AAM Best Execution Policy – Appendix A

³ FINRA Notice to Members 01-22

to the general markets and pricing may be better or worse than the quoted inter-dealer markets. Factors that can determine the quality of execution are discussed below.

- i. **Bond Markets Can Be Illiquid** - Bonds in general are much less liquid than equities thus contributing to wider spreads between the bid and ask as well as very limited availability. Generally, liquidity is the greatest for highly rated issues with common features. Thus, the most liquid bonds would be U.S. Treasuries that generally trade in one million dollar denominations. There are numerous primary and secondary dealers who disseminate markets for these securities. As both quality and availability deteriorate so does the efficient markets that will trade them.
- ii. **Limited Supply** – If the bond is in very limited supply the markets for that bond will be less efficient. This is especially true with “odd-lots” or bond pieces that trade in less than round lot quantities. If only one dealer owns a specific issue and no others are available then the offering dealer is the only market available. Examples would include Municipal bonds, CMO’s, and many corporate bonds. In these cases a trader will interpolate the offering against other similar offerings to determine the fairness of the offering. However, for best execution purposes, there is no other market to compare prior to execution.
- iii. **Size of Order** – The size or quantity of an order will dictate heavily the best price execution. Most bond market makers have increased costs and risk associated with execution of less than round lot quantities. A round-lot generally is considered \$1MM in size. Thus, offering prices will generally be higher for odd-lot pieces.
- iv. **Market Conditions** – In times of interest rate volatility or credit quality issues, the number of available market makers generally can decline dramatically. Additionally, spreads between bid and ask will generally widen. This can have an adverse impact on the selection of market makers available to offer bonds.
- v. **Complexity of Bond Terms** – The less complex a bond issue is, in terms of its coupon, payment structure, creditworthiness, seniority in structure, callability etc., generally the more competitive market that will be available. This is highly prevalent in the municipal market, mortgage market and agency market. It exists, but generally to a lesser degree in the corporate markets. The more complex a bond issue is, the fewer market makers that will be available and the less efficiency that will be available to traders in filling bond orders.

In reviewing the Best Execution effectiveness of AAM, each of these factors can have a substantial impact on the actual execution of orders to buy bonds.

- b. Orders to Sell Bonds** – When AAM receives an order to sell bonds, the trader must conduct a search to determine the best bidders. Then the trader shall publish a bid wanted list and shall endeavor to obtain at least three bids (where available). One of the three bidders can be AAM. The trader will reflect the best bid to the customer for execution.

Once again, this process does not insure the best possible price execution but rather that AAM exercised reasonable diligence to identify the best market bid for the bonds to be sold. Many of the same issues are prevalent here as with orders to buy bonds. Additionally, most dealers only display offerings on bonds but do not advertise quotations on bids they are willing to pay for bonds. This fact makes the trader's knowledge of firms that will bid specific bonds very important. Additionally, AAM may search for firms that are offering like bonds and approach them to bid a position. Finally, the firm may use a Broker's Broker to gather bids from their own sources. In cases where AAM purchases the bond for its own account, it will be at the highest bid obtained in this process.

III. Trade Data Used In Testing Best Execution

The Best Execution policy of AAM requires that data be gathered semi-annually concerning actual trades executed by AAM. That data will be displayed against other trades in the same or similar bonds performed that day. The only two sources of independent trade data that currently exist are MSRB and TRACE daily trade reports. MSRB displays certain data for municipal transactions for the prior day and TRACE similarly displays trade data for corporate bond trades for the previous day. This data is for all firm transactions including dealer and customer buys and sells. As the firm policy requires, the data will be quantified and displayed on a range graph showing the AAM execution price in relationship to matching transactions appearing in MSRB and TRACE reports.

This examination of the first half of 2011 displays data of 14,147 bond trades that matched by CUSIP securities reported in the MSRB and/or TRACE for the same day.

IV. Efficiency Determination of Trades

Efficiency of trading is determined by comparing the execution price of a bond transaction by AAM to those that occurred the same day. The data will be examined to determine the maximum spread between the lowest trade of the day and the highest trade. The effectiveness of the trader and the firm in maximizing price advantage would be to keep the spread between the AAM execution and the actual trades the lowest possible. Thus, a 100% efficient trade would be an AAM trade that occurred at the best price of the day. Likewise, a 0% efficient trade would be a trade that occurred at the worst price of the day. The following graph depicts the efficiency of the trades examined at AAM for the current period.



The data in this report is based on		14,147 trades	
AAM Trade Efficiency Rating			
	Less than 33.33%	33.33 to 66.67%	Greater than 66.67%
# of trades	2,235	6,336	5,576
Percentage	15.8%	44.8%	39.4%

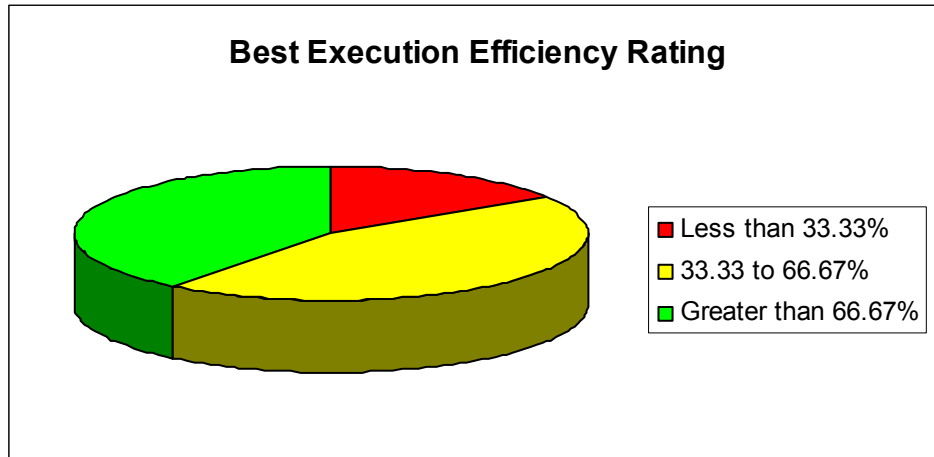
V. Analysis of the Data Collected in the First Half of 2011

Of the 14,147 trades matched on the same trade date, the results are: 5,576, or 39.4%, scored in the top 1/3rd and are considered the highest efficiency executions. Average efficiency trades (those scoring between 33.3% and 66.7%) numbered 6,336 or 44.8%. Trades scoring in the least efficient (<33.3%) numbered 2,235 or 15.8%. Overall, the data examined herein shows that AAM scored average or excellent execution in both buys and sells to dealers, customers and RIAs in 11,912 trades or 84.2% of the total. Thus, the firm overall receives a rating of 84.2% in execution efficiency.

It is important to note that the only executions that received a score are those sampled. Furthermore, there are many fixed income products that have no independent trade reporting mechanism by which AAM executions can be compared. These products would include, but not be limited to, corporate bonds not published by TRACE, municipal bonds not published by MSRB, certificates of deposit, mortgage and asset backed bonds, treasury bonds and agency bonds. However given the limitations discussed herein this is the best data available

at this time. As additional reporting becomes available it will allow AAM to expand its examination of its efficiency of execution.

Efficiency grouping of AAM
1st half of 2011



84.2% average or superior trade execution

Conclusion

This analysis was created to examine the compliance of AAM trading staff to its Best Execution Requirement pursuant to FINRA Rule 2320. AAM compared 14,147 matching transactions from January 2011 through June 2011. The trades included both AAM buys and sells of municipal and corporate bonds to all firm clients including customers, dealers and RIAs. The AAM execution prices were matched and compared to market trades on the same trade date represented in the MSRB and TRACE daily trade blotters. In the first half of 2011, the firm performed 11,912 (84.2%) executions in the average or excellent execution brackets with 2,235 trades (15.8%) of the executions in the lowest 1/3 efficiency bracket.

Overall for the first half of 2011, AAM was able to deliver 84.2% of the trades it executed for its Broker/Dealer clients within the top to middle 2/3 of execution efficiency. AAM regards an 84.2% level of efficiency within the TRACE and MSRB matched transactions as acceptable performance in assisting our clients to obtain Best Execution. This 2011 report, along with its supporting data will be used to further examine the trading efficiency of AAM.

Attachment A – AAM Best Execution Policy

BEST EXECUTION REQUIREMENT (FINRA Rule 2320)

Requirements

AAM has an affirmative duty to provide its customers with the best execution reasonably available for fixed income transactions. This means that AAM has a duty to seek to obtain for its customers the most favorable market terms for customer orders. In addition, AAM is required to periodically assess the quality of competing markets to ensure that orders are directed to markets providing the most beneficial terms for its customers. FINRA Conduct Rule 2110 does not specifically address best execution, however it is often applied in the context of best execution, as the Conduct Rule imposes the FINRA's requirement that member firms conduct themselves consistent with a "high standard of commercial honor and just and equitable principals of trade." It can be asserted that a firm has failed in this responsibility in cases where a fair and competitive price has not been achieved in securities transactions.

Best execution might also be defined as AAM's obligation to conduct a regular and rigorous assessment of execution quality to ensure that each customer's order is executed in a timely manner and at the best available price. Although the FINRA does not offer specific guidelines, and does not restrict compliance with best execution to achieving the best price, price is in fact, very often the first and foremost basis for review. As a general rule, the execution price is required to be the National Best Bid or Offer ("NBBO"), although with respect to, among other things, larger sized orders and fast moving markets, best execution possibly may take into account what is the best price available in view of the quantity of the order and market conditions with respect to the security, including the depth and liquidity of the market.

Also taken into consideration are other values and services the firm may receive related to the direction of trades, such as custody, clearance and settlement, availability of hard-to-borrow securities, and other numerous considerations. Through their examination programs and other guidance, the FINRA and SEC have set guidelines and rules to more clearly define the term "best execution."

Registered Representatives should also be aware of MSRB Notice 2004-03 (January 26, 2004) titled, "Review of Dealer Pricing Responsibilities." That notice reminds dealers of two obligations they owe to customers. The first is to obtain the best prevailing bid or offer and the second is to determine the fairness of that bid or offer.

Fair and Reasonable Pricing for Bond Purchases

The AAM policy recognizes that most bonds trade over-the-counter and no central quotation system exists to determine the best bid or ask at any given time. Bond markets trade based upon an individual market maker's bids and offers. Market makers must be contacted individually to determine if a market exists on an individual bond and what, if any, current bid/ask quote is available. In many cases there may be only one bid or offer on illiquid or rare bond issues and thus AAM may, as a practical matter, have no choice in certain markets at what price to execute. Additionally, if bonds are bid by AAM for its own inventory account, or offered from its own inventory account, AAM will provide bid/offers reflective of the value of the security to AAM.

AAM requires its trading staff to adhere to its pricing guidelines when executing both orders to buy or to sell bonds for the firm's customers. On orders to buy bonds on behalf of a customer, under the Bond + Services Agreement, the trader must use at least one national inter-dealer bond listing service to check the order and order size against listings of bonds for sale from numerous dealers. The following listing services are available for use by AAM bond traders: Bloomberg systems and inter-dealer markets, the Bond Express System, Knight BondPoint Internet Platform, Broker's Broker Interdealer Internet Platforms, Private Dealer Internet Platforms, quotations from offering dealers or the services of a licensed Broker's Broker. Executions with any offering dealer may include negotiations as to price and size in order to gain a better price improvement. This process ensures that AAM has used reasonable diligence to obtain the best possible pricing given the nature of the order, the inter-dealer availability of the offering, and the condition of the markets at the time of execution.

The trader shall execute the transaction at the best prevailing price, which is likely to be dependent on the order size. Alternatively the trader may offer bonds to its broker/dealer clients from the AAM inventory provided that the price is consistent with the prevailing market price of a comparable bond. It is the responsibility of each trader's assigned supervisor to identify transactions that may fall outside these parameters. Supporting documentation shall be maintained in a central file with Michael Dudley, Chief Compliance Officer.

Sale of Bonds

When AAM receives an order to liquidate a customer's bond position, the trader must conduct a search to determine the best bidders. Then the trader shall publish a bid-wanted list and shall endeavor to obtain at least three bids (where available). The trader will provide a bid to the customer based on the best prevailing market price for the security.

Once again, this process does not ensure the best possible execution but that AAM exercises reasonable diligence to identify the best market bid for bonds to be sold. Many of the same issues are prevalent here as with orders to buy bonds. Additionally, most dealers only display offerings on bonds but do not advertise quotations on prices that they are willing to pay for bonds. This fact makes the trader's knowledge of firms that will bid specific bonds very important. Additionally, AAM may search for firms that are offering like bonds and approach them to bid a position. Finally, the firm may use a Broker's Broker to gather bids from the Broker's Broker's own sources. In cases where AAM purchases a bond for its own account, it will be at the highest bid obtained through this process.

Traders will use one or a combination of the above bond services to obtain three bond price quotes for each trade. Traders will utilize, but are not limited to, the bond services listed above. Use of these services is intended to identify entities/traders that have positions in a security. Price quotes and the source of a quote will be noted on each bond trade ticket. In the event of inability to obtain at least three quotes, the trader will note the reason on the trade ticket. Registered Representatives should also be aware of MSRB Notice 2004-03 (January 26, 2004) titled, "Review of Dealer Pricing Responsibilities." That notice reminds dealers of two obligations they owe to customers. The first is to obtain the best prevailing bid or offer and the second is to determine the fairness of that bid or offer. It is the responsibility of each trader's assigned supervisor to identify transactions that may fall outside these parameters.