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Best execution and the investment adviser: policies and procedures to meet the obligation

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Registered investment advisers face a high level of regulatory scrutiny, particularly in the area of advisers' trading practices. Federally registered advisers' policies and procedures must address trading practices, including those procedures by which the adviser satisfies its best-execution obligation, uses client brokerage to obtain research and other services (the so-called 'soft-dollar arrangements'), and allocates aggregated trades among clients." Advisers subject to state regulation should also adopt similar policies and procedures.

Many advisers mistakenly believe that if they have not been delegated absolute discretion by their clients to select a broker-dealer (i.e., the adviser has selected "no" in response to Item 8.C.3 on its Form ADV Part 1A), the duty does not apply. If the adviser, however, has any input or influence into the selection of the broker-dealer, the adviser must fulfill the duty to seek best execution.

What is best execution and why does it matter?

It is understood that investment advisors owe a fiduciary duty to their clients. As fiduciaries, advisers must act in the best interest of their clients in all matters connected with the advisor-client relationship, and not for their own personal interest. This stringent duty has been interpreted by regulators to place specific obligations on advisors, including the requirement that they seek "best execution" of their clients' securities transactions.

The Securities and Exchange Commission (SEC) has stated that advisers must "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances."

Advisers might assume the duty of best execution requires them to obtain the lowest commission costs for their clients. While trading at advantageous commission costs are important, it is not the only consideration for best execution. The duty requires advisers to undertake a qualitative review to determine whether the transaction represents the best execution for the particular client at the particular time and under the particular circumstances.

Factors that advisers should consider in analyzing best execution include not only the price of the security and commission amount, but also:

- Execution speed;

- Confidentiality;
- Market depth;
- Capital commitment;
- Recent order flow; and
- Knowledge of the other side of the trade.

Demonstrating best execution

To satisfy their fiduciary obligations, advisers must have systems in place to ensure that the costs of executing securities transactions, as well as the indirect benefits the adviser receives as a result of choosing a particular broker-dealer, are fair to the client.

The first step in achieving best execution is to establish an effective process for evaluating the quality of execution that the adviser receives for its clients. Indeed, the SEC has stated that investment advisers periodically and systematically must evaluate the execution performance of the broker-dealers executing their transactions.

Importantly, best execution cannot be determined on a trade-by-trade basis. Rather, advisory firms must establish policies and procedures that focus on seeking best execution in the aggregate for their clients. There is a range of best practices and specific procedures firms that can put into action to satisfy their fiduciary obligations, and each firm must develop policies and implement procedures that make sense for their business.

Which policies are implemented will be determined by the firm’s size and its actual business practices. Set forth below are the basic principles advisers should consider when crafting (or revising) their best exaction policies and procedures.

Consider establishing a committee: Although not necessary or suitable for every advisory firm, if the size of the firm warrants it, consider creating a best-execution committee that meets on a regular basis to evaluate the firm’s overall trade management policies and procedures, as well as relevant industry and technological changes that impact trade execution.

Develop firm-wide policies: The first job of the committee and the firm’s chief compliance officer (CCO), is the development of an overall policy. The policy should address all of the factors that can drive and impact execution costs based on the exact nature of the adviser’s business model.

Implement procedures and surveillance tools to test best execution: Once the best-execution policy is established, the next step is creating surveillance tools and implementing procedures to monitor and test for best execution. These steps may consist of a review of executed transactions and the preparation of a report evidencing the information and data analyzed. Results from this report should be reviewed by the best-execution committee and the CCO, who then provides and institutes recommendations for change if appropriate.

Other useful procedures include comparing projected brokerage commissions at the outset of the brokerage relationship to actual commissions charged over time. Any significant variance between the projected and actual can then be evaluated to determine whether there are opportunities for the firm to gain additional trading value for its clients and whether there have been exceptions to the firm's policies.

In addition to reviewing the actual transactions, advisers should undertake an analysis of other available brokerage alternatives on a periodic basis. For instance, this could include reviewing broker-dealers "Rule 606" reports periodically -- a requisite filing for broker-dealers that provides various uniform statistical measures of the firm's execution quality.

Document the review: Documenting the review and recommendations is essential. The reviewer should draft a report describing how the review was undertaken, the findings of the review, any necessary changes that and the steps that were or will be taken to make any necessary changes. The document that is prepared should be dated, signed by the CCO (or a designee of the committee), and filed, along with any backup documentation, as part of the adviser's books and records. Further, the review and the format of the reporting should be consistently applied and the information should be presented in a way that facilitates forensic testing over time.

Ensure policies are adhered to by all affected employees: As with all compliance policies, they are of little benefit if employees are not trained or made aware of the expectations of the firm. To help ensure that the firm's trading policies and procedures are communicated throughout the organization, the CCO and other key personnel should conduct (and keep records of) best execution training on a periodic basis.

The best advice for all advisory firms is to always keep the interests of the firm's clients in mind.

Each area of the firm's operations, particularly areas like trading that are at the heart of the adviser-client relationship, must be closely monitored. This is accomplished by developing appropriate policies and implementing systematic procedures to ensure they are adhered to at all times.

Even when the determination of the broker-dealer rest with the client, advisers must ensure they are meeting their best-execution obligations. And even where the choice of broker-dealer is made strictly and exclusively by the client (also known as directed brokerage), as a fiduciary, the adviser should periodically inform the client if, based on analysis, the directed brokerage relationship is resulting in execution on less favorable terms than what the adviser could potentially obtain in a non-directed brokerage relationship. This should be documented in the firm's files, typically through a CRM system or other client database in accordance with the organization's books and records protocol.

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