

Best Execution Considerations for Advisers

By Tina Mitchell

Every registered investment adviser has a fiduciary duty to seek best execution when placing transactions for clients. In addition to seeking best execution, the Securities and Exchange Commission (“SEC”) has issued a variety of guidance stating that advisory firms must also perform and document reviews of their brokerage and trading practices to help ensure that clients are receiving the best overall deal for each transaction in light of applicable circumstances.¹ Even though states have not been as forthcoming in their guidance, they generally take the same position.

In this Risk Management Update, we discuss consideration factors for seeking best execution, testing protocols for different types of securities, and steps for performing and documenting required reviews.

Seeking Best Execution

There are many important factors to consider when seeking best execution that go beyond execution price and transaction costs. To begin, a firm should perform and document an analysis, both initially and at least annually, of the range of services that will be provided by each broker-dealer being selected for client trading. Some of these include, for example:

- Execution capabilities and opportunity for price improvement;
- The promptness of execution;
- Handling large trades;
- Ability to maintain confidentiality of trading intentions;
- Availability of technology to process trades;
- Reliable and accurate settlement capabilities;
- Research capabilities;
- Access to company management and IPOs;
- Competitiveness in the marketplace;
- Financial responsibility and responsiveness to the adviser; and
- Additional services provided to clients (e.g., custodial services).

It’s also extremely vital that advisers identify and address conflicts of interest surrounding their brokerage selection and trading practices. Associated conflicts can arise under several scenarios, such as: (i) using an affiliated broker for trading; (ii) having soft dollar arrangements; (iii) trading in investment products that provide compensation to the firm, affiliates, and/or its supervised persons; (iv) entering into revenue sharing arrangements with the broker; (v) receiving services from the broker that do not benefit clients; and (vi) obtaining client referrals under directed brokerage arrangements.²

While clear and transparent disclosure regarding a firm’s brokerage selection and applicable conflicts is required, certain conflicts may need to be eliminated for the firm to ensure adherence to its fiduciary responsibility. This would be the case in a situation where trading with an unaffiliated broker could provide a client with lower overall costs and/or more benefits. This also is relevant when purchasing certain investments for clients that result in benefits and/or compensation to the firm, its employees or any affiliates. For example, the SEC has outlined through written guidance and recent enforcement actions that advisers investing in mutual funds for their clients need to consider, as part of their duty to seek best execution, the fees charged to clients under the mutual funds’ available share class arrangements and select the class that is most beneficial and economical to clients.³ Disclosing the fact that the firm’s selection process includes mutual funds that pay 12b-1 fees to certain employees may not be enough, especially if there is an available share class of the same mutual fund that would result in lower costs to clients.

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1. See SEC Risk Alert “Compliance Issues Related to Best Execution by Investment Advisers” issued July 11, 2018 at <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf>; “General Information on the Regulation of Investment Advisers” at <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm>; and “Compliance Programs for Investment Companies and Investment Advisers” at <https://www.sec.gov/rules/final/ia-2204.htm>

2. This list is not inclusive of all conflicts, it is only showing some of the more common ones.

3. See “OCIE’s 2016 Share Class Initiative” Risk Alert issued July 13, 2016 at <https://www.sec.gov/ocie/announcement/ocie-risk-alert-2016-share-class-initiative.pdf>; and SEC’s Press Release “Two Advisory Firms, CEO Charged With Mutual Fund Share Class Disclosure Violations” dated December 21, 2018 at <https://www.sec.gov/news/press-release/2018-303>

Another relevant factor is how brokerage selection and trading are structured at a firm. Common practice for medium to large size firms is having a list of approved brokers, which usually is created by the portfolio management team, along with dedicated trading personnel that have the authority to place trades with any approved broker they believe will provide the best trade execution. Larger advisers tend to have a formal governance structure around brokerage and usually will have a trading oversight committee who approves the broker selection and other matters, such as best execution. Smaller advisers usually work with one or two brokerage firms, which have “institutional” platforms that provide both custody and trade execution (“Custodian Brokers”). Generally, under this type of arrangement the custody services are provided at no cost so long client transactions are placed with the broker for execution. In addition, the transaction costs are lower than the amount charged to retail clients.

The framework for both types of structures is set up to assist with the goal of obtaining best execution for clients; however, additional considerations are necessary for each. For example, having trading personnel supervised by the Chief Operations Officer or similar segregates trading authority away from portfolio management, which is important since they usually select brokers based on, among other things, the research and investment ideas provided.

Under the Custodian Broker platform, the adviser should perform a detailed comparison (both initially and ongoing) of the costs and services provided by the selected Custodian Broker to others that provide similar services. The adviser also will need to disclose in detail the benefits they receive under this type of arrangement.

Testing the Quality of Executions

The testing process needs to be customized based on the types of securities traded, along with trading frequency. The good news is that firms have choices on testing methods. Using technology and/or a service provider is an efficient way to test, and the extent of their testing is usually extensive and meaningful; however associated costs related to trade cost analysis providers can be rather high. The least expensive method is to perform the testing internally, which can be accomplished by comparing executed prices against an appropriate benchmark. For example, a good benchmark for equity trades could be the volume weighted average price (“VWAP”) for the time between the placement of the trade and the execution. If the firm does not have access to VWAP, they can compare with the open, close, high, low prices for the equity security for the trade date. For municipal bonds, firms can compare their execution price against trade data outlined on the Municipal Securities Rulemaking Board (“MSRB”) website.⁴ For corporate bonds, trade data can be obtained through TRACE⁵ (requires licensing fee payments). This type of forensic testing helps firms determine how brokers are performing over time.

Notably, advisers are not required to test the execution of every client trade, but it’s important to include a representative amount that is based on the volume of trade activity in order for the data to be useful.

Reviewing and Documenting Best Execution

While testing trade execution is an essential part of determining whether the firm is achieving best execution for its clients, it is only one component of the review process. Firms also need to analyze pre-trade, trading, and post-trade protocols to help evaluate whether the firm is fulfilling its fiduciary duty and meeting regulatory requirements. This should include:

1. Reviewing broker analysis documentation to confirm they are being vetted properly;
2. Examining trading policies and procedures to determine adequacy;
3. Obtaining input from portfolio managers and traders on the appropriateness of the firm’s current process;
4. Assessing trade execution testing reports to identify any outliers;
5. Analyzing soft dollar arrangements to consider whether mixed use and ensure the costs are reasonable considering research and services being provided;
6. Looking at client disclosures regarding the firm’s brokerage and trading practices to verify adequacy;
7. Comparing trade execution quality and routing reports from brokers used with others to assess performance vs. peers; and
8. Reviews of the commission charges to ensure that brokers are not overcharging clients.
9. Reviewing mutual fund transactions to confirm that share class selection appears to be in line with firm procedures and disclosures, and in clients’ best interests.

4. See <https://emma.msrb.org/TradeData/MostActivelyTraded>

5. See <http://www.finra.org/industry/trace-data-licensing>

The frequency of the reviews will mainly depend on the extensiveness and complexity of a firm's trading and the types of securities traded. The responsible party(ies) performing reviews is usually driven by the same factors, along with the size of the firm. Senior management can appoint a committee or delegate the responsibility to a department or even a single employee. Suffice it to say that a large advisory firm that trades tens of thousands of shares or more a day should have a committee that meets at least quarterly. Additionally, compliance staff should independently review and test the process at least annually and attend the committee meetings.

Documentation is key and is necessary to substantiate a firm's review and best execution determination. Committees should have minutes of each meeting that outline what they reviewed, their findings and any recommendations made to senior management. Employees tasked with reviews should maintain memoranda that contain the same information noted above. Also, all supporting documents substantiating the findings should be retained.

Conclusion

Best execution is just one of the SEC's current focus areas for which they continue to find deficiencies. Others include, safeguarding client non-public information, assessing and billing advisory fees, dealing with senior investors, electronic communication policies, marketing and advertising, cybersecurity, and solicitor arrangements, just to name a few.

As fiduciaries, investment advisers are tasked with ensuring that they always act in the best interest of clients. This can be accomplished by having a strong compliance program in place, which includes detailed policies and procedures that reflect the firm's business practices and address applicable regulatory requirements, along with having robust testing and review processes.

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