



## THE IMPORTANCE OF BEST EXECUTION

### What Best Execution Means

**Introduction.** Every registered investment adviser has a duty to provide “best execution” on all securities transactions for their clients. This duty is not specifically set forth in any particular statute, but rather, arises from the adviser’s fiduciary obligation to exercise reasonable care to obtain the most favorable terms for its clients. The Securities and Exchange Commission (“SEC” or the “Commission”) has defined this duty as the requirement that an adviser “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.”<sup>1</sup>

**Qualitative versus Quantitative Considerations.** Considering what constitutes best execution, the SEC has indicated that, while a significant factor, the lowest commission costs do not necessarily constitute best execution. Rather, the duty of best execution requires a *qualitative* inquiry as to whether the transaction represents the best execution for a particular client at a particular time and under the particular circumstances. In fulfilling its duty of best execution, an adviser should consider the full range of a broker’s services, including:

1. The value of research provided;
2. Execution capability;
3. Commission rate;
4. Financial responsibility; and
5. Responsiveness

**No “Bright Line” Test.** The precise nature of the duty of best execution is characterized in varying ways. For example, best execution evaluates client transactions to see if they are receiving the “best net price considering all relevant circumstances,” which in turn “maximize[s] the value of investment decisions.”<sup>2</sup> An adviser’s best execution duty also is met when trades are effected at the “national best bid or offer.”<sup>3</sup>

### How to Monitor and Test for Best Execution

**Monitoring Best Execution.** An adviser may fulfill its best execution obligations for equities, fixed income securities and derivatives not just by seeking the best price or the lowest commission rate, but rather by formulating and implementing a monitoring *process* through which the adviser may evaluate those factors affecting the quality of execution of client trades.

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<sup>1</sup> *In re Oakwood Counselors, Inc., et al.*, Investment Advisers Act Release No. 1614 (Feb. 10, 1997); see also the SEC’s 1986 Soft Dollar Interpretive Release, SEC Rel. No. 34-23170 (Apr. 23, 1986).

<sup>2</sup> See Gene Gohlke, Associate Director of the Office of Compliance Inspections and Examinations, ICI Securities Developments Conference (Dec. 7, 2001).

<sup>3</sup> See *In re Marc N. Geman*, Admin. Proc. File No. 3-9032 (Aug. 5, 1997).

Monitoring should be done on a periodic, systematic basis. This includes:

1. Appointing a best execution review committee;
2. Adopting written policies and procedures, including documentation requirements for best execution monitoring;
3. Collecting information and reviewing broker-dealers and venues used to satisfy testing obligations; and
4. Assessing client disclosures related to the organization's best execution practices and any related conflicts.

Each of these areas is further described below.

1. Establish a Best Execution Review Committee: To establish a Best Execution Review Committee, first consider who the members should include (*e.g.*, traders, portfolio managers, research analysts, and compliance personnel). Then establish the objective of the Committee (*e.g.*, to establish and review the adviser's broker-dealer relationships and trading practices). In small firms, this might just be a two-person committee. In very small firms with one-man shops, a single professional, such as the CCO, would carry this responsibility.
2. Adopt Written Policies and Procedures: Advisers can adopt a number of different policies and procedures in order to adequately review best execution. During examinations of investment advisers, SEC staff generally focuses a great deal of attention upon the processes and mechanisms used to test best execution. This may include reviewing whether the adviser:
  - Has a set of written criteria to ensure consistency and evidence the systematic nature of the adviser's best execution review;
  - Uses pre-approved brokers;
  - Has a Best Execution Review Committee, which performs systematic reviews of brokers;
  - Uses third-parties or technology services to test for best execution;<sup>4</sup> and
  - Has written meeting minutes or other documentation reflecting the topics discussed at the Best Execution Review Committee meetings.
3. Collect and Review Information: Advisers should collect and evaluate qualitative and quantitative data to measure the firm's best execution results. Based on the adviser's policies and criteria used in selecting broker-dealers, this may be accomplished through:
  - Periodic and systematic evaluations of the executions of client transactions;
  - Assessing terms of contracts with service providers involved in the adviser's execution process;
  - Evaluating the quality of execution "against the quality likely to be received from alternative venues...including periodically assess[ing] the quality of competing

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<sup>4</sup> See Andrew J. Donohue, Keynote Address Before the SIA Institutional Brokerage Conference, at <http://www.sec.gov/news/speech/2006/spch103006ajd.htm>.

markets to ensure that its order flow is directed to markets providing the most advantageous terms for the customer's order;"<sup>5</sup> and

- Considering whether the current list of recommended broker-dealers is the best available or are there alternatives that would give clients a better overall qualitative execution.

4. **Client Disclosures:** In reviewing its trading practices to evaluate best execution, the adviser should check to ensure that its practices are disclosed to clients. An adviser's brokerage and execution policies are required to be disclosed on its Form ADV and within provisions of the adviser's investment management agreements. Failure to disclose brokerage practice conflicts to clients may constitute a violation of the anti-fraud provisions of the federal securities laws and Sections 206(1) and (2) of the Advisers Act.<sup>6</sup>

In assessing such disclosures, consider the adviser's trading practices and related conflicts. For example, if the adviser permits clients to direct trades to a particular broker, the SEC explained in *re Mark Bailey* that the adviser would have an obligation to make full disclosure of its duties and responsibilities, which includes disclosing that the client will forgo any benefit from savings on execution costs that the adviser could obtain for its other clients, such as negotiating volume discounts on batched orders.<sup>7</sup>

**Testing Best Execution.** Advisers testing of best execution will vary based upon that firm's unique trading practices. An adviser that trades only open end mutual funds will not likely need a testing system as rigorous as a firm that transacts in equities, fixed income and derivatives.

Smaller firms that only use one or two custodians (typically at discount brokerage firms) may have an arrangement whereby those custodians do not charge custodial fees so long as the advisory firm places client trades with the brokerage arm of the custodian. If that is the case, the firm should request information from the custodian on its execution rates (which commonly are delivered as Rule 605 and 606 reports) and then document why the adviser believes that best qualitative execution is obtained by using just that one or two custodians and the benefits clients receive as a result of using that custodian broker-dealer. Additional guidance from the SEC on checking order execution and routing practices of trading centers may be found at <http://www.sec.gov/investor/pubs/exquality.htm>.

For equity transactions, a comparison can be made of a representative amount of trades to the security's volume weighted average price ("VWAP"). This can help determine over a period of time how brokers are performing and whether execution prices are worse than the VWAP, and if so, why.

For fixed income trades, a comparison can be made by periodically obtaining various quotes from different traders and maintaining them either on a log or on the trade memorandum. Over time, this may help the adviser to evaluate the execution capabilities of various brokers.

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<sup>5</sup> *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 271 (3rd Cir. 1998).

<sup>6</sup> See, e.g., *In the Matter of Lawrence J. Lasser*, Admin. Proc. File No. 3-12527 (Jan. 9, 2007) (lack of disclosure regarding use of fund brokerage commissions constituted violation of the Advisers Act) and *In the Matter of Duff & Phelps Investment Management Company*, Admin. Proc. File No. 3-10606 (Sep. 28, 2001) (violation of the anti-fraud provisions where adviser failed to disclose directed brokerage arrangements on its Form ADV).

<sup>7</sup> See *In re Mark Bailey & Co.*, IA Act Release No. 1105 (Feb. 24, 1988).

Comparisons also may be done by sampling executed fixed income trades against the execution prices listed on websites such as [www.nyse.com](http://www.nyse.com).

### **Final Thoughts**

In addition to assessing the quality of a broker's execution, an adviser should recognize and consider the potential conflicts of interest it faces in directing client trades to a particular broker. The adviser must always act in the best interest of the client, and not because of other considerations. Qualitative evaluation of the brokers used is very important, which should take into consideration other benefits received such as trading capabilities; soft dollars, which may be received to assist the adviser with brokerage and research services; client servicing; ability to correct trade errors; benefits received from the custodian such as educational events and compliance bulletins; and of course, execution capabilities. Through the development of a systematic approach towards best execution with ongoing monitoring and testing, the adviser will be able to fulfill its fiduciary obligations.

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