



## Practical Compliance Tips for Best Execution Analysis

by Sarah Weber, Jacko Law Group, PC

Investment advisers face a high level of regulatory scrutiny and advisers' trading practices are an area of particularly heightened attention. This article provides a detailed look at an area of adviser trading where fiduciary duties are paramount: best execution. Federally registered advisers' policies and procedures manuals must address "Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ('soft dollar arrangements'), and allocates aggregated trades among clients."<sup>1</sup> Advisers subject to state regulation should adopt similar policies and procedures. Indeed, regulators at both levels view adequate policies and procedures in this area as an indicator of a strong culture of compliance.

### What Is Best Execution and Why Does It Matter?

It is well known that investment advisers owe a fiduciary duty to their clients. The fiduciary duty that advisers are held to is an exacting one. As fiduciaries, advisers must act in the best interest of their clients in all matters connected with the adviser-client relationship, and not for their own personal interests. This duty requires scrupulous good faith and candor. Advisers must act in complete fairness and never exert any influence or pressure, take selfish advantage, or deal with clients in such a way that it benefits them or prejudices the client.

This stringent duty has been interpreted by regulators to place specific obligations on advisers, including the requirement that they seek "best execution" of their clients' securities transactions. The Securities and Exchange Commission ("SEC") historically 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."<sup>2</sup>

Advisers might assume the duty of best execution requires them to obtain the lowest commission costs for their clients. This is not the case. 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.<sup>3</sup>

According to a statement by senior SEC staff, "best execution encompasses a number of factors, starting with the price of the execution and the opportunity for price improvement – that is, finding a better price somewhere in the open market. Other factors include speed and likelihood that the order will actually be executed. For institutional investors, anonymity and liquidity might be overriding concerns. In any case, the quality of the

execution must be viewed from the investor's perspective – not the firm's."<sup>4</sup>

Factors 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.

Although most frequently discussed in the context of equity trades, the duty of best execution applies to all securities, including fixed-income and derivatives. The less transparent and less centralized nature of fixed income and derivative securities markets, however, presents additional challenges for the fulfillment of advisers' best execution obligations.

In sum, best execution is not just based on a set of particular points. Instead, it is measured on a variety of factors and circumstances, which may evolve with changes in the adviser's business and advances in industry technology. Consequently, best execution is often cited by regulators as a primary area of inspection and enforcement, and as an area where deficiencies are frequently noted.

*(Continued on page 2)*

### INSIDE THIS ISSUE

**Supervisory Liability: Who's Accountable in the Eyes of the Regulators? - Page 5**

**Detecting and Preventing Misappropriation - Page 9**

**New Canadian Proposals for Registration of Non-Resident Investment Fund Managers - Page 14**

**Spotlight on Internal Investigations - Page 17**

**Should You Have a Formal ERISA Compliance Program? - Page 20**

**"I'll See You in Court!" - Page 23**

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## Demonstrating Best Execution

An adviser's fiduciary duty requires it to make sure that the costs associated with its selection of a broker-dealer do not benefit the adviser in a way that prejudices the client. Advisers, therefore, 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.

**RISK MANAGEMENT TIP:  
Show your firm's culture of compliance - Document your best execution policy and make the policy available to your clients and prospects upon request.**

## Implement Effective Policies and Procedures

The first step towards achieving best execution is to establish an effective process for evaluating the quality of execution that the adviser receives for its clients. The SEC has stated that investment advisers must "periodically and systematically evaluate the execution performance of broker-dealers executing their transactions."<sup>5</sup> In developing policies and procedures for evaluating best execution, advisers should ask two overlapping questions: (1) Are the current broker-dealers they are using for transactions the best available? (2) Are there alternatives that would be better for the client? These ultimate questions drive the processes used to evaluate best execution.

Importantly, best execution cannot be determined on a trade-by-trade basis. Rather, advisory firms (small and large) must establish policies and procedures that focus on seeking best execution in the aggregate for their clients. There is no one-size-fits-all program for evaluating best execution. Each firm must develop policies and implement procedures that make sense for their business, and for the corner of the advisory world they occupy. There is a range of best practices and specific procedures

firms can put into action to satisfy their fiduciary obligations. Which are implemented will be determined by the firm's size and its actual business practices.

## Establish a Committee

Although not necessary or suitable for every advisory firm, if the size of the firm warrants it, create a best execution committee. This committee should meet 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. The committee can then issue recommendations to the firm's management to improve or change best execution policies and procedures as appropriate. The committee should carefully document its meetings and recommendations.

## Develop Firm-Wide Best Execution Policies

The first job of the best execution committee, or the firm's Chief Compliance Officer ("CCO"), should be the development of an overall best execution policy that emphasizes the firm's fiduciary responsibilities to maximize client portfolios within the client's investment objective constraints. The policy should address some or all of the following, depending on the exact nature of the adviser's business model:

1. The execution capabilities of the broker(s);
2. The confidentiality provided by the broker(s);
3. Availability of technological aids to process trade data;
4. Opportunity for price improvement;
5. The promptness of execution of securities transactions;
6. Competent block trading coverage ability, if necessary;
7. Capital strength and stability;
8. Reliable and accurate communications and settlement capabilities;
9. Administrative ability;
10. Commissions/trading costs;
11. Knowledge of other buyers and sellers;
12. The broker's ability and willingness to position a portion of the order;
13. Research provided (and other soft dollar considerations);
14. Breadth of services provided to clients;
15. Availability of information regarding the most favorable market for executing the trade;

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16. Conflicts of interest with the broker and conflicts that may result from trading activity;
17. Whether to allow client directed brokerage; and
18. Whether to limit client transactions to a list of pre-approved brokers.

**RISK MANAGEMENT TIP:**  
**The first step in addressing conflicts of interests with the selection of a broker is asking yourself a simple question: “Am I using this broker-dealer because it is best for my client, or because of other considerations?” The answer should be because it is best for the client.**

### 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. Initial procedures should 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/or the CCO. The committee should provide recommendations, as necessary, which should be implemented and reviewed on a periodic basis to measure effectiveness. Depending on the size of the firm and the frequency of its trading activating, the review can occur on a monthly, quarterly or annual basis. Notably, reviews performed annually would be appropriate only for firms whose trading activity is extremely infrequent.

Analysis of trading practices should focus on the various best execution factors the firm has identified in its policy, which may include surveying commission costs, promptness of execution, block trading coverage ability, evaluation of price per share, services rendered by brokers, conflicts of interest with the broker(s), ability to allocate trades, and soft dollar benefits received. The supporting documentation to be reviewed should include broker trading reports, commission summaries, transaction reports, and failed trades. Depending on the level and complexity of trading activity the review can involve sampling and forensic testing. Once the firm reaches a certain threshold of activity, the firm may need to purchase and implement software that allows the firm to systemize the review. The review should also include interviews with employees that have contact with the broker, including traders, portfolio managers, and back office and client service personnel, who can provide qualitative feedback on broker capabilities and service.

Based upon the analytics, the CCO or committee can then consider whether it is appropriate to amend the type or kind of brokers used. 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 also undertake an analysis of other available brokerage alternatives on periodic basis. For instance, advisers can compare broker-dealers by periodically reviewing their Rule 606 reports, which are required for broker-dealers, and provide various uniform statistical measure of the broker-dealer's execution quality. Again, the designated reviewer should focus on the same qualities identified in the firm's policy and provide a report of his or findings to the CCO or the best execution committee.

### Document the Review

Documenting the analytical review and recommendations is key for future best execution reviews. As the reviewer is completing the process, he or she should draft a report describing how the review was undertaken, the findings of the review, any necessary changes that result from the findings, 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 so that comparisons can be made (1) from period to period, (2) against peers, and (3) by trading method.

Always keep in mind that if the procedure is not documented, in the regulator's eyes it never occurred!

### Ensure Policies are Adhered to by all Affected Employees

As with all compliance policies, they are of little benefit if employees are not made aware of them and trained in how to comply with them. To help ensure that the firm's trading policies and procedures are communicated down the lines, the firm should conduct appropriate training, including: discussing the firm's best execution policies at the annual compliance meeting; specifically educating appropriate firm personnel on trading policies and procedures, and requiring an attestation confirming their receipt and understanding of those policies; and educate personnel on updates and modifications of existing trading controls.

### Disclosures to Clients

In addition to implementing appropriate policies and procedures internally, firms must adequately disclose their trade management practices on Form ADV, as well as ensure consistency between internal policies and practices and their public disclosures. Though not addressed by a specific Item in the disclosure brochure, best execution is an important aspect of Item 12 (brokerage practices) and can also be relevant to Item 10 (Other Financial Industry Activities and Affiliations). In the disclosure brochure, advisers should discuss:

*(Continued on page 4)*

- Broker selection practices. Include a general description of the firm's broker selection policies and procedures. For example, list the qualities the firm considers in its evaluation of transactions.
- Conflicts of Interest. Advisers must clearly disclose and adequately explain their actual and potential conflicts of interest with respect to trading practices, including: the use of an affiliated broker on an agency or principal basis; soft dollar benefits; if client-directed brokerage is permitted explain that clients who choose their own brokers can be subject to higher trading costs and less optimal execution; any trade aggregation and allocation policies; and relationships with market makers or market centers.

**RISK MANAGEMENT TIP: In addition to documenting the procedures used to test best execution, advisers must also periodically evaluate the effectiveness of their test procedures. This evaluation can be done as part of the adviser annual review and should also be documented and maintained for the requisite time period.**

### Books and Records Requirements

As noted above, documentation (and recordkeeping) is the key to compliance success. Even if you have procedures in place to ensure your clients are receiving best execution, if you don't have the documentation to show those procedures have been performed, your compliance program will fail you in the regulator's eyes. Your documentation should show:

\* The processes the firm uses to select brokers and to oversee broker performance, including the characteristics and qualities of the brokers that led to the selection, the post-trade analysis of the selected brokers (and retention of all backup documentation reviewed and prepared in the process), and any steps that are taken to improve the selection process over time.

\* The processes the firm uses to evaluate conflicts of interest.

\* Records that support the firm's negotiation of brokerage commissions, and retention of all client agreements and any other client instructions that might interfere with the firm's ability to receive the best commission rate (i.e., client directed brokerage).

Federally registered advisers should maintain their records related to best execution for five years (for the first two years the records should be stored in the firm's offices, thereafter they may be stored offsite). State regulations vary, so advisers should be sure to review the relevant statutes and regulations and implement corresponding procedures for record retention.

### Conclusion

The best advice for any advisory firm 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 those policies are adhered to. Use this article as a tool to help your firm meet its compliance obligations with respect to trading practices. ♦

<sup>1</sup> Investment Advisers Act Release No. 2204 (Dec. 17, 2003), available at <http://www.sec.gov/rules/final/ia-2204.htm>.

<sup>2</sup> In re Oakwood Counselors, Inc., et al., Investment Advisers Act Release No. 1614 (Feb. 10, 1997).

<sup>3</sup> Securities Exchange Act Release No. 34-23170 (April 28, 1986) ("1986 release"), available at <http://www.sec.gov/rules/interp/34-23170.pdf>.

<sup>4</sup> Gene Gohlke, Associate Director of the Office of Compliance Inspections and Examinations, ICI Securities Developments Conference (December 7, 2001).

<sup>5</sup> 1986 release.

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