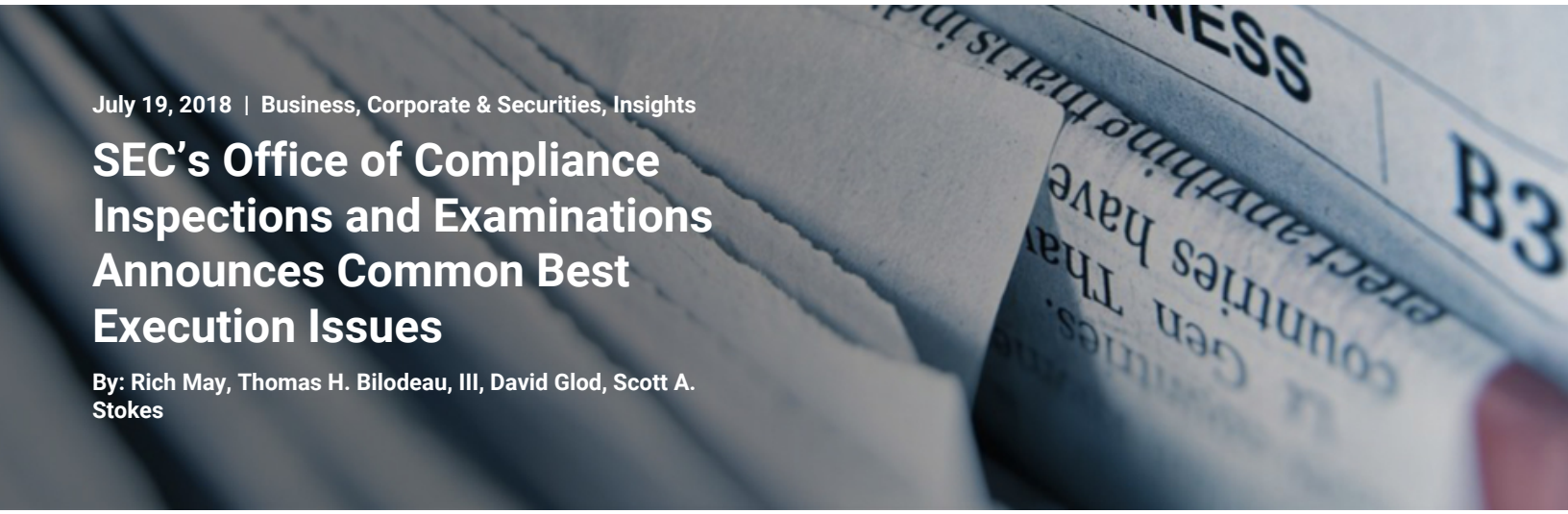

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SEC's Office of Compliance Inspections and Examinations Announces Common Best Execution Issues

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The SEC Office of Compliance Inspections and Examinations ("OCIE") recently issued a risk alert with respect to information concerning the most common deficiencies that the staff has cited in recent examinations of advisers' compliance with their best execution obligations under the Investment Advisers Act of 1940 (the "Advisers Act").

The most common best execution deficiencies cited include:

Not performing best execution review
The staff observed advisers that could not demonstrate that they periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions.

Not considering relevant factors during best execution review
The staff observed advisers that did not consider the full range and quality of a broker-dealer's services in directing brokerage – including execution capability, financial responsibility, and responsiveness to the adviser.

Not seeking comparisons from other brokers
The staff observed advisers that did not solicit input from traders and portfolio managers; made no quality or cost comparisons with other broker-dealers; and/or used a single broker upon only a cursory review.

Disclosure issues
The staff observed advisers that failed to disclose best execution and soft dollar practices.

Soft dollar allocation issues
The staff observed advisers that failed to allocate mixed-use products and services.

Weak policies and procedures

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> The staff observed advisers that failed to adopt or follow best execution policies and procedures.

OCIE took the opportunity to remind advisers that as a fiduciary, when an adviser has the responsibility to select broker-dealers and execute client trades, the adviser has an obligation to seek to obtain "best execution" of client transactions, taking into consideration the circumstances of the particular transaction. An adviser should consider the full range and quality of a broker-dealer's services including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the adviser. "[T]he determinative factor [in an adviser's best execution analysis] is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account." Advisers should therefore periodically and systematically evaluate the execution quality of broker-dealers executing their clients' transactions.

OCIE further noted that soft dollar arrangements (where an adviser receives brokerage and research services) can also implicate best execution issues. Under Section 28(e) of the Securities Exchange Act of 1934, an adviser may pay more than the lowest commission rate in soft dollar arrangements without breaching its fiduciary obligation, provided that certain specified conditions are met. Where a product or service obtained with client commissions also serves other functions that are not related to the making of investment decisions, an adviser should make a reasonable allocation of the costs of the product or service according to its use and keep adequate books and records concerning such allocation. Advisers must disclose soft dollar arrangements and must provide more detailed disclosure when the products or services they receive do not qualify for Section 28(e)'s safe harbor.

In concluding, OCIE indicated that typical adviser responses include amending their disclosures regarding best execution or soft dollar arrangements, revising their compliance policies and procedures, or otherwise changing their practices regarding best execution or soft dollar arrangements.

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