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Client Alert

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OCIE Issues Risk Alert on Issues Related to Best Execution by Investment Advisers

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The Office of Compliance Inspections and Examinations (OCIE) of the Securities and Exchange Commission (SEC) identified common deficiencies cited in recent examinations of over 1,500 investment advisers in a risk alert (the "Risk Alert"), published on July 11. The Risk Alert identifies common deficiencies relating to advisers' compliance with their best execution obligations under the Investment Advisers Act of 1940 (the "Advisers Act"). This Risk Alert provides a general background on best execution obligations for investment advisers and outlines the common deficiencies detailed in the Risk Alert.

Background on Best Execution

Under the Advisers Act, investment advisers selecting broker-dealers for executing client trades have an obligation to seek to obtain "best execution" of client transactions, taking the circumstances of the particular transaction into consideration. OCIE noted in the Risk Alert that the determinative factor in the best execution analysis is whether the transaction represents the best qualitative execution for the managed account, rather than whether the transaction has the lowest possible commission cost. Soft dollar arrangements may also impact an adviser's analysis of best execution, particularly those arrangements entered into under Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), which provides a safe harbor that allows advisers to pay more than the lowest commission rate available for a trade under certain conditions without breaching their fiduciary obligations to clients. The Risk Alert also reinforces the need for specific disclosures directly related to these and any other potential conflicts.

Identified Deficiencies Relating to Best Execution

The Risk Alert identified the following deficiencies relating to advisers' best execution obligations:

- *Not performing best execution reviews.* Some advisers could not demonstrate that they periodically and systematically reviewed and evaluated the execution performance of broker-dealers that execute client transactions.
- *Not considering materially relevant factors during best execution reviews*. Some advisers did not consider the full range and quality of a broker-dealer's services in directing brokerage. For example, advisers did not evaluate any qualitative factors relating to a broker-dealer's execution and did not solicit and review input from the adviser's traders and portfolio managers as part of their best execution reviews.
- *Not seeking comparisons from other broker-dealers*. Some advisers utilized certain broker-dealers without considering the quality and costs of services of other broker-dealers. OCIE found that some advisers utilized a broker-dealer: (i) for all clients without comparisons to similar broker-dealers initially and/or on an ongoing basis; (ii) based solely on a cursory review of the broker-dealer's policies and practices; or (iii) based solely on the broker-dealer's brief summary of services without seeking comparisons from other broker-dealers.
- *Not fully disclosing best execution practices*. Some advisers did not fully disclose their best execution practices. For example, some advisers did not disclose that certain types of client accounts may trade the same securities after other client accounts and the impact of this practice on execution prices. OCIE also observed advisers that did not review trades to ensure that prices obtained were within an acceptable range, despite contrary statements in the advisers' brochures.
- *Not disclosing soft dollar arrangements*. Some advisers did not provide full and fair disclosure of soft dollar arrangements in their Form ADV. For example, advisers did not adequately disclose: (i) their use of soft dollar arrangements; (ii) that certain clients may bear more of the cost of soft dollar arrangements than other clients; or (iii) products and services acquired with soft dollars under Section 28(e) of the Exchange Act.
- *Not properly administering mixed-use allocations*. Some advisers did not appear to make a reasonable allocation of the cost of a mixed use product or service or did not produce support of the rationale used.
- *Inadequate policies and procedures relating to best execution*. Some advisers did not have any policies relating to best execution, failed to monitor broker-dealer execution performance as a result of insufficient internal controls and/or had policies that did not take the current business of the adviser

into account.

- *Not following best execution policies and procedures*. Some advisers did not follow their own policies regarding (i) their best execution review; (ii) how they allocate soft dollar expenses; and/or (iii) their ongoing monitoring of execution price, research and responsiveness of their broker-dealers.

Practice Points and Tips

OCIE closes the Risk Alert by advising that "OCIE encourages advisers to reflect upon their own practices, policies, and procedures in these areas and to promote improvements in adviser compliance programs." The SEC's follow-up efforts regarding its risk alerts, however, have evolved significantly to become much more than encouragement and promotion. For example, in July 2016, OCIE issued a risk alert titled "OCIE's 2016 Share Class Initiative." Approximately 18 months later, the SEC's Division of Enforcement ("Enforcement") announced its "Share Class Selection Disclosure Initiative." By way of further perspective, the number of best execution cases filed by Enforcement against advisers has increased over the past several years. Advisers should view this Risk Alert as the SEC putting them on notice of increasing OCIE and SEC Enforcement scrutiny of adviser best execution. Advisers may consider, therefore, conducting assessments of their best execution policies, procedures and practices, and disclosures to clients in a manner that aligns with the guidance in the Risk Alert, as well as documenting these efforts.

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