

MEMO# 31285

July 12, 2018

SEC's OCIE Publishes a Risk Alert on Compliance Issues Related to Best Execution by Investment Advisers

[31285]

July 12, 2018 TO: ICI Members

Chief Compliance Officer Committee

Small Funds Committee SUBJECTS: Compliance

Investment Advisers RE: SEC's OCIE Publishes a Risk Alert on Compliance Issues Related to Best Execution by Investment Advisers

Yesterday the SEC's Office of Compliance Inspections and Examinations (OCIE) published the latest in its series of Risk Alerts.[\[1\]](#) This Risk Alert summarizes many of the most common deficiencies that OCIE staff has cited in recent examinations of advisers' compliance with their best execution obligations under the Investment Advisers Act of 1940. This Risk Alert is briefly summarized below.

Advisers' Best Execution Fiduciary Obligation

Prior to summarizing deficiencies OCIE identified in over 1500 adviser examinations, the Risk Alert notes that, as a fiduciary, when an adviser is responsible for selecting broker-dealers to execute client trades, it has a duty of best execution and must execute the transaction in a manner "that the client's total costs or proceeds in each transaction are the most favorable under the circumstances." Among other things, this duty requires the adviser to 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." Also, "the determinative factor [on 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 must also consider the impact of soft dollar arrangements on best execution. As expressed in the Risk Alert, "[u]nder 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 conditions are met."[\[2\]](#)

Common Deficiencies Associated with Best Execution

The Risk Alert identifies the following as "examples of many of the most common deficiencies associated with advisers' best execution obligation" identified by OCIE:

- **Not performing best execution reviews.** This deficiency involved advisers not being able to demonstrate – through documentation or otherwise – that they periodically and systematically evaluate the execution performance of broker-dealers used to execute client transactions.
- **Not considering materially relevant factors during best execution reviews.** Examples of this cited in the Risk Alert includes advisers’ failure to (1) evaluate any qualitative factors relating to a broker-dealer, such as the broker-dealer’s execution capability, financial responsibility, and responsiveness to the adviser; and (2) failing to solicit and review input from the adviser’s traders and portfolio managers.
- **Not seeking comparisons from other broker-dealers.** With regard to this deficiency, OCIE observed advisers utilizing broker-dealers without seeking out or considering the quality and costs of services available from other broker-dealers. Examples of this included using a single broker-dealer without assessing competing broker-dealers or comparing broker-dealers and conducting only a cursory review of a broker-dealer.
- **Not fully disclosing best executing practices.** OCIE observed advisers that either acted contrary to statements in their client brochures regarding reviewing trades and not disclosing how the adviser’s trading practices may impact execution prices.
- **Not disclosing soft dollar arrangements.** OCIE observed advisers that failed to provide full and fair disclosure in Form ADV of their soft dollar arrangements by not adequately disclosing: the use of soft dollar arrangements, that certain clients may bear more of the cost of soft dollar arrangements than other clients, and products and services acquired with soft dollars that did not qualify as eligible brokerage and research services under the Section 28(e) safe harbor.
- **Not properly administering mixed use allocations.** An example of an adviser not properly administering mixed use allocations involved advisers not appearing to make a reasonable allocation of the cost of a mixed-use product or service according to its use or not producing support, through documentation or otherwise, of the rationale for mixed use allocations.
- **Inadequate policies and procedures relating to best execution.** Examples of inadequate compliance policies and procedures or internal controls regarding best execution include advisers that had no policies relating to best execution, advisers with inadequate controls because they failed to monitor broker-dealer execution performance, and advisers with policies that did not take into account the current business of the adviser, including the types of securities traded by the adviser.
- **Not following best execution policies and procedures.** OCIE staff observed advisers that failed to follow their best execution policies and procedures by: not seeking comparisons from competing broker-dealers to test for pricing and execution; not allocating soft dollar expenses in accordance with their policies; and not following internal policies regarding the ongoing monitoring of execution price, research, and responsiveness of broker-dealers.

Conclusion

According to the Risk Alert, the examinations in which the above discussed deficiencies were observed resulted in a range of actions including advisers revising their disclosure relating to best execution or soft dollar arrangements, revising their compliance policies and procedures, or revising their best execution practices or soft dollar arrangements.

endnotes

[1] See *Compliance Issues Related to Best Execution by Investment Advisers*, OCIE (July 11, 2018), which is available at:

<https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf>.

[2] According to the Risk Alert, “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.” Risk Alert at p. 2.

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