

# Alert

## OCIE Best Execution Risk Alert: Guidance and Lessons for Private Fund Managers

July 24, 2018

On July 11, 2018, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert<sup>1</sup> focusing on the most common deficiencies relating to best execution found by the SEC staff ("staff") in recent examinations of investment advisers. The Risk Alert provides a snapshot of OCIE's expectations regarding a fund manager's best execution policies and procedures.

### The Obligation of Best Execution

An investment adviser's obligation to seek best execution for client securities transactions is based in an investment adviser's fiduciary duties. The SEC and its staff have long indicated that an investment adviser must satisfy fiduciary standards of care in selecting brokers for clients, negotiating commissions and compensation terms for clients' securities transactions, and supervising execution quality.

While the staff's position that there is a duty of best execution is unambiguous, the factors that an investment adviser may use in evaluating whether its clients are receiving best execution and the relative weights given to the various factors are not fixed or enumerated. In selecting broker-dealers for client accounts and in agreeing to the economic terms of the resulting trading activities, an adviser may take into consideration numerous quantitative and qualitative factors in seeking best execution, including the commission rates, the quality of execution, the research provided to the adviser, the broker-dealer's financial responsibility and responsiveness to the adviser.<sup>2</sup>

Managers are also permitted, under Section 28(e) of the Securities Exchange Act of 1934, to utilize soft dollars to purchase eligible research and brokerage services from broker-dealers. Section 28(e) allows an adviser to cause a client to pay more than the lowest possible commission rate without violating the adviser's duty to seek best execution, provided that certain conditions are met, including disclosure of the soft dollar arrangements.

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<sup>1</sup> Securities and Exchange Commission, Office of Compliance Inspections and Examinations, *Risk Alert: Compliance Issues Related to Best Execution by Investment Advisers* (July 11, 2018).

<sup>2</sup> See, e.g., Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Rel. No. 23170 (April 28, 1986); see also Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Rel. No. 54165 (July 18, 2006). Both of these releases were cited in the Risk Alert.

### **Recent Examination Deficiencies**

The Risk Alert highlighted several areas of particular best execution-related weakness, including the following:

- Advisers that did not perform a best execution review or that were unable to substantiate that such a review had been performed;
- Advisers that did perform a best execution review but “did not consider the full range and quality of a broker-dealer’s services” in that review;
- Advisers that “did not evaluate qualitative factors relating to a broker-dealer including, among other things, the broker-dealer’s execution capability, financial responsibility and responsiveness to the adviser” as part of their best execution review;
- Advisers that did not “seek[ ] out or consider[ ] the quality and costs of services available from other broker-dealers,” a weakness that appears to have been exacerbated where the adviser used a single broker for its clients’ trading;
- Insufficient disclosure of execution practices;
- Failures to carry out best execution procedures that were disclosed to clients;
- Insufficient disclosure of soft dollar practices;
- “Mixed-use” allocations not being made on a reasonable basis or that lack sufficient support for the allocation; and
- Weak controls, including citations for a lack of policies relating to best execution, insufficient internal controls and monitoring, and the use of “off-the-shelf” policies that do not address the adviser’s business.

The staff indicated that examinations upon which the Risk Alert was based “resulted in a range of actions[,]” including amended disclosures, revised compliance policies and procedures and changes to best execution or soft dollar arrangements.

### **Lessons for Private Fund Managers and Other Investment Advisers**

Many of the points raised by OCIE in the Risk Alert are fairly obvious and repeat or echo OCIE statements and actions in analogous areas in the recent past. These include the following lessons:

1. Advisers should have tailored policies on best execution and the use of soft dollars.
2. Offering documents should have accurate disclosures about an adviser’s best execution and soft dollar policies.
3. Advisers should disclose any conflicts or risks related to their best execution and soft dollar practices.
4. Advisers should actually adhere to their policies and their related disclosures on best execution and soft dollars.
5. Documentation of best execution analyses and soft dollar practices should be maintained.

However, there are some less obvious and more nuanced messages in the Risk Alert that are worth considering:

#### *Qualitative and Quantitative Factors*

The Risk Alert stresses the need for advisers to review pricing and other *quantitative* factors “to assess . . . [a] broker-dealer’s execution performance.” While this is not a new concept, the language – particularly in the context of broker comparisons (discussed below) – creates the impression that the staff may be expecting more objective support on this aspect than in the past.

At the same time, the staff indicated that focusing *solely* on quantitative factors when reviewing a broker-dealer’s services may not be enough to satisfy an adviser’s duty to seek best execution. The Risk Alert notes that “[t]he staff observed advisers that did not consider the full range and quality of a broker-dealer’s services in directing brokerage” and specifically mentioned managers that, “as part of their best execution review, did not evaluate *qualitative* factors relating to a broker-dealer including, among other things, the broker-dealer’s execution capability, financial responsibility and responsiveness to the adviser.”<sup>3</sup> In other words, the staff seems to be sending the message that qualitative and quantitative analysis both should be part of a best execution review.

#### *Broader Input*

The Risk Alert also specifically mentions deficiencies where advisers “did not solicit and review input from the adviser’s traders and portfolio managers[.]” For advisers with decentralized trading and investment functions, seeking broader involvement in the best execution process is something to consider.

#### *Comparisons*

The Risk Alert strongly implies that the staff expects to see advisers considering multiple execution options, especially where all or substantially all of a firm’s trading is directed to a single broker-dealer. It may not be sufficient for a best execution analysis solely to review and examine the services received from a single provider; rather, the implication is that best execution requires that execution rates and quality of service be evaluated on both an absolute (e.g., “is this level of performance meeting our expectations?”) and on a relative (e.g., “how does this level of performance compare to what is offered by others?”) basis.

The staff stated that both the “quality and costs” of alternative brokers should be considered. While such a statement is consistent with prior guidance on best execution and soft dollars, advisers should be sure (as discussed above) that their comparisons address *both* qualitative and quantitative elements. Large disparities in execution commissions and costs, for example, should be noted and the compensating differences in services should be explained.

All of this can present challenges for advisers trading in securities or instruments for which execution is dominated by a small number of brokers, or where there are solid business reasons to utilize a leading broker-dealer in that space. The Risk Alert does not offer specific ways to address these situations, other than providing an underlying impetus that these challenges be addressed in a thorough and thoughtful manner.

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<sup>3</sup> Emphasis added.

### *Mixed-Use Allocations*

Unlike the criticisms of soft dollar practices, where the staff only cited failures to disclose the existence of, and potential conflicts or risks in the use of, soft dollar arrangements, the staff's criticism of mixed-use allocation went beyond disclosure. The Risk Alert stated, "the staff observed advisers that did not appear to make a reasonable allocation of the cost of a mixed-use product or service according to its use[.]" Advisers should be ready for the staff to challenge the reasonableness of any mixed-use allocation and should focus on having a well-supported methodology that would be acceptable to a third party. In some cases, it may be helpful to have a client (e.g., the Board of Directors of a fund) approve the mixed-use allocation methodology.

### *Surveillance and Testing*

The staff clearly indicated that they expect the supervision of the process to be rigorous, with tailored approaches and policies. They also indicated that advisers should be monitoring "execution performance" as a separate item. For many advisers, this may mean that a more rigorous transaction cost analysis (or similar execution benchmarking) system and process may be needed.

### **Next Steps**

OCIE noted that it "encourages advisers to reflect upon their own practices, policies and procedures in these areas and to promote improvements in adviser compliance programs." As we expect that reviews of best execution practices will continue to be a part of many OCIE examinations, fund managers should evaluate their best execution policies and procedures in light of the Risk Alert and ensure that those procedures are being followed, including with respect to documentation.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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