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Eight Common Best Execution Deficiencies and How to Prepare for Your Next Exam

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Earlier this year the SEC's Office of Compliance Inspections and Examinations issued a Risk Alert providing examples of common deficiencies found in advisers' compliance with their best execution obligations. By highlighting these deficiencies, the Risk Alert provides advisers with a roadmap to assess both the effectiveness of their best execution policies and procedures and the adequacy of their disclosures so that they can be prepared for their next SEC examination.

The deficiencies highlighted in the Risk Alert, along with key takeaways for advisers, include:

- *Not performing best execution reviews.* An adviser should maintain documentation demonstrating that it systematically evaluates execution performance.
- *Not considering materially relevant factors during best execution reviews.* As part of its best execution reviews, an adviser should consider qualitative factors such as execution capability, financial responsibility and responsiveness, and traders and portfolio managers should be involved in the review.
- *Not seeking comparisons from other broker-dealers.* In utilizing a particular broker-dealer, an adviser should consider the quality and costs of services available from other broker-dealers. It is not enough for an adviser to simply rely on a review of its current broker-dealer's policies and prices.
- *Not fully disclosing best execution practices.* An adviser should fully disclose its best execution practices, including that certain types of client accounts may trade the same securities after other client accounts (if applicable) and the potential impact of this practice on execution prices. In addition, an adviser should periodically check to ensure that its best execution disclosure accurately represents the adviser's practices.
- *Not disclosing soft dollar arrangements.* An adviser should fully disclose its soft dollar arrangements, including the use of such arrangements, that certain clients may bear more of the cost of such arrangements than other clients, and that certain products and services purchased with soft dollars may not fall within the Section 28(e) safe harbor.
- *Not properly administering mixed use allocations.* A "mixed use" item refers to a product or service that is obtained with client commissions that only partially relates to the making of investment decisions. An adviser must make a reasonable allocation of the costs of a mixed use item according to its use and keep adequate books and records concerning such allocation.
- *Inadequate policies and procedures relating to best execution.* Best execution policies and procedures should take into account the current business of the adviser. In addition, it is critical to maintain proper internal controls to monitor execution performance.
- *Not following best execution policies and procedures.* In addition to maintaining adequate compliance policies and procedures, an adviser should ensure that it actually follows those policies and procedures. For example, an "off-the-shelf" compliance manual that includes an exhaustive list of factors to consider when determining and testing best execution will hurt an adviser in an SEC examination if the adviser is not actually following its procedures.

The Risk Alert identifies the types of inquiries that are likely to come up in an SEC examination. We believe advisers should consider taking the following actions now in order to be prepared:

- *Review existing best execution policies and procedures.* The key question an adviser should ask itself is whether its procedures fit its current business. Failing to review and revise procedures as the business evolves (or having procedures that are not followed) will lead to issues on examinations. Advisers should make sure their procedures include, at a minimum, a review of the qualitative factors (e.g., execution capability, financial responsibility, responsiveness) and quantitative factors (e.g., price and commission rates) identified in the Risk Alert, as well as conflicts. Also, if an adviser is not periodically comparison-shopping with other broker-dealers or if its portfolio managers are not involved in the review process, the adviser should make appropriate changes to its procedures. Further, advisers may want to consider establishing a best execution committee because although not required, many institutional investors consider it best practice. Lastly, advisers need to confirm all best execution reviews are properly documented.
- *Review existing disclosures.* Advisers should ensure their disclosures are accurate and consistent across Form ADV, offering documents and DDQs. Maintaining adequate and tailored policies is important, but it is also critical to fully disclose such practices and any related conflicts.
- *Review Mixed Use Allocations.* The Risk Alert makes clear that the staff will continue to scrutinize mixed

use allocations, both on a process and a results basis. The key issue facing an adviser is whether there is a reasonable basis for each allocation and whether there is proper documentation. To make the strongest case to an SEC examiner, some advisers may want to consider building in the use of objective criteria to the allocation determination (e.g., determining the average usage time of a mixed-use item on non-investment decision making matters, and allocating costs on that basis).

In light of the Risk Alert, advisers are strongly advised to take steps now to carefully review the adequacy and effectiveness of their best execution policies and procedures and review their current disclosures for accuracy and consistency.

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