The "Why, What and How" of Best Execution
by Tina Mitchell and Krista Zipfel

1. The "Why"

Investment advisers, large or small, are fiduciaries and have an ongoing duty to clients to ensure that the needs of those clients always come first. This is a very important obligation and one that is especially true in cases where clients have given advisers discretion and trading authority over their assets. To drill down a bit more, when it comes to best execution, investment advisers have the following specific fiduciary obligations: a) to act in the best interest of clients when trading securities for clients' accounts, including attempting to avoid any conflicts of interest; b) to continually seek to obtain the best overall deal for clients when placing clients' trades; c) to periodically review executed client trades and the firm's trading practices to help ensure that clients are receiving best execution; and d) to disclose any unavoidable conflicts of interest pertaining to client trading.

Because of the "why", which is fiduciary duty, investment advisers have to determine the "what" and "how" of their overall best execution process.

2. The "What"

There actually is more than one "what" in the best execution process: the first being "what is best execution?" and the second being "what are the considerations in seeking best execution?"

"What is best execution?"

The SEC has not yet officially defined best execution in any rules or regulations; however, in their 1986 Soft Dollar Interpretative Release, SEC staff expressed the point of view that best execution is the execution of "transactions for clients in such a manner that the client's total cost or proceeds … [are] the most favorable under the circumstances."[1]

More recently, in July 2007 SEC staff released a copy of a "welcome letter" that they send to newly registered investment advisers titled "Information for Newly-Registered Investment Advisers."[2] In this letter, the SEC stated that the term "best execution" means "seeking the best price for a security in the marketplace as well as ensuring that, in executing client transactions, clients do not incur unnecessary brokerage costs and charges." It goes on to say "You [investment adviser] are not obligated to get the lowest possible commission cost, but rather, you should determine whether the transaction represents the best qualitative execution for your clients."

Taking into account the above information, it is very important for an investment adviser to define best execution within the firm, based on the firm's business, or more

specifically, the firm's investment strategies and trading practices. In fact, without a clear definition, "how will a firm be able to seek it, obtain it and test for it?" which we now know is required.

So the question becomes, "what is 'best execution' in the context of the firm?" Well, there's an old saying that goes "It isn't rocket science." However, in the case of defining and understanding "best execution", it can be pretty darn close! But let's take it step by step.

The first step is to look at some of the factors that a firm should consider when defining best execution. These include: a) types of securities traded; b) broker-dealers used; c) trading venues utilized; d) soft dollar arrangements; e) maximizing clients' benefits; and f) conflicts of interest.

So, taking into account the factors listed above and the fact that the SEC definition has two parts to it - a "seeking" part and an "obtaining" part - a firm could define best execution by outlining in writing the steps it takes during the pre-execution stage (seeking), the execution stage (seeking and obtaining), and the post-execution stage (obtaining) of client trading. For example, for pre-execution a firm could outline that it only uses certain brokers that have been "qualified", what those qualifications are (please refer to next section for suggested criteria when selecting brokers for best execution), what ECNs (electronic communication networks) are used, if any, and that the firm has adopted and implemented specific trading policies and procedures to help ensure best execution. For the execution stage, a firm could include information on who (portfolio managers or traders) places trades and what internal controls have been put in place to avoid conflicts. Last, but not least, for the post-execution stage, a firm could include information on what processes are in place to review clients' trade execution and the firm's trading practices, how the firm detects and resolves trade errors, and, of course, soft dollar arrangements.

Now, let's take a look at the factors advisers should consider in creating a process for seeking best execution.

"What are the considerations in seeking best execution?"

The SEC gave us some guidance on the matter in the 1986 Soft Dollar Interpretive Release when the staff wrote: "A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided as well as execution capability, commission rate, financial responsibility, and responsiveness to the money manager. The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account."[3] Advisers should therefore consider a range of both qualitative and quantitative factors.

Some of these factors advisers may want to consider are:

- Execution and operational capabilities of the broker-dealer (e.g. adequacy of order entry systems; sufficiency of lines of communication; promptness of execution; promptness and accuracy of reports of execution; efficiency in the clearance and settlement of trades; ability and willingness to correct errors, as well as frequency of trade errors; availability of prime brokerage arrangements; and willingness and ability to step-out trades, which is especially important for advisers who have a lot of clients who direct brokerage).

- Expertise of the broker-dealer (e.g. to execute trades for the particular type of security; to maintain anonymity for the adviser; to access various market centers; and to locate liquidity and minimize implementation costs).

- Access to people, products and services through the broker-dealer (e.g. research (if any) provided by the broker-dealer; research analysts and company insiders; initial public offerings (IPOs) for clients; non-transaction fee mutual funds; and third-party managers).

- Financial condition and business reputation of the broker-dealer.

- Trade implementation costs (e.g. market impact cost; lost opportunity to trade; time-to-market cost; and commissions on agency trades or spreads on principal trades).

Additional information on factors to consider and general guidelines on seeking best execution may be found in the CFA Institute Trade Management Guidelines[4] and in an article by Gene Gohlke published by AIMR.[5]

When using or recommending broker-dealers to clients, advisers must also consider actual or potential conflicts of interest, including but not limited to:

- Adviser directing trades to a broker-dealer in return for some benefit (e.g. for client referrals; for receipt of research ("soft dollars"); or for receipt of other products or services outside the soft dollar safe harbor);

- Using affiliated brokers on an agency or principal basis;

- Trade aggregation and allocation policies;

- Side-by-side management; and

- Access to IPOs (Access to IPOs is generally a benefit to clients; however, if an adviser places trades with a particular broker, who provides poor execution, in the hopes of obtaining access to IPOs for clients, it is considered a conflict).

Now that we've identified the "why" and "what" of best execution, let's examine the "how".

3. The "How"

The "how" of best execution includes "how to demonstrate", "how to test", and "how often to test" best execution.

"How to demonstrate best execution"

Demonstrating best execution involves a process. The SEC has stated that: "In this connection, money managers should *periodically and systematically* evaluate the execution performance of broker-dealers executing their transactions."[6] "Systematically" implies having a deliberate process. The steps in this process should include: a) adopting written policies and procedures; b) appointing a brokerage committee or responsible person (depending on the size of the firm); c) collecting information and reviewing broker-dealers and venues used (i.e. testing); d) documenting the process and results; and e) making disclosures to clients about the policies and conflicts of interest.

In the adopting release of Rule 206(4)-7 of the Investment Advisers Act of 1940, the SEC stated that: "an adviser's policies and procedures, at a minimum, should address … to the extent … relevant to that adviser: … Trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services ("soft dollar arrangements"), and allocates aggregated trades among clients."[7] Therefore, advisers must adopt formal trade management policies and procedures and establish internal controls to prevent conflicts of interest.

The next step in the process is for advisers to appoint a brokerage committee. The members of the committee should include traders, portfolio managers, research analysts, and compliance personnel. The brokerage committee's charge should be to establish and review the firm's broker-dealer relationships and trading practices. In small firms, this might be just a two-person committee. In very small firms, like one-man shops, rather than a committee, a single person such as the CCO will carry this responsibility.

Third, advisers should collect and evaluate qualitative and quantitative data to measure execution results. The data collected is dictated by the criteria the firm set in selecting broker-dealers and trading venues in the firm's definition of best execution. (See "How to test best execution" below for specific testing suggestions.)

Next, advisers need to document their process if they want to be able to demonstrate that they are adhering to their policies and are meeting their best execution obligation. The documentation should include:

- Written trading and best execution policies and procedures;

- Brokerage committee meeting minutes which summarize: a) brokers and trading venues kept, added, or removed; b) information collected (supporting documentation should be attached); c) evaluations, findings, discussions, and action taken; d) consistency of disclosures with practices and conflicts (i.e. Form ADV Part II disclosures should be reviewed during brokerage committee meetings); and e) any changes in the process that were made and why; and

- Disclosures provided to clients.

Finally, advisers must disclose information about their brokerage practices to clients and potential clients. In an OCIE letter dated May 1, 2000, the SEC said: "Investment advisers must use client assets for the benefit of clients, and must disclose certain information about their brokerage practices." The letter also stated: "If advisers use client brokerage to obtain research or other products and services, they must fully and accurately disclose this practice to clients."[8] In that same letter the SEC provided some examples of activity that would violate this responsibility.

Disclosures should be made on Form ADV Part II, Item 8, 12, and 13. In particular, advisers are required to disclose the factors they consider in seeking best execution under Item 12.B and benefits received and resulting conflicts under Item 13.A. Advisers should review that the disclosures to clients of their practices and conflicts of interest in Form ADV are complete and consistent with disclosures made in their advisory agreements and the firm's practice.

"How to test best execution"

The question on the minds of many Chief Compliance Officers seems to be how to review or test for best execution.

There is no such thing as a "one size fits all" testing system. Just as a firm needs to define best execution based on the firm's business, it also needs to create a testing system that fits its trading practices. Start by looking at what types of securities are traded for clients. A firm that trades mainly open end mutual funds for its clients' accounts will not need a testing system as rigorous as a firm that trades equities and/or fixed income.

Are clients allowed to direct brokerage for their accounts? If a firm allows this practice, it is important to understand that even if a client directs the firm to use only one specific broker, the firm still has a fiduciary duty to perform a review to determine if these clients are receiving best execution. In fact, the SEC has clearly stated such in a 2003 administrative action.[9]

There are also issues that smaller firms may have to consider differently than larger firms. For example, smaller firms tend to only allow one or two custodians for clients' assets, and those custodians usually do not charge custodial fees so long as the advisory firm places client trades with the brokerage arm of the custodian. When that is the case, the firm should document why it believes that best execution is obtained when it is only

using one or two custodians and more specifically, what benefits clients receive from the custodian/broker(s). Firms should also document (and disclose to clients) any conflicts of interest that are inherent in the arrangements and the benefits received by the firm.

Large firms tend to have separate trading departments and the capability to trade with a number of brokers, but it may be beneficial to consider to whom the trading personnel report. In other words, do they report to the firm's portfolio managers? If so, consider what type of conflicts this presents and implement internal controls that will help mitigate the conflicts.

Technology can play a big role in pre-trade and post-trade testing and could be very cost effective in the long run. For example, since trade errors fall under the best execution umbrella, wouldn't it be in the best interest of clients and cost efficient to the firm if there was a system in place that checked trades prior to placement and also after execution? This type of testing could be created either in house or obtained by vendors that provide trade review software.

The good news is that firms are not expected to ensure that they obtained best execution for every trade. However, advisory firms should perform enough reviews and sample testing to give them a good sense - or a "reasonable belief" - that they are in fact seeking and obtaining the best overall deal for their clients at the time of the trades. There are a number of ways a firm can "sample test", which can be performed in house or by third party vendors or a combination of both.

For in house testing of equity trades, a comparison can be made of a representative amount of trades to the security's volume weighted average price ("VWAP"). This could help determine over a period of time how brokers are performing against such a benchmark to see if there is a pattern. In other words, is there one or more brokers that, in more cases than not, provided execution prices that were worse than the VWAP? If so, it would probably be prudent to find out why and/or discontinue placing trades with the broker(s) until more information is obtained.

Fixed income trading is very difficult to test, given the way bonds are traded. There are a few ways, however, that a firm can perform sample testing of its fixed income trades. For instance, when seeking to place a fixed income trade, a firm can obtain a couple of quotes from different traders and mark them down on the trade ticket. This process is a bit time consuming, but does not need to be done for every fixed income trade. It also documents the fact that the firm shopped around before placing the trade and consequently placed the trade with the appropriate broker. A firm can also compare a sampling of their executed fixed income trades against the execution prices listed on websites such as www.investingbonds.com.[10]

There also are a number of third party vendors that review a firm's trading practices and executions within a defined period of time and will provide written reports. The reviews cover a number of items, such as execution price vs. a benchmark, commissions per share, market impact of trades, the costs of any delay when the trader placed the trade,

and overall aggregate trends in a firm's executions. Vendors are generally able to test in more depth since they have access to a wealth of market information, both current and historical, that most firms do not have or cannot afford. Although reports from vendors can be costly and complicated to understand, they can also be beneficial in the long run if the information is applied and helps the firm to seek and obtain better execution in the future.

"How often to test"

As already mentioned, the SEC has stated that best execution should be evaluated "*periodically*", which implies performing evaluations on a regular basis. The frequency with which advisers review best execution or perform certain tests also needs to fit the firm's trading practices. For the unique case where a firm purchases open end mutual funds only (not ETFs, which should be treated like stocks when it comes to testing best execution) and uses a single custodial broker for all transactions, performing an annual review of the custodial broker and trading costs may be sufficient. However, for most firms and for much testing (e.g. comparisons to VWAP and examining brokerage reports) the brokerage committee or responsible person should be testing and reviewing best execution at least quarterly.

Conclusion

In order to fulfill their best execution obligation, investment advisers should take a comprehensive look at the "why", "what", and "how" of the best execution process. Advisers have a fiduciary duty to seek and obtain best execution for client transactions. Advisers should define best execution in the context of their firm, taking into account the nature of the firm's business and trading procedures. To demonstrate that they are satisfying their fiduciary obligations, advisers should establish a systematic process, periodically test the process, document the process, and make complete disclosures to clients regarding their policies and conflicts of interest.

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[1] Securities and Exchange Act Release No. 23170 (April 23, 1986).
[2] This letter is on the SEC website (http:www.sec.gov/divisions/investment/advoverview.htm) and provides summary information on the key provisions of the Investment Advisers Act of 1940 in order to help newly SEC registered investment advisers understand their compliance responsibilities.
[3] See endnote 1.
[4] CFA Institute Trade Management Guidelines (Nov. 2002), available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007
[5] "What Constitutes Best Execution?" by Gene A. Gohlke, AIMR, 2001. (AIMR is now the CFA Institute)
[6] See endnote 1.
[7] Investment Adviser Act Release No. 2204 (Dec. 17, 2003), publicly available at http://www.sec.gov/rules/final/ia-2204.htm.
[8] OCIE Letter (May 1, 2000), publicly available at http://www.sec.gov/divisions/ocie/advltr.htm.
[9] In the Matter of Jamison, Eaton & Wood, Inc., Investment Advisers Act Release No. 2129 (May 15, 2003)
[10] This website provides execution prices on corporate, municipal and US government bonds traded the same day, the day before or historically.

Tina L. Mitchell is the CEO & President of Dynamic Compliance Consulting LLC, a compliance consulting firm located in Southern California. She can be reached at tlm@dynamiccomplianceconsulting.com.
Krista Zipfel is the President and CEO of Advisor Solutions Group, Inc., a compliance consulting firm serving primarily small to medium size investment advisers. For more information, visit www.advisorsolutionsgroup.com.