

Chapman Client Alert

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Current Issues Relevant to Our Clients

OCIE Issues Risk Alert Identifying Most Common Best Execution Deficiencies

On July 11, 2018, the Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") issued a National Exam Program Risk Alert outlining the most common deficiencies that OCIE staff has identified in recent examinations of registered investment advisers' best execution practices. A copy of the Risk Alert is available [here](#). The Risk Alert is an opportunity for investment advisers to review their compliance policies and procedures regarding best execution and make improvements where necessary.

Background

Investment advisers are fiduciaries under the Investment Advisers Act of 1940 (the "Advisers Act"). Under the Advisers Act, advisers have an obligation to seek to obtain "best execution" of client securities transactions when selecting broker-dealers and executing trades. The best execution standard requires registered advisers to execute client transactions in such a manner that the client's total costs or proceeds in each transaction are the most favorable under the circumstances. This means assessing the full range and quality of a broker's services in directing brokerage such as the value of research provided, the execution capability of the broker, commission rates, and the responsiveness and financial responsibility of the broker. The standard does not require the lowest possible commission cost for the client, but an evaluation of whether the transaction represents the best qualitative execution for the managed account based on these factors.

An adviser's assessment of best execution may also be impacted by the adviser's receipt of brokerage and research services known as "soft dollar arrangements." Under the safe harbor of Section 28(e) of the Securities Exchange Act of 1934, advisers may pay more than the lowest commission rate in soft dollar arrangements without breaching their fiduciary obligation, provided that certain conditions are met. Advisers must however disclose soft dollar arrangements under Part 2A of Form ADV, including providing more detailed disclosure when the products or services they receive do not qualify for the Section 28(e) safe harbor.

Common Compliance Issues Relating to Best Execution

The Risk Alert outlines many of the most common deficiencies the SEC's OCIE staff identified with respect to advisers' best execution practices which are summarized below.

1. *Not Performing Best Execution Reviews*

OCIE staff observed investment advisers that could not show that they conducted periodic and systematic reviews of the execution performance of broker-dealers used to execute client transactions.

2. *Not Considering Materially Relevant Factors During Best Execution Review*

OCIE staff observed advisers that did not consider the full range and quality of a broker-dealer's services in directing brokerage. The staff noted certain advisers did not consider any qualitative factors relating to a broker-dealer (*i.e.*, the broker-dealer's execution capability, financial responsibility, and responsiveness). OCIE also observed advisers that did not solicit input from their traders and portfolio managers in performing a best execution review.

3. *Not Seeking Comparisons from other Broker-Dealers*

OCIE observed advisers that utilized certain broker-dealers without considering the quality and costs of services available from competing broker-dealers. Moreover, the staff observed advisers that utilized one or more broker dealers solely based on that broker-dealer's brief summary of its services without seeking comparisons from other broker-dealers.

4. *Not Fully Disclosing Best Execution Practices*

OCIE staff also observed advisers that did not provide full disclosure of best execution practices, including advisers that did not disclose that certain types of client accounts may trade the same securities after other client accounts and the related impact on execution prices of these practices. The staff also observed advisers that maintained execution practices contrary to those stated in their Form ADV.

5. *Not Disclosing Soft Dollar Arrangements*

OCIE staff observed deficiencies in disclosure of soft dollar arrangements in advisers' Form ADV, including the failure to disclose that certain clients may bear more of the cost of soft dollar arrangements. The staff also observed failures to provide adequate disclosure regarding products and services acquired with soft dollars that did not qualify as eligible brokerage and research services under the Section 28(e) safe harbor.

6. *Not Properly Administering Mixed Use Allocations*

OCIE staff observed advisers that did not reasonably allocate the cost of a mixed-use product or service according to its use, as well as advisers that failed to provide evidence, through documentation or otherwise, of the rationale for mixed use allocations.

7. *Inadequate Policies and Procedures Relating to Best Execution*

OCIE staff observed advisers with inadequate internal controls and policies related to best execution, including

advisers with no best execution policies in place or those with policies that did not take into account the business of the adviser (including the type of securities traded by the adviser). The staff also observed that advisers failed to monitor broker-dealer execution performance.

8. *Not Following Best Execution Policies and Procedures*

OCIE staff observed advisers that had adopted best execution policies but failed to follow their own policies regarding best execution review. This included seeking comparisons from competing broker-dealers to test pricing and execution. OCIE staff also observed advisers that did not allocate soft dollar expenses in accordance with their policies, and those that did not follow their policies regarding ongoing monitoring of execution price, research, and responsiveness of broker-dealers.

Conclusion

The Risk Alert notes that the examinations within the scope of the OCIE staff's review resulted in a range of actions including enforcement actions against certain of the advisers. The purpose of the Risk Alert is to encourage advisers to reflect upon their own practices, policies and procedures and make any appropriate changes to address or strengthen their adviser compliance systems where necessary.

For More Information

If you would like to discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

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