

# OCIE Lists Most Common Best Execution Deficiencies

July 25, 2018

On July 11, 2018, the Office of Compliance Inspections and Examinations (“OCIE”) released a risk alert (“Risk Alert”) describing the most commonly cited deficiencies in recent examinations involving best execution of client transactions.<sup>1</sup> The Risk Alert complements the proposed interpretative guidance issued by the Securities and Exchange Commission (“SEC”) in April which discussed the duty of an investment adviser to seek best execution.<sup>2</sup> The Risk Alert is an additional reminder that registered investment advisers should review their compliance policies and procedures concerning best execution and determine whether they are achieving their objectives.

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## THE DUTY OF BEST EXECUTION

Under the Investment Advisers Act of 1940 (the “Advisers Act”), an investment adviser has a duty to seek best execution of client transactions. In other words, an adviser must execute securities transactions for clients in such a manner that “that the client’s total cost or proceeds in each transaction are the most favorable under the circumstances.” In doing so, the adviser should 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.” It is not enough to find the lowest possible execution price.

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<sup>1</sup> Available at <https://www.sec.gov/ocie/announcement/risk-alert-most-frequent-best-execution-issues-cited-adviser-exams-1>.

<sup>2</sup> Securities and Exchange Commission, Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation, Release No. IA-4889; File No. S7-09-18 (April 18, 2018), available at <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>. For a discussion on the proposed interpretative guidance, please refer to our prior client update, available [here](#).

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## COMMON DEFICIENCIES

OCIE found deficiencies involving the processes which advisers are supposed to follow in executing client trades and in disclosing information to clients regarding best execution. The Risk Alert notes the following shortcomings OCIE has observed:

### Selection and Evaluation of Broker-Dealers

- *Evaluations of broker-dealer performance.* Advisers did not perform, or could not demonstrate that they performed, periodic or systematic evaluations of the execution performance of broker-dealers used.
- *Evaluation of best execution factors.* Advisers did not consider qualitative factors such as “the broker-dealer’s execution capacity, financial responsibility, and responsiveness.” Advisers also “did not follow their internal policies” with respect to these qualitative factors and “did not solicit or review input from the adviser’s traders and portfolio managers.”
- *Broker-dealer comparisons.* Advisers failed to compare, sometimes contrary to disclosures, “competing broker-dealers initially and/or on an ongoing basis” and selected broker-dealers only after “ cursory reviews of the broker-dealer’s policies and prices” or a “brief summary of its services.”

### Disclosure of Practices

- *Deficient disclosures and disclosures inconsistent with practice.* Advisers did not fully disclose best execution practices, including “that certain types of client account may trade the same securities after other client accounts and the potential impact of this practice on execution practices.” The staff also found that, contrary to disclosures, advisers “did not review trades to ensure that prices obtained fell within an acceptable range.”
- *Soft-dollar disclosures.* With respect to soft-dollar arrangements (that is, arrangements in which advisers use client brokerage to obtain research and other services from broker-dealers), advisers failed to adequately disclose (i) their use, (ii) “that certain clients may bear more of the cost,” and (iii) instances where some products or services do not qualify as eligible brokerage and research services under Section 28(e) of the Securities and Exchange Act of 1934 (the “Exchange Act”). Advisers should keep in mind that soft-dollar arrangements do not necessarily breach an adviser’s duty even in instances where an adviser may pay more than the lowest execution price. However, advisers must disclose the existence of such soft-dollar arrangements and instances where products or services do not qualify under section 28(e) of the Exchange Act.

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- *Soft-dollar services and mixed-use allocations.* Some investment advisers receive services through soft-dollar arrangements that may have mixed uses, some of which are covered by Section 28(e) and others of which are not. In these circumstances, many investment advisers have policies and procedure that require the adviser to make a reasonable allocation of the cost of these services according to their use (and for the adviser to pay for a portion of the services using their own “hard” dollars). The staff found that many advisers could not support or document the rationale for mixed-use allocations, “did not allocate soft dollar expenses in accordance with their policies,” and “did not appear to make a reasonable allocation of the cost of a mixed-use product or service according to its use.”
  - *Internal Controls.* Advisers did not have (i) policies or procedures relating to best execution, (ii) adequate internal controls that monitor execution performance, and (iii) up-to-date policies reflecting the current business practices of the adviser, including the type of securities traded.

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Please do not hesitate to contact us with any questions.

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