InteractiveBrokers

# SPOTLIGHT ON

Best Execution and Trade Allocation Guidance

The Securities Exchange Commission ("SEC") and state regulators have often stated that an Adviser's fiduciary duty concerning the trading activities the Adviser conducts on behalf of its clients is a key obligation. Most importantly, regulators regularly examine Advisors' compliance with their fiduciary duties of best execution and trade allocation, and sanction Advisors for violations of their duties. This Spotlight provides an overview of Adviser's best execution and trade allocation obligations. Please keep in mind that there is no bright line test for determining whether an Adviser has met their best execution and trade allocation obligations but we outline the relevant factors regulators have highlighted.

## BEST EXECUTION

### What is "best execution"?

As a fiduciary, an adviser has an obligation to seek to obtain "best execution" of client transactions. In meeting this obligation, an adviser must seek to execute securities transactions for clients in such a manner that the total cost or proceeds of client transactions are the most favorable under the then-prevailing market conditions. The focus is not on the lowest possible commission cost or price improvement alone, but on whether the adviser has set up procedures to seek the best qualitative execution on client trades. In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing trades. As the SEC has explained, an investment advisor's fiduciary duty to its clients includes an obligation to

> "execute securities transactions for clients in such a manner that the clients' total cost or proceeds in each transaction is the most favorable under the circumstances. In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services when placing brokerage, including, among other things, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research services provided."
> *See* http://www.sec.gov/divisions/investment/iaregulation/memoia.htm, citing Exchange Act Release No. 23170 (April 23, 1986).

Recently, regulators have focused on order routing practices and venue selection, especially the examination of conflicts of interest. Recent commentary and discussions from regulators appear to place a burden on Advisers to look at where their brokers are sending their orders and why. For example, regulators focus on whether brokers are sending orders to their own dark pools first or more often than to other outside venues. Another concern is routing to a venue that gives the dealer a rebate or financial incentive to use that venue. All of these conflicts can compromise a broker's obligation to seek best execution for all client trades and in turn bring into question an Adviser's decision to custody its assets and route its orders through brokers engaging in these practices.

### Factors to Consider when selecting a broker-dealer to custody and execute your clients' trades:

- Price improvement
- Block Trading coverage and ability
- Commissions/trading costs
- Knowledge of other buyers and sellers
- Research provided via soft dollars or commission sharing arrangements
- Specialization
- Financial stability
- Responsiveness
- Venue selection
- Capital commitment
- Certainty of execution
- Confidentiality
- Technology

### Best Practices:

**Regulatory guidance also suggests that Advisers adopt the following best practices.**

1. **Establish a Best Execution review committee or team:**
   A. Ensure that the Committee has non-investment management and trading representation (legal and compliance staff representation is suggested) to ensure rigor around these discussions.

   B. This Committee's directive would be to ensure best execution is being sought on client trades and to learn from trading behavior and patterns.

   C. The Committee should review a random sampling of executed trades as well as any "cross trades."

   D. The Committee should review all other possible conflicts such as placement of brokerage, personal trading, or gifts and entertainment from brokers.

   E. The Committee can meet at any necessary intervals but not less than annually to coincide with the firm's review and update of its Form ADV.

2. **Adopt Written Policies and Procedures:**
    A. We strongly suggest detailed written procedures given the sometimes-unclear nature of the subject matter. Expect regulators to test how you follow the procedures.
    B. We suggest that you conduct testing at regular intervals so you can identify both material issues and minor improvements to your processes.
    C. For smaller firms with limited staff, you may want to consider using a third-party vendor to assist with best execution measurement services. Brokers may provide this service directly or through an affiliate offering best execution analytics. However, please keep in mind that regulators may look skeptically upon a best execution analytic product provided by the broker you are using, given the potential conflict of interest and bias.

## Trade Allocations:

Regulators have traditionally focused heavily on trade allocation practices, as Advisers may manipulate the outcomes of trades and favor themselves or certain clients through their trade allocation practices. The SEC has brought cases under both Section 206 of the Investment Adviser's Act of 1940 and Section 10(b) of the Securities Exchange Act of 1934 against advisers for manipulative trade allocation practices or failure to disclose conflicts of interest. Most states have similar rules and guidance governing allocation practices.

A key SEC pronouncement in this area is the 1995 SMC Capital No-Action letter, which specifically validated Adviser's ability to submit block or aggregated orders to the broker at once so long as no account is favored and the adviser provides detailed disclosure to their clients and in their Form ADV.

As with Best Execution, Advisers are expected to have robust oversight and disclosure practices on their trade allocation practices. Advisers are expected to provide for a formal trade allocation review group or Committee, although this can be combined with the firm's Best Execution Committee or group. This makes sense for many firms as the same parties involved in best execution decisions are likely closely involved with allocation decisions as well.

Allocation policies and procedures should be defined and very closely followed unless there is a very compelling reason for a waiver of general procedure. Regulators heavily scrutinize Advisers' allocation policies and procedures and any exceptions from the applications of these policies. Trades removed from a block trade and not allocated according to written procedures are a red flag to regulators.

For example, regulators have made clear that allocation procedures should be made along security and instrument lines, and not vary dependent on the types of accounts or investment vehicles being managed such as a comingled fund or a separate account. If the manager makes distinctions to allow different policies for different investment vehicles, this practice should be disclosed in great detail in the manager's Form ADV Part 2 and in the Adviser's contract with clients.

Most often, allocation issues arise when an Adviser is purchasing shares in a volatile market in either direction, or in the case of a particularly hot Initial Public Offering ("IPO") and more recently access to highly sought-after private companies. The Adviser may be tempted to give a better allocation to a related account or an account paying a performance fee or the account of a preferred client. In these cases, having written, established pre-trade allocation procedures are vital and they should be followed closely unless extenuating circumstances exist. An Adviser can expect to have to explain and defend in detail what those "extenuating" circumstances were and why the procedure and its outcome were fair to all clients.

## Best Practices:

**Regulatory guidance suggests that Advisers should follow these best practices.**

1. All allocation methods and decisions should be done before execution. If for some reason this is not possible, allocations should be made as close to execution as possible (and prior to actual settlement). Post execution allocations should be limited and must be able to be justified, preferably via a written exception document.
2. Robust and clear disclosure of practices to all clients via both your Form ADV as well as your Investment Management Agreement with clients. Clients should be made aware of your practices before they hire you.
3. Proper record keeping, consistent with Adviser's Act requirements, at a minimum. (We discuss this in more detail below.)
4. Design very detailed written descriptions of any deviations from standard practices, preferably through your Best Execution/Trade Allocation Committee. You may want to consider a formal sign off process for any policy waivers at both the time of trade and any subsequent Committee Review. This exception review should look for concerns such as performance dispersion, where performance of accounts may be impacted by allocation decisions. Reports from these processes can be provided to regulators upon being audited.
5. A straight forward, pro rata approach is always a good cautious approach.

**Books and Records Required**

All transactions must be properly record kept under Adviser's Act Requirements. Rule 204-2(a)(3) requires the following factors to be met to comply:

> *(3) A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser concerning the purchase, sale, receipt or delivery of a particular security, and of any*

*modification or cancellation of any such order or instruction. Such memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed such order; and shall show the account for which entered, the date of entry, and the bank, broker or dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.*