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Better Best Execution:

A Guide for Investment Advisers

March 15, 2016

This is a jointly issued report of the Healthy Markets Association and
Abel Noser Solutions.

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The authors wish to thank Stanislav Dolgoplov, Micah Hauptman, Eugene Noser, Lee Schneider, Nicole Tichon, and Camden Williams for their review, comments, and valuable contributions. The views expressed in this Report do not necessarily reflect the views of our members, clients, or those who provided review. All errors are the responsibility of the authors.

About Healthy Markets Association

Healthy Markets is an investor-focused not-for-profit coalition looking to educate market participants and promote data-driven reforms to market structure challenges. Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets.

Healthy Markets can be found online at healthymarkets.org.

About Abel Noser Solutions

Abel Noser Solutions' history began in 1975 when Abel/Noser, founded by Stanley S. Abel and Eugene A. Noser, launched a brokerage to offer institutional investors low-cost, high-quality trading. The firm developed new techniques to show its trading could compete with pricier alternatives. In 2007, Abel/Noser formally launched Abel Noser Solutions, run by James Noser and Ted Morgan, as an independent, broker-neutral provider of TCA products and services. Today, Abel Noser Solutions continues to pioneer new methods and tools to help investors measure their trading results.

Abel Noser Solutions can be found online at <http://www.anstca.com/>.

INTRODUCTION

Regulators and market participants are increasingly focusing on investment advisers' "best execution" obligations as an area for ripe for modernization.

While the SEC has made it clear that investment advisers have "best execution" responsibilities, it is not clear what those responsibilities entail. In this cloudy environment, investment advisers have spent decades developing various strategies to fulfill their duties. These strategies have varied significantly over time, across firms, and even across asset classes and funds within firms. In recent years, technological advances in markets and trading operations, and more recently, regulators' expectations, have accelerated the evolution of these increasingly sophisticated strategies.

This Report seeks to offer investment advisers:

- a practical review of the legal framework of their best execution obligations and processes;
- a summary of the substantive requirements and their disclosures obligations;
- a survey of many current strategies used by investment advisers to meet their obligations; and
- a preview of likely refinements to the regulation of and strategies used by investment advisers.

LEGAL FRAMEWORK

It is generally accepted that investment advisers, like brokers, have a duty of best execution when trading on their clients' behalf.¹ This is despite the fact that there is no clear directive in statute or rule for an investment adviser to seek best execution.² Instead, investment adviser's

¹ SEC, *General Information on the Regulation of Investment Advisers*, available at <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm> (last viewed 12/31/15). It has become generally accepted by many lawyers and other market participants that the Investment Advisers Act of 1940 has a directive for advisers to achieve best execution. See, e.g., Investment Company Institute, *Frequently Asked Questions About "Best Execution"*, available at https://www.ici.org/policy/regulation/advisers/faqs_best_execution ("Under the Investment Advisers Act of 1940, every registered investment adviser, including an investment adviser to a mutual fund, has a duty to obtain "best execution" on all securities transactions for their clients."). For the purposes of this Report, we will refer to these duties as "best execution" responsibilities, even though, technically, they arise as a result of advisers' fiduciary duties, and not, strictly speaking, from the broker-dealers' more directly regulated "best execution" responsibilities. See FINRA, *Rule 5310: Best Execution and Interpositioning*, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10455.

² The phrase "best execution" appears nowhere in the Investment Advisers Act of 1940. The word "best" appears just once in the Act. Under recently enacted Section 211(g), the Commission is authorized to promulgate rules to require investment advisers, brokers and other firms to "act in the best interest of the customer" "when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide)." Investment Advisers Act of 1940, Section 211(g).

best execution obligations arise from a loose combination of interrelated rules and case law, most notably: (1) brokers' analogous "best execution" obligations; (2) advisers' statutorily imposed fiduciary duty to act in their customers' best interests, (3) a collection of mandatory disclosures, (4) SEC enforcement cases, and (5) case law.

Legal Framework for Broker-Dealers

Brokers bear primary responsibility for best execution. The responsibility for investment advisers, in turn, primarily focuses on their decisions to select and utilize brokers in ways that fulfill their fiduciary duties. Investment advisers are not necessarily expected to have expertise in execution strategies: that is what they pay brokers for. But investment advisers do need to make sure their brokers are doing their jobs. Thus, to assess the obligations of an investment adviser, it may be helpful to first review a broker-dealer's obligation to seek best execution for their customer orders.

A broker has a duty to seek best execution for his customers' orders.³ This obligation to obtain best execution "is based, in part, on the common law agency duty of loyalty, which obligates an agent to act exclusively in the principal's best interest, and also has been incorporated explicitly in FINRA rules."⁴ Broadly speaking, this requires any broker acting as an agent to a customer to "exercise reasonable care to obtain the most advantageous terms for the customer."⁵

Certainly, price is an important consideration. But that is not just the explicit share price.⁶ To look at the total price to the customer, a broker must also consider various fees charged throughout the execution chain (e.g., fees charged by exchanges, alternative trading systems (ATs), liquidity providers or executing brokers).⁷

While a number of FINRA rules touch upon best execution, FINRA Rule 5310 further requires a broker acting as agent to use reasonable diligence to ascertain the best market for the subject

The legislative history and subsequent rulemaking efforts in this area appear to be centered on imposing a fiduciary duty on broker-dealers similar to that already resting with investment advisers.

³ See, e.g., *Newton v. Merrill, Lynch, Pierce, Fenner & Smith*, 135 F.3d 266, 269-70, 274 (3d Cir. 1998); see also, *In the Matter of Morgan Stanley & Co., Inc.*, Exch. Act Rel. No. 55,726, at 9 (May 9, 2007), available at <https://www.sec.gov/litigation/admin/2007/34-55726.pdf>; *In re Herzog, Heine, Geduld, LLC*, Exch. Act Rel. No. 54148 (July 14, 2006) 2006 WL 1982741, at *5.

⁴ FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, Reg. Notice 15-46 (Nov. 2015), available at https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

⁵ *Id.* (citing Sec. Exch. Act, 59 FR 55006, 55007 at n.15 (November 2, 1994)).

⁶ In this regard, brokers' routing decisions are backstopped by Rule 611 of Regulation NMS, the "Order Protection Rule." Rule 611 requires an exchange to implement policies and procedures that are reasonably designed to prevent trade-throughs or orders from executing orders at prices outside the National Best Bid and Offer. Further, Rule 611 only protects the top of the book, and many larger orders will clear multiple levels. Unfortunately, guidelines and practices after the first price level has been cleared are inconsistent.

⁷ See FINRA, *Best Execution: NASD Regulation Reiterates Member Firm Best Execution Obligations And Provides Guidance To Members Concerning Compliance*, Reg. Notice 01-22 (Apr. 2001), available at <http://www.finra.org/sites/default/files/NoticeDocument/p003889.pdf>.

security.⁸ To establish that they have fulfilled this obligation, FINRA requires them to consider the:

- character of the market for the security (e.g., price, liquidity, and volatility);
- size and type of transaction;
- number of markets checked;
- accessibility of the quotation; and
- terms and conditions of the order.⁹

The subjective nature of these considerations allows a broker to fulfill its best execution obligations even if it uses an execution channel with higher built-in transaction fees if the relevant facts and circumstances justify it.

In addition, regulators historically have allowed broker-dealers to evaluate execution quality on an aggregated basis pursuant to “regular and rigorous review” of its routing and execution arrangements, including what it could have received at other markets.¹⁰ In laying out the standards for this “regular and rigorous review,” FINRA has stated that brokers should consider:

- price improvement opportunities (i.e., the difference between the execution price and the best quotes prevailing at the time the order is received by the market);
- differences in price disimprovement (i.e., situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);
- the likelihood of execution of limit orders;
- the speed of execution;
- the size of execution;
- transaction costs;
- customer needs and expectations; and
- the existence of internalization or payment for order flow arrangements.

¹¹

That is to say brokers traditionally have not been required to analyze best execution on an order-by order basis, although, as discussed in greater detail below, this expectation appears to be changing.¹²

⁸ See FINRA, *Rule 5310: Best Execution and Interpositioning*. However, several other FINRA rules supplement this “Best Execution” rule, most notably Rule 2121, which governs commission rates and fees, including markups and markdowns. FINRA Rule 2121, *Fair Prices and Commissions*.

⁹ See FINRA, *Rule 5310: Best Execution and Interpositioning*.

¹⁰ FINRA, Supplemental Material 0.09 to Rule 5310, *Rule 5310: Best Execution and Interpositioning*.

¹¹ Id.

¹² See FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*.

Source of Obligations for Investment Advisers: Fiduciary Duty

Courts and the SEC have found that the Investment Adviser's Act of 1940 (the "Advisers Act") imposes a fiduciary duty on advisers to act in the best interests of their clients. The anti-fraud provisions of Section 206 have been interpreted to require an investment adviser to act in the utmost good faith with respect to its clients, and to provide full and fair disclosure of all material facts, particularly where an adviser's interest may conflict with its client's.¹³ The duty to seek best execution for clients' securities transactions flows from these fiduciary duties.

While the fiduciary duty gives rise to a best execution obligation, it nevertheless provides little guidance to advisers seeking to meet their obligations or regulators seeking to enforce them. Investment advisers have sought to fill much of this void by developing defensible policies, procedures, and practices demonstrating their commitment to achieving best execution. In recent years, these activities have evolved dramatically, and we will discuss the evolution of these practices in detail below.

Source of Obligations for Investment Advisers: Mandatory Disclosure Obligations

The Advisers Act requires investment advisers to disclose important information to their clients.¹⁴ Over the years, the SEC has relied upon its authority under the Advisers Act to adopt a number of substantive disclosure obligations that directly and indirectly impact advisers' best execution obligations.

In particular, the SEC requires investment advisers to file Form ADV with the SEC.¹⁵ Form ADV requires investment advisers to "[d]escribe the factors that you consider in selecting or recommending broker-dealers for client transactions and determining the reasonableness of their compensation (e.g., commissions)."¹⁶ Many advisers also disclose their commitment to achieve best execution and the factors used by their advisers to select brokers to effectuate the funds' transactions.

¹³ See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 190, 184 (1963). In some circumstances, investment advisers are permitted to take actions that might otherwise be viewed as inconsistent with this fiduciary duty, provided that certain conditions are met. For example, "Section 28(e) provides a safe harbor to money managers who use the commission dollars of their advised accounts to obtain investment research and brokerage services, provided that all of the conditions in the section are met." *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Sec. and Exch. Comm'n, Rel. No. 34-23170, (Apr. 28, 1986), available at <https://www.sec.gov/rules/interp/34-23170.pdf>.

¹⁴ See *SEC v. Capital Gains Research Bureau, Inc.*, at 186 ("[a] fundamental purpose [of the Advisers Act is] to substitute a philosophy of full disclosure for the philosophy of caveat emptor."). Consistent with this disclosure-based regulatory regime, the Advisers Act has relatively few statutory prohibitions and limited proscriptions as to substantive conduct.

¹⁵ See Advisers Act, Section 203(c); see also SEC Rule 203-1 and SEC Rule 204-1.

¹⁶ Item 12 of Form ADV Part 2A.

In addition, registered investment companies, including mutual funds and closed-end funds, are required to provide statements of additional information (“SAI”) to supplement the information described in the fund’s prospectus.¹⁷ The SAI requires a description of the fund’s brokerage allocation and other practices that may impact best execution.¹⁸

Advisers must also clearly disclose and adequately explain their actual and potential conflicts of interest with respect to their trading practices.¹⁹ Trading conflicts that may impact best execution include the use of an affiliated broker on an agency or principal basis; research and/or brokerage obtained through soft-dollar arrangements; and interest in, or material business relationships with, broker dealers, including use of brokerage to recognize sales and distribution activities of broker-dealers and their affiliates for products offered advised by the adviser or its affiliates.

While Part 2 of the Form ADV (or in the case mutual funds, the SAI) is typically viewed as an appropriate place to make such disclosures, best execution disclosures are also often contained in investment advisory agreements, firm brochures, other regulatory filings, firm websites and marketing materials.²⁰

¹⁷ See, e.g., Selected Funds, Selected Funds SAI (Dec. 22, 2015), *available at* <http://selectedfunds.com/downloads/SFSAI.pdf> (“With respect to securities transactions for the portfolios, the Adviser determines which broker to use to execute each order, consistent with its duty to seek best execution of the transaction.”; see also Westport Funds, Westport Select Cap Fund SAI (May 1, 2009) *available at* <http://www.westportfunds.com/files/SAI.pdf>, (“In placing orders for portfolio securities of the Funds, the Adviser is required to give primary consideration to obtaining the most favorable price and efficient execution. Within the framework of this policy, the Adviser will consider the research and investment services provided by brokers or dealers who effect, or are parties to, portfolio transactions of the Funds or the Adviser’s other clients. Such research and investment services are those which brokerage houses customarily provide to institutional investors and include statistical and economic data and research reports on particular companies and industries. Such services are used by the Adviser in connection with all of its investment activities, and some of such services obtained in connection with the execution of transactions for the Funds may be used in managing other investment accounts. Conversely, brokers furnishing such services may be selected for the execution of transactions of such other accounts, and the services furnished by such brokers may be used by the Adviser in providing investment management for the Funds. Commission rates are established pursuant to negotiations with the broker based on the quality and quantity of execution services provided by the broker in light of generally prevailing rates. The Adviser’s policy is to pay higher commissions to brokers for particular transactions than might be charged if a different broker had been selected on occasions when, in the Adviser’s opinion, this policy furthers the objective of obtaining the most favorable price and execution. In addition, the Adviser is authorized to pay higher commissions on brokerage transactions for the Funds to brokers in order to secure research and investment services described above, subject to review by the Board of Trustees from time to time as to the extent and continuation of the practice. The allocation of orders among brokers and the commission rates paid are reviewed periodically by the Board of Trustees.”).

¹⁸ See Form N-1A, Item 21.

¹⁹ See Lori Richards, Director, Office of Compliance Inspections and Examinations, Sec. and Exch. Comm’n, Before the Eighth Annual Investment Adviser Compliance Summit (Feb. 27, 2006), *available at* <https://www.sec.gov/news/speech/spch022706lar.htm>; See also: CFA Institute, Trade Management Guidelines (Nov. 2002), *available at* <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007>.

²⁰ 40 Act Lawyer, Best Execution; Legal and Practical Considerations for Investment Advisers and Funds, at 15, *available at* [https://www.40actlawyer.com/Articles/Best%20Execution%20\(Schnase%207-15-13\).pdf](https://www.40actlawyer.com/Articles/Best%20Execution%20(Schnase%207-15-13).pdf).

Source of Obligations for Investment Advisers: Enforcement Actions

The SEC has increasingly used its enforcement powers to expand and further clarify investment advisers' obligations.²¹ While the SEC has aggressively pursued other types of actions against investment advisers, enforcement for best execution cases has traditionally been somewhat rare. That said, the few cases that have been brought provide critical insight into how the SEC views investment advisers' best execution responsibilities. Most notably, the actions have typically centered on discrepancies between how the adviser (or its fund) discloses it selects brokers and trades versus how it actually does.

For example, in 2008, the SEC brought an enforcement action against Fidelity Management and Research Company ("Fidelity") for violating its best execution obligations.²² The SEC found that Fidelity "allowed certain employees' receipt of travel, entertainment and gifts and certain employees' family or romantic relationships to enter into the selection of brokers."²³ Of course, Fidelity did not disclose these factors in its Form ADV or SAs. This practice, according to the SEC, resulted in the substantial possibility of higher execution costs for Fidelity's customers, in violation of Section 206 of the Advisers Act.²⁴

In 2011, the SEC brought an action against Pegasus Investment Management LLC ("Pegasus") for best execution violations.²⁵ According to the settlement order, Pegasus entered into an arrangement with a proprietary trading firm whereby trades of that firm were bundled with trades of funds managed by Pegasus in order to obtain reduced commission rates from an executing broker. In exchange for benefiting from the funds' trading volume, the proprietary trading firm allegedly made monthly cash payments to Pegasus. The SEC alleged that the receipt of the advisers' receipt of undisclosed payments constituted fraud. The SEC argued that Pegasus's fraud was receiving benefits that were generated by the use of fund assets and also suggested that the receipt of the rebate made it impossible for Pegasus to satisfy its best execution obligation.

More recently, in 2013, the SEC brought an action against Goelzer Investment Management ("Goelzer") for alleged discrepancies between Goelzer's statements regarding its best execution

²¹ See Barry P. Barbash and Jai Massari, Symposium: Regulation of Private Funds, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 Rutgers Law Journal 627 (Spring 2008), available at <http://lawjournal.rutgers.edu/volume-39-issue-3>.

²² *In the Matter of Fidelity Management and Research Company, and FMR Co., Inc.*, Inv. Adv. Act Rel. No. 2713 (Mar. 5, 2008) (citing to Investment Advisers Act, Section 206), available at <https://www.sec.gov/litigation/admin/2008/ia-2713.pdf>.

²³ *Fidelity*, at 6.

²⁴ *Fidelity*, at 6..

²⁵ *In the Matter of Pegasus Investment Management, LLC, Peter Benjamin Bortel, and Douglas Wayne Saksa*, Inv. Adv. Act. Rel. No. 3215 (June 15, 2011), available at <https://www.sec.gov/litigation/admin/2011/ia-3215.pdf>.

policies and its actual practices.²⁶ In particular, Goelzer stated that it considered a list of factors and conducted comparative brokerage firm commission rate analysis in its Form ADV, but when asked by the SEC, Goelzer was unable to provide any evidence its analysis.

Collectively, while the SEC does not appear to be imposing any specific requirements on investment advisers through its enforcement powers, it is still sending a clear message to both disclose material information and do what you say you do.

INVESTMENT ADVISERS' OBLIGATIONS

With this background, we now turn to the substantive best execution obligations for investment advisers. The SEC has stated that investment advisers are obligated, 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.”²⁷

This language could mistakenly be read to suggest that the SEC would require an investment adviser to execute each trade at the lowest “total cost” or best price for the customer. Yet, such a results-based approach is simply unworkable, as it would make the investment adviser a guarantor for the actions of brokers to which it may send orders and other market participants beyond the adviser’s control.

The SEC appropriately recognizes this concern, and instead allows investment advisers to meet their obligations by having processes that are designed to obtain best execution for clients’ trades, given the timing and circumstances.²⁸ In developing these processes, the SEC has suggested that investment advisers consider, among other things:

- commission rates,
- their brokers’ trading expertise and execution capabilities,
- the value of research provided, and
- access to markets.²⁹

Ultimately, however, the SEC leaves it up to investment advisers as to determine how they will consider these factors and what strategies it may use to fulfill their best execution obligations.

²⁶ *In the Matter of Goelzer Investment Management, Inc. and Gregory W. Goelzer*, Inv. Adv. Act. Rel. No. 3638 (July 31, 2013), available at <https://www.sec.gov/litigation/admin/2013/34-70083.pdf>.

²⁷ See, SEC, *General Information on the Regulation of Investment Advisers*, available at <https://www.sec.gov/divisions/investment/iaregulation/memoia.htm> (last viewed 12/31/15).

²⁸ *Id.*, (citing Exchange Act Release No. 23170 (April 23, 1986)).

²⁹ Sec. and Exch. Comm’n, *Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exch. Act Rel. No. 23170 (Apr. 23, 1986), available at <https://www.sec.gov/rules/interp/34-23170.pdf>.

INVESTMENT ADVISERS' STRATEGIES

Over the years, investment advisers have developed a multitude of various policies, procedures, and practices designed to demonstrate their reasonable efforts to achieve best execution, including:

- establishing and maintaining best execution committees;
- measuring and regularly reviewing execution quality;
- regularly evaluating broker performance and selection;
- quantifying the value of research and reviewing commission-sharing agreements; and
- periodically reviewing policies, procedures, and practices.

Best Execution Committees

Investment advisers typically establish Best Execution Committees,³⁰ which are often the heart of an investment adviser's efforts to satisfy its best execution obligations. These Committees are generally staffed by individuals with relevant trading, legal, and compliance backgrounds.

Best Execution Committees are commonly tasked with:

- maintaining, and periodically reviewing and revising the firm's overall trade management policies and procedures (including best execution policies, the development of "approved" brokers lists, and broker selection guidelines);
- assessing relevant industry and technological changes that may impact trade execution;
- regular and rigorous review of execution quality periodically reviewing the firm's broker selection, trading performance and execution quality; and
- overseeing internal or third-party service providers with analyses of the firm's broker selection, trading performance and execution quality.

In practice, most Best Execution Committees appear to meet on at least a quarterly basis, with additional meetings, calls, or reviews conducted throughout the year on specific issues that may arise, such as a regulatory settlement by a broker-service provider. When issues arise regarding an investment adviser's compliance with its best execution obligations, the Best Execution Committee's work will likely be a key point in the inquiry. Accordingly, many investment advisers prepare detailed information packets for Committee meetings and formal meeting minutes. Effective Best Execution Committees often follow the procedures laid out within Form ADV, and play an active role in evaluating trading performance and broker selection.

³⁰ CFA Institute Trade Management Guidelines (Nov. 2002) at 6, available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007>.

Measuring and Reviewing Execution Quality

Investment advisers periodically evaluate the range and quality of brokerage services that they receive from their broker-dealer service providers. In assessing execution quality, advisers typically focus on three often interrelated questions:

- Based on post-trade analyses of client order execution, are the full costs incurred by clients (including market impact, opportunity costs, spreads, and commissions) consistent with my duty to seek best execution?
- Are my policies, procedures, and practices sufficient to ensure compliance with my best execution obligations?
- Are my disclosures regarding my practices for placing orders, selecting brokers, and monitoring trading performance accurate?³¹

An investment adviser may conduct its trade evaluation process in-house or it may outsource some or all of the process to a third-party service provider. Sophisticated third-party service providers often have developed proprietary systems that allow them to gather and analyze raw execution data in ways that most investment advisers cannot. The SEC has recognized that advancements in technology and the availability of third-party assistance has the potential to greatly assist advisers in evaluating a broker's execution and in fulfilling their best execution obligation; therefore, investment advisers may have an obligation to pursue such technological or third-party assistance if it would improve their evaluation of execution quality.³²

Investment advisers may have an obligation to pursue ... technological or third-party assistance if it would improve their evaluation of execution quality.

In order to assess quantitative factors, such as price and commission rates, many advisers request periodic trading reports from their brokers that show such things as commissions charged, transactions executed and failed trades. However, these reports can also become far more detailed, examining trading performance across brokers and execution venues by:

³¹ See Appendix J of Selected Staff Reports and Other Publications of the SEC, 2-J Investment Advisers: Law and Compliance Appendix J.

³² See SEC Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments, V-3 (1994).

effective spread, realized spread (over various timescales to demonstrate toxicity), implementation shortfall and other cost metrics.³³

Many investment advisers also use broker-provided tools to analyze trades in an interactive fashion, analyzing performance and other metrics cross-sectionally. For example, an investment adviser could use a transaction cost analysis tool to compare actual executed prices to various benchmarks, including volume-weighted average price, opportunity cost implementation shortfall, performance, open or close price and other customer benchmarks. The most common metric would typically measure the actual executed transaction price versus the national best bid and offer at the time an order was submitted. They could do this kind of analysis on different security subsets, such as average daily volume, market cap or sector. Sophisticated transaction cost analysis tools can also break down commissions per share, market impact of trades, the costs of any delay when the trader placed the trade and the overall trends in a firm's executions.

A recent survey from Greenwich associates found that over 90% of large buy-side firms utilize transaction cost analysis ("TCA") across asset classes.³⁴ But the ability to perform TCA varies significantly across asset classes. In equities, TCA is far more advanced than other asset classes due to the availability of quote, trade and depth-of-book level data, and more specifically microsecond level resolution. In other asset classes (such as fixed income), the lack of this level of data makes useful TCA exceedingly difficult. Still, with the introduction of mandatory fixed income trade reporting by FINRA,³⁵ fixed income analysis (excluding Treasuries) is becoming more commonplace. Derivatives present different issues unique to their markets, such as when an asset is only traded on a single execution venue. That said, they may allow for the examination of price slippage and implementation shortfall. Foreign exchange lacks virtually any transparency necessary to perform detailed, useful analytics (such as market-wide quote data),

³³ Modern trade analytics can be traced back to at least 1972, when a landmark study attempted to measure the impact of block trades by comparing the prices after the block print went up. Alan Kraus, Hans R. Stoll, *Price Impact of Block Trading on the NYSE*, The Journal of Finance Vol. 27, No. 3, 569-588 (1972). By the end of 1988, the volume weighted average price (VWAP) was being used to show that the total cost of a trade was 23 basis points, even though the commissions were just 18. Stephen A. Berkowitz, Dennis E. Logue, and Eugene A. Noser, Jr., *The Total Cost of Transactions on the NYSE*, The Journal of Finance, Vol. 43, No. 1, 97-112 (1988). Over time, investment advisers started to poke holes in the all-day VWAP questioning its validity as a way to measure their trading costs. The reasoning was simple: a portfolio manager may not have sent the order to their trading desk until 11:00AM so measuring the desk against the full day VWAP did not seem terribly accurate. With the advent of timestamps, firms began to think of their trading costs against other benchmarks, such as Available VWAP (AVWAP), Interval VWAP (IVWAP), and Implementation Shortfall (IS). See, Wayne Wagner, *The Complete Guide to Securities Transactions: Improving Performance and Reducing Costs*, John Wiley & Sons (1989).

³⁴ Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*, Mar. 2, 2016, available at [https://dashboard.greenwich.com/equities/us-equities-venue-analysis-drives-next-generation-tca?_cldee=ZGxhdWVyYQdYlMlNvbQ%3d%3d&utm_source=ClickDimensions&utm_medium=email&utm_campaign=Greenwich%20Access%20for%20Non%20Asset%20Managers%20-%20Prospects&urlid=2](https://dashboard.greenwich.com/equities/us-equities-venue-analysis-drives-next-generation-tca?_cldee=ZGxhdWVyYQdYlMlMlNvbQ%3d%3d&utm_source=ClickDimensions&utm_medium=email&utm_campaign=Greenwich%20Access%20for%20Non%20Asset%20Managers%20-%20Prospects&urlid=2)

³⁵ FINRA obligates broker-dealers to report corporate bond transactions using its Trader Reporting and Compliance Engine (TRACE). For more information about TRACE reporting, please see <http://www.finra.org/industry/trace#sthash.DqWn9vDc.dpuf>.

although some firms are increasingly offering to provide this type of analysis based on proprietary and limited datasets.³⁶

Regularly Evaluating Broker Performance and Selection

Investment advisers regularly evaluate brokers and many also evaluate venues to which their orders are routed. Many investment advisers conduct these reviews on at least a quarterly basis, although monthly reviews are also common. To assist in these reviews, investment advisers increasingly utilize questionnaires to their brokers and/or execution venues,³⁷ and many create scorecards based on various qualitative and quantitative measures. This information typically is performed in conjunction with the TCA performed by the firm or the firm's third party provider.

While the exact factors an adviser will utilize may differ from firm to firm, the basic elements of scorecarding generally include the following information:

- material differences in execution quality including such metrics as VWAP, TWAP, price improvement, price disimprovement, implementation shortfall, realized spread, effective spread;
- Pricing feeds utilized (e.g., securities information processor (SIP) or market centers' direct feeds);
- speed and average size of execution;
- passive order performance and likelihood of execution;
- explicit transaction and commission costs;
- breadth and depth of reach, including algorithmic routing capabilities, order-type availability, and access to various pools of liquidity;
- the existence of conflicts of interest, such as broker owned trading desks interacting with broker owned dark pools;
- venue performance related to system availability and capacity;
- information leakage risks;
- past or current regulatory issues and disciplinary actions;
- transparent operating procedures such as order handling procedures and order execution algorithms;
- performance during strenuous market conditions; and
- performance during times of peak trading, such as at the market open and close.

³⁶ See, e.g., Mercer Enhances FX Trading Analytics Capability Through Agreement With Abel Noser Solution, (Apr. 16, 2015), available at <http://uk.mercer.com/newsroom/Mercer-enhances-FX-trading-analytics.html>.

³⁷ Healthy Markets has created the Healthy Markets ATS Questionnaire™ to assist investment advisers and routing brokers with evaluation of Alternative Trading Systems (ATSs). This questionnaire is available on the Healthy Markets website at <http://www.healthymarkets.org/ats-questionnaire>.

The above represents some of the basic elements found in scorecards but is not an all-inclusive list. Some firms have developed and even patented their scorecards for evaluations.³⁸

Increasingly, investment advisers are also evaluating the venues to which their orders are routed and executed. Even further, investment advisers are increasingly evaluating prospective brokers and venues to whom they do not route orders. While it may be impractical to evaluate the universe of brokers and venues available on a monthly or quarterly basis, some investment advisers conduct various levels of due diligence for these unused, but potential brokers and venues.³⁹

Investment advisers appear to be increasingly conducting reviews and scorecarding of current and alternative brokers and venues.

Quantifying the Value of Research and Reviewing Commission Sharing Agreements

Many investment advisers frequently review the value of the research they receive and their commission sharing arrangements to help ensure that they continue to stay within the safe harbor outlined by the SEC.

Soft dollars generally refers to the payments made by investment advisers using commissions generated by their trades, often to help offset the costs of portfolio management research. Although SEC rules permit this practice, investment advisers are obligated to ensure the quality of transactions effected on behalf of its clients, including seeking to obtain best execution, minimizing transaction costs, and using client brokerage to benefit clients.

Section 28(e) of the Exchange Act establishes a safe harbor for investment advisers who use client funds to purchase research services for the accounts and protects the investment adviser from liability for a breach of fiduciary duty solely on the basis of having paid more than the lowest commission rate, if the investment adviser determines according to its best execution guidelines that the amount of the commissions are reasonable in relation to the value of services

³⁸ Scottrade for example was issued patent 7,698,200 *Method and system for evaluation of market centers for security trading performance* to scorecard its venues. Credit Suisse also developed the *AES Alpha Scorecard* to aid the counterparty with its ability to identify venue toxicity and allows clients to determine counterparties based off of the scorecard results.

³⁹ Notably, brokers are obligated to do so. FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, at 5. Evaluating prospective venues is a critical component of a broker's regular and rigorous review, which FINRA recently reaffirmed. See FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, at 5 ("a firm should regularly consider execution quality at venues to which it is not connected and assess whether it should connect to such venues.").

received.⁴⁰ The “burden of proof” that the commissions paid are reasonable in relation to the value of the brokerage and research services received rests with the investment adviser.

Perhaps one of the most important elements for the investment adviser complying with the burden of proof is disclosure under Item 12 (Brokerage Practices) of form ADV Part 2A, which requires an investment firm to describe the factors considered in selecting brokers and determining the reasonableness of their commissions and to describe any arrangement in which the investment advisor is paid cash by or receives some economic benefit. Many investment advisers have practices of frequently reviewing and amending Form ADV to stay reflective of the investment adviser’s current processes.⁴¹

Reviewing Policies, Procedures, and Practices

Investment advisers typically create and retain records documenting both the process and results of its best execution, broker selection, and policies and procedures reviews to help demonstrate their due diligence efforts and compliance with their best execution obligations.

Investment advisers often conduct interviews to gather relevant information from their broker service providers. These interviews often cover areas such as a broker’s best execution practices and experience with handling complex trades. In addition, some investment advisers may conduct more holistic due diligence regarding the broker’s capitalization levels and financial stability, ownership structure, or relationships with affiliates.

Investment advisers may also review execution venues as well.⁴² Further, these reviews often differ according to the type of venue in question. For example, reviews of an ATS may differ in nature than those of a broker or platform provider.

In particular, recent regulatory enforcement cases against ATSs have prompted many investment advisers and routing brokers to send them comprehensive questionnaires. These questionnaires often cover technology, order flow characteristics, client characteristics, execution quality, relationships with affiliates and third-parties, order routing practices, conflicts of interest, and other potentially relevant information.⁴³ The information gathered from such questionnaires and due diligence is often incorporated into the investment advisers regular and rigorous review of best execution. And investment advisers are learning from this

⁴⁰ For more information on this safe harbor, please see Sec. and Exch. Comm’n, *Commission Guidance on the Scope of Section 28(e) of the Exchange Act*, Rel. No. 34-45194, (Dec. 27, 2001), available at <https://www.sec.gov/rules/interp/34-45194.htm>.

⁴¹ See CFA Institute, *CFA Institute Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage*, (Nov. 2004), available at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n1.4005>.

⁴² Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.

⁴³ Healthy Markets Association has developed and publicly distributes its ATS Questionnaire to parties upon request. Please see the Healthy Markets website at <http://www.healthymarkets.org/ats-questionnaire/>.

new analysis. In fact, a recent survey of buy-side traders found that 45% of traders who used venue-level analysis had changed their order routing practices based upon their findings.⁴⁴

EVOLVING EXPECTATIONS

In recent years, as markets have become increasingly complex and automated, the specific types of analyses and reviews conducted by investment advisers have become increasingly sophisticated. At the same time, regulators' expectations for investment advisers appear to be evolving along with these advancements. For this reason, it is paramount for an investment adviser to keep current with evolving market-structure to ensure that analysis and reviews incorporate the latest information and techniques available.

Increasingly Sophisticated Analyses

Since the Buttonwood Agreement fixed commissions at not less than 25 basis points,⁴⁵ the cost of executing trades has been the subject of controversy. Of course, because trades were then based on a call and executed on a face-to-face basis, the costs of execution were relatively explicit.

Today, by contrast, as trading commissions have reduced significantly,⁴⁶ implementation costs for large block trades may dwarf the commissions paid to brokers, as shown in the chart below.⁴⁷ As this shift has occurred, so has investment advisers' focus on their true and total costs of trading.

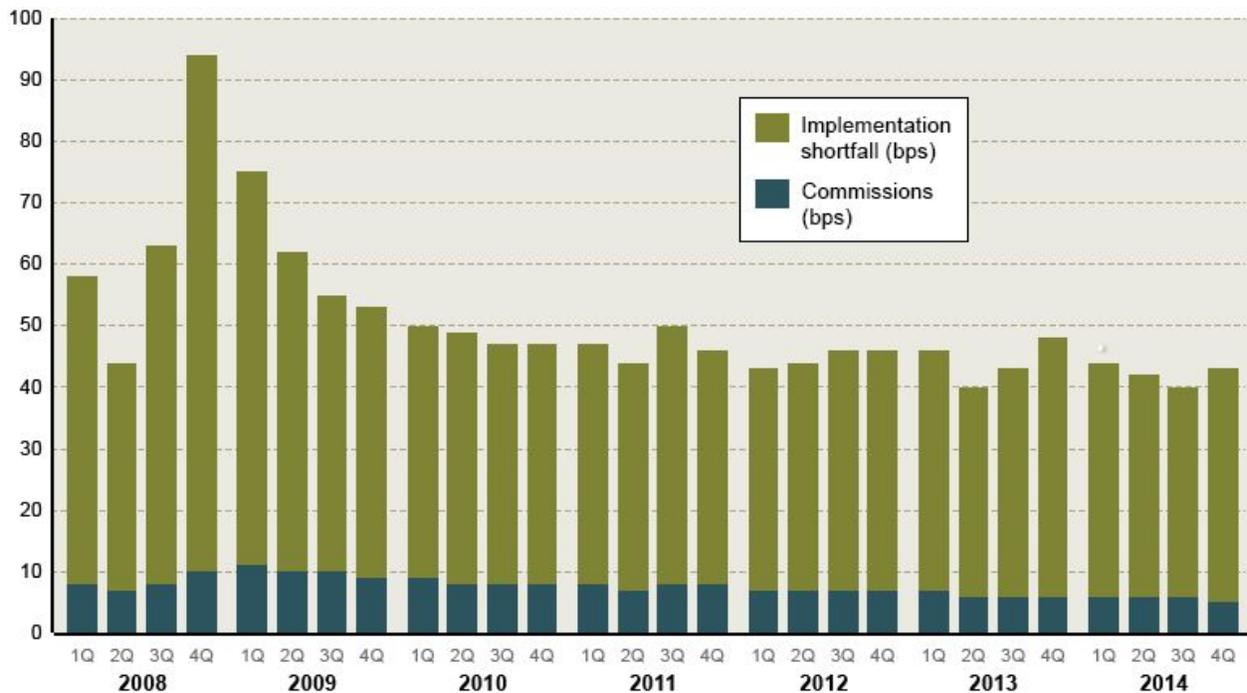
Implementation Shortfall and Commission Costs

⁴⁴ Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.

⁴⁵ Buttonwood Agreement, 1792 ("We the Subscribers, Brokers for the Purchase and Sale of the Public Stock, do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day for any person whatsoever, any kind of Public Stock, at a less rate than one quarter percent Commission on the Specie value of and that we will give preference to each other in our Negotiations. In Testimony whereof we have set our hands this 17th day of May at New York, 1792.").

⁴⁶ Since fixed minimum commissions were prohibited in 1975, commission costs have generally been on a long decline towards zero. This decline accelerated with the advent of competition for executions, the "unbundling" of commissions and research payments, and increases in technology-driven trading opportunities. See generally, Stanislav Dolgoplov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, *Journal of Law, Economics and Policy*, Vol. 4, No. 2, pp. 311-368, 2008,

⁴⁷ Meaningful trading analytics is significantly limited by the availability of comprehensive data. This block trading data, obtained from ITG, Inc., is referenced here to be illustrative of the relative weights of commissions versus other costs of trading. One of the greatest contributions regulators and market participants could make to improve fairness and transparency in the market could be to improve the collection and publication of meaningful order and execution statistics.



Data as of December 31, 2014. Source: Investment Technology Group

Trade analytics is now a key component to drive down total trading costs to ensure compliance with best execution responsibilities. With the ability to capture orders and executions down to the millisecond level and compare the market data to an investor's trades also provided at the millisecond level, a new level of measurement ability is now possible. And many investment advisers are doing it. According to a survey of buy-side trades by Greenwich Associates, a leading research firm, over three-quarters of all equity traders indicated that they used TCA as part of their investment process.⁴⁸

Trade analytics has also evolved to encompass other asset classes like fixed income, FX, options and futures. Each of these asset classes has been subject to regulatory efforts and market evolutions that attempt to improve transparency and visibility into broker behavior and transaction costs. For example, FINRA and the Municipal Securities Rulemaking Board recently proposed disclosures of mark-ups and and mark-downs in fixed income trading. And Congress and the SEC have been considering these improvements for a few years.⁴⁹ Fully automated fixed income trading is now here, as are numerous trading venue options.⁵⁰ As these other markets

⁴⁸ Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.

⁴⁹ See Bond Transparency Act of 2014 (S.2114), 113th Cong. (2014); see also Michael S. Piwowar, Commissioner, Sec. and Exch. Comm'n, *Advancing and Defending the SEC's Core Mission*, (Jan. 27, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540671978>.

⁵⁰ For example, in September, 2015, Liquidnet began operating an ATS for fixed income trading. See http://www.liquidnet.com/uploads/Liquidnet_Launches_Fixed_Income_Dark_Pool_1.pdf.

evolve to have greater transparency, we may expect regulators to ratchet up their expectations, as they have with the equities markets..

Increasing Regulatory Expectations

The SEC has provided essentially no guidance to investment advisers for several years regarding what it expects from them for best execution. At the same time, FINRA appears to have dramatically expanded best execution obligations for brokers. In light of recent technological advances in trading systems and pricing mechanisms, and regulators' increased focus on best execution for brokers, we expect regulatory expectations for investment advisers to be ripe for evaluation. This may occur through rulemaking, guidance, enforcement actions, or (most likely) some combination of all three mechanisms.

As has always been the case for best execution, the primary focus is again on the brokers. In November 2015, FINRA issued new Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets.⁵¹ The guidance was compelling in several respects, including that it suggests a broker:

- may be required to conduct more order-by-order reviews of execution quality;
- may be required to perform detailed analysis for fixed income trading and to consider electronic trading platforms;
- should regularly consider execution quality at venues to which it is not connected and assess whether it should connect to such venues;
- should take into account market and technology changes that might alter its best execution analysis;
- must consider material differences in execution quality across order-types; and
- should use direct feeds to measure execution quality if it has access to them and is otherwise using them to make routing or execution decisions.

Perhaps most importantly, by focusing analysis on an order-by-order basis, FINRA appears to be significantly (albeit indirectly) narrowing the scope of factors that may be relied upon in making order handling decisions.

This may result in focusing more heavily on explicit costs for individual orders (which tend to be a function of just price and fill rates), while potentially having the unintended effect of increasing overall trading costs (which may be heavily influenced by slippage and information leakage). For example, suppose an institutional investor wants to buy one million shares of XYZ stock. The investor engages the services of a broker-dealer through the broker's smart order router (SOR). The SOR may then divide the investor's order into smaller orders to be sent out over time for potential execution at different market centers. Further, the investor's trading decision itself may actually give rise to multiple orders for the broker. Should the broker route the order to the venue that is most likely to fill it at the lowest cost? What if by sending the order

⁵¹ FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*.

to that venue, the broker is likely to tip off other market participants to the existence of a large remaining order? In this case, the broker may best reduce the overall transaction costs for its customer by forgoing with its first orders the market center with the lowest initial cost because the resulting information leakage and slippage may significantly increase the costs for the remaining orders. This may be particularly relevant for routing orders to exchanges or some ATs that have smaller transaction sizes and participants who are more likely to engage in algorithmic trading strategies that may result in “toxic” fills.

It is not yet clear how FINRA intends to reconcile its mandate that brokers minimize customers’ total costs with this new order-by-order analysis. Given the fact that the majority of the total costs to customers in certain transactions may be the implementation costs (as opposed to commissions), the resolution of this issue will have significant impacts on brokers and, indirectly, investment advisers.

Another key element of FINRA’s recent guidance was on its expectation that brokers engage in detailed analysis for fixed income trading.⁵² As described above, best execution analysis has traditionally been far more robust for equities than for other assets, due in large part to the relative transparency of the markets and the relative ability of firms to engage in meaningful analysis. With the increasing automation and transparency of other asset classes, the ability of brokers to engage in similar forms of analysis is increasing rapidly. FINRA’s attention on this asset class comes at a critical time, with increasing electronic trading and attention on the disparity in execution costs between equities and fixed income.

The guidance further encourages brokers to consider whether electronic platforms for fixed income trading may improve execution quality and should be incorporated into the broker-dealer’s routing decisions. FINRA cited the rise of electronic trading and recent advance in trading technology and communications systems as the rationale underlying these new principles. FINRA’s guidance is consistent with SEC’s longstanding view that the scope of the duty of best execution must evolve with the markets and technology.⁵³

While FINRA’s work doesn’t directly impact investment advisers, it clearly means that brokers are now expected to do more.

[T]he scope of the duty of best execution must evolve with the markets and technology.

The New York Attorney General, as well as the SEC and FINRA, have recently highlighted a

⁵²FINRA, *Best Execution: Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*.

⁵³ See Sec. and Exch. Comm’n, *Order Execution Obligations*, Exch. Act Rel. No. 37-619A (Aug 29, 1996).

number of venues' abuses to which investment advisers and their brokers may be expected to respond. Over the past several years, regulators and prosecutors have brought regulatory actions against some of the largest, oldest, and most-respected ATs, including:

- Barclays,
- Credit Suisse,
- eBX,LLC(Level),
- GoldmanSachs,
- ITG,
- Liquidnet,
- Pipeline, and
- UBS.

The misconduct ranged from minor recordkeeping violations, to illegally accepting sub-penny orders, to failing to police the pool as advertised, to affirmatively alerting high-frequency traders to orders in the pool. In at least some cases, the operators of the ATs were the very same type of predatory traders that they were supposedly protecting their subscribers against. Far from just an isolated problem with ATs, the SEC also recently settled actions against registered exchanges for failing to properly disclose specially-created predatory order types.

The regulatory impact of these developments for investment advisers is not yet direct. In the absence of clarification by the SEC, legal experts, consultants, funds' Best Execution Committees, and others are left to speculate what impact, if any, they may have on investment advisers' obligations.

Some of this misconduct likely resulted in suboptimal executions for investors. Routing brokers and investors are responding by conducting unprecedented levels of due diligence and analyses. Some have elected to temporarily or permanently stop routing to some ATs involved in regulatory settlements. Some firms are undertaking special reviews of their execution quality with these settling ATs, as well as using questionnaires and interviews to expand their understanding of each ATs' operations and conflicts of interest.⁵⁴

Ultimately, we expect investment advisers and those acting on their behalf to insist that ATs and other market venues (including internalizers) provide enhanced disclosures along the lines of some proposed by the SEC in the new ATs-N, as well as advanced statistics against which they can better measure execution quality and conflicts of interest.

We also expect regulators to help investment advisers and their service providers by expanding and improving the availability of data. For example, this may be through enhancing order routing and execution reports required by Rules 605 and 606, or by refinements to ATs

⁵⁴ For example, a large number of firms have requested copies of the Healthy Markets ATs Questionnaire™, which we suspect they may be using to evaluate ATs and affiliated brokers. In addition, Healthy Markets prepares an ATs Transparency Index™, which investment advisers may also utilize to assist them in their understanding of ATs' operations and conflicts of interest.

disclosures.⁵⁵ Importantly, we do not expect regulators to foist broker-like best execution obligations on investment advisers. However, given the overall impact order routing and venue selection may have on trading costs, we do expect regulators' expectations of investment advisers to continue evolving with the markets and technology.

CONCLUSION

Investment advisers' have historically had broad flexibility to develop their own strategies to fulfilling their best execution obligations. Now, advancements in the markets and technology and new regulatory actions appear to be increasing expectations for advisers. And while the SEC has yet to take formal action to expand or clarify investment advisers' obligations, investment advisers should nevertheless be aware of changes in the markets and technology, and revise their policies, procedures, and practices to keep up.

⁵⁵ See, e.g., *Regulation of NMS Stock Alternative Trading Systems*, 80 Fed. Reg. 80998 (Dec. 28, 2015).