HEALTHY MARKETS
TRANSPARENCY & TRUST

August 7, 2018

Via Electronic Mail (rule-comments@sec.gov)

Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release No. IA-4889; File No. S7-09-18

Dear Mr. Fields:

The Healthy Markets Association appreciates the opportunity to comment on on the best execution-related aspects of the Commission's proposed interpretation regarding a standard of conduct for investment advisers.[1]

In this comment letter, we:

- Provide an overview of Healthy Markets' longstanding interest in improving best execution obligations for the buyside;
- Offer some background on investment advisers' best execution obligations;
- Review key enforcement actions against investment advisers;
- Explore the reason for, and impact of, best execution-related European regulatory reforms;
- Review the Proposal's best execution-related guidance;
- Explore how the recent OCIE Risk Alert changes expectations for investment advisers;
- Survey strategies used by investment advisers to fulfill their best execution responsibilities; and
- Recommend specific best execution-related enhancements to the Proposal.

[1] *Proposed Commission Interpretation Regarding Standard of Conduct for Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation*, Sec. and Exch. Comm'n, 83 Fed. Reg. 21203, (May 9, 2018), *available at* https://www.sec.gov/rules/proposed/2018/ia-4889.pdf (Proposal). This comment does not address any other aspects of the Proposal.

The Proposal asks "[d]oes the Commission's proposed interpretation offer sufficient guidance with respect to the fiduciary duty under section 206 of the Advisers Act?"[2] With respect to the guidance on best execution, it does not.

As proposed, the best execution guidance misses an opportunity to enhance investor protections by more clearly establishing what is - and what is not - expected of investment advisers in their quest to fulfill their best execution obligations. Unfortunately, the Proposal offers almost no clarity as to how an adviser may comply with its best execution obligations, nor does it offer asset owners or the Commission any meaningful way to hold advisers accountable for compliance.

We urge the Commission to more clearly articulate expected best execution-related practices, and potentially offer investment advisers a rebuttable presumption of compliance with best execution obligations, if that standard is met. That standard should provide basic contours of the obligation, including that the adviser:

- has established and maintains a best execution committee that meets on at least a quarterly basis;
- measures and reviews (on a not less than quarterly basis) execution quality, based on a minimum list of "materially relevant factors";
- regularly evaluates broker performance and selection utilizing a minimum list of factors;
- makes active decisions regarding order routing and execution based upon its reviews;
- has appropriate policies and procedures, and practices related to the payment for research, including that it:
    - identifies and determines the value of research received and utilized;
    - establishes research payment mechanisms that can comply with its Section 28(e) obligations;
    - Establishes research payment mechanisms that decouple the amount paid for research from trading volumes;
    - Establishes research cost allocation mechanisms that ensure that customers who pay for the research directly benefit from that research (so as to constrict cross-subsidization);
- periodically reviews (on a not less than annual basis) best execution policies, procedures, and practices, as well as disclosures related thereto; and

[2] Proposal, at 20.

- The adviser fully discloses its best execution policies, procedures, and practices, including all relevant conflicts of interest, soft dollar arrangements, etc..

We urge the Commission to significantly revise the Proposal and adopt any necessary revisions to rules promulgated under Section 206 of the Advisers Act to provide greater (1) clarity for investment advisers and (2) protections for investors.

About Healthy Markets and Our Interest in Best Execution

The Healthy Markets Association is an investor-focused not-for-profit coalition working 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.[3]

The quest for better best execution for investment advisers is one that his driven Healthy Markets since our founding. In March 2018, we released the third edition of Better Best Execution[4]. That report offers US investment advisers:

- a practical review of their best execution obligations and related disclosures; and
- a survey of various strategies used by investment advisers to meet their rapidly changing obligations.

In that report, we repeatedly identify the lack of clear expectations from the Commission as a challenge for investment advisers seeking to fulfill their duties. Put simply, we found that investment advisers don't have a clear picture what's required of them due to the lack of extensive guidance from the Commission.

We have repeatedly asked regulators to help fill that void, openly requesting more robust guidance for investment advisers regarding best execution. For example, in June 2017, Healthy Markets urged newly-confirmed Chairman Clayton to, amongst other

[3] To learn more about Healthy Markets, please see our website at http://www.healthymarkets.org.
[4] The third edition of Better Best Execution was provided to Healthy Markets' members and is available at https://www.healthymarkets.org/better-best-execution-report/better-best-execution.

items, adopt guidance regarding best execution for investment advisers.[5] Two months later, we reiterated that request to the Treasury Secretary.[6] Earlier this year, in April 2018, Healthy Markets urged the Commission to take direct action to reconcile some of the unintended consequences of the implementation of MiFID II, as well as the Commission staff's related "no-action" letters.[7] In that letter, we again urged the Commission to adopt guidance on best execution obligations for investment advisers.[8]

This Proposal could be that guidance.

Background on Investment Advisers' Best Execution Obligations

In the United States, the Investment Advisers Act of 1940 (the "Advisers Act") has been interpreted by the Commission and courts as imposing a fiduciary duty on advisers to act in the best interests of their clients. In addition, 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,

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[5] Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Jay Clayton, Sec. and Exch. Comm'n, June 13, 2017, *available at* https://healthymarkets.org/wp-content/uploads/2018/04/06-13-17-HM-letter-market-structure-reforms.pdf.

[6] Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Steven T. Mnuchin, US Dep't of the Treasury, Aug. 9, 2017, *available at* https://healthymarkets.org/wp-content/uploads/2018/04/08-09-17-HM-letter-Presidential-Report.pdf.

[7] Letter from Tyler Gellasch, Healthy Markets Association, to Hon. Jay Clayton, Sec. and Exch. Comm'n, Apr. 2, 2018, *available at* https://healthymarkets.org/wp-content/uploads/2018/05/04-02-18-HM-letter-Impact-on-Payments-for-Research.pdf.

[8] *Id*.

particularly where an adviser's interest may conflict with its client's.[9] The duty to seek best execution for clients' securities transactions flows from these fiduciary duties.[10]

Importantly, it is unclear how investment advisers should fulfill their best execution obligations. Substantively, the Commission staff 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."[11]

The SEC appropriately does not require the absolute best price on each individual trade, however, but 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.[12] In developing these processes, the Commission staff 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.[13]

Ultimately, however, the Commission has historically left it up to investment advisers to determine how they will consider these factors and what strategies they may use to fulfill their best execution obligations.[14]

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[9] *See e.g.*, *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979) ("[Section] 206 establishes federal fiduciary standards to govern the conduct of investment advisers."). *See also 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, Exch. Act Rel. No. 34- 23170, (Apr. 28, 1986), *available at* https://www.sec.gov/rules/interp/34-23170.pdf ("1986 Release").

[10] See 1986 Release ("an adviser, as a fiduciary, owes its clients a duty of obtaining the best execution on securities transactions.").

[11] See SEC, *General Information on the Regulation of Investment Advisers*, *available at* https://www.sec.gov/divisions/investment/iaregulation/memoia.htm (emphasis added) (last viewed July 27, 2018).

[12] *Id*.

[13] 1986 Release.

[14] As discussed below, we note here that the proposed Commission interpretation and the Commission staff's recent "Risk Alert" could collectively offer significant new contours for those expectations.

Many investment advisers' "best execution" practices are outlined in their required disclosures. For example, Item 12 of Form ADV Part 2A 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)."[15] It further mandates that if an adviser receives "research or other products or services other than execution from a broker-dealer or a third party in connection with client securities transactions ("soft dollar benefits")," it must disclose its practices and discuss "the conflicts of interest they create."[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.

In addition, registered investment companies, including mutual funds and closed-end funds, are required to provide statements of additional information ("SAI") to supplement

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Compliance Issues Related to Best Execution by Investment Advisers, Sec. and Exch. Comm'n, July 11, 2018, *available at* https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20IA%20Best%20Execution.pdf (OCIE Risk Alert).

[15] Form ADV Part 2A, Item 12.

[16] Form ADV Part 2A, Item 12.A.1.

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]

Factors that are commonly disclosed include price; costs; speed; likelihood of execution and settlement; size; nature; and anything else the firm deems relevant to the execution of an order. They may also include provision of research.

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 a brokerage to recognize sales and distribution activities of broker-dealers and their affiliates for products offered by the adviser or its affiliates.

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[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.

While Forms ADV and SAIs are typically viewed as appropriate places to make best-execution-related disclosures, these types of disclosures are also often contained in investment advisory agreements, firm brochures, other regulatory filings, firm websites and marketing materials.[20]

Notably, Section 28(e) of the Securities Exchange Act of 1934 has provided a safe harbor wherein, provided certain conditions are met, investment advisers will not be deemed to be acting unlawfully or in breach of their fiduciary duties (of best execution) solely because they use client commissions to pay brokers for research.[21] The result is that, while there has been generally no guidance on what steps investment advisers must take to fulfill their best execution obligations, there is guidance on what does not violate its best execution duty--reasonable payments for research.

Key Enforcement Actions Against Investment Advisers

While Commission enforcement actions related to best execution cases have been rare, they nevertheless provide critical insight into how the SEC views investment advisers' best execution responsibilities. As we think of it, Commission actions have typically centered on discrepancies between how the adviser (or its fund) disclose how it selects brokers and trades versus how it actually does so.

For example, in 2008, the Commission brought an enforcement action against Fidelity Management and Research Company ("Fidelity") for violating its best execution obligations.[22] The Commission 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 SAIs. This practice resulted in the substantial possibility of higher execution costs for Fidelity's customers in violation of Section 206 of the Advisers Act.[24]

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[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.
[21] Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78bb(e).
[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.

In 2011, the Commission brought an action against Pegasus Investment Management LLC ("Pegasus") for best execution violations.[25] According to the settlement order, Pegasus had 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 Commission charged that the receipt of the advisers' receipt of undisclosed payments constituted fraud. The Commission argued that Pegasus committed fraud by receiving benefits that were generated by the use of fund assets, and it also suggested that its receipt of the cash payments made it impossible for Pegasus to satisfy its best execution obligation.

In 2013, the Commission brought an action against Goelzer Investment Management ("Goelzer") for alleged discrepancies between Goelzer's statements regarding its best execution 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 Commission staff, Goelzer was unable to provide any evidence of that analysis.

Notably, none of these cases appear to suggest any specific requirements on investment advisers. Rather, each seems to be about the accuracy of the firm's disclosures.

This disclosure focus shifted slightly in 2017, when the Commission brought an action against KMS Financial Services ("KMS Financial") for, amongst other things, failing to analyze whether its clients were obtaining best execution.[27]

In July 2018, the OCIE Risk Alert continued quite a bit further. As discussed above, that document makes clear -- for the first time -- that investment advisers are expected to take specific actions to fulfill their best execution obligations. That said, we do not yet

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[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.

[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] *In the Matter of KMS Financial Services, Inc.*, Adv. Act Rel. No. 4730 (July 19, 2017), *available at* https://www.sec.gov/litigation/admin/2017/34-81169.pdf (also bringing the action for failing to disclose payments KMS Financial received from a clearing broker for its clients' investments in mutual funds in the clearing broker's no-transaction-fee mutual fund program and failing to pass through a reduction in brokerage costs to its advisory clients after it had negotiated lower rates).

know if the deficiencies identified in that document will lead to relevant enforcement actions.

Impact of European Reforms

After years of study, regulators in the United Kingdom and European Union have adopted new business conduct rules that are quickly being implemented around the globe.

In May 2014, the UK's Financial Conduct Authority (FCA) (the successor to the FSA) revised its rules to "ensure investment managers seek to control costs passed onto their customers with as much rigour as they pursue investment returns."[28] Similarly, the June 2014 Market in Financial Instruments Directive (MiFID) II reforms place a heavy emphasis on improving investor protection by introducing robust controls to avoid conflicts of interest, encouraging greater transparency, and by significantly reforming the use of commission dollars to pay for research (so-called "unbundling").

Previously, European rules required brokers and investment advisers to engage in "all reasonable steps" to ensure best execution. Under MiFID II, which officially took effect on January 3, 2018, that standard was raised significantly to require "all sufficient steps to obtain … the best possible result for their clients taking into account:

- price,
- costs,
- speed,
- likelihood of execution and settlement,
- size,
- nature, or
- any other consideration relevant to execution."[29]

This change raised the regulatory expectation from simply having a reasonable process, to having a process that actually achieves a specific result. And it also clearly detailed the most relevant factors for money managers to consider.

[28] Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (PS14/7), at 6, May 2014, *available at* https://www.fca.org.uk/publication/policy/ps14-07.pdf.
[29] MiFID II, Article 27.

The new rules further require firms to have detailed specifications for selecting brokers, routing orders, and paying for research. For example, an adviser may be expected to know not only why it selected a broker, but why it selected a particular algorithm. It may also have to monitor for performance and adjust its decisions accordingly. At a minimum, the new regime requires explicit knowledge of the dollar amounts charged for any research that might be paid by the adviser's underlying customers.

To improve analysis of firms' compliance with these standards, the new rules also dramatically expand disclosures of order routing and executions.[30]

The US regulatory response to these MiFID II reforms has been mixed. The SEC has offered "clarifications" through a handful of "no action" letters to SIFMA,[31] SIFMA AMG,[32] and ICI[33] that may be viewed as both facilitating compliance with, but also blunting the impact of, the MiFID II reforms. Specifically, the SEC "no action" letters provide that:

1. broker-dealers, on a temporary basis, may receive research payments from money managers in hard dollars or from advisory clients' research payment accounts;
2. money managers may continue to aggregate orders for mutual funds and other clients; and

[30] RTS 28 reporting, which started April 30, 2018, breaks down orders into a few different categories, including "passive" (i.e., providing liquidity), "aggressive" (i.e., taking liquidity), and "directed." The reports further require disclosure of the percentages the top five firms/venues are of total volume and total order numbers. See, e.g., Regulatory Technical Standards 28, European Commission, June 8, 2016, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0576&from=EN. RTS 27 reporting, which started in June 2018, provides quantitative statistics for the previous quarter that will allow firms to compare venue execution quality. Regulatory Technical Standards 27, European Commission, June 8, 2016, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0575&from=EN.

[31] Letter from Elizabeth Miller, Sec. and Exch. Comm'n, to SIFMA, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/sifma-102617-202a.htm.

[32] Letter from Heather Seidel, Sec. and Exch. Comm'n, to Timothy Cameron and Lindsey Keljo, SIFMA AMG, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf.

[33] Letter from Aaron Gilbride, Sec. and Exch. Comm'n, to ICI, Oct. 26, 2017, *available at* https://www.sec.gov/divisions/investment/noaction/2017/ici-102617-17d1.htm.

> 3. money managers may continue to rely on an existing safe harbor when paying broker-dealers for research and brokerage.[34]

The response by market participants has been equally interesting. Some research providers have reportedly begun offering their research in Europe at very low costs, often fractions of what they had, just months earlier, received for those same services. The lower costs will benefit the firms' investment advisory clients, particularly those who have committed to paying for research out of their own assets.

On the other hand, those research providers will still expect payment. As a result, many have speculated that these firms will be paid through less transparent means, including receipt of more executions or, perhaps more disturbingly, through bundled commissions arising from trading by non-MiFID-covered customers ("cross-subsidization"). In fact, we at Healthy Markets are aware of at least one global research provider explicitly advising a US-based investment adviser of this "cross-subsidization" payment option.

One thing is abundantly clear: regulators on the other side of the Atlantic Ocean have found risks for investors, and found that many advisers' policies, procedures, practices, and disclosures to be deficient.[35] Regulators in Europe have responded with sweeping enhancements to their expectations for money managers regarding best execution, as well as with dramatically enhanced disclosures by money managers, and brokers.

The Proposal's Interpretation of Best Execution

The Proposal dedicates a total of one paragraph to the duty of best execution, which is entirely copied below:

> **Duty to Seek Best Execution**
>
> We have addressed an investment adviser's duty of care in the context of trade execution where the adviser has the

[34] Press Release, SEC Announces Measures to Facilitate Cross-Border Implementation of the European Union's MiFID II's Research Provisions, Sec. and Exch. Comm'n, Oct. 26, 2017, *available at* https://www.sec.gov/news/press-release/2017-200-0.

[35] *See, e.g.*, Financial Conduct Authority, *Firms continue to fail to meet our expectations on their use of dealing commission*, Mar. 3, 2017, *available at* https://www.fca.org.uk/publications/multi-firm-reviews/firms-fail-meet-expectations-use-dealing-commission.

> responsibility to select broker-dealers to execute client trades (typically in the case of discretionary accounts). We have said that, in this context, an adviser has the duty to seek best execution of a client's transactions. In meeting this obligation, an adviser must seek to obtain the execution of transactions for each of its clients such that the client's total cost or proceeds in each transaction are the most favorable under the circumstances. An adviser fulfills this duty by executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of the transaction. As noted below, maximizing value can encompass more than just minimizing cost. When seeking best execution, an adviser 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 adviser. In other words, the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution. Further, an investment adviser should "periodically and systematically" evaluate the execution it is receiving for clients.[36]

This language appears to be no more than a reiteration of past ambiguous statements. It does not state who should do the reviews, what should be reviewed, or how frequently they should occur. Put simply, it does not offer any substantive standards or clear disclosure requirements.

This language stands in sharp contrast to the significant best execution obligations imposed on broker-dealers by FINRA rules.[37] And it stands in sharp contrast to the

[36] Proposal, at 21207.

[37] See, e.g., FINRA Rule 5310 (providing that, "[i]n any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."); see also *Best Execution Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, FINRA, Reg. Notice 15-46, Nov. 2015, *available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

expectations established by the new MiFID II regime. It even sharply contrasts with the expectations set forth in the subsequently released OCIE Risk Alert (addressed below).

Past Guidance and the OCIE Risk Alert

Historically, the Commission has offered almost no details regarding an investment adviser's best execution obligations, other than to (1) declare the adviser has a duty of best execution, and (2) flesh out some of the details regarding an exception to the best execution obligation--payments for research under Section 28(e).[38] Many investment advisers have appreciated the flexibility that has accompanied this ambiguity. That said, as the best execution landscape has evolved in recent years, this lack of specificity has created risks for advisers and asset owners.

The recent OCIE Risk Alert provided all market participants with some much-needed guidance as to what would be viewed as likely violations of an adviser's best execution obligations. For example, it is finally clear that a firm would be deficient if it:

- Doesn't perform best execution reviews;[39]
- Fails to consider "materially relevant factors" during their best execution reviews;[40]
- Doesn't seek comparisons from other broker-dealers;[41]
- Doesn't fully disclose their best execution practices;[42]
- Doesn't disclose their soft dollar arrangements;[43]
- Doesn't properly administer mixed allocations;[44]
- Doesn't have inadequate policies and procedures for best execution;[45] or
- Doesn't follow its best execution policies and procedures.[46]

Unfortunately, this guidance is also framed in the negative, which leaves many critical questions for investment advisers and their underlying asset owners unanswered. Most notably, what meets the bar?

[38] See, e.g., 1986 Release.
[39] OCIE Risk Alert, at 2.
[40] *Id.*, at 2.
[41] *Id.,* at 3.
[42] *Id.,* at 3.
[43] *Id.,* at 3.
[44] *Id.,* at 3.
[45] *Id.,* at 4.
[46] *Id.,* at 4.

- While an adviser must perform best execution reviews, with what frequency must they be performed? Who should perform them?
- While an adviser must consider "materially relevant factors," what are they? And how should they be weighted?
- While an adviser must seek comparisons from other broker-dealers, what must that entail?

Further, as described below, there are also significant issues not addressed in the OCIE Risk Alert, such as whether certain soft dollar practices are still viewed as consistent with "best execution," even though they may violate MiFID II and be inconsistent with customers' changing expectations.

Put simply, the OCIE Risk Alert demands that firms have "adequate policies and procedures for best execution," yet it provides only the barest guidance as to what that means. Investment advisers are still left questioning whether they are doing enough to ensure they meet their best execution obligations.

Unfortunately, the current applicable disclosure obligations also leave quite a bit to be desired. The disclosures for many investment advisers -- even those with remarkably different practices -- are remarkably similar. It is not likely that even a very sophisticated asset owner would likely be able to differentiate between two different advisers, based on their disclosed "broker selection" or other best execution-related disclosures. Similarly, even disclosures that have been reviewed and updated since the advent of MiFID II do not appear to fully clarify for investors all elements of how investment research may be identified, valued, allocated, and paid for. As a result, investment advisers with policies, procedures, and practices that may be more "customer friendly" are likely not directly rewarded for their approach. Customers simply can't tell them apart from other advisers with less "customer friendly" approaches. Frankly, we can't.

In the absence of robust guidance, many investment advisers remain concerned that they may be retroactively viewed by the Commission, other regulators, or private parties as having failed to meet their obligations. The Proposal and the OCIE Risk Alert do not adequately alleviate those well-founded concerns. In fact, there are "deficiencies" that are formally articulated in the OCIE Risk Alert that appear to have never previously been articulated by the Commission or staff. And while many of these "deficiencies" are well outside the bounds of the best practices and strategies outlined below, it is still regulation by threat of enforcement (and potentially, enforcement).

Current 'Best Execution' Strategies of Investment Advisers

Over the years, investment advisers have developed 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 received and used, and reviewing commission-sharing agreements;
- periodically reviewing their policies, procedures, and practices; and
- routinely evaluating relevant disclosures.

These strategies are evolving rapidly with the advent of the MiFID II reforms and based upon the OCIE Risk Alert. Notably, MiFID II's obligations are causing firms around the world -- even those that are not directly affected -- to revise their policies, procedures, and practices in fundamental ways.

This cross-border impact is being driven in part by US and European customers who are demanding consistent policies and practices, as well as by global investment advisers looking to simplify compliance regimes.

Best Execution Committees

Investment advisers typically establish Best Execution Committees,[47] 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, regulatory, and technological changes that may

[47] CFA Institute Trade Management Guidelines (Nov. 2002) at 6, *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2004.n3.4007.

impact trade execution;

- periodically reviewing the firm's broker selection, trading performance and execution quality;
- overseeing internal or third-party service providers with analyses of the firm's broker selection, trading performance and execution quality; and
- periodically reviewing research payments and usage, as well as other commission sharing relationships.

Many Best Execution Committees 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.

Measuring and Reviewing Execution Quality

Many advisers have determined that their best execution obligations and competitive pressures require them to engage in increasingly sophisticated transaction cost analysis (TCA). According to a buy-side survey from over two years ago by Greenwich Associates, over three-quarters of all equity traders reported using TCA as part of their investment process.[48]

While trading commissions have fallen significantly in recent years,[49] the relative importance of implementation costs has risen.[50] As this shift has occurred, so has the

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[48] 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=ZGxhdWVyQGdtYWlsLmNvbQ%3d%3d&utm_source=ClickDimensions&utm_medium=email&utm_campaign=Greenwich%20Access%20for%20Non%20Asset%20Managers%20-%20Prospects&urlid=2.

[49] 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, Stanislov Dolgopolov, *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,

[50] Meaningful trading analytics is significantly limited by the availability of comprehensive data. One of the greatest contributions regulators and market participants could make to improve fairness and

focus for many investment advisers' on to their true and total costs of trading. Many firms believe that in order to do this cost analysis effectively, they need details regarding not only the handling of their own orders, but also a comprehensive view of the marketplace within which that order routing occurs.[51]

In equities, TCA is far more advanced than in other asset classes due to the availability of quote, trade and depth-of-book level data, and more specifically, microsecond level resolution. To obtain some basic quantitative metrics, such as price and commission rates, many advisers request periodic trading reports from their brokers that show such basic metrics 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: effective spread, realized spread (over various timescales to demonstrate toxicity), implementation shortfall, and other cost metrics.[52]

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. For child orders, the most common metric would typically measure the actual executed transaction price versus the national best bid and offer at

transparency in the market could be to improve the collection and publication of meaningful order and execution statistics. It is not surprising that these reforms have recently been implemented in Europe, and, in the United States, are being considered separately by the Commission.

[51] We note that many third-party TCA providers and broker-offered TCA products still rely upon the SIP data feeds for execution quality analysis. Given the known latencies between the private data feeds and the SIP feeds, as well as the known exploitation of those latencies by some market participants, we worry that these tools provide an incomplete, and a potentially misleading, view of a firm's true execution quality.

[52] 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).

the time an order was submitted.[53] They could do this kind of analysis on different security subsets, such as average daily volume, market cap or sector.

Trade analytics is not just confined to equities, but has also evolved to encompass other asset classes like fixed income, FX, options and futures. While over 78% of large buy-side firms utilize TCA across asset classes,[54] the sophistication of TCA varies significantly across asset classes. Still, with the introduction of mandatory fixed income trade reporting by FINRA[55] and new vendor tools, fixed income analysis is becoming more commonplace.

Derivatives present different issues unique to their markets, such as when an asset is traded on a single execution venue. That said, TCA for some derivatives may be able to examine price slippage and implementation shortfall. Other types of derivatives, however, are much more difficult to analyze. Foreign exchange lacks most of the transparency needed to perform detailed, useful analytics (such as market-wide quote data), although some firms are increasingly offering to provide this type of analysis based on proprietary and limited datasets.[56]

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.[57] Most notably, the Commission has proposed dramatic reforms to order handling disclosures.[58] If enhanced and adopted, the new order routing disclosures would dramatically improve the quality and quantity of information available

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[53] We note that this comparison to the NBBO is increasingly done using a consolidation of the various exchanges' proprietary data feeds, where are generally closer to real-time than the SIPs. This is important because the latency difference may lead to significantly different execution quality. See generally, *In the Matter of Citadel Securities LLC*, Exch. Act Rel. No. 34-79790, (Jan. 13, 2017), *available at* https://www.sec.gov/litigation/admin/2017/33-10280.pdf (reflecting that Citadel had falsely declared that it was providing "best prices" when it was simultaneously taking a better price in reliance on the exchange proprietary feeds).
[54] Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.
[55] FINRA obligates broker-dealers to report corporate bond and Treasury transactions using its Trader Reporting and Compliance Engine (TRACE).
[56] *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.
[57] For example, FINRA and the Municipal Securities Rulemaking Board recently finalized disclosures of mark-ups and mark-downs. FINRA Rule 2232 and MSRB Rule G-15. Notably, the MSRB's "best execution" rule came into effect in March 2016. MSRB G-18, available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-18.aspx.
[58] *Disclosure of Order Handling Information*, Sec. and Exch. Comm'n, 81 Fed. Reg. 49432 (July 27, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-07-27/pdf/2016-16967.pdf.

to investment advisers, so that they may better fulfill their best execution obligations.[59] Similarly, the European Commission has adopted enhanced disclosure requirements as part of MiFID II.[60] Collectively, these disclosures will likewise provide significant inputs for firms' best execution analysis, particularly their evaluations of broker performance and selection.

In fact, we at Healthy Markets believe that this limited ability to perform high quality, useful analysis may have contributed to the recent regulatory actions in foreign exchange trading and other hard-to-assess asset classes. In general, we believe that order routing and execution quality are likely to improve in any asset class wherein a service provider's performance is can be readily assessed and compared to others. Put simply, accountability is likely to improve performance.

Regularly Evaluating Broker Performance and Selection

Most Investment advisers regularly evaluate brokers,[61] and many also evaluate the trading 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 their reviews, investment advisers increasingly use interviews and questionnaires to their brokers and/or execution venues.[62] Many investment advisers create scorecards based on various qualitative and quantitative measures. This information is typically evaluated in conjunction with the TCA performed by the firm or the firm's third-party provider.

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[59] For a more detailed discussion on the need for these disclosures, and specific improvements that should be made before they are adopted, please see Healthy Markets' comments to the Commission's proposal. See generally, Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, Sec. and Exch. Comm'n, Sept. 26, 2016, *available at* https://www.sec.gov/comments/s7-14-16/s71416-19.pdf; letter from Tyler Gellasch and Chris Nagy, Healthy Markets Association, to Brent J. Fields, Sec. and Exch. Comm'n, Jan. 6, 2017, *available at* https://www.sec.gov/comments/s7-14-16/s71416-1464340-130322.pdf.

[60] See, e.g., Regulatory Technical Standards 28, European Commission, June 8, 2016, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0576&from=EN; see also, Regulatory Technical Standards 27, European Commission, June 8, 2016, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0575&from=EN.

[61] Notably, the Commission staff has identified a failure to "demonstrate that [and adviser] periodically and systematically evaluated the execution performance of broker-dealers used to execute client transactions" was a deficiency. OCIE Risk Alert, at 2.

[62] 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.

Broker Reviews

While the exact factors that an adviser utilizes may differ from firm to firm, frequently used elements include:

- material differences in execution quality including such metrics as VWAP, TWAP, price improvement, price disimprovement, implementation shortfall, realized spread, and 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.

The above factors represent some, but not all, elements frequently found in scorecards. Some firms have developed and even patented their scorecards for evaluations.[63]

Venue Reviews

Many investment advisers also review execution venues.[64] 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.

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[63] 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.
[64] Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.

Recent regulatory enforcement cases against ATSs have prompted many investment advisers and routing brokers to send ATSs 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.[65] The information gathered from such questionnaires and other due diligence is often incorporated into an investment adviser's review of best execution.

This is not just a regulatory exercise, but a business one as well. In fact, a 2016 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.[66]

Evaluating Unused Brokers and Venues

In addition, investment advisers are increasingly evaluating prospective brokers[67] and venues to which 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 nonetheless conduct some level of due diligence for potential brokers and venues on an ad hoc or periodic basis.[68]

Quantifying the Value of Research and Reviewing Commission Sharing Agreements

Many investment advisers frequently review the value of both the research they receive and the amount of their payments for research to help ensure that they continue to stay within the safe harbor outlined by Section 28(e). However, qualifying for Section 28(e) in the United States is significantly different than what is expected in the United Kingdom.

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[65] Healthy Markets Association has developed and publicly distributes its ATS Questionnaire to parties upon request. Please see the Healthy Markets website.
[66] Greenwich Associates, *US Equities: Venue Analysis Drives Next Generation of TCA*.
[67] Notably, the Commission staff recently identified as a deficiency "advisers that utilized certain broker-dealers without seeking out or considering the quality and costs of services available from other broker-dealers." OCIE Risk Alert, at 3.
[68] 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.").

In the United Kingdom, regulators demand that asset managers explicitly quantify the value of research they consume, decouple the amount paid for research from the volume they trade, and ensure that the fund paying for research is actually benefiting from such research. All of these principles are directly embedded in MiFID II. To date, the SEC has not explicitly required any of these MiFID II concepts in order to comply with the Section 28(e) safe harbor.

This leaves many investment advisers caught between their historical practices and changing expectations of their customers and European regulators. There are several critical complications.

Whether Customer Funds That Pay for Research Must Directly Benefit From That Research

There appears to be no specific requirement in the US that the research even benefit the fund whose assets are being used to pay for it. Yet, under MiFID II, if customer funds are used to pay for research, the must be specifically budgeted by the customer and benefit the customer. So, is an advisory customer receiving "best execution" if it is paying for research that does not directly benefit it?

Whether Research Payments Are Fixed or Vary Based on Trading Volumes

While payments for research must be "reasonable" under Section 28(e), there appears to be no regulatory requirement that the payment amounts be directly tied to a dollar value. Commission payments in the US have often been tied to the volume of trading by the adviser. A firm trading twice as much based on the same exact research received could end up having its customers pay twice as much for that research.

Of course, this argument could also hold in reverse. What happens when an investment adviser trades dramatically less than it has in the past? Or notional value-linked commissions go down with asset prices? Or if the research informs a decision to not trade at all? The research may be extremely valuable for the investment adviser, and ultimate asset owner, but the payment to the research provider in these scenarios may be extremely limited. These scenarios may moderate what otherwise might be viewed as potentially higher research payments over time.

This type of arrangement, where brokers are paid for research in amounts that are dependent upon the volume of trading by the adviser--as opposed to the true value of the actual research provided--has been historically prevalent in the US.[69] But is an advisory customer receiving "best execution" when the payment amount may be disconnected from any particular dollar value? Again, the Commission guidance to date is silent, while MiFID II demands that research payment amounts be decoupled from the volume traded.

Whether Research Payments Are Based on Notional Values Traded

Commissions in some products (or in securities outside of the United States) may be based on the underlying market value of the underlying trade. In these instances, changes in the market values of those financial products could dramatically impact the commission amounts attributed to trades. For example, as European markets have risen in 2017, payments for research for some asset owners have risen commensurately. Again, asset owners and regulators may question the appropriateness of having the compensation to research providers change merely because of changes in the value of the underlying transactions.

What Can Be Treated as Research

There are also significant questions regarding about what is categorized as "research." For example, in the United States, a broker providing "access" to corporate executives is considered "research", while it is not in the United Kingdom.[70] Assume that a US-based investment adviser is introduced to an executive team of a Chinese technology company by a broker-dealer. That adviser could, under existing US rules, "pay" that broker-dealer for that "research" by directing trades from a purely US-based fund. Again, the US customers could be subsidizing the adviser's other customers.

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[69] In many instances, firms will engage in a voting practice wherein traders and portfolio managers will rank and weight brokers for research and execution values based on objective and subjective criteria, and then attempt to "direct" their overall trading activities (and "commission wallet") to those brokers in those ratios.

[70] When explicitly denying "corporate access" as a permissible use of client funds, the Financial Conduct Authority found "[n]one of the investment managers we visited could justify to us how Corporate Access met the evidential criteria for research under our rules to allow them to pay for it with dealing commissions." Financial Conduct Authority, *Changes to the use of dealing commission rules: feedback to CP13/17 and final rules* (PS14/7), at 6, May 2014, *available at* https://www.fca.org.uk/publication/policy/ps14-07.pdf.

What If an Investment Adviser Is Forced to Pay Bundled Commissions?

The bundling of research and execution payments has had a dramatic impact on research providers and investment advisers. Some large research providers have traditionally *required* investment advisers to pay for that research by sending them orders for execution. This benefits the research providers with increased trading volumes, which can lead to both increased market share, and increased revenues (particularly if the firm also engages in principal trading).

Unfortunately, this insistence forces investment advisers and asset owners to choose between getting the research they need and the ability to shop for potentially higher quality or lower cost executions. What should an investment adviser do in this scenario?

Evolving Practices And Remaining Risks

As a result of these concerns, many investment advisers are following what amounts to a four-part process in addressing research payments. First, investment advisers are establishing or modernizing mechanisms to quantify the value of your research they are receiving. This may be accepting the value relayed by the research provider, attempting to determine an internal valuations, utilizing a third-party reference, or some other method. As a founding premise, this requires identifying, analyzing, and tracking all research received. While it may be a significant change for some firms, it may also be difficult to justify payments for research without having that research first clearly identified and valued.

Second, investment advisers are establishing or modernizing mechanisms to set and follow research budgets. Under MiFID II, this may be setting an RPA amount.In the US, this may mean determining a per-strategy or even per-customer research dollar amount. Notably, this is typically decoupled from the amount of trading projected.

Third, investment advisers are establishing or modernizing mechanisms to allocate research costs fairly (this may mean on a pro-rata basis, per strategy, or some other way). Notably, this frequently seeks to address potential cross-subsidization concerns).

Lastly, investment advisers are establishing or modernizing research payment mechanisms (such CSAs, RPAs, etc.).

Ultimately, the lack of clear direction from the Commission and the different requirements in Europe create significant operational, competitive, regulatory, and legal risks for investment advisers seeking to fulfill their best execution obligations. In particular, while the Commission has remained silent on these issues, customers, lawyers, other regulators, and even courts may venture to establish their own standards (and perhaps legal obligations) for investment advisers.

Reviewing Policies, Procedures, Practices, and Related Disclosures

The importance of essentially "doing what you say you do" has been a key theme in both the Commission's past enforcement cases on best execution, as well as the Commission staff's recent OCIE Risk Alert.

Many investment advisers have processes to review and amend Form ADV, responses to requests for proposals, and other materials that reflect the investment adviser's current best execution policies, procedures, and practices.[71] As policies, procedures, and practices change, many investment advisers have found it important to have a process to regularly review and update them, along with their related disclosures.

Enhancements to the Interpretive Guidance

We recommend that the Commission use this opportunity to inform investment advisers as to what is required to fulfill their best execution obligations and protect asset owners from potential abuses.

Specifically, we strongly recommend that the Commission's Office of Compliance Inspections and Examinations work with the Division of Investment Management and the Division of Trading and Markets to flesh out the contours of a rebuttable presumption that an investment adviser had met its best execution obligations if the adviser had met a minimum standard of care.

We would further recommend that the standard of care include that the adviser:

- has established and maintains a best execution committee that meets on at least a quarterly basis;

[71] 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.

- measures and reviews (on a not less than quarterly basis) execution quality, based on a minimum list of "materially relevant factors";
- regularly evaluates broker performance and selection utilizing a minimum list of factors;
- makes active decisions regarding order routing and execution based upon its reviews;
- has appropriate policies and procedures, and practices related to the payment for research, including that it:
    - identifies and determines the value of research received and utilized;
    - establishes research payment mechanisms that can comply with its Section 28(e) obligations;
    - Establishes research payment mechanisms that decouple the amount paid for research from trading volumes;
    - Establishes research cost allocation mechanisms that ensure that customers who pay for the research directly benefit from that research (so as to constrict cross-subsidization);
- periodically reviews (on a not less than annual basis) best execution policies, procedures, and practices, as well as disclosures related thereto; and
- The adviser fully discloses its best execution policies, procedures, and practices, including all relevant conflicts of interest, soft dollar arrangements, etc..

While FINRA's and Commission's expectations for best execution for broker dealers are robust, there are no similar expectations for investment advisers. Unfortunately, given the changing expectations of foreign regulators and many customers in the US, this lack of specificity has created new risks for investment advisers and asset owners.

To help protect investors and promote more fair and efficient markets, we urge the Commission to clearly and directly state what is (and is not) expected of investment advisers. This should be through dramatically enhanced guidance and, if necessary, revisions to Commission rules under Section 206 of the Advisers Act.

Conclusion

Thank you for the opportunity to share our thoughts on the proposed interpretation. We urge you to expand the interpretation to offer greater clarity and protections for investors.

Sincerely,

Tyler Gellasch
Executive Director

Cc: Dalia Blass, Director of the Division of Investment Management