BEST EXECUTION

Legal and Practical Considerations for Investment Advisers and Funds

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Introduction

"Best execution" is an issue for every fiduciary that exercises discretion in the placement of brokerage for client trades -- that is, for every investment adviser or other investment professional that chooses what broker-dealer, exchange or other market center to use to execute an order to trade securities in a client's account. Clients and regulators alike are keenly interested in where and how brokerage is placed, since commission rates[1] -- as well as other aspects of brokerage placement -- can significantly impact a client's total return and can be rife with conflicts of interest.

This paper focuses on the duty to seek "best execution" imposed by the federal securities laws and ancillary common law on investment advisers placing brokerage for their clients, including their registered fund clients overseen by directors. Many of same issues apply to fiduciaries placing brokerage in other contexts as well, such as broker-dealers handling customer trades or plan fiduciaries managing ERISA accounts. However, in those contexts, additional legal considerations (such as FINRA or ERISA restrictions) may apply that are not within the scope of the discussion here.

This paper addresses both legal and practical considerations surrounding best execution. The principal focus is on the duty of an investment adviser to seek best execution for all clients for which the adviser has discretion to place brokerage. In the case of funds, this paper also discusses the duty of fund directors to monitor best execution as part of their on-going "watchdog" function. Although a fund director's duty is distinct and somewhat different from that of the adviser, it is closely related and is therefore discussed along with the adviser's duty under each relevant heading below.

What is Best Execution?

The term "best execution" is not explicitly defined in the federal securities statutes or regulations. However, available legal guidance says that achieving best execution involves more than merely keeping commission rates or spreads below a specific level. Various authorities describe best execution as the duty to "execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances"[2] or the duty "to seek to obtain the most favorable terms for a

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[1] For the sake of brevity, this paper often refers to "brokers" and "commissions" without explicitly mentioning the related concepts of "dealers" and "spreads." Most of the issues discussed in this paper apply equally to the placement of trades with a dealer that are executed on a principal basis for a spread as they do to trades executed by a broker on an agency basis for a commission. However, there are distinctions between equity securities and markets, which are commonly traded through brokers for a commission, and fixed-income securities and markets, which are commonly traded through dealers at a spread, so that not all aspects of best execution for equities will necessarily fit when applied to fixed-income securities. For a more complete discussion of these distinctions, see the comment letter of the Bond Market Association (now part of SIFMA) filed with the SEC addressing the best execution concept as applied to broker-dealers, at http://www.sec.gov/rules/sro/nasd/nasd2004026/mgross090705.pdf.

[2] Securities Brokerage and Research Services, Release No. 34-23170 (April 23, 1986); In the Matter of Kidder, Peabody & Co., Inc., et al., SEC Release IA-232 (October 16, 1985). On its website, the SEC says the following about best execution, at least as applicable to broker-dealers:

> "In deciding how to execute orders, your broker has a duty to seek the best execution that is reasonably available for its customers' orders. That means your broker must evaluate the orders it receives from all customers in the aggregate and periodically assess which competing markets, market makers, or electronic communications networks (ECNs) offer the most favorable terms of execution. Some of the factors a broker needs to consider when executing its customers' orders for best execution include: the opportunity to get a better price than what is currently quoted, the speed of execution, and the likelihood trade will be executed."
> http://www.sec.gov/answers/bestex.htm

Similarly, the ICI's website defines best execution as follows:

customer transaction reasonably available under the circumstances."[3] Given this, best execution might be best viewed as a PROCESS[4] using the following working definition:

Best execution is the process by which an adviser seeks the most favorable terms for a client's trade reasonably available under the circumstances.

The SEC Staff has recognized that it cannot necessarily determine whether best execution is being achieved by looking merely at the commission rates being charged to any given account or any given trade. The circumstances of each account and each trade vary too widely. Not surprising, then, that the Staff has stated publicly that it looks at the process by which an adviser seeks to achieve best execution,[5] a particularly logical approach given that an adviser's duty is consistently stated as the duty to SEEK best execution, not necessarily to GET it.

Why Should Advisers and Funds be Concerned with Best Execution?

Sophisticated investors have long been aware that the cost of placing the trades in their accounts can have a significant impact on total return and will typically use brokerage costs as one measure for assessing an adviser or a particular investment opportunity. Today, even less sophisticated investors are learning that brokerage costs are an important factor to take into account when selecting advisers or investments.

In addition, best execution has been on the SEC's regulatory agenda for many years and is garnering increased attention from the SEC Staff as well as the media. Best execution is an item routinely considered in SEC regulatory inspections and has been identified as among the

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> "While there is no specific definition of 'best execution' under the securities laws, a broker-dealer has a duty to ensure that customers receive best execution on their orders by taking into account all the facts and circumstances surrounding a customer order. Factors a broker-dealer may consider include, among other things, the price of an order, the size of an order, and the trading characteristics of the security involved." http://www.ici.org/policy/regulation/advisers/faqs_best_execution

[3] Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Release Nos. 33-8349; 34-48952; IC-26313 (December 19, 2003) (Concept Release) at VI.; Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds, The Office of Compliance, Inspections and Examinations, U.S. Securities & Exchange Commission (September 22, 1998) (the 1998 Soft Dollar Sweep Report). See, also, Newton v. Merrill Lynch, Pierce, Fenner & Smith, 135 F.3d 266 (3rd Cir. 1998) (en banc), cert. denied sub nom Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Kravitz, 525 U.S. 811, 1998 [sometimes referred to as Newton I].

[4] In a similar vein, the Trade Management Guidelines issued by the CFA Institute define best execution as the "trading process Firms apply that seeks to maximize the value of a client's portfolio within the client's stated investment objectives and constraints." CFA Institute Trade Management Guidelines (November 8, 2002) at 4, 12.

[5] Remarks of Paul Roye, as Director of the Division of Investment Management, at the National Symposium on Investment Adviser Regulation in Philadelphia (September 10, 2001). See also the remarks of the former head of OCIE, which highlight the Staff's focus on process:

> "[D]uring regular examinations, as we work our way through targeted areas, you can expect us to pay careful attention to the internal controls you have established for each area. Whether it's best execution, pricing securities, or determining portfolio performance, we will ask you to explain your control environment. We hope to see strong systems in place. We'll ask for reports and other output, such as checklists, exception reports and management reports. We will also interview senior management to determine their contribution to the control environment. Finally, we will assess the timeliness and reasonableness of your responses to the problems you identified."

Compliance Professionals Play Proactive Defense, Remarks of Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations, at the National Society of Compliance Professionals National Membership Meeting in Washington, DC (October 18, 2001).

top deficiencies the SEC staff finds.[6] The Staff has taken numerous opportunities to remark publicly on the increasing importance of best execution.[7] Moreover, the SEC specifically listed best execution as one of the areas that advisers and funds should consider[8] when establishing their compliance programs under the SEC compliance rules.[9]

Without doubt, the SEC will also bring a best execution enforcement action when it believes warranted. One example is the administrative proceeding brought against Jamison, Eaton and Wood, Inc. (Jamison).[10] According to the SEC's findings, Jamison failed to make proper disclosures to certain clients whose accounts were held by full service broker-dealers, and these clients paid higher commissions than the firm's other clients. Some of these clients were referred to Jamison by registered representatives (RRs) of these full service broker-dealers under informal referral arrangements. Jamison did not disclose to its referred clients that it faced a potential conflict of interest in receiving referrals from RRs of full service broker-dealers, nor did it disclose to all of its referred clients other available brokerage options. Moreover, Jamison did not periodically review the direction and placement of its client brokerage in light of its duty to seek to obtain best execution and the evolving market for custody and execution services, in violation of the Advisers Act.[11]

In another best execution proceeding, the SEC pursued Portfolio Advisory Services LLC (PAS)[12] for entering into oral arrangements with five brokers to direct commissions to them in return for referring clients to a hedge fund formed by PAS. According to the SEC Order, PAS would direct trades to a market maker that displayed the best price at the time of the trade. When the trade was confirmed, PAS would report the trade to its prime broker, which provided clearance, custodial and other back office services for PAS. PAS would also instruct the prime broker to add a 5¢ per share commission on the trade to a referring broker, even though the

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[6] See Fiduciary Duty: Return to First Principles, Remarks of Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations, at the IAA/IA Week Eight Annual Investment Adviser Compliance Summit in Washington, DC (February 27, 2006).

[7] See remarks of Paul Roye, as Director of the Division of Investment Management in Priorities in Investment Adviser Regulation, Remarks Before the IA Compliance Summit and Best Practices Update in Washington, DC (April 8, 2002) and in Mutual Fund Management: Taking Responsibility, Maintaining Trust and Influencing Positive Change, Remarks Before the 2002 Mutual Funds and Investment Management Conference in Orlando, Florida (March 25, 2002), where he said, "As you know, best execution is a duty of every money manager to its clients and also is an issue of substantial current interest to the Commission and the staff." See also remarks of Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations (OCIE), who listed best execution in the areas of current focus in investment adviser examinations and stated, "We are also continuing to look at advisers' processes for placing orders for their clients' accounts. Among our objectives in this area is to determine if an adviser seeks to obtain best execution. We are also reviewing advisers' use of clients' funds for soft dollar abuses or undisclosed payments for client referrals." Furthering Good Compliance: Current Areas of Focus in SEC Examinations, Remarks Before the National Regulatory Services, 17th Annual Spring Compliance Conference in Miami Beach, Florida (April 8, 2002).

[8] Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204; IC-26299 (December 17, 2003) (Adopting Release), at II.A.

[9] The compliance rules are Rule 206(4)-7 under the Advisers Act for advisers and Rule 38a-1 under the Investment Company Act for funds.

[10] In the Matter of Jamison, Eaton & Wood, Inc., Advisers Act Rel. No. 2129 (May 15, 2003) (Jamison). Unless otherwise noted, administrative proceedings referenced in this paper were settled by Consent Order entered into by the respondent(s) without admitting or denying the SEC's findings.

[11] The substantive violations in the Jamison proceeding were stated under Sections 206(2) (prohibiting fraud) and 207 (prohibiting false statements in SEC filings) of the Investment Advisers Act of 1940. Among the remedies imposed by the SEC's Consent Order -- in addition to a monetary penalty -- was the requirement that Jamison continue to maintain a standard investment contract containing a separate paragraph, designated "Placement of Brokerage," which contains all of the disclosures spelled out by the SEC in the Order, and which permits the client to direct its brokerage to a particular broker, in writing, if the client so chooses.

[12] In the Matter of Portfolio Advisory Services, LLC, and Cedd L. Moses, Advisers Act Release No. 2038 (June 20, 2002) (PAS).

referring broker's firm had no role in executing the trade, thereby causing clients to pay unnecessary commissions. This was found to violate the adviser's duty to seek best execution by interposing a broker-dealer between clients and a market maker on OTC trades in order to compensate the broker-dealer for referring clients to the adviser.[13] [14]

Lastly, advisers and funds should be concerned about best execution for another reason. Although the discussion about best execution tends to focus on equity trades and commission rates, the SEC has made it clear that an adviser's obligation to seek best execution applies to fixed-income trades, as well as all other asset classes.[15] While some best execution concepts carry over effectively from the equity markets, others do not since non-equity markets tend to be decentralized, dealer-driven markets lacking in transparency, available data (especially for illiquid securities) and benchmarks, making many of the familiar best execution concepts inapplicable or difficult to apply. Although fixed-income, derivative and other asset classes present their own challenges for best execution, the industry has nonetheless been encouraged to focus on this "relatively unchartered territory" and continue to develop tools to measure non-equity trade execution.[16]

Isn't Best Execution All About Getting the Lowest Commission Rates or Best Spread?

Not necessarily. Certainly, commission rates and spreads are part of the best execution 'equation,' but those are not the only considerations. Advisers may – and probably should -- take into consideration numerous factors when selecting broker-dealers to place trades, not just

[13] The substantive violations in the PAS proceeding were stated under Sections 206(2) (prohibiting fraud) and 207 (prohibiting false statements in SEC filings) of the Investment Advisers Act of 1940. Similarly, Section 206 and Section 207 charges were leveled against the adviser in In the Matter of Tilden Loucks & Woodnorth, LLC, Lasalle St. Securities, LLC, and Ralph B. Loucks, Advisers Act Release No. 3494 (October 29, 2012) (Loucks), where the adviser allegedly charged its clients commissions exceeding the fees it paid to the broker to execute trades, without disclosing to clients that it kept the excess amounts. This was at odds with disclosure suggesting that clients were getting discounted brokerage rates and that the adviser was conducting an annual survey to ensure best execution.

[14] For other proceedings involving best execution, see Loucks, *supra*; Evergreen Investment Management Company, LLC and Evergreen Investment Services, Inc., Release Nos. IA- 2888, IC-28759 (June 8, 2009) (adviser failed to accept higher offer for security held by fund client, in breach of duty to seek best execution); Fidelity Management & Research Co., Inc. and FMR Co., Inc., Release Nos. IA- 2713, IC-27175 (March 5, 2008) (among other things, lavish gifts inappropriately influenced fund adviser's placement of brokerage, in violation of its duty to seek best execution); Folger Nolan Fleming Douglas Capital Management, Inc., Neil C. Folger and David M. Brown, Release No. IA-2639 (August 23, 2007) (clients referred to adviser paid higher commission rates through referring broker, with little corresponding benefit and no disclosure); Sage Advisory Services LLC, Advisers Act Release No. 1954 (July 27, 2001) (churning to generate soft dollar credits); In the Matter of Founders Asset Management LLC, Advisers Act Release No. 1879 (June 15, 2000) (among other things, adviser falsely stated in Form ADV that it would seek best execution when in fact it was directing commissions to a broker that charged higher rates in return for client referrals); and In the Matter of Fleet Investment Advisors, Advisers Act Release No. 1821 (September 9, 1999) (adviser breached its duty by failing to seek the best available price on certain fixed-income transactions for clients).

[15] See the Keynote Luncheon Address Before the SIA Institutional Brokerage Conference, given by Andrew J. Donohue, Director of the SEC Division of Investment Management, in New York, New York, on October 30, 2006:

> "When considering an investment adviser's best execution obligations, both regulators and industry participants tend to focus mostly, if not exclusively, on the trading of equities. However, an investment adviser's duties with respect to seeking best execution apply equally to fixed income securities and other asset classes."

[16] Id. In some measure, the industry is responding to this challenge. For example, in the absence of helpful guidance from the SEC, SIFMA (the Securities Industry and Financial Markets Association) has issued a white paper addressing best execution guidelines for fixed-income securities, available at http://www.sifma.org/issues/item.aspx?id=21333. FINRA continues to develop the TRACE (Trade Reporting and Compliance Engine) to facilitate the reporting of over-the-counter secondary market transactions in eligible fixed-income securities, helping to make more data available in that market. Services such as TradeWeb also provide post-trade analytical tools to the fixed-income and other markets allowing price benchmarking and peer group comparisons for best execution purposes. In addition, the profound reforms being instituted in the trading markets for swaps, security-based swaps and other derivatives (see http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml) may eventually impact best execution in those markets as well.

the commission rate or spread which factors into the net price of the security.[17] Although the commission rate (and to a lesser extent spread) may be easier to quantify and is therefore paid a great deal of attention, it is not always the determinative factor, nor is the adviser obligated to get the lowest commission cost in every case.[18]

The real cost of a particular trade might be viewed in simple mathematical terms as:

Commission (or Spread) Cost
+
Market Impact Cost (including the price movement caused by the trade itself)
+
Timing Cost (delay during which unfavorable price movements may occur)
+
Opportunity Cost (of failing to find liquidity or otherwise failing to complete a trade)
=
Real Cost of a Trade

This simple formula helps to illustrate that speed, confidentiality and access to liquidity can impact the real cost of a trade just as the commission rate can.

In reality, the true cost of a trade is even more complex, requiring that advisers evaluate a whole host of factors when placing brokerage. Factors often cited as those to consider in selecting broker-dealers include their:

- trading expertise
- reputation
- integrity
- ability to maintain confidentiality of client's trading program
- infrastructure and facilities
- responsiveness
- financial stability and capability, including the willingness and ability to commit its own capital to
- facilitate large trades
- access to IPOs and other underwritten offerings
- access to a range of secondary markets
- reliability in executing trades and keeping records
- fairness in resolving disputes

as well as the timing and size of a particular order, available liquidity and other current market conditions.[19]

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[17] This was reiterated again in the SEC's 2008 Proposed Director Guidance on Soft Dollars, *infra* note 28, in the text surrounding notes 38, 39 and 40.

[18] This was acknowledged by the SEC well over 30 years ago when it stated, "The Commission wishes to remind money managers that the determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account." Release No. 34-23170, *supra* note 2. See also, Concept Release, *supra* note 3, at VI: "Although a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost."

[19] See the factors cited in Release No. 34-23170, *supra* note 2, and in the CFA Institute Trade Management Guidelines, *supra* note 4, at 7-8.

In addition to controlling costs on individual trades, advisers must also consider whether overall costs might be lowered using other methods, such as:

- volume discounts that might be available if more trades were directed to one particular broker-dealer, or
- getting ancillary benefits from brokerage, such as commission recapture used to offset account expenses, which would lower the overall effective cost of the trade.

While these ancillary methods may arguably extend beyond the scope of an adviser's duty to seek best execution on any given trade, they will likely be viewed as an integral part of the adviser's fiduciary obligation to act in the best interests of its client when placing their brokerage. For example, one of the basic allegations in a leading brokerage case, Tannenbaum v. Zeller,[20] was that the directors (and the adviser) had violated their fiduciary duty by foregoing commission recapture which could have been utilized for the purpose of offsetting the advisory fee, but instead approved commission recapture which was utilized for purposes that benefited the adviser (to support distribution and purchase research). Fortunately in that case, the court found that fully-informed, independent directors had reached a reasonable business decision to forego recapture and therefore held that they had not breached their fiduciary duty. However, the point remains that advisers and directors should be taking into account available commission recapture opportunities.

What Types of Trading and Commissions Practices Impact Best Execution?

A number of trading and commissions practices can bear on best execution. A few of these are discussed below. Since brokerage in a client's account is generally viewed as an asset of the client,[21] all viable uses of brokerage should be analyzed to make sure that best execution is indeed being achieved within applicable legal parameters. More specifically, the impact on best execution of these common types of arrangements and practices should be considered and analyzed closely if implemented:

Soft dollars: "Soft dollar practices" generally refers to arrangements whereby an adviser uses commission dollars generated by its clients' trades to pay for research or brokerage services or other benefits. Since using a client's brokerage in this way could benefit the adviser itself or the adviser's other clients, soft dollar practices raise not only best execution issues but conflict of interest issues as well. Accordingly, questions such as these should always be asked: Is someone other than the client benefiting from the brokerage? Or is the client paying an unnecessarily high commission rate in order to obtain that benefit?

If the benefit being obtained by the use of brokerage qualifies as "research" or "brokerage services"[22] under Section 28(e) of the Securities Exchange Act of 1934, that section provides a safe harbor[23] shielding the adviser from legal liability for "paying up" to obtain that benefit – that

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[20] Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977). Cf. Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975) (adviser and affiliated directors liable for failure to recapture brokerage).

[21] In the fund context, this principle was reaffirmed by the SEC: "Fund brokerage is an asset of the fund, and its use to pay for distribution expenses implicates rule 12b-1, which regulates the use of fund assets to pay selling brokers or otherwise finance the sale of fund shares." Release No. IC-26591 (September 2, 2004), at I.

[22] In determining whether something is "research" under Section 28(e), the controlling principle is whether it provides lawful and appropriate assistance to the money manager in the performance of its investment decision-making responsibilities. Release No. 34-23170, *supra* note 2. "Brokerage services" are generally considered to include effecting securities transactions (i.e., execution) and incidental functions, such as clearance, settlement and custody. See Securities Exchange Act of 1934, Section 28(e)(3)(C).

[23] Because Section 28(e) is a "safe harbor," it cannot be violated *per se*. This means that transactions not fitting within the safe harbor are not automatically legal violations. Rather, they must be scrutinized within the legal framework of fiduciary and other duties owed by an adviser to its client without the protection afforded by the safe harbor.

is, for paying a higher commission than it might otherwise have paid using a different broker. The adviser will be shielded under the safe harbor so long as it determines in good faith that the commission was reasonable in relation to the value of the brokerage and research provided[24] by the broker-dealer, viewed in terms of either that particular transaction or the adviser's overall responsibilities with respect to the accounts as to which the adviser exercises investment discretion.

Congress enacted Section 28(e) to avoid claims – breach of fiduciary duty or other legal claims -- against advisers who did not necessarily pursue the lowest commission rates available after fixed commission rates were abolished on "May Day" 1975. Section 28(e) counters the notion that advisers are legally obligated to seek the lowest commission available in all cases and shields advisers from a claim that they violated their duty of best execution by not seeking a lower commission rate when paying up for research or brokerage services. Moreover, 28(e) is typically read to allow advisers to use brokerage to obtain research that might benefit itself and its other clients, in addition to the client whose brokerage was used.

Soft dollars continue to be controversial and continue to haunt the industry as an area of abuse. A 1998 SEC industry sweep revealed numerous inappropriate uses of soft dollars to obtain items clearly outside of the Section 28(e) safe harbor of "research and brokerage" services, such as rent, phone, utilities, marketing, salaries, entertainment, travel, meals, copier, office supplies, fax machines, couriers and backup generators.[25] Separately, a Task Force of the NASD (now FINRA), with the support of the ICI, has recommended that the SEC substantially narrow its interpretation of Section 28(e) to better tailor it to the types of soft dollar services that benefit the adviser's client rather than the adviser.[26]

In more recent years, the SEC has issued interpretive guidance regarding client commission practices (including soft dollars)[27] and proposed guidance to fund directors overseeing adviser trading practices (including use of soft dollars).[28] While this guidance generally confirms the continuing viability of soft dollar practices, it narrows somewhat the definitions of "brokerage" and "research" that are permitted under the Section 28(e) safe harbor.[29] It also confirms that

[24] Of course, all of this is based on the problematic assumption that the research and brokerage services obtained can be valued with any reasonable certainly, particularly when it is provided on "bundled" basis along with execution. For an industry discussion of this, see Ivy Schmerken, "Broker Research: What is it Worth?" (April 25, 2006) on Wall Street & Technology at http://www.wallstreetandtech.com/electronic-trading/showArticle.jhtml;jsessionid=LADZVAXB4BCIXQE1GHRSKHWATMY32JVN?articleID=161600239&_requestid=250980.

[25] It also discovered many mixed uses of items provided by a broker in exchange for soft dollars that were not properly allocated between "soft dollars" and "hard dollars" and not properly disclosed. For example, computer systems that provide both research and administrative uses should be reasonably allocated according to the anticipated use of the system and only that component that assists the adviser in making investment decisions should be paid by the adviser with commission dollars under Section 28(e). 1998 Soft Dollar Sweep Report, *supra* note 3, at Section II.F.1.

[26] Report of the NASD Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs (November 11, 2004) available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p012356.pdf, at p.6.

[27] See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Release No. 34-54165 (July 18, 2006) (2006 Soft Dollar Interpretive Release).

[28] See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Release Nos. 34-58264; IC-28345 (July 30, 2008) (2008 Proposed Director Guidance on Soft Dollars).

[29] Notably, although the 2008 guidance generally affirmed the viability of "soft dollars," it did cast doubt on the use of soft dollar research to benefit client accounts other than those whose commissions generated the soft dollars used to obtain the research, contrary to the typical reading of Section 28(e) that research and brokerage obtained within the safe harbor can be used to benefit all accounts over which the adviser exercises discretion. Specifically, the guidance tells fund directors they should obtain from advisers certain information about how the adviser allocates soft dollar benefits among clients, and about whether research services are "inappropriately" benefiting another of the adviser's clients at a fund's expense. See pp. 30 and 32 of the guidance. At a minimum, this could be read as casting a negative light on the practice of not allocating soft dollar benefits. For a more complete discussion of this issue and the guidance

the enactment of Section 28(e) did not alter an investment manager's basic obligation to seek best execution.[30] As a result, when operating within the 28(e) safe harbor, advisers may be shielded from certain fiduciary claims as a result of "paying up," but they ostensibly remain obligated to consider all the other elements of best execution when placing client trades.

As a result of the controversy surrounding soft dollars, some advisers choose not to use soft dollar arrangements at all, citing ethical concerns with the inherent conflicts of interest. Despite these concerns, however, soft dollar practices are still widespread in the industry. In any event, any soft dollar arrangements should be scrutinized closely when considering best execution.

Directed brokerage to offset expenses: Here, the term "directed brokerage" is used to refer to an arrangement in which a client directs the adviser to place the client's portfolio transactions with a particular broker-dealer that has agreed to offset or pay certain client expenses, such as custody or transfer agency fees. This type of arrangement can, in effect, recapture some of the client's commissions and reduce the overall effective cost of the client's trades, even if the trade is placed with a traditional broker-dealer ostensibly charging its published commission rate of 5¢-6¢ a share.

In this type of directed brokerage arrangement, the expenses paid by the broker-dealer benefit only the client whose brokerage is placed with that broker-dealer.[31] Otherwise, it would raise the same conflicts of interest, fiduciary and cross-subsidization issues raised by a classic "soft dollar" arrangement. Nonetheless, directed brokerage arrangements should be undertaken only subject to best execution, meaning that the terms of the trades must still be the most favorable reasonably available under the circumstances, and must be consistent with an adviser's fiduciary obligation to act in the client's best interest.[32] Further, note that directed brokerage generally does not fall within the safe harbor protection of Section 28(e) because the benefits being obtained (payment of client expenses) are not "research and brokerage services," and consequently, fiduciary and other issues would be raised if a client were asked to "pay up" in order to participate in the directed brokerage arrangement.

In the case of a fund client, if a directed brokerage arrangement benefits someone other than the fund whose brokerage is being used -- for example, the adviser itself -- the arrangement might violate the Investment Company Act of 1940, since the benefit obtained may constitute "compensation" to the adviser for the purchase or sale of fund property, which is proscribed under Section 17(e)(1).[33] This can be a trap for the unwary when measuring expense caps

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generally, see James G. Silk and Y. Rachel Kuo, Considering the SEC's Proposed Guidance for Fund Boards on Portfolio Trading Practices, *The Investment Lawyer* (December 2008).

[30] See Exchange Act Release No. 23170 (Apr. 23, 1986), cited in the 2006 Soft Dollar Interpretive Release, *supra* note 27.

[31] See CFA Institute Soft Dollar Standards: Guidance for Ethical Practices Involving Client Brokerage, Section V, page 7: "Because Brokerage is an asset of the Client, not the Investment Manager, the practice of Client-Directed Brokerage does not violate any Investment Manager duty per se. [However, in] a Client-Directed Brokerage Arrangement…the Investment Manager must not use Brokerage from another Client account to pay for a product or service purchased under the Client-Directed Brokerage Arrangement."

[32] For a more complete discussion of an adviser's fiduciary duty, see the question in this paper that addresses the legal framework surrounding best execution.

[33] Section 17(e)(1) of the Investment Company Act of 1940 provides:

(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person –

> (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker,….

agreed to by advisers for their mutual fund clients. For instance, if the adviser has agreed to a contractual expense cap, fund brokerage cannot be used in a directed brokerage arrangement to decrease the fund's expenses and therefore reduce the amount the adviser has to absorb or reimburse under the expense cap. The SEC has stated that this would "almost certainly" violate Section 17(e)(1) as prohibited compensation for the purchase or sale of any fund property, unless the benefit received fell within the safe harbor of Section 28(e).[34]

Consequently, funds should "gross up" their expenses for directed brokerage offsets when measuring which expenses are subject to an expense cap contractually agreed to by an adviser or other affiliate covered by Section 17(e)(1). On the other hand, if the expense cap is voluntary, the SEC has stated that grossing up is not necessary.[35]

Directed brokerage in exchange for fund share distribution: In the past, funds (and their advisers) were permitted to take a broker-dealer's sales of fund shares into account when selecting broker-dealers to execute the fund's portfolio transactions. However, in 2004 the SEC adopted rule amendments banning the use of fund brokerage to finance the sale of fund shares or to compensate brokers for their fund share promotional activities.[36] Rule 12b-1(h)(1) prohibits funds from compensating a broker-dealer for selling fund shares by directing fund brokerage transactions to that broker. The prohibition applies both to directing transactions to selling brokers and to indirectly compensating selling brokers by participation in step-out and similar arrangements in which the selling broker receives a portion of the commission. The ban extends to any payment, including any commission, mark-up, mark-down or other fee (or portion of another fee) received or to be received from the fund's portfolio transactions effected through any broker or dealer.

In adopting the new rule, the SEC recognized that the provisions which prohibit a fund's trades to be placed with selling brokers might inadvertently compromise best execution since, in some cases, the broker-dealer that can provide best execution on a particular fund trade may also happen to be a selling broker that helps to distribute the fund's shares. To avoid this problem, Rule 12b-1(h)(2) was adopted, which permits the selection of a selling broker to execute the fund's portfolio trades, but only if the fund or its adviser has implemented policies and procedures designed to ensure that the selection of that broker is not influenced by considerations about the broker's assistance with distribution. In other words, the selection of that broker must be based only on the broker's ability to provide best execution or other permissible considerations, and not in whole or in part on the basis of the broker's selling activities.

Client referrals: Advisers using client commissions to compensate brokers for referrals of clients to the adviser face a number of issues, many of which have been mentioned under the other types of arrangements discussed above. If the "client referrals" are actually investors who buy shares in a mutual fund managed by the adviser, Rule 12b-1(h) prohibits placing fund brokerage with the referring broker in recognition of those referrals.

If, on the other hand, the "client referrals" are clients referred to the adviser's non-fund advisory business -- for example, its private account management business or hedge fund business – other issues are raised. For example, even brokerage placement in recognition of referrals

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For example, the adviser's use of fund client brokerage to compensate brokers for referring clients to the adviser was determined to violate Section 17(e)(1) in In the Matter of Fleet Investment Advisors, *supra* note 14.

[34] Payment for Investment Company Services with Brokerage Commissions, Release No. IC-21221 (July 21, 1995) at n.9.

[35] Id.

[36] See Prohibition on the Use of Brokerage Commissions to Finance Distribution, Release No. IC-26591 (September 2, 2004), adopting Rule 12b-1(h). FINRA has adopted corresponding changes to its rules governing broker-dealers.

must be consistent with the adviser's fiduciary duty to act in the client's best interest and with the adviser's duty to seek best execution.[37] Moreover, arrangements to compensate for client referrals will not fall within the scope of Section 28(e) discussed above and that safe harbor will therefore not be available to justify a client being asked to pay higher commissions than would otherwise be available in order to reward the referring brokers. In addition, an adviser's receipt of client referrals in exchange for brokerage commissions generated from fund client accounts would violate Section 17(e)(1) under the Investment Company Act,[38] which in substance prohibits an adviser from accepting compensation for the purchase or sale of fund property unless the adviser is acting as an underwriter or broker. Even brokerage for referral arrangements that are otherwise permissible raise conflicts of interest for the adviser that must be disclosed.[39]

Given all the potential issues at stake, any time an adviser uses client brokerage to reward a broker, caution should be exercised and, in any event, the conflict of interest, fiduciary and disclosure angles must be analyzed to see if the client's brokerage is being used in a circumstance in which the client itself does not benefit, in a circumstance in which a different client or party (such as the adviser) benefits or in a circumstance where the arrangement is not adequately disclosed.[40]

<u>Aggregation, allocation and sequencing</u>: Deciding whether to aggregate or "bunch" trades executed simultaneously, deciding how to allocate bunched trades among participating accounts in the event of a partial fill and deciding how to sequence unbunched trades can all impact the price, commission rate and other terms obtained on a trade for any particular account and, as a result, can bear on best execution.[41] These issues can become particularly acute if the adviser is simultaneously trading multiple accounts with different brokerage arrangements, such as accounts where brokerage has been directed to a particular broker by the client, wrap accounts where trading away from the sponsoring firm adds otherwise unnecessary brokerage costs or accounts where other brokerage restrictions apply (for example, no soft dollars, no trading with certain brokers, and so on). A full discussion of these complex issues is beyond the scope of this paper, but several points can be made:

[37] See Jamison, *supra* note 10 (failure to seek best execution for clients referred by broker-dealers and failure to disclose brokerage options to clients); PAS, *supra* note 12 (interpositioning broker to compensate for client referrals to adviser's hedge fund violates antifraud provisions of Advisers Act when it results in clients paying unnecessary brokerage charges); and In the Matter of Founders Asset Management LLC, *supra* note 14 (adviser makes a false statement in Form ADV when it states that it seeks best execution when in fact it is directing trades for execution at 20¢ a share commission rate while lower commission rates were available in order to compensate brokers for client referrals).

[38] See In the Matter of Fleet Investment Advisors, *supra* note 14, and the 17(e)(1) discussion in note 33 *supra* and surrounding text.

[39] Virtually all these problems were discussed in In the Matter of Fleet Investment Advisors, *supra* note 14, as well as the subsequent SEC proceeding brought against several of the individuals involved, In the Matter of Clarke T. Blizzard and Rudolph Abel, Advisers Act Release No. 2253 (June 23, 2004). See also, In the Matter of Chris Woessner, Initial Decision Release No. 225, SEC Administrative Proceeding, File No. 3-10607 (March 19, 2003) (Senior Vice President of Marketing allegedly aided, abetted and caused advisory firm's fraud by not that clients' brokerage was directed to a particular broker-dealer in exchange for referring a pension plan client).

[40] These issues can become particularly thorny when client orders are "bunched" or aggregated together for execution and then placed with a particular broker-dealer in exchange for a product, service or other benefit. Advisers should ensure that their legal obligations are being met with respect to every client participating in the trade and that each client is being treated fairly relative to the others and relative to the benefit being obtained.

[41] A seminal no-action letter addressing many of these issues in the context of funds is SMC Capital, Inc. (File No. 132-3) (pub. avail. Sept. 5, 1995).

- An adviser's fiduciary duty will require it to treat its clients fairly and equitably, both individually and with respect to one another.[42] This may not mean clients need to be treated equally in every case, but reasonable procedures should be adopted to achieve fair treatment over time, and those procedures should be fully disclosed and consistently applied.
- In particular, practices should be avoided if they have the effect of systematically disadvantaging one client or group of clients relative to another. If an adviser's practices could be viewed as systematically disadvantaging a client or group of clients in some way – for example, if directed trades are never bunched and are always sequenced after the bunched trade – the client's consent to this practice should be obtained, at a minimum through full disclosure.

Cross-trades, agency cross-trades and principal trades: The use of cross-trades, agency cross-trades and principal trades to effect trades on behalf of client accounts can also impact best execution. Indeed, in certain circumstances, advisers may be able to reduce or eliminate brokerage commissions for certain trades using these practices. However, because of the built-in conflicts of interest, each of these practices has its own legal restrictions and considerations, a full discussion of which is beyond the scope of this paper.[43] Nonetheless, advisers and fund boards looking for potentially advantageous trading arrangements might consider these alternatives in appropriate circumstances.[44]

What is the Overall Legal Framework Surrounding Best Execution?

The duty for an adviser or fund to seek best execution is not expressly stated in the federal securities laws. Rather, it is implied or inferred from various sources. The legal framework for best execution includes statutory, fiduciary, contractual and industry practice elements.

Federal securities laws:

- Section 206: Under the Investment Advisers Act, courts have imposed on advisers a fiduciary duty that includes an affirmative duty of "utmost good faith, and full and fair disclosure of all material facts" and an affirmative obligation "to employ reasonable care to avoid misleading" clients.[45] This fiduciary obligation has long been interpreted to include the duty to seek best execution under Section 206 of the Act, which generally prohibits adviser fraud.[46] Hence, Section 206 is the section under which SEC

[42] See the Trading Practices discussion at the Division of Investment Management: SEC Roundtable on Investment Adviser Regulatory Issues held on May 23, 2000 at the Commission. Transcript: http://www.sec.gov/divisions/investment/roundtable/iadvrndt.htm.

[43] A seminal resource addressing these types of trades is Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Release No. IA-1732 (July 17, 1998).

[44] Indeed, cross trades between mutual funds managed by the same adviser may be effected under Rule 17a-7 of the Investment Company Act of 1940, provided the conditions in the rule are met.

[45] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 at 194, 84 S.Ct. 275 (1963), citing Prosser on the Law of Torts, among other authorities.

[46] In the Matter of Fleet Investment Advisors, *supra* note 14, citing Kidder Peabody & Co., Inc., Edward B. Goodnow, Advisers Act Release No. 232, 1968 SEC LEXIS 251 (October 16, 1968) and other cases. See also Rule 206(3)-2(c) under the Investment Advisers Act, which refers to the adviser's duty to act in the best interests of its clients, including the duty "with respect to best price and execution" for client transactions. Also, note the remarks of Paul Roye, Director of the Division of Investment Management, who stated, "Section 206…prohibits misappropriating client funds…[as well as] a variety of other unscrupulous activities, such as overstating performance results, usurping investment opportunities that belong to clients, failing to disclose soft dollar practices, failing to seek best execution on client transactions, and favoring certain clients or proprietary accounts in allocating trades without disclosing the practice." Priorities in Investment Adviser Regulation, Remarks Before the IA Compliance Summit and Best Practices Update in Washington, DC (April 8, 2002) (emphasis added).

administrative proceedings are typically brought alleging best execution violations against advisers.[47]

- Section 15(c): Section 15(c) of the Investment Company Act of 1940 requires fund directors to request and evaluate the information necessary to evaluate the terms of the advisory contract, initially and at each renewal. For advisers with discretion in placing client brokerage, the advisory agreement typically requires that they seek best execution. Accordingly, as part of their fiduciary duty as a "watchdog," directors are expected to request and evaluate appropriate best execution information when approving an initial advisory agreement or renewal. Note that Section 15(c) also imposes on advisers a duty to furnish the information directors need to evaluate the advisory contract. As a result, even if the directors do not ask for best execution information, fund management is expected to provide it, particularly any information where there may be a conflict of interest.[48]

- Section 36(a): Advisers to a registered investment company and fund directors are both subject to Section 36(a) of the Investment Company Act of 1940, which authorizes actions against officers, directors, advisers or principal underwriters for breaches of fiduciary duty *involving personal misconduct* with respect to an investment company.[49] Cases dealing with soft dollar and other trading practices are often stated under Section 36(a), particularly if there is a breach of duty with regard to affiliated brokers. Significantly, some courts have implied a shareholders' right of action under Section 36(a) as well.[50]

- Disclosure: The federal securities statutes, regulations and forms also require that material information about brokerage practices be disclosed, which is discussed in more detail under the question about disclosure set out below.

Fiduciary duty under common law:

- Adviser's duty: An adviser's duty to seek best execution has also been implied from basic common law fiduciary principles governing principals and agents. This has been stated to include the duty of undivided loyalty, as well as the duty to exercise due care.[51] Among other things, this means that advisers must act in their client's best interest when placing brokerage and that any conflicts of interest must be adequately disclosed.

- Directors' duty: Fund directors also have fiduciary duties under state common law, including the duty to exercise due care in discharging their responsibilities and the duty

[47] See the Folger, Jamison, PAS, Founders, Fleet and other cases cited above.

[48] See Tannenbaum v. Zeller, *supra* note 20, and Moses v. Burgin, 445 F.2d 369, 376 (1st Cir. 1971), which involve allegations that management failed to provide relevant information to the directors.

[49] Section 36(a) has been described as a "reservoir of fiduciary obligations" that is designed to protect shareholders from the many subtle abuses that are not separately prohibited in the Investment Company Act. See Brown v. Bullock, 194 F. Supp. 207, n.1 at 238-239 (S.D.N.Y.), aff'd, 294 F.2d 415 (2d Cir. 1961) (en banc).

[50] See, e.g., In Re ML-Lee Acquisition Fund II, L.P. Securities Litigation, 848 F. Supp. 527 (D. Del. 1994); Robert Young, et al. v. Nationwide Life Insurance Company, et al., 2 F.Supp.2d 914 (S.D. Tex. 1998); and Strougo v. Scudder, Stevens & Clark, Inc., 964 F.Supp. 783 (S.D.N.Y. May 6, 1997). Cf., e.g., Chamberlain v. Potapchuk, 02CV 5870 (EDNY 2005).

[51] "The origins of the best execution duty predate the federal securities laws and may be traced to the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his or her principal." 1998 Soft Dollar Sweep Report, *supra* note 3, at Section II.H., citing a 1916 Massachusetts case and also referring to the Second Restatement of Agency. See also, SEC v. Capital Gains Research Bureau, Inc., *supra* note 45.

of loyalty.[52] These duties apply to the directors' activities in monitoring best execution as well.

Contractual obligations:

- Most advisory agreements obligate the adviser to seek best execution for every trade, at least for those advisers that undertake the responsibility to use their discretion in placing client trades. Failing to seek best execution may therefore afford a client contractual remedies in addition to remedies available under other avenues.

Industry practice:

- While there is some comfort in running with the crowd, maintaining the historic status quo in best execution may not be good enough anymore. Today, saying that "everyone uses these particular brokers" or "we've been accepting their standard rates for years" is unlikely to be a sufficient explanation if asked why an adviser is not seeking to reduce trading costs by all reasonably available means.

- Moreover, the CFA Institute Trade Management Guidelines[53] may become a de facto gold standard for "best practices" in the industry with regard to trading issues, as often occurs in other arenas when an industry-recognized "blue ribbon panel" issues guidance. Increasingly, advisers that do not meet those guidelines will be out-of-step with industry practice.

What Standard of Conduct Applies to Seeking Best Execution?

An adviser's duty of care: It is unclear exactly what standard of conduct applies to an adviser's duty to seek best execution, meaning whether an adviser is expected to exercise ordinary prudence or whether the adviser will be held to some other standard of care when seeking best execution. On the one hand, cases and commentary seem to assume that an adviser will be held to a "reasonableness" or negligence standard in exercising its fiduciary function, the usual standard that applies in a claim of breach of duty of care.[54]

On the other hand, many advisory agreements contain provisions that purport to absolve an adviser from certain liabilities, except for those from which an adviser may not be protected as a matter of law. For example, a broad version of this clause might read:

> "[Adviser] shall not be liable for any error of judgment or mistake of law or for any loss arising out of any investment, or for any act or omission taken with respect to the Account, except for willful misfeasance, bad faith or gross negligence in the performance of its duties, or by reason of reckless disregard of its obligations and duties hereunder and except to the extent otherwise provided by law."[55]

[52] Some sources also refer to a director's duty of obedience (that is, to ensure that the organization stays within the bounds of its power and authority) and duty of oversight (that is, to oversee operations conducted by management), although most often those are treated as specific duties that must be discharged by directors like all others within the framework of the basic fiduciary duties of care and loyalty.

[53] CFA Institute Trade Management Guidelines, *supra* note 4.

[54] See SEC v. Capital Gains Research Bureau, Inc., *supra* note 45, and "Best Execution of Mutual Fund Portfolio Transactions" by Arthur Delibert and Lori Schneider of Kirkpatrick & Lockhart LLP, presented at the 2001 Investment Company Directors Conference (November 12-14, 2001) at 5.

[55] Narrower versions of this clause absolve the adviser from liability for losses arising from the adviser's "mistake of investment judgment" and still others for losses suffered as a result of "any error of judgment or mistake of law in connection with [the Adviser's] performance" under the advisory agreement.

Despite no-action authority to the effect that use of “hedge clauses” – clauses that “hedge” or limit the adviser’s liability to the client, whether in the form of liability limitations, indemnities, or otherwise – can constitute “fraud” in certain cases,[56] these provisions are still in widespread use. On its surface, this type of clause appears to absolve the adviser from liability at least for simple negligence, meaning a lack of due care.[57] Historically, liability limitations of this type were intended to shield advisers from claims of negligence in the selection of portfolio securities, which involves the exercise of professional judgment and could be subjected to endless second-guessing after the fact. As a result, it was typically considered acceptable to hold advisers to the more lax, gross negligence standard, at least for decisions involving professional judgment.

Nonetheless, it is unclear whether and how these clauses would be applied to shield the adviser from liability for failing to meet its best execution obligation. Arguably, the selection of brokers involves a measure of professional judgment, just as the selection of securities. Would these clauses be applied to avoid liability under tort law in cases where the adviser is alleged to have negligently breached its duty of care in seeking best execution? In the same vein, would these clauses be applied to avoid liability if the claim is brought as a contract law claim alleging breach of the advisory agreement provision that requires the adviser to seek best execution? The case law in this arena does not provide a definitive answer. It also remains to be seen whether or how courts would apply these clauses to shield the adviser from any other liability for failing to seek best execution, such as breach of duty under Section 206[58] or Section 36(a).

The distinction between negligence and gross negligence may be important in a dispute where the level of care taken by an adviser in seeking best execution becomes an issue.[59] Case law often defines gross negligence as conduct so extreme that it may be difficult to hold an adviser liable for failing to take the requisite care unless the adviser has completely abdicated its best execution responsibility or has established a pattern of repeated failures tending to show conscious indifference.[60]

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[56] See Heitman Capital Management, LLC (pub. available Feb. 12, 2007). Note, however, that the Staff’s concern in this letter seems to be whether this type of clause might mislead the client into believing that any rights they may have to pursue the adviser under the securities laws would be cut off, rather than whether it is permissible to use this type of clause to alter the otherwise applicable standard of care in general.

[57] At least for a fund client, an adviser ostensibly would not be held to a standard more lax than that provided in Section 17(i) of the Investment Company Act of 1940, which in substance prohibits an adviser being protected from liability for willful misfeasance, bad faith or gross negligence in the performance of its duties, or by reason of reckless disregard of its obligations and duties under the advisory agreement.

[58] As previously discussed, Section 206 of the Advisers Act is the anti-fraud section the SEC uses to ground many of its claims against advisers in best execution cases, including those that involve failures to disclose. About the standard of care under Section 206, the SEC says:

> “If the misstatement or omission of a material fact is negligent, then Section 206(2) is violated; if the misstatement or omission is made with scienter, then Section 206(1) is violated.” Jamison, *supra* note 10, at IV.A. (emphasis added).

[59] This is less likely to be an issue when counseling an adviser client prospectively about fiduciary obligations, since counsel would not normally be comfortable advising a client that it is alright to be negligent, regardless of how the advisory agreement reads.

[60] Of course, what constitutes gross negligence in any given case would be determined under the substantive law applicable in that case. However, proving gross negligence is generally considered fairly difficult. Cases often define gross negligence as “the failure to show even the slightest amount of care” or a “gross deviation from what an ordinary person would do under the same circumstances” or some similar formulation that often includes an element of intentionality, willfulness or recklessness. See Prosser and Keaton on the Law of Torts, Ch.5 §34 (5th ed. 1984); and Modern Tort Law §10.19 (rev. ed.). For example, in Texas, gross negligence has been defined as the “entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it.” Robert Young, et al. v. Nationwide Life Insurance Company, et al., *supra* note 50, at 929, quoting Bennett v. Howard, 170 S.W.2d 709, 713 (Tex. 1943). See also the discussion under note 66, *infra*, about gross negligence under Delaware corporate law.

Moreover, these limitations of liability presumably will not protect an adviser from claims for breach of the fiduciary duty of loyalty, for example, in a case of involving conflict of interest, self-dealing or bad faith. But a limitation of liability might become important in cases that turn on the adviser's duty of care.

Personal misconduct under Section 36(a): A number of courts have addressed the question of what conduct constitutes a breach of fiduciary duty under Section 36(a) of the Investment Company Act of 1940, which prohibits breaches of fiduciary duty involving personal misconduct. Cases suggest that the "involving personal misconduct" language in Section 36(a) might require showing something more than a defendant's "mere" breach of duty, although it may not be necessary to show personal gain, conflict of interest or dishonesty.[61] "Nonfeasance of duty" or "abdication of responsibility" would be enough, according to statements in some cases and the legislative history of Section 36(a).[62] Another court has stated that "misfeasance" of duty is enough.[63] Authority even exists suggesting that negligence is enough to establish a claim under Section 36(a).[64]

Directors' duty of care: In exercising their obligation to monitor best execution, fund directors also have a duty of due care. Depending on the state law and trust or charter provisions governing their actions as directors, they are likely to be held to a negligence or gross negligence standard in exercising due care.[65] Legal standards and limitations on director liability vary widely from fund to fund, some purporting to absolve their directors from liability for everything they legally can, others purporting to hold their directors to the usual high fiduciary standards applicable to trustees of a common law trust.[66] Of course, just like advisers, fund directors will be subject to a fiduciary duty of loyalty in addition to the fiduciary duty of care and any otherwise available limitation of liability is unlikely to protect a director from claims of breach of loyalty. However, the difference between negligence and gross negligence may become important if a dispute arises over the level of care exercised by the directors in their "watchdog" role to monitor best execution.

Despite a lack of clarity about the exact standard of conduct that applies, leading cases[67] still illustrate that claims for breach of duty – including those under Section 36(a) -- can be

[61] Strougo, *supra* note 50; and Seidel v. Lee, et al., 954 F.Supp. 810 (D. Del. 1996).

[62] Strougo, *supra* note 50. See, also, In Re Nuveen Fund Litigation, No. 94C 360 (N.D. Ill. June 11, 1996); and see Steadman Security Corp., SEC Opinion Memorandum, 1983 SEC No-Act. LEXIS 2238 (April 18, 1983), for another discussion of the legislative history of Section 36(a).

[63] Robert Young, et al. v. Nationwide Life Insurance Company, *supra* note 50.

[64] See SEC v. Continental Growth Fund, Inc., et al., Fed. Sec. L. Rep. (CCH) ¶91,437 (1964); and Steadman, *supra* note 62.

[65] Ostensibly, however, directors would not be held to a more lax standard than gross negligence. See Section 17(h) of the Investment Company Act of 1940.

[66] Provisions vary from state to state and from charter to charter (or trust instrument to trust instrument). Note, however, that directors governed by the Delaware General Corporation Law, 8 Del.C., §101 et seq., are generally held to a gross negligence standard in exercising their fiduciary duty of care, when viewed in light of the business judgment rule of judicial review. See generally Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Delaware Corporation Law and Practice §15.06 (Drexler, Black and Sparks); and §141.2.2.4 Folk on the Delaware General Corporation Law (4th ed.). Delaware courts have repeatedly defined gross negligence as "reckless indifference to or a deliberate disregard of the whole body of stockholders" or actions that are "without the bounds of reason." See Smith v. Van Gorkom, *supra*, and cases cited there. One case describes the plaintiff's task in showing breach of a director's duty of care, where there is no conflict of interest and no facts suggesting suspect motivations, as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) at 967. Delaware directors may be further protected by charter provisions that eliminate or limit their personal liability for monetary damages for breaches of care or that provide them with indemnification in certain cases.

[67] Such as Tannenbaum v. Zeller, *supra* note 20.

significantly undercut if the adviser and the fund directors follow a well-thought out and well-documented process in their decision making, including separate determinations by the independent directors in cases involving potential conflicts of interest between the adviser and its client.

How Might an Adviser Go About Establishing a Best Execution Process?

Consistent with the definition of best execution discussed above, advisers might approach best execution as a process with the overall aim of making it understood and implementing it consistently firm-wide. This is a more certain way to:

- achieve best execution for each individual account and uniformly across all accounts
- treat all advised accounts fairly relative to one another
- demonstrate to regulators that the adviser is properly discharging its duty of best execution.

Like most internal processes, best execution is not a “one size fits all” situation, meaning no one model or process will work for every advisory firm. However, advisers should consider the following questions when formulating their best execution process or procedures:

- What is the goal? This might encompass a general statement of the firm’s best execution policy.
- Who is responsible?
    - Different individuals or groups may be responsible for different elements in the process. For example, the trading desk may be responsible for placing brokerage only with broker-dealers who meet certain specified criteria or who appear on a list of pre-approved brokers. The compliance department may be responsible for periodic monitoring of the brokers selected based on those same criteria, and so on.
    - Some advisers form a best execution (or brokerage practices) committee.[68] Members might include representatives from the trading desk, portfolio management, operations, compliance and legal. The committee’s duties often include monitoring brokers’ performance, for not just commission rate and price, but also market impact, opportunity costs and all the other factors that bear on broker performance. This type of committee would typically take the lead in deciding whether and when to bring in outside consultants to evaluate best execution.
- What criteria will be used to select brokers? This is discussed in more detail above in the question discussing the real cost of a trade.
- How will best execution be evaluated and how often?
    - A full, formal evaluation of brokerage placement should occur not less than annually. At least quarterly, key brokerage placement information should be reviewed.[69] More frequent evaluations should occur where circumstances warrant (for example, problems have been identified). Some firms keep track of certain brokerage data on daily reports circulated to trading and portfolio management personnel.
    - Traders, portfolio managers and other relevant personnel should be asked for their subjective input on brokers in addition to the hard data generated to evaluate best execution.

[68] The CFA Institute Trade Management Guidelines, *supra* note 4 at p.6, make a similar suggestion, calling for a Trade Management Oversight Committee responsible for developing, evaluating and changing (when necessary) a firm’s trading practices.

[69] For investment company clients, see the discussion about Rule 31a-1(b)(9), *infra* note 72, and text surrounding.

- For fund clients, what information will be reported to the fund's Board of Directors and when?[70]
    - Many fund directors give best execution full, formal consideration not less than annually, in conjunction with the annual meeting at which they consider the advisory agreement (the so-called 15(c) meeting), so that they will have the necessary basis to determine whether the advisory agreement should be renewed (that is, whether the adviser is fulfilling its duty to seek best execution).
    - Key brokerage placement information should also be provided to the fund Board at each quarterly meeting. Some fund groups provide monthly reports to the directors between meetings.
    - What information should be provided to the directors? At a minimum, directors should be provided the following information for each fund, to the extent relevant and available.[71] Note that investment companies are legally required to maintain and keep current most of this information.[72]
        - The identification of the broker-dealers to which the adviser has allocated fund trading and brokerage
        - Total dollar amount of portfolio transactions allocated to each broker and executed on an agency basis, and total dollar value of principal trades completed with each dealer (at least top 10; complete lists if feasible; include all affiliated brokers)
        - Brokerage commissions paid to each broker (including amounts paid directly and, to the extent known, paid indirectly via commission-splitting, steps-outs and other similar arrangements), and, to the extent possible, spreads paid on principal trades with each dealer

[70] See the IDC/ICI webinar for fund directors on Portfolio Trading and Best Execution at http://www.ici.org/pdf/webinar_13_idc_trade.pdf outlining, among other things, a fund director's oversight responsibilities regarding trading issues and various questions directors can ask to oversee best execution.

[71] See the SEC's discussion of this in the 2008 Proposed Director Guidance on Soft Dollars, *supra* note 28, at pp. 17-19.

[72] Rule 31a-1 under the Investment Company Act of 1940 provides:

> (b) Every registered investment company shall maintain and keep current the following books, accounts, and other documents:
> …
> (9) A record for each fiscal quarter, which shall be completed within ten days after the end of such quarter, showing specifically the basis or bases upon which the allocation of orders for the purchase and sale of portfolio securities to named brokers or dealers and the division of brokerage commissions or other compensation on such purchase and sale orders among named persons were made during such quarter. The record shall indicate the consideration given to:
>
> (i) sales of shares of the investment company by brokers or dealers,
>
> (ii) the supplying of services or benefits by brokers or dealers to the investment company, its investment adviser or principal underwriter or any persons affiliated therewith, and
>
> (iii) any other considerations other than the technical qualifications of the brokers and dealers as such.
>
> The record shall show the nature of the services or benefits made available, and shall describe in detail the application of any general or specific formula or other determinant used in arriving at such allocation of purchase and sale orders and such division of brokerage commissions or other compensation. The record shall also include the identities of the persons responsible for the determination of such allocation and such division of brokerage commissions or other compensation.

See also Rule 31a-1(b)(2)(iii), (b)(5) and (b)(6) for other records required to be kept by investment companies related to their brokerage placement and orders.

        - Average commission rate paid to each broker, and estimate of the average spread paid on principal trades with each dealer where available
        - The basis upon which allocation of orders was made to each broker and dealer
        - Portfolio turnover rate
        - Use of brokerage to pay fund expenses
        - Use of brokerage to generate soft dollar credits
        - Use of brokerage to recognize share sales or client referrals
        - Use of brokerage to obtain any other products or services
        - Comparative period information (so meaningful comparisons are possible and trends can be identified)
        - Explanation of any significant exceptions to established brokerage policies.
    - Fund directors should also be given regular access to discuss trading practices with the portfolio managers, who should be asked to confirm that they believe they are getting best execution for their trades. Portfolio managers have a keen interest in making sure their trades are executed on the best terms available since trading costs affect performance and typically therefore the portfolio manager's compensation. This tends to align their interests with the interests of the directors in assuring that best execution is being achieved.
- How will each step in the process be documented in the record? Specifically, if certain trades are executed on terms less favorable than those available for other trades, an explanation should be adequately documented. Alternative trading methods should be considered and clear documentation of the decisions made in his process should be kept.
- How often will the process be evaluated and updated if necessary?
    - As with all internal policies and procedures, the best execution process itself should be evaluated and updated not less than annually.[73] Interim adjustments should also be made quarterly, if quarterly brokerage data indicate adjustment is warranted. More frequent adjustments may be necessary in the event of major developments (such as an SEC deficiency letter or major case decision).

Other specific steps or best execution controls that might be adopted can be found in the SEC's 1998 Soft Dollar Sweep Report[74] which lists numerous "good" controls that the SEC Staff observed in the course of the sweep inspections. Although the sweep was aimed specifically at soft dollar practices, many of the controls listed could also apply to best execution and other trading practices as well.

Having a well-developed best execution process will, of course, not shield an adviser from liability for glaringly out-of-line commission rates or out-of-the-ordinary brokerage practices. In other words, process alone is not enough, if the process generates consistently non-standard or problematic results. But without a process, the SEC Staff will have little to go on in determining whether even reasonable, standard brokerage practices in fact represent best execution.

For fund directors, a well laid-out process, free of divided loyalties, will also be crucial to their actions being protected under the so-called business judgment rule, which would normally

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[73] The compliance rules referenced previously call for advisers and funds to review their compliance policies and procedures not less than annually.

[74] *Supra* note 3, at Appendix F.

shield individual director decisions from being second-guessed as they monitor for best execution.[75]

Must the Best Execution Process be Formalized into Written Policies and Procedures?

In addition to establishing a best execution process, advisers should consider to what extent that process should be formalized into written policies and procedures. Typically, this will depend on each firm's individual circumstances and needs. Even though advisers and funds are not specifically required to adopt written best execution procedures, best execution is specifically named as one of the areas advisers and funds are expected to consider in establishing their written compliance program under the SEC's compliance rules.[76] Moreover, developing formal, written procedures can be a powerful tool for planning, implementing and evidencing the best execution process. Written procedures can also be immensely useful in reminding personnel about the process at appropriate intervals and in training new personnel.

On the other hand, if the best execution process is formalized into writing, appropriate care must be taken to ensure that the actual process undertaken at the firm is consistent with the written procedures adopted. As in all areas of securities compliance, it may be just as devastating for a firm to adopt procedures and then not to comply with them than to have never adopted the procedures at all.[77] An adviser's best execution process should also be harmonized with the firm's disclosures in Form ADV and, for fund clients, in the fund's registration statement. It should also be harmonized with applicable provisions in the advisory agreement and with any other trade management policies or procedures adopted, such as those addressing soft dollars, trade allocations, participation in IPOs, directed brokerage and the like.

What are ATSs and How Do They Fit into the Best Execution Picture?

No clear guidance exists on the weighting that advisers should give to each of the factors considered when selecting brokers or trading venues, in other words, on how important commission rates (or spread) are relative to the other factors advisers can and typically will take into account when placing brokerage. However, there has been heightened focus on commission rate, due in large part to the heightened profile and availability of ATSs.

An ATS (Alternative Trading System) is, in short, a system that brings together buyers and sellers of securities, and does not govern subscriber conduct or discipline subscribers.[78] In practice, an ATS is a networked application that connects potential buyers and sellers electronically, and matches trades that meet predefined criteria.

An ECN (Electronic Communications Network) is a type of ATS and is typically registered with the SEC as either a broker-dealer or an exchange.[79] An ECN facilitates continuous matching of customer buy and sell orders while providing those orders with direct electronic access to Nasdaq or other markets.

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[75] See generally, §3.10 Law of Corporate Officers and Directors, Indemnification and Insurance (Bishop 1997-2002); and §§1036-1040 Fletcher Cyclopedia Corporations (Perm. Ed.).

[76] See Adopting Release, *supra* note 8, at III.A.

[77] Note that In the Matter of Fleet Investment Advisors, *supra* note 14, included assertions that the adviser circumvented or violated its own written soft dollar procedures.

[78] See Rules 300 through 303 of Regulation M under the Securities Exchange Act of 1934 for the full definition of and rules governing ATSs.

[79] The exact definitions of all these terms and the services they each provide are still evolving. Somewhat confusingly, the term ECN is sometimes also used for electronic crossing network, which electronically matches buy and sell orders at a derived price.

Recently, another type of ATS has garnered attention, known as a "dark pool."[80] Unlike ECNs, dark pools are crossing networks that provide liquidity but do not display order information on the usual quotation systems, so that trades are completed in a more anonymous fashion. Dark pools can be independently-owned, broker-owned, consortium-owned or exchange-owned networks. Generally, they offer trading services to institutional investors who seek to trade a large position in a way that will minimize price movement and thereby reduce trading costs.[81]

What is important today is that advisers at least consider these alternative trading systems in the process of seeking best execution, for the potential advantages they offer. For example, an ATS might provide a low-cost alternative to traditional broker-dealers. With increased competition in commission rates, an adviser could be heavily criticized for not at least looking into the availability of alternatives for executing appropriate trades. In years past, the "standard" 5¢ or 6¢ a share commission rate from full service broker-dealers was considered acceptable. Today, that may no longer the case with some ATSs charging execution-only commission rates of far less than that.[82]

There are concerns commonly raised about some ATSs, however, among them:

- They can lack liquidity
- They raise the potential for inadvertent cross trades
- It is unclear who will stand behind failed trades
- They generally do not commit their own capital to facilitate block trades
- There is no human being guiding the trade and better execution might be achieved if there were.

These concerns may dictate that another marketplace or broker be selected for certain trades. ATSs are clearly not the source for best execution of every trade in every case. But advisers – and fund directors – should be taking them into consideration in evaluating best execution, if they are not doing so already.

[80] See the 2008 Proposed Director Guidance on Soft Dollars, *supra* note 28, at p. 15: "Newer trading venues, such as 'dark pools,' and the use of advanced mathematical models or algorithmic trading systems, crossing networks, and other alternative trading systems, are increasingly prevalent." See also the SEC Fact Sheet entitled "Strengthening the Regulation of Dark Pools," SEC Open Meeting (October 21, 2009) at http://www.sec.gov/news/press/2009/2009-223-fs.htm.

[81] More detail about the structure of today's market and the various trading venues can be found in the SEC's Concept Release on Equity Market Structure; Proposed Rule, Release No. 34–61358 (January 14, 2010). Proposed rules aimed at increasing the transparency of dark pools can also be found in Regulation of Non-Public Trading Interest, Release No. 34-60997 (Nov. 13, 2009).

[82] But see Frank J. Wsol, Sr., et al., v. Fiduciary Management Associates, Inc. and East West Institutional Services, Inc., 266 F.3d 654 (7th Cir. 2001), an ERISA case in which the trial court found, and the appeals court affirmed, that 6¢ per share execution cost was not a breach of fiduciary duty under ERISA, when 2¢ went to the executing broker and 4¢ went to an introducing broker that provided research, even though the introducing broker was "shady" and "disreputable" and was involved in "skullduggery" with the investment adviser. The court determined that the defendants' unsavory conduct did not make a difference to the case because, despite the goings-on, the complaining fund was not harmed:

> "For surprising as this may seem, the shady operation that was [the introducing broker] appears to have given the fund all the benefits it would have received had [the adviser] either retained a reputable introducing broker or dealt directly with the executing brokers. In either case, [the adviser], which is to say the fund, would have paid 6 cents a share per trade; that is the standard fee and there is no proof that [the adviser] could have obtained comparable trading services for less." Id. (emphasis added)

One wonders if this case would have been decided the same way today.

How Often Should Best Execution be Assessed?

The SEC has made it abundantly clear that to ensure advisers are fulfilling their duty of best execution, they are required to "periodically and systematically" evaluate the quality of execution services received from the broker-dealers that are used to execute fund trades.[83] However, in light of the rapid changes in our trading markets, it is unclear what will suffice to meet the "periodic and systematic" standard.

This illustrates the SEC's view of the evolutionary nature of best execution:

> "A number of factors go into an analysis of best execution, including trading prices, commissions, speed of execution and certainty of execution. As part of the duty, an adviser is required to <u>review periodically and systematically the quality of execution</u> services received. <u>The scope of the duty evolves as changes occur in the market that give rise to improved execution, including opportunities to trade at more reasonable prices</u>."[84] (Emphasis added)

The landscape is changing too rapidly for any single evaluation of best execution to be valid for very long, due to such factors as:

- globalization of markets
- technological advances
- advent of new markets and trading systems (ATSs/ECNs/dark pools)
- extended trading hours
- decimalization
- explosion in trading volumes
- increase in regulatory scrutiny
- increase in media and client scrutiny

As a result, many advisers evaluate their best execution on a more formal basis not less than annually, and on a more limited basis quarterly. More frequent evaluations may be undertaken if special issues or circumstances exist. In addition, the adviser's best execution policies and procedures themselves should be reviewed not less than annually as part of its overall annual compliance program review.[85]

What Tools are Available to Help Assess Best Execution?

<u>*Independent consultants*</u>: Advisers and fund directors alike might be aided in their evaluation of best execution by an independent consultant's analysis of relevant brokerage data.[86]

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[83] Remarks of Lori Richards, Director of the SEC's Office of Compliance, Inspections and Examinations, at the ICI Conference 2001 Mutual Fund Compliance Conference (June 14, 2001). See also, PAS, *supra* note 12, at III.I; Release No. 34-23170, *supra* note 2 (money managers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions); and Order Execution Obligations, Release No. 34-37619A (September 6, 1996) at 176 ("[T]he Commission believes that because technology is rapidly making [electronic] systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders."). Even though some of these sources refer to the best execution duty of broker-dealers, the proposition cited is no less relevant to advisers.

[84] Jamison, *supra* note 10, citing <u>Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc</u>., 135 F.3d 266, 270-271 (3d Cir. 1998); PAS, *supra* note 12; and Order Execution Obligations, Exchange Act Release No. 34-37619A, 62 S.E.C. Docket 2210, 2243 (September 6, 1996).

[85] As mentioned previously, advisers and funds are required to review their compliance policies and procedures not less than annually under the SEC compliance rules (Rule 206(4)-7 for advisers and Rule 38a-1 for funds).

[86] There are several organizations that hold themselves out as providing this type of service, such as ITG, Abel/Noser, Elkins/McSherry and others.

Independent reports may be even more important in cases where affiliated broker-dealers are used, since an in-house analysis might be viewed as potentially slanted or tainted.

If a consultant is engaged, care should be taken to ensure that the consultant is comparing apples to apples. For example, the consultant should be told whether non-execution services were provided in exchange for brokerage on the transactions included in the sample universe. The methodology and benchmarks used should be fully explained and understood. These factors can affect the results and the usefulness of the information generated.

When fund directors request an independent evaluation, the question may come up as to who will pay for the consultant's report – the adviser or the fund client. Although Section 15(c) under the Investment Company Act says the adviser must provide the Board with the information necessary to evaluate the advisory agreement, is fair to burden the adviser with the entire cost? Moreover, will the report potentially be biased toward the adviser if the adviser is paying the consultant's bill? As a practical matter, it may be better to divide the cost between the adviser and the fund in some fair way, which may also more readily accommodate the evaluation being expanded to include an analysis of best execution on the adviser's non-fund accounts as well.

Brokers and ECNs: The brokers, ECNs and market centers an adviser already uses to execute trades may also provide helpful analytical data and tools to assist in evaluating best execution.[87] Advisers should look into such services to evaluate best execution on an on-going basis and generate the regulatory record necessary to demonstrate that the adviser is seeking best execution at all times.

Exchange Act filings: The SEC has adopted two rules aimed at increasing the visibility of execution quality of the U.S. securities markets for public investors.[88] Taken together, the rules are intended to significantly improve the opportunity for public investors to evaluate what happens to their orders after they submit them to a broker-dealer for execution. The rules were adopted in direct response to the SEC's concern about "market fragmentation" -- the trading of orders in multiple locations (for example, on exchanges, over-the-counter and via ECNs) without interaction among those orders.[89] By increasing the visibility of order execution and routing practices, market forces are expected to generate greater competition and efficiency in the national market system. The two rules adopted were:

- Rule 605 of Reg NMS (formerly Rule 11Ac1-5) under the Securities Exchange Act of 1934, which requires "market centers" (national securities exchanges, Nasdaq Stock Market, ECNs and market makers) to make available to the public monthly electronic reports concerning their order executions. These include certain basic measures of execution quality, such as effective spread, rate of price improvement and disimprovement, fill rates and speed of execution. Users can analyze order executions for a particular security or for any particular group of securities, as well as for any size or type of orders across those groups.

- Rule 606 of Reg NMS (formerly Rule 11Ac1-6), which requires broker-dealers that route non-directed customer orders to make public certain reports on order routing and execution, including the top 10 venues to which orders are routed for execution and any others that received 5% of more of the broker's orders. They must also discuss the

[87] For example, Instinet's trading system purports to offer among other things a suite of transaction cost analytics for three phases of the trading cycle: pre-trade, real time and post-trade.

[88] Disclosure of Order Execution and Routing Practices, Release No. 34-43590 (November 27, 2000).

[89] The SEC had been concerned about market fragmentation for quite some time, even issuing a release in February 2000 in which the Commission published an NYSE proposal for public comment and also requested comment on a wide range of issues relating to market fragmentation. See Securities Exchange Act Release No. 42450 (Feb. 28, 2000), 65 FR 10577.

material aspects of the broker's relationship with each venue reported, including a description of any payment for order flow arrangement and any profit-sharing arrangement.

Investment Company Act filings: For a short time in the 1990s, the Form N-1A registration statement for mutual funds was amended to require disclosure of a fund's average commission rate as a line item on the financial highlights table.[90] That requirement was short-lived, however, the SEC eventually coming to the conclusion that average commission rate was technical information with only marginal benefit for typical investors and that it therefore did not need to be included in the Financial Highlights table in either the Prospectus or shareholder reports.[91] That may not be the last time this proposal is raised, however.[92]

What Disclosure Considerations Should be Taken into Account with Best Execution?

The failure to fully and accurately disclose what an adviser is doing in selecting brokers and allocating portfolio transactions may cause as much trouble as doing it. This is as true in seeking best execution as it is with other matters. While disclosure may not cure all problems, it may avoid compounding a problem if conduct is called into question.

In an enforcement action, the SEC may build its case around a failure to disclose, alleging, for example, that an adviser failed to disclose certain brokerage allocation practices in its Form ADV. Failure to disclose allegations might be coupled with the closely related allegations of making false statements, for example, that the adviser stated in its Form ADV that it would seek best execution at the most favorable prices, when in fact it was paying higher commissions than were otherwise available in order to reward brokers for referrals.[93]

Where are an adviser's key best execution disclosures found?

- In Form ADV[94]
- For funds, in their Form N-1A registration statement (typically in the Statement of Additional Information)[95]
- In the Investment Advisory Agreement (which can serve a disclosure function, as well as a consent function)
- Possibly in other regulatory filings (for example, in fund financial statement notes, particularly for transactions with affiliated brokers)
- Possibly in other documents (for example, on a website or in promotional/sales literature)

An adviser's best execution disclosures will typically be held to the usual standard of "materiality" under the federal securities laws. Information will be considered "material" if a

[90] This requirement was adopted in Release No. IC-21221 (July 21, 1995). Although commentators pointed out that these figures would not be meaningful to investors since they didn't reflect spreads or execution quality, the SEC adopted the proposal anyway.

[91] The disclosure requirement was eliminated in Release No. IC-23064 (Mar. 13, 1998).

[92] The Commission said in the rescinding release that it believed there continued to be some merit in ensuring that information about the average commission rates paid by funds is publicly available and would therefore consider adding that requirement to Form N-SAR in the future. Id.

[93] As an example, see Jamison, *supra* note 10, in which the adviser allegedly failed to disclose conflicts of interest in its Form ADV; and In the Matter of Founders Asset Management LLC, *supra* note 14, in which the SEC took issue with certain brokerage practices of the adviser; however, instead of asserting "substantive" regulatory violations, such as the failure to seek best execution or the breach of fiduciary duty, all of the violations asserted by the SEC in the Founders proceeding were based on alleged failures to disclose or alleged false statements in Form ADV.

[94] In particular, see Form ADV, Part 1A, Item 8, and Part 2A, Items 11, 12 and 14.

[95] In particular, see Form N-1A, Item 21.

reasonable client or prospective client would have considered the information important in deciding whether to invest with the adviser.[96] A fair number of administrative cases have demonstrated that the SEC believes an adviser's brokerage practices are material and should be disclosed.[97]

Various steps can be taken to mitigate the risk of potential disclosure violations, such as:

- Involving key personnel in creating disclosure. Drafting disclosure should not be within the sole purview of the lawyers. Traders and portfolio managers should periodically read the disclosure about brokerage practices and verify that the disclosures accurately and completely describe what in fact they do.
- Checking disclosures for consistency routinely, particularly Form ADV disclosures and SAI disclosures (for funds).
- Disclosing potential or actual conflicts of interest. Using the phrase "conflict of interest" where relevant and disclosing any procedures or practices in place to mitigate the detrimental effects of a potential conflict should be considered.
- Avoiding "boilerplate syndrome." Although there is comfort in using "tried and true" language that has become standard in the industry, boilerplate may not apply to every situation and must be tailored where necessary. Additional disclosures beyond the boilerplate may be necessary in any specific case to make disclosure materially accurate and complete.

Conclusion

Although best execution is an ever-evolving area of the law, keeping these points in mind will help every adviser fulfill its duty to seek best execution and help fund directors to properly monitor that effort.

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[96] In the Matter of Fleet Investment Advisors, *supra* note 14, citing SEC v. Steadman, 967 F.2d 636, 643 (D.C. Cir. 1992).

[97] See, e.g., Folger, *supra* note 14; Jamison, *supra* note 10; PAS, *supra* note 12; Founders, *supra* note 14; and Fleet, *supra* note 14. In Fleet, the SEC stated affirmatively that information regarding an investment adviser's directed brokerage arrangements is material and must be disclosed to clients. Id., citing Sheer Asset Management, Inc. and Arthur Sheer, Release No. IA-1459 (Jan. 3, 1995).

