WHITE PAPER:

FIXED-INCOME BEST EXECUTION

Background

Among the most important of an investment adviser's fiduciary duties is the requirement that the adviser seek "best execution." Best execution is not formally defined in the Investment Advisers Act of 1940 and there is no uniform "best practices" when it comes to best execution. The general consensus, however, is that best execution contemplates an investment adviser executing securities transactions on behalf of a client with the goal of maximizing value for the client under the particular circumstances occurring at the time of a transaction. There is also the general consensus that best execution is not easily quantifiable and encompasses many factors.

Much of the existing guidance regarding an investment adviser's duty to seek best execution has been developed in the context of equity securities and the equity markets. Significant differences exist, however, between the equity markets and the fixed-income markets. For example, a far greater number and far more types of financial instruments trade on fixed-income markets than on the equity markets.

Fixed-Income Markets

Fixed income markets are characterized by bilateral transactions between parties as principals as opposed to equity markets in which transactions are undertaken on centralized exchanges facilitated by agents. Fixed-income markets are fragmented and often subject to limited transparency as a result of the absence of a centralized reporting mechanism for completed transactions. The characteristics of the fixed-income markets present an investment adviser with practical difficulties in assessing and documenting fixed-income best execution.

SIFMA Guidelines

The Securities Industry and Financial Markets Association ("SIFMA") has released a White Paper on best execution guidelines ("Guidelines") for fixed-

income securities. SIFMA defined best execution in the context of fixed-income securities as an investment adviser's "duty to determine and evaluate the circumstances under which the overall value of investment decisions for its clients with respect to those securities will be maximized."

According to the SIFMA White Paper, an investment adviser should adhere to the following guidelines when developing or evaluating their fixed-income best execution policies and procedures:

Guideline 1 – Policies and Procedures

An advisory firm should develop best execution policies and procedures tailored to its operations and the types of fixed-income securities in which it trades. An advisory firm's policies and procedures should reflect the following core elements:

- Identifying the key components of favorable and efficient fixed-income executions;
- Identifying significant factors and information to be considered in selecting fixed-income trading counterparties;
- Determining and documenting trade execution policies and procedures;
- Developing a defined system of controls and risk management regarding fixed-income executions;
- Providing regular supervision and rigorous review of the fixed-income best execution process; and
- Testing and monitoring compliance with policies and procedures.

Guideline 2 – Establishment of a Best Execution Committee or Similar Structure

A best execution committee may help in establishing and evaluating periodically the process an advisory firm will follow. The committee could be composed of individuals involved with the advisory firm's trading process, such as portfolio management, trading, legal, compliance, and operations/systems personnel, and

hold regularly scheduled meetings to discuss and review the effectiveness of the advisory firm's policy and procedures.

Guideline 3 – Review of Quantitative and Qualitative Information

An advisory firm should evaluate and determine, in light of its access to reliable market data for the types of fixed-income securities in which it will primarily invest on behalf of clients, the extent to which its best execution policy should include pre-trade evaluation of data and execution decisions and/or post-trade analysis of transactions.

Guideline 4 – Counterparty Selection

An advisory firm should identify specific quantitative and qualitative criteria for selecting counterparties and such counterparties should be evaluated periodically against these criteria. Some common factors that should be considered by an adviser include:

- Price;
- Likelihood of execution;
- Likelihood of execution within a desired time frame;
- Market conditions;
- Ability of a counterparty to execute in desired volume;
- Ability of a counterparty to act on a confidential basis;
- Ability of a counterparty to act with minimum market effect;
- Creditworthiness of a counterparty in relation to risk created by the transaction;
- Willingness and ability of a counterparty to make a market in particular securities;
- Operational coordination by a counterparty with the asset management firm and custodians of the firm's clients, including ability to

communicate, to settle trades reliably and to quickly and effectively resolve differences;

- Counterparty's reputation for ethical and trustworthy behavior;
- Client preferences/guidance (i.e., minority-owned, regional-based, ERISA, registered investment company, etc.) for permissible counterparties;
- Use of automation by a counterparty;
- Willingness of a counterparty to commit capital to a particular transaction;
- The market knowledge of a counterparty; and
- Ability of a counterparty to execute difficult transactions in unique and/or complex securities.

Guideline 5 – Utilizing Technology

An advisory firm should consider and incorporate available technological recourses when developing its best execution process.

Guideline 6 – Dealing with Conflicts of Interest

Regardless of whether an advisory firm's emphasis is pre- or post-trade, the firm's policies and procedures and internal monitoring systems need to address potential conflicts of interest that could impair the firm's ability to obtain best execution. The following areas raise the potential for conflicts of interest that may affect the fixed-income best execution process:

- Compensation and promotion incentives that may reward portfolio managers and/or traders based on the number of transactions and volume;
- Proprietary trading and personal trading;
- Payments for research;
- Product sales consideration for trade flow;

- Broker-dealer affiliations;
- Gifts and entertainment; and
- Portfolio managers' and traders' relationships with counterparties.

Guideline 7 – Transaction Reports

Transaction reports, particularly when viewed on an aggregate basis and over time, can provide a valuable tool when gauging and evaluation the success of an advisory firm's best execution efforts. Although market data may often be an imperfect tool for evaluating best price, investment advisers should make reasonable efforts to (i) gather transaction data that is available and (ii) review patterns and outliers or atypical trading patterns revealed in that data with portfolio employees and their supervisors to trigger questions, evaluate patterns and undertake more detailed review when appropriate.

Guideline 8 – Use of Market Data to Evaluate Best Execution

When readily available, post-trade market data can help to ensure an effective best execution process. Post-trade information, may, however, have limitations, particularly with respect to fixed-income securities traded in less transparent markets, and advisory firms should evaluate carefully the usefulness of such data when developing their best execution process.

Summary

Best execution in the context of fixed-income securities is appropriately defined as an investment adviser's duty to determine and evaluate the circumstances under which the overall value of investment decisions for its clients with respect to those securities will be maximized. The SIFMA Guidelines are intended to adapt the principles of best execution to the fixed-income markets, and to fill the current void of practical guidance.

About the Author

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