BEST EXECUTION: WHY INVESTMENT MANAGERS MUST UP THEIR GAME

You need to up your Best Execution governance because it is a commercial necessity, not just a legal and regulatory requirement.

1 BACK TO BASICS

Best Execution is a long-established obligation for investment managers but it remains poorly evidenced.

Just to recap, there are four reasons investment managers must achieve Best Execution for their clients:

- **Legal (contractual)** – investment managers acting as an agent are required to obtain Best Execution
- **Legal (statute)** – some laws require investment managers and trustees/directors to obtain Best Execution
- **Regulatory** – all major regulators have implemented rules governing Best Execution
- **Commercial** – Best Execution boosts performance which increases AUM, fees and profits

2 LEGAL REQUIREMENT

From a legal perspective, an investor (the principal) instructs an investment manager (the agent) to manage investments. An agent has a responsibility to perform their duties with honesty, skill and care, i.e. not negligently. Best Execution comes into play in two respects:

- **Honesty** – if an investment manager is profiting from additional charges/fees/expenses which are not explicitly disclosed and approved, they could be making a secret profit
- **Skill and care** – an investment manager is expected to know the costs they incur for their clients, to manage these costs and to only incur the costs necessary to manage the portfolio

In too many cases, investment managers don’t know enough about the costs they are incurring for their clients or how to effectively manage them.

3 REGULATORY REQUIREMENT

Regulatory requirements differ on Best Execution but the principles remain the same. If you provide investment management services, you have a duty to obtain Best Execution for your clients.

In the US, EU and most other jurisdictions, the regulatory requirements include:

1. **Responsibility** – a person or committee should be made responsible for Best Execution
2. **Understanding** – the investment manager should understand the transaction costs their clients incur
3. **Policy** – there must be a written policy to manage Best Execution which covers all instrument types and markets
4. **Implementation** – the Best Execution policy must be fully implemented
5. **Exceptions** – possible breaches of the Best Execution policy must be flagged, investigated and resolved
6. **Monitoring** – periodic monitoring of the implementation of Best Execution must be undertaken and reports prepared along with remedial actions taken, including amending the Best Execution policy, if appropriate
7. **Reporting** - the results of monitoring must be reported to the person or committee responsible for Best Execution
4 COMMERCIAL REQUIREMENT

When investment managers trade, their clients pay for each trade. The costs associated with each trade vary based on the instrument type and trading venue (amongst other factors). The higher the transaction costs the lower the client’s portfolio value, which pushes down performance.

Investment funds performance is usually tightly distributed around the mean, a small improvement in a fund’s transaction costs can move it up several places in the performance league table.

An added incentive to get Best Execution right is the cost of getting it wrong. The case everyone remembers is the infamous Fidelity dwarf tossing. A broker (Jefferies) went from earning $1.7m commission from Fidelity in the first six months of 2002 to earning $24.5m in the first 9 months of 2004 based on a range of “hospitality” they offered. The fine Fidelity paid was just $8m, the reputational damage to Fidelity and some of their senior management was far more serious.

5 PROACTIVE MANAGEMENT

For the record, there is no great Best Execution “Scandal”. Investment managers are not reaping millions in hidden fees or seeking out poor executions. What the investment management industry has done is failed to effectively document and evidence Best Execution.

Best Execution is a hot topic for regulators because they don’t like gaps in controls. Fix the gaps and you fix the problem.

A simple system like our own GRC-Maestro can be used to ensure investment managers have implemented and evidenced a comprehensive Best Execution control environment.

GRC-Maestro ensures regulators can identify who is responsible for Best Execution, the policies implemented, exceptions identified and actions/resolutions undertaken. When periodic monitoring is performed GRC-Maestro records the investigations performed, the results and resulting reports.

More details on using GRC-Maestro for Best Execution are available here.

6 IN CONCLUSION

Investment managers must view Best Execution as a responsibility that is fundamental to their business, not just another set of regulatory rules.

If I were a client, a regulator, or a senior manager of an investment management company, I would expect the trading costs to be firmly under control. I would expect this control to include a detailed account of client-level and firm-level transaction costs with the ability to drill down by broker and/or liquidity venue.

Best Execution isn’t especially complicated, it just needs to be understood and effectively managed.

For information on how the GRC-Maestro platform helps regulated firms manage their Mandate Compliance, contact us:

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