

Best Execution is an Evolution, not a Revolution

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The Markets in Financial Instruments Directive (MiFID) has broken the concentration rule and opened competition for execution services. In return for the open competition, execution providers must ensure that their clients are getting a fair deal out of it by achieving and proving what is called “best execution”. MiFID was hailed as a second “Big Bang” that would deeply transform the way in which securities transactions are conducted on a pan-European basis.

More than a hundred days have passed since the actual enactment of MiFID, and it is now possible to draw the first empirical conclusions on whether it is the revolution of the European capital markets it is supposed to be, or a more gentle evolution towards a new balance of power between investors, brokers and exchanges, with technology being the catalyst behind this transformation.

In the first part of 2008 we have witnessed the first baby steps in best execution implementations, with some participants more advanced than others. There is no denying the amount of innovation to be done, but where do the four corners of the industry – liquidity providers, sell-side, buy-side, and technology vendors - stand at this stage?

Liquidity Providers

Of particular interest is whether the imposition of a principles-based best execution policy has made any difference to trading practices, particularly when the fragmented

market for which a best execution policy is necessary has yet to materialise. While it’s true that Chi-X has established the first MTF in Europe and taken the first steps in siphoning liquidity from an exchange, we’re still a long way off the fragmented market that MiFID envisaged.

While they are said to be under siege, historical exchanges are still participating in the lion’s share of all trading on a listed product. The reasons for that are threefold:

Firstly, liquidity hasn’t fragmented yet – alternative venues are few and far between, and internalisation isn’t really gaining ground. Secondly, we’re still seeing exchanges involved in one merger after another (The constitution of Euronext, and NYSE to form NYSE-Euronext, and now OMX-NASDAQ). The exchanges are not only increasing their trading volumes, but are also diversifying their asset class coverage, trying to turn themselves into one-stop-shops, creating higher entry barriers for competitors. Lastly, executing on a traditional exchange is still the de facto and effortless way of ‘doing’ best execution.

Alternative venues are coming online progressively. Chi-X is already a clear success; Equiduct and Project Turquoise are also both working hard to go live this year with their technological platforms being implemented as we speak. And lately, a new consortium of banks is being constituted to provide an alternative to LIFFE and EUREX for Futures markets – currently codenamed ‘Project Rainbow’.

Sell-Side

It is the brokers who are expected to focus the most on best execution. After all, this is where they can demonstrate expertise and show leadership. The reality however is slightly lagging behind this logic. Firstly, algorithmic trading has been all the rage for the past three years and has certainly been the biggest innovation in electronic trading. We are now entering a second phase in algorithmic development: after benchmarks.

Brokers are now beginning to offer liquidity seeking, multi-asset and adaptive algorithms to their clients. This second generation is built with ‘best execution’ as the top priority, improving on the previous generation by the following these four principles:

- Liquidity is the most important objective of the algorithm: the first objective is to be able to rebuild the lost market transparency. The next step is then the possibility to incorporate some new predictive model to see beyond the transparent (market-data obtained) liquidity and discover the full liquidity available. The liquidity predictive models are today just being invented, and will require continuous and extensive R&D to mature.
- Real-time events trigger the execution: trading occurs in dynamic markets and advanced tools are becoming available to process complex events in real-time. Complex Event Processing (CEP) technology provides the best results in terms of performance

and lowest latency – decisions can be made in a few milliseconds.

- Complex decision-making requires optimization methods: The level of complexity for best execution requires a mathematical approach to quickly make optimum execution and routing decisions. The usage of optimization methods applied to trading translates into again few milliseconds for very complex decisions (which previously would have taken minutes or would have been impossible to solve). This seems to be a unique way to obtain decisions on how to route orders to different liquidity pools taking into account the best execution instructions.
- Different algorithms need to exist for different market conditions: one all-purpose algorithm cannot take into consideration the trading requirements in different market conditions. For instance, selling in quiet market conditions is very different to selling on a big sell-off day; trying to save 5 basis points cost and/or market impact when the market is going down by 200 basis points is not intelligent. Different flavours of algorithms provide an arsenal at your disposal for different market conditions

Secondly, SOR (Smart-Order Routing) is the number one investment undertaken by brokers for best execution. Bank after bank is implementing projects in quick succession. Dominated in the US by LAVA's proprietary solution, the domain is wide open in Europe because players do not want to be locked-in as they are in America. The pioneering solutions are just coming online as we speak. As a matter of fact, you need multiple destinations to route your orders, smartly or not, and again, most of them are not yet live.

Buy-Side

In reality, trading desks in investment firms are not overly concerned with best execution. What concerns them is avoiding 'worst execution'. The important consideration for a

buy-side trader is to be able to fully implement the investment idea. A few pence up or down on the average price has little importance, what really matters is the ability to actually implement the investment idea in full.

On the other hand, nobody wants their fingers burnt by a less-than-competent broker. Therefore, investment managers must, and actually do, implement structured measurement tools and methods to assess the performance of their brokers. This is the first essential step to be able to compare the quality of service received from the sell-side, based on tangible parameters. This is where Execution Management Systems (EMS), complete with Transaction Cost Analysis modules are gaining a lot of momentum and will soon be a central part of the trading process. In the end, this is about 'best selection': selecting the right broker for the right trade, more than achieving the best possible trade in every given scenario.

Technology Vendors

Two areas are bristling with innovations related to best execution; SOR (smart-order routing) and EMS (execution management systems).

Smart Order Routing

In the SOR space we have three types of vendors currently competing for domination of this new market. Firstly, incumbent providers of dealing platforms are offering proprietary add-ons providing elementary SOR capabilities. This is the case of Fidessa, GL Trade and ION. Secondly we have algorithmic trading engines implementing second generation algorithms capable of achieving SOR. They have gained their expertise and business clout not only in the equities automated trading space, but also in FX aggregation. This is particularly true of Progress Apama and Streambase. Finally, a generation of pure Smart-

Order Routing players are starting to emerge. They come with designed-for-purpose solutions which are not encumbered by legacy developments (Quod Financial).

Execution Management Systems

The EMS sphere is beginning to gain some serious ground on the buy-side due to a number of factors. Firstly the FIX protocol has become so ubiquitous that it is easy to plug an EMS between the OMS and the broker, thereby removing the biggest technological barrier of entry for such a system. Secondly, most firms have moved to a centralised trading desk model covering all executions across all assets, not just cash equity, but also FX, futures and options and fixed income. There is a lot of pressure to standardise and automate the way trades are done, which is the perfect territory for an EMS. Lastly, advanced EMS are coming along with their own Transaction Cost Analysis modules, allowing detailed comparisons between brokers' performance, and enabling firms to retrospectively achieve 'best selection'.

In conclusion, MiFID is definitely changing the way business is transacted on the secondary markets. However, we are a long way from the binary "switch of a lever" revolution that most seers and fortune tellers have been predicting over the past two years. What is really happening is a progressive, yet palpable, evolution:

- Alternative trading venues are coming online with the demand meeting this new supply
- Technology vendors are creating working solutions to the liquidity fragmentation problem, as well as the measurement tools to assess the quality of the service provided
- The sell-side is bearing the bulk of the investment in best execution, and rightly so
- The buy-side is yet to be convinced that behind the hype, clear and tangible benefits can be accounted. ■