



Best Execution and the Case for FIX

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The concept of “Best Execution” has been around for quite some time and in most markets. Originally defined as achieving the best price at a certain point it has grown to include a multitude of aspects such as price, speed and timing of execution, market impact, trading strategy and commission. Led by firms such as Plexus and Elkins-McSherry, the trading cost consulting industry has developed around defining and evaluating best execution, an area attracting even greater scrutiny at present given the pressure on returns and the fragmentation of markets..

Just as the notion of best execution has existed for some time, so has it formed part of many jurisdictions’ regulations. Defined and examined only loosely until recently, there are strong signs that best execution regulations are about to change, led by the regulators in Europe where the UK’s Financial Services Authority (“FSA”)’s Consultation Paper 154 (“CP154”) and the European Unions Investment Service Directive (ISD) are being discussed.

Adopted in 1993, the original ISD set out conditions under which investment firms and banks could conduct business in the member states of EU. Ten years later and advances in capital markets such as multiple trading venues and technology-based sell-side offerings have

rendered this original directive somewhat out-dated. Enter a proposed new ISD which more precisely defines best execution.

The new ISD will:

- provide a benchmark where the execution of client orders can be judged in the context of multiple markets
- require firms to show adequate policies are in place rather than review every trade for best execution
- expand best execution to include implicit costs such as spread, market timing, liquidity and opportunity short-fall
- ensure that liquidity will flow to the most efficient market (presumption is that it doesn’t now)

Although only at draft stage, the new ISD sets out some fairly radical developments in the pre and post trade space. Recognising that orders, whether executed or not, ultimately contribute to a market price, broking firms will be compelled to make public client limit orders that they are unwilling or unable to execute at a specific price and this will extend to off-exchange trading – however, clients may direct that their orders be excluded from this requirement, as a result of which it is unlikely that few will choose to advertise their intentions fearing market impact. Most firms will be obliged to report price and volume information of executed trades as close to real-time as possible – and again this includes off-exchange trading.

With consultation paper 154 the FSA also refines the concept of best execution and talks about the overall transaction cost rather than just achieving the best price. Moreover it removes the SETS benchmark acknowledging that better prices may be achieved outside of the central trading venue.

CP 154 outlines that firms should:

- provide to clients information on their order routing practise and any details of how prices are researched
- reveal execution venues available / used OR disclose details of its order flow on an historical basis
- disclose any conflicts of interest that mean one execution venue or broker could be chosen over another

These proposals from the FSA are likely to influence other European regulators.

Though both CP 154 and the new EU ISD are not yet a reality change is certain with resulting implications on buy and sell-sides alike. It will be necessary to revise business processes and strategies and indeed perform many activities not currently undertaken in any widespread manner.

Technology will play an important role in fulfilling regulator's obligations and this will manifest itself in two major forms. Firstly technology will be necessary to efficiently fulfil best execution reporting requirements – the fund manager running off a spreadsheet, a trade blotter and telephone will find it harder to meet upcoming requirements than the firm with an OMS, connectivity and end-to-end STP. Secondly, under pressure from investment

consultants, fund managers will either have to introduce the necessary technology or business is likely to flow to those firms showing a better capability than others for best execution – especially in an environment of low investment returns where poor execution can materially affect actual returns. Trading practices will obviously play an important role here but technology will also be significant.

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Now nearly ten years old FIX has become the de facto industry standard for electronic trading, first in the Equities arena and lately as an upcoming standard for other asset classes such as FX, Derivatives and Fixed Income. With FIX firms can issue solicitations of interest, trade electronically with each other and receive real-time execution information regardless of the respective trading systems used. It can be used as a common protocol to access crossing networks, ECNs, ATs and DMA offerings and with the recent release of version 4.4 of the protocol, it can be used right up to the point of settlement.

But specifically, how will adoption of FIX help you to meet these upcoming regulatory changes?

As outlined, the new regulations infer a greater emphasis on trade analysis, record keeping and client reporting. Trading using FIX infers a wide ranging set of raw trade data and better availability of other related and downstream information. Taken together this means that such analysis is both easier and cheaper to gather.

Indications of interest (IOIs) and advertisements (execution reports) have grown significantly in volume with buy-sides slowly beginning to appreciate their value in the search for liquidity. As a result, more firms are beginning to evaluate and even implement plans to create repositories of liquidity data which stores historic information. By going through historical IOIs/ads firms are able to determine who has been offering the best prices for a security and using this as a tool to identify execution venues where best execution might be achieved.

With buy-side dealing increasingly becoming self-directed, certainly for the smaller flow, immediacy of access to traditional brokers has become more important. DMA, or direct electronic access to exchanges through a broker's membership, fulfils this and allows buy-sides to trade exactly when they want to. DMA is becoming a widespread offering with FIX the predominant protocol used to access the service.

The removal of the SETS benchmark reflects the emergence of multiple trading venues; that a better price may be achieved on ITG, Liquidnet or E-Crossnet say rather than the central exchange. Thus firms having access to these destinations are logically better placed to demonstrate having made efforts to achieve best execution. There are generally always several ways of accessing such alternative sources of liquidity and FIX is normally one such medium.

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Timing can be key to achieving best execution and technology plays an important role alongside the skill of the trader. Electronic trading strategies such as VWAP engines, ECN pegging or limit order sweeps and sophisticated model-driven plays are all ways in which best execution can be achieved. Again FIX tends to be the protocol through which these services are accessed.

Whilst attaining and evaluating best execution means much more than simply having an electronic capability it is evident that automation and protocols like FIX have an important part to play. FIX consolidates a number of technical ways of achieving best execution – you can use the same infrastructure to reach most any execution venue, to capture and analyse trade information and to engage automated trading strategies.

FIX needn't be expensive and time-consuming to implement. Off-the-shelf FIX-enabled OMSs are becoming more common and arguably more affordable but still reside at the pricier end of the scale. However, a recent development by vendors has seen the introduction of a rental based model where for around \$3,500 a month a firm can buy a FIX-enabled trading front-end complete with network and the potential to connect to a high number of

other FIX-enabled counterparties. With extremely short lead times and almost no capital costs this model is compelling for those without FIX. Further, as a solution that can be used to slash confirmations bills and deployed across FX, Fixed Income and Derivatives, the business case for FIX becomes stronger and easier.

As protocols like FIX progress it will become harder for the firm with phone, blotter and spreadsheet to compete with those having richer, electronic toolsets. In an ever competitive marketplace with evolving and challenging regulations there is thus a strong case for technical changes in the way participants operate and interact with FIX being the enabler. **FIX**