

Made in Canada : Best Execution Does Not Equal Best Price



There is ongoing debate – and much confusion – concerning the definition of best execution.

While regulators within respective domains are crafting legislation geared towards addressing the state of current market mechanics within their own jurisdictions, the “best execution” definition continues to vary amongst industry participants, and across jurisdictions.*

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But why even get hung up on definitions? Because to say you have achieved best execution, you must be able to prove it. And to prove it, you must be able to define it.

Jurisdictionally Speaking ...

As is typical with many issues involving the United States, the American point of view gets construed as the universal approach mainly due to the country's size and presence. Best execution regulation will be written, however, and it will reside within distinct national and “supra-national” jurisdictions such as the European Commission.

In writing these regulations, measurement is a necessary, and perhaps obvious, requirement to assessing the success of their best execution mandates.

Market participants can gain a better understanding of how they measure up in the best execution equation – and what they need to do to be successful in meeting a best execution mandate – by examining the similarities and differences of best execution legislation in Canada, Europe and the U.S.

U.S. Securities & Exchange Commission

Former U.S. Securities and Exchange Commission (SEC) Chair Arthur Levitt effectively kicked off the process in the year 2000 by releasing the first definition for best execution geared toward the specific mechanical act of executing a front office trade.

“In placing a trade, the trading desk will seek to find a broker-dealer or alternative trading system that will execute a trade in such a way that the trader believes will realize the maximum value of the investment decision.”

By the year 2002, the SEC had updated its own definition stating best execution was “a duty to seek the most favorable execution terms reasonably available given the specific circumstances of each trade.”

The year 2002 definition critically shifted the focus in two ways. It emphasized the fiduciary nature of the trading decision through the word “duty”, and it introduced a more encompassing cost reference with the “favourable execution terms” phrase.

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The seemingly innocuous change of definition achieved two purposes. It created a link backwards, or upwards, into the pre-trade world of the transaction, between the act of execution, and the fiduciary, pre-trade, decision-making process before the trade. It also created a link forward into the post-trade worlds of clearing and settlement with the "terms of execution" reference.

European Commission

The European Commission (EC) has gone even further, and deeper, with its definition of best execution, and created a list of specific inputs and attributes which would go into a single transaction. By doing so, it has provided industry participants some much needed guidance and visibility towards what they need to achieve best execution.

Still on the table in the EC's most recent draft is the recommendation that *certain* fiduciary aspects on the Buy Side of meeting best execution can be "discharged" to the Sell Side through a written agreement. In this instance, however, the Buy Side must be able to monitor and measure the Sell Side's performance.

Canadian Securities Administrators

In Canada, the Canadian Securities Administrators' working paper gives us a somewhat less itemized definition

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vis-à-vis Europe, but it nevertheless offers a concise definition concerning best execution for Canada. Here, we find four key functional attributes for achieving best execution: price; speed; certainty; and total cost (measurement).

Realizing the Spirit of Best Execution

In order for us to get our arms around this issue, we at Stratix Consulting have developed a dual-purpose "Industry Model/Framework" which allows us to model inputs and attributes of a single trade, while at the same time allowing us to capture the various functional domains across the industry.

Our framework provides us with a starting point for identifying, assessing and measuring the attributes and inputs – not to a million transactions, but to a single transaction. It demonstrates where the traditional components (or services) for the "trade" exist. Also, it highlights some of the "new" services which are available both to improve transaction productivity and to help achieve best execution.

In our framework there are also large areas of "common functional components" that, depending on the respective business model, may reside inside or outside a firm's trade function domain.

Since we have qualified the "what," or input costs, to best execution, we are able to realize the fourth element of total cost and, subsequently, measurement. But, to achieve best execution, we still need to account for the other three elements: price, speed and certainty.

"... the mechanical execution environment must meet a high standard of performance"

To ensure that these three elements are realized, the *mechanical execution environment must meet a high standard of performance*, namely through real time connectivity and a low latency transaction environment. There are certain generic mechanical attributes of a transaction which must exist in "real time" to capture, or crystallize, the "what" of trade execution:

- ticket-tied, pre-trade compliance/ decision support/ research;
- order book displaying entirety of executable markets/ prices;
- algorithms, analyzing real-time market data, while incorporating historical market data, to determine optimal "order execution launch";
- sub-second connectivity across liquidity pools (e.g. traditional exchanges, ECN's, ATS's, in-house systems, brokers, etc.) to execute those algorithms against those markets/prices;
- post trade allocation; and
- Transaction Cost Analysis (TCA),
 - actively reviewing order execution vs. benchmark expectations while incorporating cost data (exchange/trading fees, Jitney fees, commissions, soft dollars, etc.).

It is important to note that given the regulatory bent being directed towards all those participating in the marketplace being responsible for best execution, consideration has to be given to the nature of costs related to the post-trade process. Achieving a great price for a transaction that is offset by an unaccounted for post-trade cost effectively negates the achievement of best execution. *Overall* favourable execution terms must be considered.

Walking the Best Execution Talk

A firm participating in the lifecycle of a transaction will need to be careful if it offers "best execution" as a service. As we have seen, the fiduciary duty, implicit across all the various definitions, creates a link throughout the lifecycle of the

transaction, from the decision making process through to settlement.

That being said, lowest cost is not necessarily the final arbiter for best execution. Obviously, different investment objectives along with different fiduciary responsibilities will create different approaches and different best execution equations. The economics of a particular transaction might be such that the input costs might be higher for that transaction, but the Portfolio Manager or Trader has still achieved best execution.

The subjective pre-trade decision costs that go into the slower trade may warrant a higher cost structure. As long as you have met your stated mandate and can measure and subsequently audit its attainment through a TCA mechanism, you will have achieved a best execution mandate.

One of the unique features of the best execution regulation is its ambition as it cuts vertically, and horizontally, within and across organizations. Clearly, this is not a back office issue given its penetration into the pre-trade decision domain. It represents a unifying thread throughout the entire trade process, touching all aspects of the trade.

As a result, you may need to redefine your business model, either to capture new functionality that you don't have,

“... strategy needs to be created to determine where you are, and where you want to be.”

or don't offer. Or you may need to pull back somewhat and give up doing certain functions that you currently do because you can't meet a best execution imperative. In any case, some form of transaction function strategy needs to be created to determine where you are, and where you want to be.

Pragmatic Approach to Best Execution

The last recession coupled with renewed growth left many companies with a fairly tight ship. Changing business models and globalization have also shifted some key skill sets related to best execution to outside the firm. Notwithstanding these facts, best execution necessarily touches many different functional domains within a firm. It is important to recognize that, along with both business and technology being at the table at the same time on this issue, there may also be a need for new skill sets to be added.

Decisions regarding the solution must be looked at jointly by the heads of business and technology. At the outset, the business model you employ and the economics behind it will determine whether you should even try to proclaim that you have a best execution business environment.

Moreover, regulatory drivers require significant investment in electronic trading resources and technology. This is not an

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option, as it is driven by 'stay in business' criteria. Properly done, these investments will simplify administrative process and overhead costs.

Therefore, scoring a positive return on best execution investments does not have to be a wish, since it is a reality for many. Your initial and overall approach to the issue will be an important determinant to your ultimate success. However, in Canada, when trying to achieve best execution, there is no silver bullet.

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