



Defining best execution

By Jennifer Plaia Carberry, NYFIX, Inc.

In the trading world, there is much controversy about defining best execution. From a broker-dealer perspective, the definition is quite a simple one. As a broker-dealer, I am required to act as a fiduciary on behalf of my client. Very simply, this means that I must put my client's interests first and act solely on the client's behalf. This also means that I must put aside any competing interests of my own. Weighing my own interests at the cost of my customer would be compromising my fiduciary duty. Acting as the executing broker for my client, the client is paying me a commission for my services and I am therefore required to attain the best possible execution that I can for that client and mandated to fulfill the client's interests in the role of fiduciary.

The next logical question is 'how do I know I am achieving the best execution for my client?' The first consideration should be the client's priorities. The client's primary objective is typically either speed or price when it comes to executing their orders. How does the broker know which to prioritize? Aside from the ubiquitous 'know your client,' the type of order the client submits designates, with a certain degree of accuracy, what parameter is of primary importance to the client. A market order denotes speed as the primary objective, while a limit order designates price as the main objective. With an increasingly complex market structure, other factors invariably play a part in execution quality including anonymity, the opportunity for price improvement, the elimination of market impact or price dis-improvement as well as overall transaction costs.

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An example of a broker correctly assuming fiduciary duty in a trade would be as follows. The current market for IBM is 87.50 by 87.52, 5000 by 5000. Your client sends you an order to buy 10,000 shares of IBM at 87.50. You execute the trade for a better price, buying the shares at 87.47, receiving price improvement over the National Best Bid or Offer (NBBO) and you pass along the price improvement to your customer. This illustrates a broker acting in accordance with best execution requirements. If the broker had taken the fill for inventory and then given the client the limit price of 87.50, that would be a violation of the broker's fiduciary duty and putting his/her own interests first. Often times, a broker can obtain a better price than what is quoted in the market as a result of crossing, not held orders or undisplayed liquidity. In complying with best execution regulations, brokers must pass along price improvements obtained on trades on behalf of their clients to the clients. Similarly, while obtaining price improvement is one way to achieve high quality execution for a client, another is the elimination of price dis-improvement.

Measuring execution quality

Technology and the existence of both fast and more manual markets can play a role with respect to best execution. For instance, if news came out on a stock that caused the price to rise significantly and your client sent a

market order to sell that stock, speed is the priority in this case. This can get complicated in the 11ac1-5 reports that each market center issues. When it comes to measuring price improvement, these reports measure price improvement over the NBBO at a particular point in time. For example, if a stock's price is quickly rising and the quote went from 18.40 x 18.45 to 20 x 20.02 in a matter of minutes and a buyer put in an order to buy at the market and receives a fill of 19.98, it could be considered price improvement of \$.02 over the 20 quote, but price dis-improvement of \$1.58 over the 18.40 quote. While these reports undoubtedly add value by helping investors compare different firms and market centers, determining execution quality and/or price improvement is often quite a difficult proposition.

Because of such inconsistencies and the market's ability to fluctuate quickly, tools to measure execution quality in other ways are coming to market. While some firms measure execution quality as compared to the VWAP (Volume Weighted Average Price) others argue that the VWAP is a faulty measure of quality because it does not take into account intra-day market conditions, but is solely a function of volume and price. Some buy-side traders would like to measure the quality of their broker executions by benchmarking them against the last execution in a particular stock before an order is sent for execution. In this context, real-time execution quality measurement tools could prove to be very useful in evaluating market centers, brokers and ultimately, best execution.

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The role of FIX in best execution

An integral part of achieving high-execution quality is determining the best market center for a particular trade and the ability to reach that market center quickly and efficiently. As the standard for electronic trade routing, FIX plays an important role in routing orders to market quickly and effectively. In addition to speed and operational efficiency, FIX has become known for the protocol that enables

specialized routing configurations, including smart routing and rule-based trading. These configurations customize both brokers' and buy-side firms' routing capabilities to satisfy a variety of strategies and market access points. The importance of FIX and electronic order routing is especially evident in the fully electronic markets such as the Nasdaq and a variety of ECNs and ATs, designed to accommodate large volumes of orders in sub-second intervals.

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The widespread use of FIX in firms' order routing infrastructures might also prove to be a useful tool in analyzing a variety of execution information. Firms can leverage the protocol to access a vast array of information that helps traders perform better and achieve faster and/or more favorably priced executions in addition to audit trails required by the SEC.

Market structure changes and best execution

The SEC creates regulations to protect investors and provide them with fair and orderly markets in which to transact business. With these goals in mind, the SEC instituted the trade-through rule in the 1970s intended to protect investor interests and ensure that they receive the best price available. The rule prevents 'trade-throughs,' which is the execution of an order in its market at a price that is inferior to a price displayed in another market. The debate revolves primarily over the fact that the trade-through rule takes into account only price, and not speed, a parameter that has become increasingly important to today's traders. The trade-through rule has never been applied to stocks traded on the Nasdaq market. Changes in market structure, including the advent of the dual-listing and the proliferation of ECNs/ATs, has fostered an environment that encourages traders to route their orders to the execution venue they deem most appropriate for their orders.

Proposed regulatory changes

The latest SEC rule change proposal calls for a uniform rule for all NMS market centers that, subject to certain exceptions, would require a market center to establish, maintain, and enforce policies and procedures reasonably designed to prevent 'trade-throughs.' Second, the Commission is proposing a market access rule that would modernize the terms of access to quotations and execution of orders in the NMS. The third proposal would prohibit market participants from accepting, ranking, or displaying orders, quotes, or indications of interest in a pricing increment finer than a penny, except for securities with a share price of below \$1.00. Finally, the Commission is proposing amendments to the rules and joint industry plans for disseminating market information to the public that would modify the formulas for allocating plan net income to reward markets for broadly based contributions to public price discovery (see <http://www.sec.gov/rules/proposed/34-49325.htm> for more information). Under the new proposals, investors would be able to 'opt-out' of the trade-through rule, essentially taking their chances with regard to execution prices in an effort to achieve speedier executions.

Impact of possible regulatory changes on best execution

The NYSE supports the trade-through rule and argues that there is no advantage to eliminating the best price guarantee, while Nasdaq and electronic communications networks favor the ability to opt-out, letting investors choose their own priorities, whether that is speed or price. The goal of the rule proposals is to 'level the playing field' among market centers. By providing a central set of regulations for a variety of execution venues, the Commission will hopefully give investors a fair and equitable platform from which to achieve best execution in whatever way the client defines it.

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Jennifer Plaia Carberry is Director of Marketing for NYFIX, Inc.