BUILDING A BEST EXECUTION FRAMEWORK

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Despite the second Markets in Financial Instruments Directive (MiFID II) being delayed to January 2018, the urgency around implementing plans for the best execution obligation has not subsided.

The push towards best execution across multiple asset classes has been gaining momentum, and the role of best execution analysis has become quite clear. The guidance provided by ESMA, for example, introduces the concept of considering available liquidity in best execution, which is a major change from the previous regime of having a general policy. This will force best execution analysis to accurately measure market conditions for every order, increasing the demand for data collection and market connectivity. Additionally, the codification of best execution as a fiduciary obligation for any asset owner of institutional investment portfolios is a major step forward.

Regulatory pressures are mounting, and as electronification and market structure changes expand globally, firms will have to commit to building a basic foundation to ensure regulatory compliance. Looking beyond simple compliance, forward-thinking buyside and sellside firms are exploring future best execution frameworks as a potential competitive differentiator.

Points to bear in mind when building out a best execution framework:

- **Defining best execution varies across asset classes.** Trades of illiquid fixed income securities that use RFQ methods are quite different from liquid instruments that can be compared using historical trade and quote data.

- **Despite claims that best execution for institutional equities is not easily measurable, statistical analysis of orders and executions in the context of the market can be quite accurate in evaluating best execution.** This type of analysis is not meant to be a precise method for evaluating individual trades but the goal is to measure the performance of strategies, algorithms, traders and venues over time.

- **Ability to achieve best execution can significantly improve performance across any portfolio with exposure to either a single asset class or across assets.** The more integrated that prediction and measurement of transaction costs is in the investment process, the more it can improve performance.

- **Best execution is a shared responsibility between sellside firms and their clients.** However, it should be noted that the fiduciary responsibility to enforce best execution policy resides with asset owners.

- **Best execution includes both the decision to choose the right investable instrument and the most appropriate trading strategy to implement that decision.** Choices should be based on finding instruments and using strategies which are most compatible with an end user’s internal systems and work flows.

- **Best execution does not merely mean best price.** It also includes the ability to settle trades via straight-through processing (STP) with consistency and without error.