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'Best Execution:' Will It Work?

By: Robert Smythe

What is 'Best Execution?'

It is often considered to be 'Best Price,' but this is not the case. 'Best Execution' factors include price, timing, certainty, anonymity, and execution costs. When optimally managed, these factors can improve portfolio performance.

What has changed in the Canadian securities marketplace that requires any action on the part of **pension plans, investment managers** and **plan sponsors**? There are two things: the emphasis on 'Best Execution' in Canada and globally, and the multiple trading venues that will be available in Canada in 2007.

Why 'Best Execution?'

Under regulatory rules, broker/dealers are obligated to achieve 'Best Execution.' Since there is no universal definition of 'Best Execution,' regulators have advised broker/dealers to establish agreements with their clients as to what constitutes 'Best Execution.'

While pension plan and investment managers look at Alternative Trading Systems (ATS), Electronic Crossing Networks (ECN), and Direct Market Access (DMA) to execute trades, they also need to understand how they can impact 'Best Execution.'

Since the new trading paradigm coming to Canada will change the way markets function, broker/dealers, pension plans, and investment managers need to prepare for this change now.

The New Trading Environment

The advent of multiple and competing marketplaces has resulted from a regulatory desire to create a framework for the competitive operation of traditional exchanges and alternative trading systems. Rule changes and alternative marketplaces began to appear in 2006.

The resulting equity marketplaces in Canada include:

- The Toronto Stock Exchange (TSX)
- SX Venture Exchange (TSX-V)
- Canadian Trading and Quotation System (CNQ) including its 'Pure Trading' facility
- Bloomberg Tradebook
- Liquidnet
- Perimeter Markets Inc. (BlockBook)
- Shorcan ATS

Other trading venues scheduled to emerge in 2007 include TriAct and Instinet.

In addition to equities, trading approaches for fixed income, options, derivatives, and other alternative investments involving trading venues such as the Montreal Exchange (MX), CanDeal/TradeWeb, and CBID must be managed. The upstairs trading capabilities of the major broker/dealers should also be factored in.

Prior to making an informed decision with regard to which marketplace will provide 'Best Execution,' the trading characteristics of these venues need be understood.

An investment manager can no longer simply toss an order to a trader and assume all is well. With the multiple options now available, wrong choices may have a noticeable impact on portfolio performance. Modern investment managers must now work even more closely with their traders to ensure that their trading strategies achieve 'Best Execution.'

The Canadian Regulatory Structure

New securities marketplaces in Canada are the result of action taken by the Canadian Securities Regulators (CSA) starting back in 2001.

In Canada, there are multiple regulators overseeing financial services. This is illustrated in Figure 1. The regulators moving 'Best Execution' forward include the Canadian Securities Administrators (CSA), provincial security regulators, and the IDA-RS.

Regulators have been concerned about the efficiency of the Canadian financial industry. Similarly, the Canadian financial industry has been concerned about the efficacy of regulatory processes. These concerns were well summarized in a December 11, 2006, speech by David Dodge, governor of the Bank of Canada, on 'Improving Financial System Efficiency: The Need for Action.'

'Best Execution,' in its broadest definition, can become the focal point for the many initiatives that are needed to improve the efficiency of the Canadian financial industry.

Canadian Regulatory Initiatives

There are currently six Canadian regulatory initiatives that impact 'Best Execution.' They are:

- 'Best Execution,' Trade-through, and Reporting Obligations involving Multiple Venues
- Soft Dollars
- Trade Information Collection and Distribution (Information Processor)
- Trading Surveillance (TREATS)
- Pre-Trade Information (XBRL)
- Trade Matching (Matching on T)

Best Execution, Trade-through, and Reporting Obligations involving Multiple Venues creates a framework for the operation of marketplaces such as traditional exchanges, ATSS, and inter-dealer bond dealers to provide trade transparencies including recording and reporting trade information electronically.

The proposed regulations clarify how advisers and registered dealers can use client brokerage commissions and include guidelines regarding disclosure of 'soft dollar' arrangements.

With multiple marketplaces, consolidated pre-trade, and post-trade information is required to facilitate 'Best Execution' and market integrity. 'Best Execution' rules require this information be sent to an information processor or vendor. Currently, there is no information processor for the equity marketplaces. Regulatory approval for information processors is expected very soon.

Market Regulation Services (RS) does real time surveillance of the markets that it regulates. RS and other regulators also need access to historical trading information. The regulators have initiated The Transaction Reporting Electronic Audit Trail System (TREATS) project to provide historical information. Real time and historical data is needed to monitor 'Best Execution.'

TREATS involves extracting, managing, and accessing large volumes of data. This mostly impacts brokers and marketplaces. A TREATS solution is planned for December 2009.

The regulators have been looking at a business reporting language (XBRL) for communicating business and financial data in a format that can be read electronically and fed automatically into other applications.

Rapid access to corporate reports will result in better trade decisions by investment managers able to rapidly receive and analyze this information electronically.

Achieving industry and regulatory consensus on trade matching began as a securities industry initiative to implement Straight Through Processing (STP) for trade matching and settlement.

Current regulatory and industry focus is on achieving trade matching on Trade Date (T).

This will improve 'Best Execution,' but can only be achieved by more efficient and accurate back office processes.

Best Execution Game Plan

To achieve 'Best Execution' in a multiple marketplace environment, pension and investment managers must:

- Understand the features and characteristics of the new trading venues
- Review your portfolio and trading patterns and determine how all available trading venues can assist you in achieving 'Best Execution'
- Determine if your current trading processes and methodologies will continue to serve your needs going forward
- Work with the parties who execute orders on your behalf to reach an understanding of what 'Best Execution' means for various trading scenarios
- Review your current business processes and technology infrastructure to ensure that it supports trading in multiple marketplaces
- Examine how electronic trading processes may help you achieve 'Best Execution' and operational efficiency
- Understand how electronic trading uses order management systems, networks, and communication standards such as the FIX Protocol as a facilitator of 'Best Execution'

Will it Work?

While many of the pieces are in place, several gaps currently exist. The regulatory framework has been identified, new trading venues are being launched, and essential technology is available. However the Information Processors are missing and connectivity to the new trading venues has not been tested.

Before we can say that 'Best Execution' is working, investment managers, brokers, and regulators will have to come to a common understanding of what constitutes 'Best Execution' under varying trading situations across multiple marketplaces as the new environment evolves throughout 2007.

We will also need to confirm that systems being developed to route trades to multiple marketplaces work. This is a key unknown, given there have been no industry-wide tests thus far.

Rather than being an issue of 'will it work,' it is an issue of 'it must work.' Ultimately, the beneficiaries of pension plans and investment accounts will demand that the securities industry meets their highest expectations for 'Best Execution.' Failure can only occur if we fail to understand what they expect 'Best Execution' to be. ■

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