When MiFID II is implemented on the 3rd of January 2018 it will mark the end of one chapter (the initial scramble for compliance), but the beginning of another. There are several areas where the new rules are likely to trigger structural changes that may take a while to bed down. Best execution is one of those areas.

The heightened levels of disclosure falling under RTS 28 requires investment firms to publish their top five destinations for order flow, which may raise question marks for any firm whose flow is not being directed to the most competitive venues. RTS 28 also requires investment firms including managers to explain how they have used “data or tools relating to the quality of execution, including any data published under... RTS 27”. It seems clear that investment managers should be working out how to integrate the newly available data into their best execution arrangements.

In turn, RTS 27 will prompt execution venues (including exchanges, MTFs, OTFs, systematic internalisers and market makers) to publish much more data relating to the quality of their trade executions (see our earlier article). This data should, in theory, make it easier to assess which venues offer better quality execution for specific asset classes.

This heightened level of transparency is therefore unlikely to be just a compliance burden. It has the potential to stoke competitive forces that could change the landscape and dynamics of the market.

MiFID has always placed emphasis on the qualitative aspects of best execution understanding that decisions around the core best execution factors of price, liquidity speed etc. are essential to demonstrate execution quality. Since MiFID I new technologies have emerged that enable more sophisticated quantitative measurement of best execution quality, like transaction cost analysis, but a common complaint is that these tools are suited to the equities markets where there is more transparency. MiFID II presents the challenge and opportunity of more information across different investment classes, technology development and an expectation investment firms use the new data to help improve execution quality and demonstration thereof.

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1 RTS 28 specifies all of the new data publication arrangements relating to investment firms’ best execution obligations. The first of these reports are due to be published in April 2018. For more information see http://ec.europa.eu/finance/docs/level-2-measures/mifid-rts-28_en.pdf

2 RTS 27 specifies all of the new data publication arrangements relating to execution venues’ best execution obligations. The first of these reports for the first quarter 2018 are due to be published by the end of June 2018. For more information see http://ec.europa.eu/finance/docs/level-2-measures/mifid-rts-27_en.pdf
LEAVING LATITUDE FOR DECISION MAKING

Best execution is difficult to quantify because of the natural trade-off between price and liquidity (immediacy of order execution). For best execution, traders and trading desks need to decide which to prioritize. The nature of each trade will determine whether traders are more focused on price and prepared to work an order over a longer time period to minimize market impact, or liquidity (being prepared to pay extra for access to greater liquidity).

NEED FOR DOCUMENTATION (KEEPING RECORDS OF PROCESSES)

Analysing transaction and market data in isolation might not always be enough to ascertain whether best execution was achieved. Simple quantitative metrics like implementation shortfall are not always the best benchmarks. Firms need to understand the rationale behind trades to gauge whether an execution strategy was appropriate. For example, a portfolio manager that is confident the price of a security will rise in value over several years may be more than willing to wait a few weeks to achieve the best entry price for his position. By contrast, a portfolio manager that is looking to take advantage of price momentum over a couple of weeks will want the trade to be executed as quickly as possible. Knowing the difference will help to explain why certain trades may have been executed at a price that differed from the prevailing market price. This places the emphasis on firms to document decision making processes so they can explain instances when they chose to prioritise liquidity over price whilst also utilising systems that can identify outliers from the market that require explanation.

DEFINING THE RIGHT POLICY

When it comes to best execution, ESMA recognises that best execution is not always just about the price attained or associated costs, though this is the requirement when servicing retail clients. RTS 28 states that firms should explain the relative importance placed on “price, costs, speed, likelihood of execution or any other consideration including qualitative factors.” So when applying their MiFID II best execution policy, it is important that firm retain sufficient leeway for traders to apply qualitative judgments in accordance with the MiFID best execution criteria.

Then they need to consider the quantitative processes they will use to optimise, measure, monitor and report on execution quality. RTS 27 will ensure an abundance of data is available relating to venues’ execution quality. RTS 28 then requires investment firms to outline how they make use of the RTS 27 data in their execution arrangements and oversight.

This will mean investment managers understanding the data that will be published by venues and by brokers, those they use and those they don’t, how this information can be used in their own execution evaluation and how it can be used in their assessment of the counterparties and venues they do or could access.

The re-stated MiFID II Best Execution policy therefore could have significant implementation ramifications throughout 2018 as firms begin to report RTS 27 and 28 data and firms work out how it will be consumed and used.
TCA SYSTEM SELECTION
Choosing the right TCA system will be crucial to monitoring and fine-tuning execution quality. However, it may be that more than one system is required. Different systems will excel at analysing different asset classes, and may even be better suited at optimising unique parts of the trade execution cycle. Some may focus on providing pre-trade analytics to gauge the potential market impact of an order and help define the best approach to execute that order. Others may be better at analysing broker and/or algorithm selection, while others could be better at selecting which venue is most appropriate. Firms will therefore need to select systems based on their specific requirements, which may necessitate a best-of-breed approach. Compliance teams should understand how these tools contribute to the delivery of best execution and both compliance and the front office should understand how these systems fulfil the firm’s stated execution policy.

CONCLUSION
Best execution will be an iterative process. Many firms might now be scrambling to tick the right boxes to achieve day one policy compliance. However, the regulations expect that all firms will take a more strategic view and use the information available to be better placed in the provision and evidencing of best execution. Ultimately, best execution is more than a compliance exercise – it is about optimising a client service process. Firms that can take advantage of emerging data sets to enhance their execution quality stand to reap real business rewards – capturing more alpha and using that performance boost to grow their business. Otherwise firms may become disadvantaged over time through poorer execution quality and their inability to demonstrate to the regulator and investors how they have adopted the change that MiFID II brings about. Increased transparency should shine a light on suboptimal practices, as investors and regulators will be armed with more data with which to question asset managers’ execution policies and processes.

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Jon leads our project assignments covering independent compliance conduct and prudential assurance, CASS client money and assets, UCITS, ICAAP and operational risk and compliance infrastructure reviews. He led Cordium’s service development for MiFID II and AIFMD and regularly leads Cordium regulatory seminars and our annual regulatory forum.

Jon has over 20 years’ financial services experience, having qualified with Coopers and Lybrand, then moving on to positions with UK regulator, UBS, Deutsche and Merrill Lynch Investment Managers. He is a Chartered Accountant with a politics degree from Warwick University.