



Insider

Frédéric Ponzo says the fragmentation of liquidity that MiFID promised has yet to materialise, meaning that best execution is lagging behind

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Avoiding worst execution

With little more than a 100 days of MiFID behind us, investment firms have already begun drawing their own conclusions on whether the directive will revolutionise the European capital markets. Of particular interest is whether the imposition of a principles-based best execution policy has made any difference to their trading practices, particularly when the fragmented market for which a best execution policy is necessary has yet to materialise. We have witnessed the first baby steps in best execution implementations, with some participants more advanced than others. There is no denying the amount of innovation to be done, but where do the four corners of the industry - buy side, sell side, liquidity providers and technology vendors - stand at this stage?

In reality, trading desks in investment firms are not overly concerned with best execution. What concerns them is avoiding 'worst execution'. The important consideration for a buy-side trader is to be able to fully implement the investment idea. A few pence up or down on the average price is of little importance. On the other hand, nobody wants their fingers burnt by a less-than-competent broker. In the end, this is about 'best selection': selecting the right broker for the right trade, more than achieving the best possible trade in every given scenario.

It is the brokers who must focus on best execution. After all, this is where they can demonstrate expertise and show leadership. The reality however is slightly lagging behind. Going beyond benchmark trades, brokers are now beginning to offer liquidity seeking, multi-asset and adaptive algorithms to their clients. This second generation is built with 'best execution' in mind. Secondly, SOR (Smart Order Routing) is the number one investment undertaken by brokers for best execution. The pioneering solutions are just coming online, but you need multiple destinations to route your orders, smartly or not, and again, most of them are not yet live.

Although they are said to be under siege, historical exchanges are still claiming the lion's share of all trading on listed products. The reasons for that are threefold. Firstly, liquidity has not fragmented yet – alternative venues are few and internalisation is not really gaining ground. Secondly, we are seeing merger after merger almost on a monthly basis, which is creating higher entry barriers for competitors. Lastly, executing on a traditional exchange is the de-facto and effortless way of achieving best execution. On the other hand, alternative venues are coming online progressively: Chi-X is already a clear success, Equiduct and Turquoise are both working hard to go live this year.

Two areas are bristling with innovations related to best execution; SOR and EMS (Execution Management Systems). In the SOR space there is the incumbent dealing platforms that are bolting on proprietary SOR add-ons. Secondly, there are algorithmic trading engines implementing second generation algorithms capable of achieving SOR; and lastly, there are the pure SOR players who bring solutions unencumbered by legacy developments.

The EMS sphere is beginning to gain some ground on the buy side. Firstly, the FIX protocol has become so ubiquitous that it is easy to plug an EMS between the OMS and the brokers. Secondly, most firms have moved to a centralised trading desk model covering all trades across all assets. There is now a lot of pressure to standardise and automate the way trades are done, which is the perfect territory for an EMS. Lastly, advanced EMS are coming along with their own Transaction Cost Analysis modules, allowing detailed comparisons between brokers' performance, enabling firms to retrospectively achieve 'best selection'. Just as beauty is in the eye of the beholder, best – or even good – execution really depends on who you are. We are still far from the fragmented vision that MiFID had predicted.

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