

Beyond best execution

The concept of best execution has become synonymous with the drive by both buy-side and sell-side firms to improve not only their levels of client services, but also to enhance their own execution efficiencies, and comply with increasingly stringent regulatory guidelines. But best execution is wholly contingent on firms' underlying technologies and business processes. [By Harry Gozlan](#)

The focus of regulators and financial institutions over the last few years has been on ensuring that there is a security lid on transactions, either from a systemic point of view, or individually. The appearance of strong needs to regulate the markets has been expressed in sectors such as derivatives transactions, with the emergence of projects related to clearinghouses for over-the-counter (OTC) derivatives, as well as more recently on exchanges supporting the trading of interest-rate swaps. New debates on the level of transparency relating to dark pools, with pre-trade transparency thresholds that may be revised to make these venues more transparent, have reflected a concern to guarantee a better organization of the market for the benefit of the individual or institutional investors.

However, by forcing market participants to continue their industrial mutation toward higher degrees of digitalization, internal structures within investment banks have considerably changed over the last few years, opening up the road to much higher levels of controls on the flows, margins, profits, capital costs, and risk, while enhancing client-service levels by providing better levels of execution. Even though the bulk of capital markets activities still rely on investment banks, hedge funds have been proactive in making the necessary changes to best benefit from market changes, and in some cases have gone so far as to drive the structure and technology of regulated venues, thus exerting healthy pressure on all



market participants. What started out as an exercise driving toward providing clients with best execution services has delivered significant other changes to capital markets units in terms of the structures and workflows, including the way prices are conveyed to firms' clients.

Execute First

From an investment bank's perspective, the motivation behind best execution is not only to comply with regulations—which tend to lag behind

market trends, even though there is strong political involvement around the world to curb bankers' "wild behaviors"—but also to maintain, and if possible, increase its market share with its clients, and improve their levels of satisfaction in order to attract the highest possible order flows for a pre-defined level of risk. To this extent, offering clients an execution service that genuinely improves the way they trade is key, taking into account new changes of attitude including higher trading frequencies, instructions driven by the application programming interface (API), hybrid voice–electronic models, cross-asset or multi-leg trades, and complex execution conditions. We know that best execution on behalf of a client is contingent on many variables: price, market impact, depth and ease of access to liquidity, latency, volume, combination of multi-leg strategies, or even a higher level of service. However, the hidden part of the iceberg, such as post-trade services and transaction cost analysis, matter too.

Bankers and brokers have spent tremendous efforts defining their best execution policies for their clients, which means they have had to implement significant internal changes allowing them to benefit from their best execution models and procedures. This starts from providing razor-sharp access to liquidity levels, customized to each client, in compliance with the level of risk and credit accepted, the volume of sales margin targeted, or the overall market sought

in each sector. It ends by implementing an automated, rules-based hedging process to wash the risk out in the market—or, alternatively, that risk can be kept internally.

Architectural and Organizational Changes

In order to achieve such a quality of service to clients, drastic internal changes must be conducted, radically transforming the transaction infrastructures at the enterprise level, worldwide, and across all asset classes. In order to implement different best execution policies that are agile and are asset-, client- and country-specific, solid fundamentals must be orchestrated throughout the organization. This starts with the transport or middleware used to convey data and trades in low-latency environments throughout internal and external venues. It should also incorporate order management systems (OMSs) to monitor the risk levels across all asset classes globally, but also—and this is key to the digital age of trading—a strong liquidity management layer that creates a flexible web of trading components around similar basic patterns, that must be able to:

- Collect all desired client instructions in a fast, consistent and flexible way
- Create aggregated market data hubs with lots of “intelligence” around how the aggregation is carried out
- Create fine-grained visions of the market for each type of client profile, trading service, pricing, and market-making service
- Eventually create the adequate level of liquidity to show to each client
- “Smart-route” various types of instructions received—not only orders, but also requests for quotes (RFQs), requests for streaming quotes (RFSQs), and indications of interest (IOIs)—with their corresponding execution conditions attached, on slow or high-frequency modes, to multiple liquidity pools, pricing engines, market-making

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- services, or proprietary liquidity
- Cross or match internally, or combine, these trading flows—clients against internal market-makers
- Connect to the external venues, whether they are exchanges, portals or banks and so on

This constitutes a global liquidity management backbone, into which each organization must inject its logic—a bit like a car engine that can produce more or less torque, power, and oil consumption, depending on its internal computer chip. This logic has been developed in smartTrade’s components, which can be used in an all-terrain manner on almost any type of trading pattern, whether locally or globally, delivering the logic and intelligence of the patterns to its clients. This approach, which combines a well-designed architecture with sophisticated components, can be implemented in-house as opposed to solutions delivered as part of a service, which apparently provide ease-of-access, although they typically also cause headaches when it comes to changing behaviors of non-standard patterns.

Toward Best Distribution

In certain markets, the value extracted from order flow stems from a tight ratio of pure volume, meaning fees received, versus structural costs, or from the ability to provide access to illiquid assets, including multi-leg products that are less liquid due to the complexity of their nature, even though the bulk of the capital markets world generates revenues from tradi-

tional market-making activities.

With today’s margin levels, volatility, and frequency or volumes received, the number of profitable market-makers is shrinking every year in markets such as foreign exchange (FX) spot, fixed income, credit, and OTC derivatives. The first generation of bank-to-client channels has brought more or less transparent prices to all clients at the same time. Now that the above-mentioned backbones are in place—officially in accordance with best-execution policies for clients—it has become possible, although not mandatory, to intelligently link the client-facing distribution infrastructure to the liquidity systems that usually encompass aggregators, smart-order routers, crossers, and connectivity providers. This is why the market needs sharp-price distribution tools, which can be fed by multiple liquidity sources and match books for the same security or instrument, and produce, on a client-by-client basis, quotes that are adjusted in terms of mark-ups, credits, throttling, and stack-replenishments, in order to sustain high-frequency updates toward a theoretically infinite number of different client profiles.

Eventually, the component offers the possibility to leverage all the pre-existing backbones, to control in advance, ex-ante, the expected level of liquidity, associated price, and corresponding risk that one wants to receive from thousands of clients, based on the profile of the client, the credit available, the risk appetite or quoting-bias—long or short—of the trading desk.

By doing so, a bank can implement an end-to-end architecture driven by best-execution criteria, and end up cracking the true industrial challenge at the heart of capital markets productivity. **W**

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