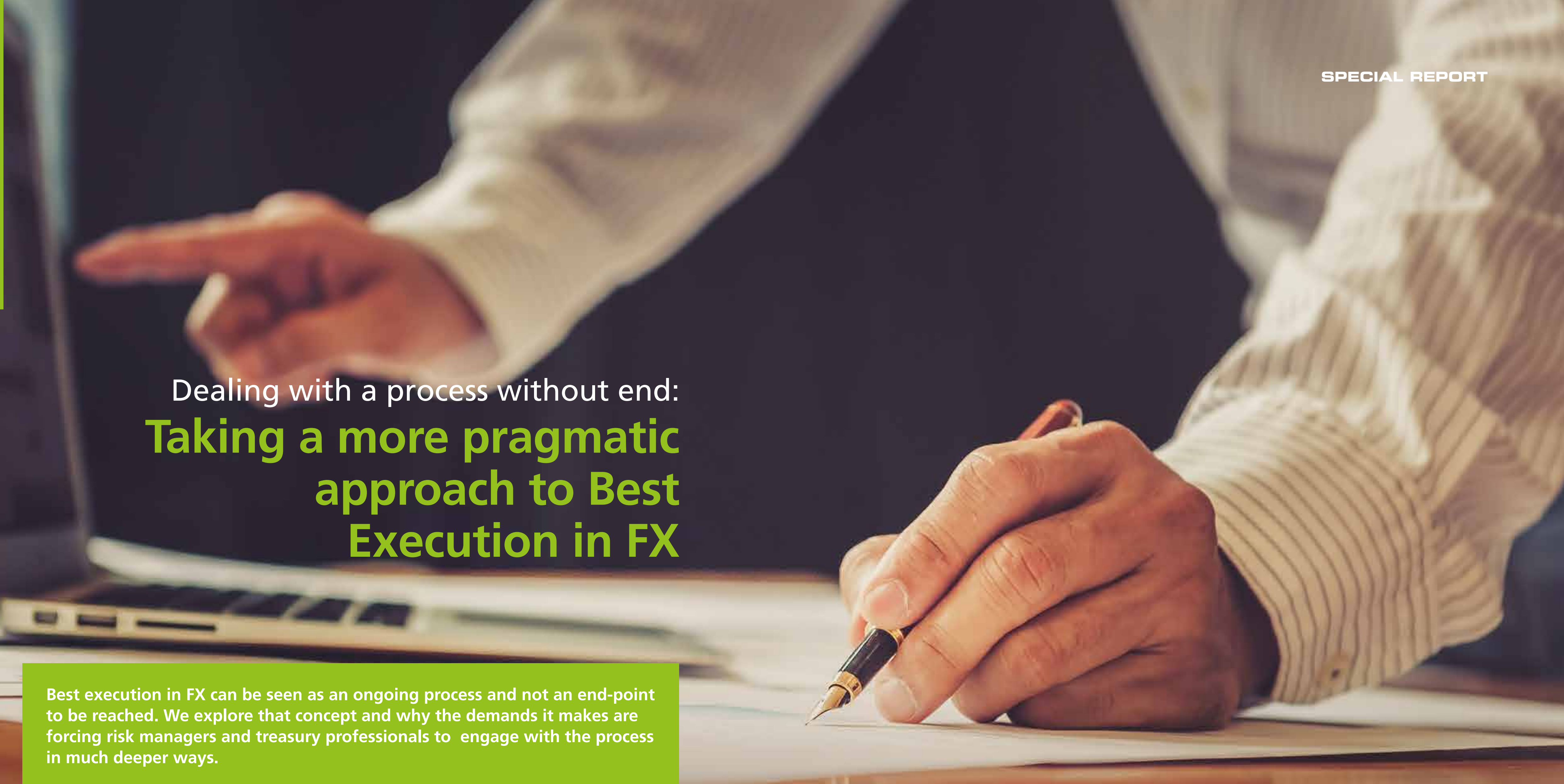

Dealing with a process without end:

Taking a more pragmatic approach to Best Execution in FX

Best execution in FX can be seen as an ongoing process and not an end-point to be reached. We explore that concept and why the demands it makes are forcing risk managers and treasury professionals to engage with the process in much deeper ways.

Typically, new regulations imposed on the capital markets will often be met with, at best, skepticism and, at worst, a sense of dread as to the impending demands and burdens it will place on market participants. The behemoth piece of European Union legislation – the second iteration of the Markets in Financial Instruments Directive (MiFID II) – was greeted in similar fashion, and was complex and difficult enough to be delayed by a year until January 3, 2018, given the necessary IT systems that needed to be built.

For investment firms caught up in the regulation, one of the most significant changes to their day-to-day trading lives has been the best execution requirements which aligns their goals with their clients by being able to provide evidence of achieving the best possible results when trading different asset classes.

This does not necessarily mean the buy side needs to get the best price – a common misconception. Instead, the rule focuses on internal compliance processes at asset managers so that “all sufficient effort must be taken to insure that every trade is executed on terms most favorable to the client, and the trading party must be able to prove it”, according to the text of MiFID II.

“The single most important implication of best execution is the realization that the risk manager or treasury professional is the party responsible for insuring its mandates are met. Best execution cannot be off-loaded to a third party. And just because you employ a TCA provider, it does not mean that you have ‘checked the box’ in a regulatory or compliance context," says James Singleton, chairman and chief executive of Curex Group.

"Market participants need to perform a pre-trade market check which is meaningful – not merely observe an undefined rate on a screen. They must evaluate trading alternatives, including new market entrants. And they must perform post trade analysis to determine whether a process of best execution is being followed," he adds.

MULTIPLE FACTORS

Previously it would have been enough to trade electronically and ask for a price from six different banks. Continuing to do that now is not enough. The MiFID II definition of best execution looks at multiple factors, which don't just include price but also, fill-rates and rejection, market impact, speed of execution, and cost, to name but a few criteria.

"This requires market participants to measure best execution in a more holistic fashion, measuring multiple metrics for a given trade or portfolio. The relevant factors and metrics will depend on that institution's best execution policy and execution methods, e.g. if an institution uses orders and algos then measures of market footprint and signalling risk may be relevant," says Pete Eggleston, co-founder of BestX, an independent transaction cost analysis (TCA) provider for the FX markets.

Given the strict requirements around what participants need to do to fulfill their best execution requirements, in theory it would be realistic for some firms to implement a best execution strategy to satisfy MiFID II and stop there.

However, while participants have come up with their own interpretations as to what that precisely means when translated into a workable solution for clients, and others have created different industry solutions, what many leading industry figures can agree on is that the process of providing best execution within a firm's trading mandate is a continually evolving process – and one that does not need to be a burden or a chore.

James Singleton

"The single most important implication of best execution is the realization that the risk manager or treasury professional is the party responsible for insuring its mandates are met."

"The dynamic nature of foreign exchange trading prevents best execution from becoming static. That dynamism is reflected in endless change - regulatory, technological, and competitive – that compels traders to find better ways to reduce costs and meet client expectations," says Michael DuCharme, director, currency solutions at Mesirow Financial.

TCA

That change, while potentially burdensome from an implementation standpoint, creates opportunities for market participants, too. One such way is using the full range of benefits of transaction cost analysis (TCA) – both pre-trade and post-trade – which is practically synonymous with best execution given the data reports that allow firms to understand the various implications of doing a specific trade under a number of different scenarios.

"TCA data is a key factor driving the ongoing processes in best execution. Having meaningful cost data provides the benchmark – and incentive – from which traders can develop strategies to improve trading outcomes," says DuCharme.

Depending on the specific trade, TCA can answer questions about how a firm should execute on a day-to-day basis, whether that should be a full risk transfer or by using algorithmic solutions that many banks and independent providers offer to help deal with more complex or difficult to execute order types.

The benefits of employing a more well-rounded best execution strategy can be startlingly obvious and lead to experimenting with different methods of execution to reduce costs.

Michael DuCharme

"Achieving best execution often means improving existing processes and systems resulting in increased efficiency, lower operational risk, and more straight through processes,"

For example, Mattias Lavefjord, a senior FX dealer at telecommunications corporate Telia Company, has been using algorithms to execute trades since 2010 when he worked at the Swedish National Debt Office and since 2012 at his current company. Historically, the firm might have tried to buy €250 million by selling the equivalent amount in Swedish krona, handing that trade to one bank in the market to execute. The market would then typically have moved against the company almost straight away, only coming back 30 minutes later where you only managed to buy €5 million.

"All you're doing is chasing the market all day long and in the end you take the price quite far from where you were," he says. "It's easier to use an algo because you get direct feedback from all the fills and we can use Bloomberg so all my colleagues can see what is going on and what has been executed."

MARKET IMPACT

On a typical EUR/SEK 100 million trade, Lavefjord says that his firm can save anywhere between $10,000 to $20,000. While these transactions are also generally restricted to a limited number of banks given corporates' governance structure about who they can execute with, Lavefjord has noticed a number of new liquidity pools he had access to – including Hotspot and FastMatch – which he admits was a "bit of surprise". That limits market impact, he says – a key consideration for how the firm executes.

"Our main concern is market impact. The worst case scenario would be if my order had a large market impact and if the price is pushed a little bit. If it's my order that is moving the market then that's not we want, but if half of the trade comes outside of Thomson Reuters or EBS, then half of the order wouldn't be seen on the screen, so that's really good for me."

Curex's Singleton says understanding market impact is critical when evaluating trading style and that for the buy side, minimizing market impact absolutely lowers their real economic cost of execution.

"How can trading customers lower their market impact? First, always execute anonymously. Second, execute in liquidity pools that have no last look. Just using an algorithm does not guarantee low impact. The type of algo and the venue where the algo executes the trade matters as well," he says.

Depending on the nature of the trading style of a specific institution, market impact can have a significant role in overall cost of a transaction. For example, if the participant is trading a large block of 1 billion AUD/USD, but splits the trade up into 10 trades of 100 million, then it is preferable to trade the first few clips of this block in a style that does not 'damage' the market for the remaining clips to be traded, according to BestX's Eggleston.

"Some firms are using their best execution process, and independently monitored performance, as a differentiator when pitching for new mandates,"

Pete Eggleston

"Trading the first 100 million with a counterparty or via an algo that creates significant adverse market impact may mean that the remaining 900 million is traded at less favourable levels than if the first clip is eased into the market with little visible footprint," he says.

What is even more compelling is that as a corporate, Telia Company is not even legally required to implement any best execution requirements, although Lavefjord admits it is probably just a matter of time before the regulators make this requirement for corporates as well.

AUDIT TRAIL

Telia Company's story is not unique. TCA has become an increasingly important tool for firms in FX as there is no central tape to determine the current price of a currency pair. Algorithms have become more widely used in FX, with 20% of institutional FX trading volume now executed using these strategies, according to a report by Greenwich Associates in February, with 60% of responders claiming that using algorithms as an execution strategy had "materially reduced the overall cost of trading FX".

"The use of electronic execution, either via algos or direct market access of orders to ECNs, has become increasingly attractive under the new regulatory environment as these methods provide a precise audit trail, including accurate time stamps," says BestX's Eggleston.

The use of new techniques and the best execution requirement has fundamentally changed the way firms execute, according to Mesirow Financial's DuCharme, where asset managers have moved away from indirect, passive execution to more active management on sophisticated currency trading platforms.

Indirect trading involves sending an order to a single market

Many firms will see meeting best execution requirements as an immense opportunity

maker who typically fills the order without oversight or influence by the investor. Because the investor isn't involved in the transaction, the dealer, sometimes the customer's custody bank, can provide a less competitive price, he says.

"Those high prices encouraged managers to trade directly with one or more counterparties. Dealing directly with counterparties results in better prices because of active negotiation and competition among dealers for the order," says DuCharme. "Previously done over the phone, now advanced electronic foreign exchange (eFX) trading systems use aggregation technology to provide investors with exchange rates from dozens of market makers and present that information in a 'depth of book' view that shows the volumes and related prices that market makers are willing to make."

VARYING REQUIREMENTS

While the evolutionary timeline has naturally led to more electronic execution, that is not necessarily the best way to execute for all transactions, according to ITG's head of FX, Ruben Costa-Santos. Indeed, depending on the currency pair, using a different method might serve a client better, which will be detailed in a TCA report.

"If there is value to using algos or other execution methods, this is not always the simple answer as it will depend on the nature of the flow you have. Very liquid G-10 currencies might be better for algorithms or if you're transacting restrictive currencies then it might be better handled by a custodian that has a local market presence. If the latter, then you can just create an overlay of TCA to monitor what you're paying for that custodian trading as well as having something that can measure market impact."

Mattias Lavefjord

"Our main concern is market impact. The worst case scenario would be if my order had a large market impact and if the price is pushed a little bit."

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How firms use these new tools is, as participants say, an ongoing process and will differ depending on the specific firm. "Clients are all starting from different points and all have varying requirements," says Costa-Santos.

For instance, those firms with only the most basic best execution requirements implemented under the first iteration of MiFID will likely see the latest requirements to be somewhat of a burden, difficult to implement and something that just gets in the way of the day-to-day job.

However, others with an interest in reducing their market impact on trades, eliminating unnecessary cost and transacting in multiple liquidity pools should see all the requirements that come with meeting the best execution requirements as an immense opportunity, say experts.

IMPROVED PERFORMANCE

"A focus on best execution is an opportunity to improve execution results which lead to lower costs and better performance. In addition, trading currency efficiently and cost effectively is an opportunity to excel in a competitive environment. Being able to stand out in a crowded field increases the likelihood of being selected for new client mandates. Achieving best execution often means improving existing processes and systems resulting in increased efficiency, lower operational risk, and more straight through processes," says DuCharme.

> "FX trading cannot be seen in isolation and instead needs to be seen in the context of how it sits more broadly in the investment process."

Ruben Costa-Santos

"Some firms are using their best execution process, and independently monitored performance, as a differentiator when pitching for new mandates," says BestX's Eggleston. "This therefore provides commercial opportunities in what has become an extremely competitive market for gathering assets."

The evolution of this space will not stop with MiFID II. Just as asset managers were refining their execution process before the best execution requirements came into effect at the beginning of the year, so will they continue afterwards.

For Costa-Santos, the impact of TCA will likely see FX's role within the investment process gain more traction and is prime for evolution. What was once a simple analysis of an individual FX portfolio or one FX trade for the industry he says, is now the need to create a multi-asset TCA functionality to take into account the FX trades that crop up as a result of making trades in equities and the bond markets.

"Previously an FX trading desk would receive an order from a portfolio manager and they would be measured against when orders hit the desk. But they now need to look at when the exposure was generated and how the overall asset manager links the effects of execution with an underlying equity trade, for example," says Costa-Santos.

The benefit of the best execution requirements under MiFID has pushed FX in front and center of the conversation, Taking a more pragmatic approach to Best Execution in FX

Experts recommend a common best execution policy to help define parameters

says Costa-Santos. "FX trading cannot be seen in isolation and instead needs to be seen in the context of how it sits more broadly in the investment process. If it's a trade related to equities or fixed income, then you can't differentiate this component. Best execution may be about buying shares in Japan or US debt from Europe and then hedging that position using FX. This has all emerged out of MiFID II."

At the moment the awareness of this issue is just an acknowledgement rather than full blown changes actually being implemented to the investment process due to a number of areas of focus including the packaged retail investment and insurance-based products (Priips) requirements coming in 2018.

"There is awareness within the client base that they need to address this and some are looking at it, while others say that's the next step. Best execution is an ongoing process and it's a continued refinement. Perhaps later this year clients can look at this as it becomes clear in asset managers' minds and it is taken into account when looking at TCA providers, whether that be FX or multi-asset," says Costa-Santos.

BEST EXECUTION POLICY

To keep these new processes in check, experts recommend a common best execution policy to help define parameters and set out the execution factors that are relevant to that institution's FX business, together with the thresholds that define an exception trade to the policy. Once defined, the next stage is implementation and monitoring, whereby the relevant metrics are computed for every trade and checked against the defined thresholds. Any exception trades should be automatically identified and flagged to relevant individuals, where typically a two stage process explains and then approves the exception.

"It is not the case that every single trade is expected to fall within the tolerance of the exception thresholds – the nature of financial markets means that on any one trade there can always be an element of randomness that results in, for example, larger costs than expected or greater market impact. Such trades simply need explaining, approving and recording," says BestX's Eggleston.

"This document should be reviewed annually to insure that practice matches policy," says Curex's Singleton. "The annual review might also identify changes that should be made to the policy. Best execution has to be owned by the market participate. The responsibility falls squarely on the shoulders of that market participant, and it is unlikely that some regulator, in the context of this policy statement, is going to second-guess the contents and preferences of the market participant as long as policy is in place and followed."