

The Mysteries of Best Execution

By Stephen J Nelson, The Nelson Law Firm, LLC

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The concept is simple enough. An investor that submits an order to buy or sell securities to his broker should receive the best available price.

Alas, the devil is in the details. Here, the question is how to determine what is “best” and whether it is available.

The traditional way to solve both issues – best and available – is to make everyone that wishes to buy or sell a particular security come to the same place. If everyone with a security to sell, and everyone who wishes to buy the security, must transact at the same place, we can be fairly certain that all that is available at any particular time is represented. The price set would be the best price because it would represent the price at which all sellers and buyers at any particular time would be willing to transact.

The theory that investors would receive best execution by making all buyers and sellers transact at a particular place justified the ancient New York Stock Exchange rule that prohibited members from transacting in listed securities off the floor. It also justified the trade-through rule, which required members to offer trades in listed securities to the New York Stock Exchange before completing the transaction on other exchanges.

This theory was not an American invention. Most European countries had one or more national securities exchanges. Until the implementation of MiFID in November of last year, trades in securities listed on these national securities exchanges had to occur there.

Unfortunately, simple solutions are not always in the public interest. Rules forcing trades into certain exchanges protected those exchanges from competition. Or, in the language of economics, they created a monopoly.

As it turns out, monopolies carry two well-known vices. First, they charge higher prices than organizations that have to worry about the competition. Second, they tend not to be innovative. The reason for this is that innovation is generally inspired by the hope of capturing higher prices by getting a step ahead of the competition. A firm that lacks competitors doesn't need to innovate to charge higher prices.

The argument for many years was that the trading of securities was not an industry where much in the way of innovation could be expected. So, the virtues of monopolization – confidence that prices are set accurately – trumped its vices – higher prices and less innovation. Then the ECN arrived in force, and it was clear that national securities exchanges charged way too much for their services and had fallen far behind the technology curve. The argument that the monopolistic exchange model best serves the public interest seems very quaint today in this age of program trading, dark pools and other creative exchange innovations.

The final nail in the coffin was driven by Reg NMS in the United States and MiFID in Europe. In each case, national securities exchanges were forced to compete for trades with other trading venues. These rules have driven uncompetitive exchanges out of business and spawned a huge number of innovations in electronic securities markets.

The collapse of national securities exchanges as the sole means of price discovery opens up the problem of best execution. If a number of venues are offering the security at different prices, how does one determine who is best? Is it necessary to canvass every system that may be offering some securities? There is usually a cost associated with becoming part of a system offering to transact securities, and the number of systems offering securities seems to be multiplying.

Traders operating in the over the counter markets have faced this problem for many years. Every firm that trades over the counter is a potential buyer or seller of every other the counter security. In that market, the problem of best execution was solved with the “3 quote” rule. A trader was required to obtain three quotes to determine the best available price.

The SEC has not been willing to apply the 3 quote rules in the market for listed securities. Instead, the SEC has provided in Reg NMS its latest definition of best execution:

Broker-dealers have a duty to seek the most favorable terms reasonably available in executing transactions on behalf of their customers. The price at which an order can be executed is of paramount importance for most investors, but in seeking the best price some investors may weigh other factors, such as the speed and certainty of execution at a specified price, even more than the possibility of execution at a better price. In today's market for equity securities, multiple marketplaces compete over price, speed, and other terms. To fulfill the duty of best execution, therefore, a broker-dealer must be able to identify the best available terms among

multiple competing marketplaces, and gain fair and efficient access to those marketplaces.

MiFID has installed a definition of “best execution” in Europe that, to my mind, is virtually identical to the SEC’s definition:

Best execution means taking all reasonable steps to obtain the best possible result for a client, taking into account price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

These definitions, however, fail to provide meaningful guidance to the hard questions. How many trading venues must a broker-dealer seeking best execution access to find the “most favorable terms?” Can the duty be limited to electronic venues? Or, must the broker-dealer station someone on an exchange floor, if the floor occasionally offers better terms? How does the broker-dealer prove that the client prefers speed and certainty of execution over price? And, when is the difference in price so great that speed and certainty are no longer important?

This problem has flowered recently in the competition for opening prices between NASDAQ and the NYSE. Both exchanges trade the same stocks nowadays and compete most aggressively in the world of electronic exchanges. But, NASDAQ has managed to introduce an opening sequence that provides a price earlier than the NYSE. For what it’s worth, NASDAQ improved its opening sequence in response to competition from the AMEX. The NYSE insists that its opening price is better, albeit slower. The NYSE nonetheless is working on the systems necessary to generate a fast open. This is the sort of behavior that robust competition induces. But, the definition of best execution fails to provide guidance as to whether a broker-dealer should execute the order against the earlier NASDAQ open price, or wait for the “better” NYS price. Robust competition tends to be messy.

One way to solve the dilemma is to let the client decide. Each of definitions provided by the SEC and MiFID suggest that different clients might weight the factors of best execution differently. Some might prefer speed and certainty, while others will want the best price, at the risk of missing a trade. But, it is equally possible that the same client will prefer speed and certainty for one order and best price for other orders. There is also the moral hazard that a client who insists that speed and certainty is most important will in retrospect decide that their broker has failed to provide best execution because the price was unfavorable.

I submit that best execution is one of those issues best resolved through adequate disclosure. MiFID requires broker-dealers to disclose to clients how they resolve best execution issues. I would have thought this means that a broker-dealer should

disclose how many venues it is prepared to access in pursuit of the execution of a particular type of order. MiFID also requires broker-dealers to disclose how they performed with respect to any particular order. In addition, dissemination of real-time trade reports to the investing public, required under MiFID and under the rules governing exchange in the United States, provides clients with an instant sense of their broker's performance.

The SEC does its best work developing and enforcing disclosure policies. Adequate disclosure enables investors to enforce fair practices by taking their business to firms that will treat them better. Competitive pressures are much more likely to improve the executions clients receive than a host of enforcement actions. The SEC should lift this page from MiFID's play book.

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