NRI

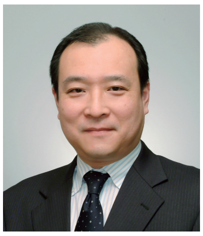
lakyara vol.150

Are best execution policies serving customers' best interests?

Mitsuhiro Tsunoda

10. October. 2012

Nomura Research Institute, Ltd.



Mitsuhiro Tsunoda
Senior Consultant
GWS IT Solutions Department

Executive Summary

PTS usage in Japan is projected to grow following a pending revision to the 5% tender-offer bid rule, but many brokerages have best execution policies that route orders to exchanges only. Brokers must revise their best execution policies in response to market changes, customers' needs, and IT systems' maturation.

JSDA's model policy says to rely on exchanges alone for best execution

Securities brokerages are obligated to obtain the best execution price and terms for clients' orders. This rule was adopted in April 2005 in conjunction with deregulation that granted proprietary trading systems (PTS) permission to use auction-based price discovery, like securities exchanges, in the aim of expanding PTS usage and stimulating inter-market competition.

Brokerages normally select at their own discretion the market to which a customer's order is routed, unless the customer has designated a specific market. However, they may not act contrary to the customer's interests in doing so. When selecting a market to which to route a customer's order, a broker should comprehensively consider all relevant factors, most notably quoted prices and transaction costs. Brokerages are required to prescribe their own best execution policies and publicly disclose them in advance. The policies identify the markets to which a broker routes orders and the method of selecting which market to use for any given order.

Once a broker has prescribed a best execution policy, the quality of the resultant trade executions is subject to scrutiny during Financial Services Agency (FSA) inspections. Consequently, many brokers formulated their best execution policies based on a model policy drafted by the Japan Securities Dealers Association (JSDA).

According to the JSDA model policy, the most reasonable approach from investors' standpoint is to use the exchange with the best liquidity, highest probability of order execution, and fastest execution speeds. The JSDA model policy advised against using PTSs and other non-exchange venues. When it was originally drafted, PTSs were considered inferior to exchanges in terms of liquidity, price transparency, and settlement risk.

PTSs' presence can no longer be ignored

Since the best execution requirement's adoption seven years ago, PTS usage had changed dramatically. Whereas PTSs were initially an after-hours trading venue for retail investors, they now are used mainly by institutional investors for trading during regular market hours.

Between 2005 and today, PTSs' share of domestic equity trading value grew from less than 0.1% to around 5%, an approximately 100-fold increase. Some analysts assert that PTSs now have adequate liquidity from the standpoint of displayed order quantities and the amount of time that PTSs display price quotes more advantageous than those available from exchanges[1].

NOTE

1) Igarashi, Eiichi, "Domestic PTSs' untapped potential" (http://www.nri.co.jp/english/opinion/lakyara/2010/pdf/lkr201069.pdf)

From the standpoint of price transparency, major information vendors now include PTS price quotes and execution prices in their data feeds. Information disparities have consequently diminished, at least for institutional investors. In terms of settlement risk, PTSs can now clear trades through the Japan Securities Clearing Corporation, thus increasing their safety as trading venues.

Additionally, a growing number of brokers, mainly major ones, are now involved with PTSs. Now that PTSs have become a presence that institutional investors can no longer ignore, their role in best execution is being reassessed.

Best execution policies have not adapted to change

However, many brokers have not yet revised their best execution policies in response to changes in trading venues.

2) Based on fiscal 2011 brokered trading volume in value terms.

Exhibit 1 classifies the top 40 brokers[2] based on PTSs' role, if any, in their best execution policies. Some 40% of the brokers have an explicit policy prohibiting use of PTSs. Another 20% make no mention of PTS in their best execution policies.

Altogether, roughly 60% of the brokers take the position that trades executed exclusively on exchanges constitute best execution.

Of the remaining brokers, about three quarters (nearly 30% of the 40) do not mention PTSs in their market selection methodologies but they do route orders to PTSs if authorized to do so in advance by the customer. Brokers whose best execution policies include PTSs as markets that may be selected for order execution account for only 10% of the top 40 brokers.

Of the 40 brokers, 16 are foreign-owned firms. Among these foreign brokers, the percentages of those who do and do not use PTSs are reversed relative to the corresponding percentages for all 40 brokers. Over 60% of the foreign brokers seek best executions from venues that include PTSs (Exhibit 2).

Japanese brokers' best execution policies are presumably written by their compliance departments in most cases. At foreign brokers, by contrast, best execution policies have reportedly been drafted by the sales department in some cases. Foreign brokers are apparently proactively utilizing their best execution policies in sales settings and emphasizing execution quality as a sales point. This is evident in the graph in Exhibit 2.

Exhibit 1: How PTSs fit in brokers' best execution policies (top 40 brokers by trading volume)

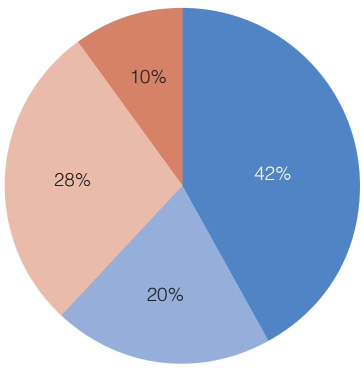
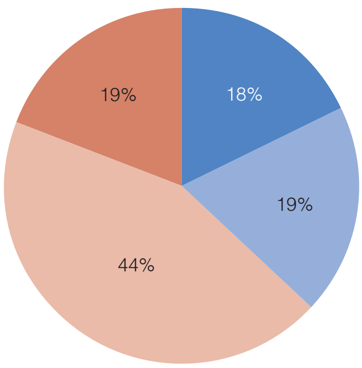


Exhibit 2: Corresponding data for the 16 non-Japanese brokers among the top 40 brokers



PTS usage prohibited
PTS usage permitted by agreement with customer
PTSs not mentioned
Execution policy includes PTSs

Source: NRI, based on brokerage firms' best execution policies

Policies' compatibility with IT that supports best execution

In October 2012, the FSA plans to exempt qualified PTSs from the 5% tender-offer bid rule. With institutional investor demand for PTS trade execution services projected to grow[3], this regulatory change presents a good opportunity for brokers to revise their best execution policies.

3) Osaki, Sadakazu, "Anticipated growth in PTS usage," Kinyu IT Focus, September 2012

In doing so, they must consider whether their new market selection methodology is feasible from an IT standpoint. Monitoring multiple markets and instantaneously selecting one to which to route an order by comparing the markets' best quotes and available bid/offer sizes is now done by computers, not humans.

One means of fulfilling this function is smart order routing (SOR), but brokers' IT departments will have to assess the feasibility of implementing SOR based on their best execution policies.

Brokers must also prepare a framework to retrospectively assess whether execution prices or market selection outcomes were indeed advantageous to customers. Brokers must not forget that the best execution requirement includes a duty to provide information on execution outcomes in response to customer requests.

Best execution policies are not etched in stone. Brokers should periodically revise their best execution policies in response to changes in the market environment, customers' evolving needs, and IT system maturation as one initiative to continually improve execution quality.

about NRI

Nomura Research Institute, Ltd. ("NRI", TYO: 4307) is an independent, global IT solutions and consulting services provider with annual sales of 335.5 billion yen as of FY ended March 2012. With front-to-back support for the buy- and sell-side, NRI's tradition of innovation has positioned them as a trusted international market leader. Leveraging NRI's global consulting business, NRI is able to provide innovative financial IT solutions for investment banks, asset managers, banks and insurance providers. For more information, visit www.nri.com.

Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

http://www.nri.co.jp/english/opinion/lakyara