US and EU Best Execution: Common Challenges, Differing Approaches

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Much of the discussions on Best Execution currently understandably focus around the implementation of Mfid 2 in Europe. The topics being discussed however are global and reflect common issues shared by the U.S. and other major equity markets. While the challenges of achieving best execution are the same, the ways and means used to achieve it have been different. Comparing the approaches used in the EU and US may be useful to clarify some of the underlying assumptions and issues for current and future best execution policy debates in both Europe and the US. Two major differences become clear: (a) Creating new pieces of market structure versus building new reporting mechanisms; and (b) a focus on price versus process. We will look at an example of one issue which illustrates these tendencies.

Best Execution is generally understood as executing a trade in a manner that maximizes the result for the client. But why do we need best execution policies? Best Ex is an attempt to address a potential "moral hazard" problem in market structure. The relationship between clients and their brokers is a principal-agent relationship. Business incentives and motivations in these relationships may have diverging interests and information asymmetry. A client, for instance, will want their broker to route orders to the optimal venues for their trade, while the broker may want to minimize their efforts and route the trade to a venue which maximizes their own revenue. Alternatively, a broker may have information about market situations not readily available to their clients creating potential adverse selection. In many cases, especially is less liquid stocks, the client does not have access to the same quality and quantity of information to monitor the broker's efforts and incentives.

The growth of electronic trading and the ensuing fragmentation of markets opened up a new set of potential moral hazards related to the speed of quoting and trading. About ten years ago when electronic trading and market fragmentation became issues, regulators in both the US and EU developed new reforms to address them. The challenge for both was to balance an equitable approach to handling client orders consistent with best execution without impinging on competition between trading venues.

The differences in approach cuts against traditional policy stereotypes. The US is usually thought of as a less regulated environment. However, in this case, the US approach has been to intervene and create new market structures while the EU focused on developing transparent reporting mechanisms that placed greater confidence in the market and market participants.

In 2005 Reg NMS (National Market System) was instituted in the U.S. market outlining rules that describe how orders should interact between different trading venues. There were two key parts. The regulators compelled trading venues to establish direct electronic linkages with each other to ensure the client received the best price even if displayed in a different trading venue. The “Trade-through” rule required all trading venues to send all orders to the venue with the best displayed price or match that price.

In 2004 the EU introduced Mfid 1. In contrast to Reg NMS, Mfid 1 did not include any market interaction rules. It gave market participants the latitude to choose the best execution strategy for their orders. It sought to address the moral hazard problem by mandating a detailed series of reporting obligations. Rather than mandating how orders should move through the venues, the Mfid directive focused on requiring brokers to review execution strategies with investors to ensure that they understand customer requirements.

While US focused on defining best ex as executing at the best price, the EU approach emphasized creating a process to obtain the best possible result taking into account price, cost, speed and likelihood of execution, etc., The EU framework explicitly avoids an absolute criterion such as price to define best execution by incorporating other factor. This served the needs of large institutional clients trading large order sizes and who require immediacy of execution. Mfid does not prescribe how orders should interact between venues. The approach for achieving best ex is to provide transparency to the client through a comprehensive reporting requiring disclosure on where trades are executed, payment incentives and how that price and trade size compares to other venues at that time.

These best execution solutions were first formulated over ten years ago. The issues surrounding trading speed and market fragmentation continued to evolve. Market fragmentation produced greater competition between venues for limited execution flow. To compete, venues sought to segment the market into different types of trading. Venues competed for market share against each other by offering technological advances in identifying potential pools of liquidity, electronic connectivity, colocation leading to higher execution speeds and high speed data feeds. The result has been a new set of potential best execution issues involving potential moral hazards.

Mfid 2 is much further along, but it is clear in the US, that a new round of regulation relating to market structure and best execution is coming. Mfid 2 appears to be following the same general philosophy for best execution as Mfid 1, in its reliance on detailed reporting to provide transparent information for investor decision making. A review of the ESMA Technical specifications suggests that the increasing complexity of the markets is being addressed by increasingly the complexity of the reporting requirements. Although accommodating all of the reporting requirements could be burdensome and undoubtedly costly, this may still be preferable to an explicitly interventionist approach.

In the US, the 2010 Concept Release on Equity Market Structure, indicated that there is a consensus that the current regulatory regime does not adequately address the new developments of the last ten years. The 2016 regulatory discussion will be dominated by the minimum tick size pilot program, where the effects of increasing the minimum spread from one to five cents for small cap stocks will be evaluated, as well as potential new regulations regarding dark pools. Early indications suggest that the US could potentially maintain its own activist philosophical approach towards best execution.