



Edhec-Risk
Asset Management Research

MiFID and the challenges of Best Execution

A new standardized framework to assess best execution

Nasty sting

“It is coming and there is no escape: a nightmarish, alien creature capable of inflicting a terrible financial sting on all it touches. No, not The Day of the Triffids; this horror story is the Day of the MiFID.”

Martin Dickson
Financial Times, July 22th 2005

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MiFID & the challenges of Best Execution

- What is the impact of MiFID on asset management companies?
- How to measure the quality of execution
- EBEX: a new benchmark for execution quality

Agenda

- Introduction
- Principles behind EBEX indicators
- Presentation of the EBEX indicators
- Interpreting EBEX – a preliminary study
- Open questions and further developments

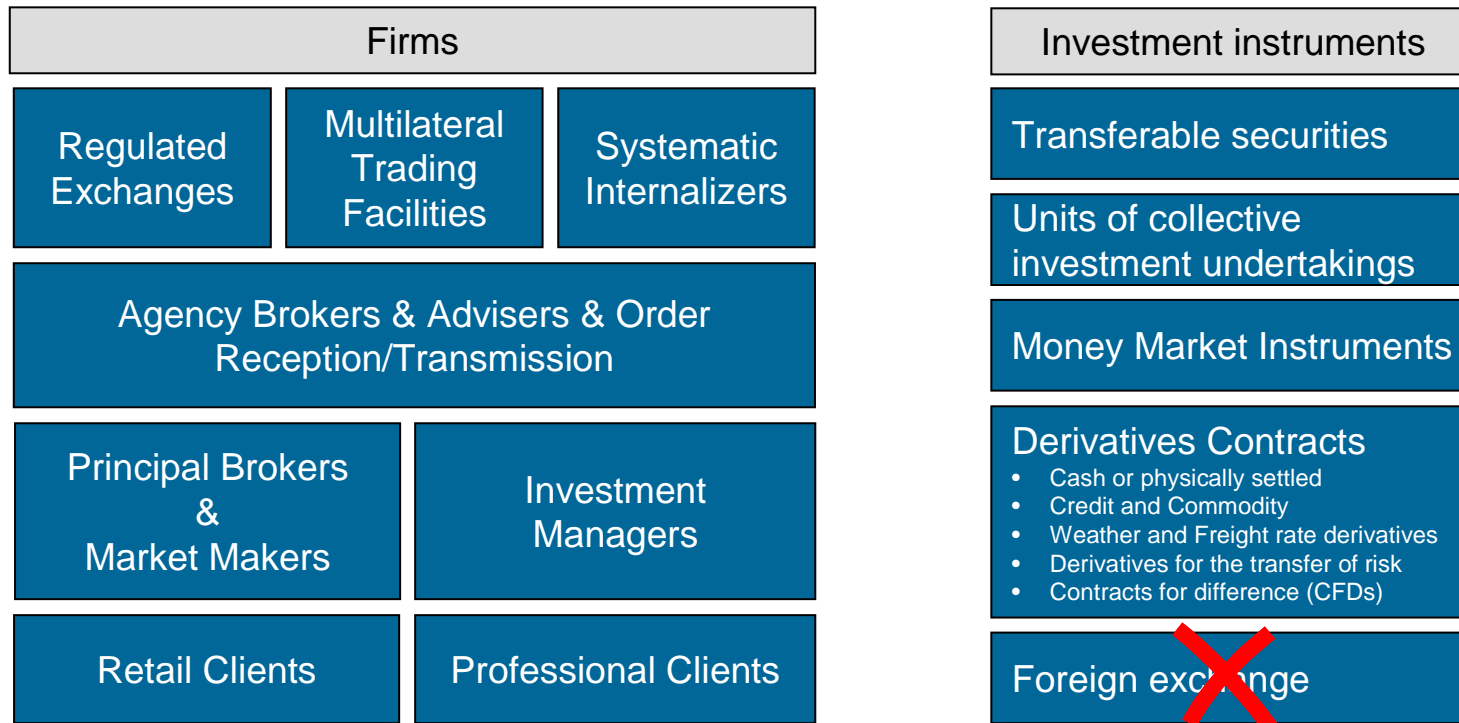
Introduction

MiFID: a far reaching Directive

- MiFID is a major update of the 1993 Investment Services Directive and relates to the financial industry as a whole.
- MiFID recognizes the existence of new forms of execution and the need to include all actors of the execution cycle and all financial instruments under a consistent regulatory framework.
- It put an end to the long-established concentration rule, whereby all orders had to be routed towards a central regulated exchange and paves the way for competition.

Introduction

MiFID: a far reaching Directive



Introduction

Best Execution: A schizophrenic provision

- Within the 2004 Directive, the Best Execution obligation has been defined as an obligation of means whereby investment firms are required to have taken all reasonable steps to obtain the best possible result for the client.
- The Best Execution obligation is therefore structured around three major principles:
 - an obligation of means to achieving the best net result for the client, involving factors that determine whether or not this best net result has been achieved pending definition of the criteria and their relative importance;
 - documentation of an execution policy that includes the execution venues and documentation of the parameters that justify these choices;
 - obligation for investment firms to demonstrate, at the demand of the client, that execution has been carried out in accordance with the agreed execution policy and that the execution policy allows achievement of the best possible result on a consistent basis.

Introduction

Best Execution: A schizophrenic provision

- It is interesting to note that, at this stage, the factors supposedly determining what the best possible result is include not only fees but a wide range of elements that can be used to qualify the quality of a negotiation, namely *“price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order”*.
- But this “Best Execution” obligation is currently causing significant concern among industry participants for two main reasons:
 - a clear absence of consensus on what best execution means, in particular because of the differences in clients’ requirements, but also because of the absence of a conceptual framework for measuring the quality of execution. (What are the elements that characterise the quality of execution, and what approach should be used to assess this quality – benchmarking, peer group analysis ...?);
 - the difficulty of demonstrating that one has satisfied an obligation of means. In most circumstances, clients and intermediaries may end up discussing the specifics of a transaction that could have justified different treatment. This is unlike an obligation of result, which, even though it is tighter for the investment firm with its repeatable and non-contestable quality measure, could have been seen as less daunting.

Introduction

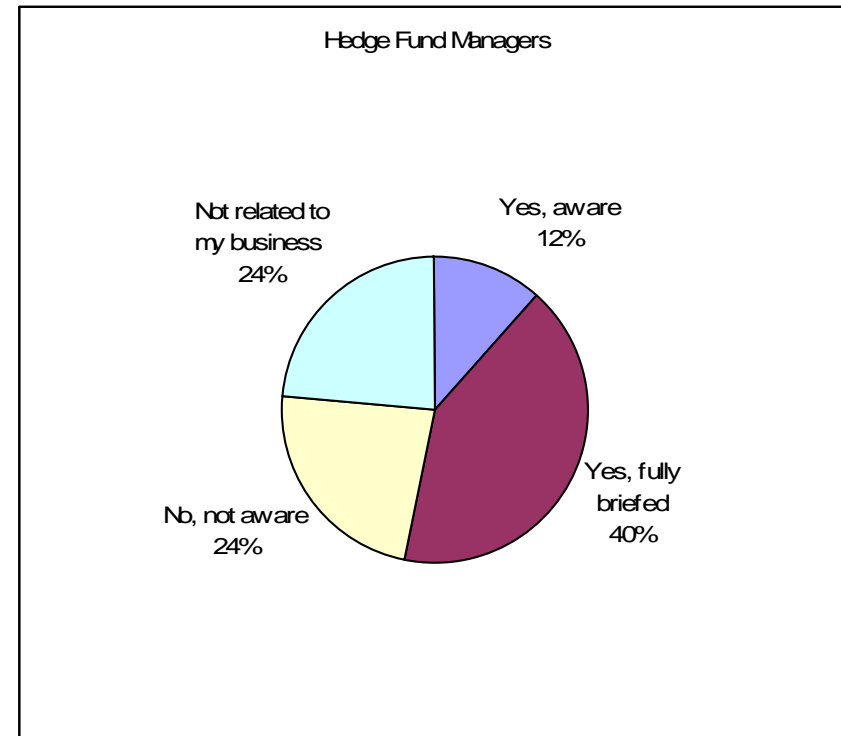
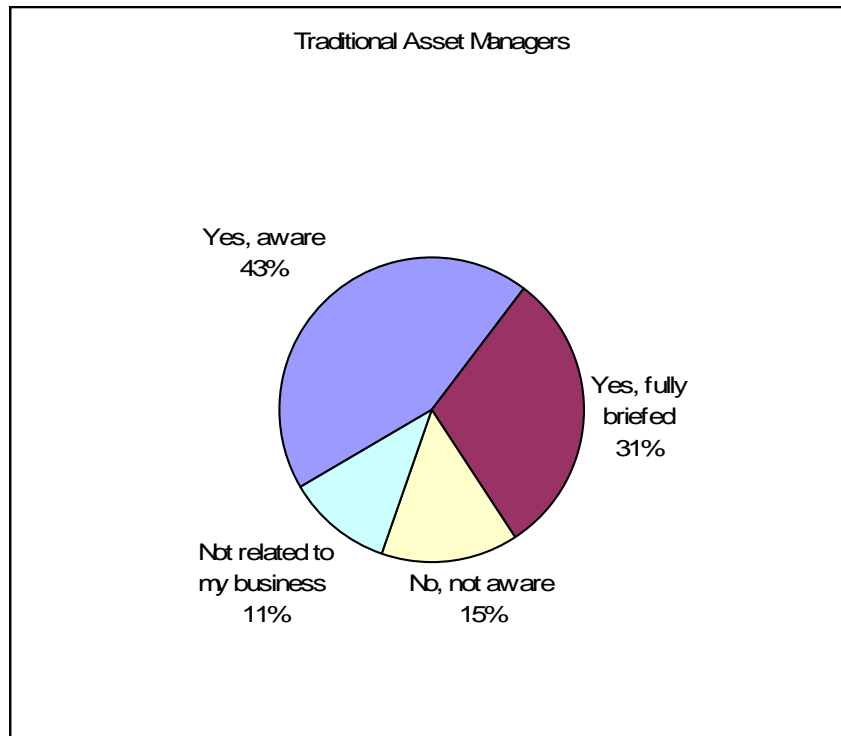
Best Execution: A schizophrenic provision

- A more important point is the significant inconsistency in how the first paragraph of the chapter is structured. This paragraph starts with an obligation of means summarised as an obligation to “take all reasonable steps to obtain the best possible result”, which is clearly inconsistent with an attempt to create an obligation of result as suggested by the emergence of a definition of what the best result should be “... taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order”.
- The regulator had two possible options, which will not be discussed here, but chose to take the two routes available at the very same time:
 - impose an *obligation of means* and leave the industry to develop standards to which clients could refer to when confronting an investment firm;
 - impose an *obligation of result* based on a clear and measurable objective.

Introduction

Nine months from the deadline, and still not rush

Are you fully aware of the forthcoming Directive on Markets in Financial Instruments?

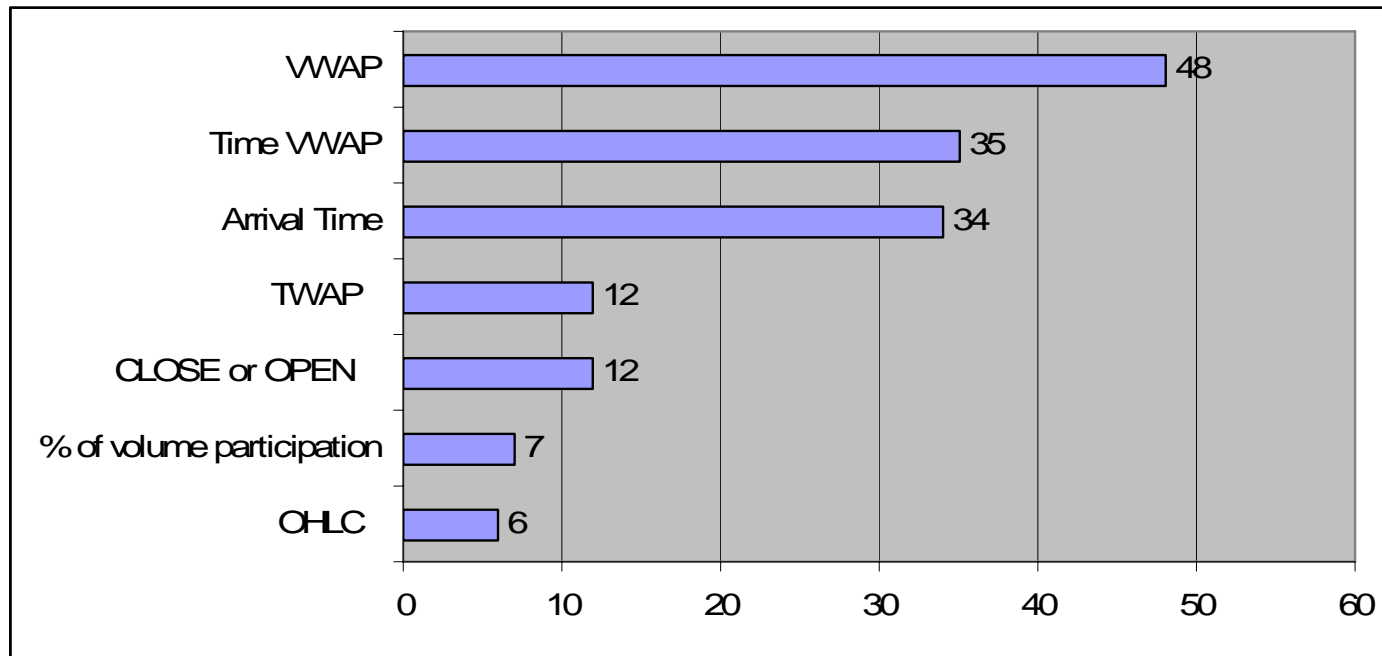


EDHEC-Risk Advisory Best Execution Survey 2007, supported by HSBC

Introduction

Nine months from the deadline, and still not rush

What benchmark do you use?



EDHEC-Risk Advisory Best Execution Survey 2007, supported by HSBC

Introduction

- Current practices in TCA: no consensus in the industry
 - on what best execution means
 - on a standardized framework
- MiFID and its best execution obligation
 - Fund managers will be under the obligation to obtain the best terms for their clients when executing orders

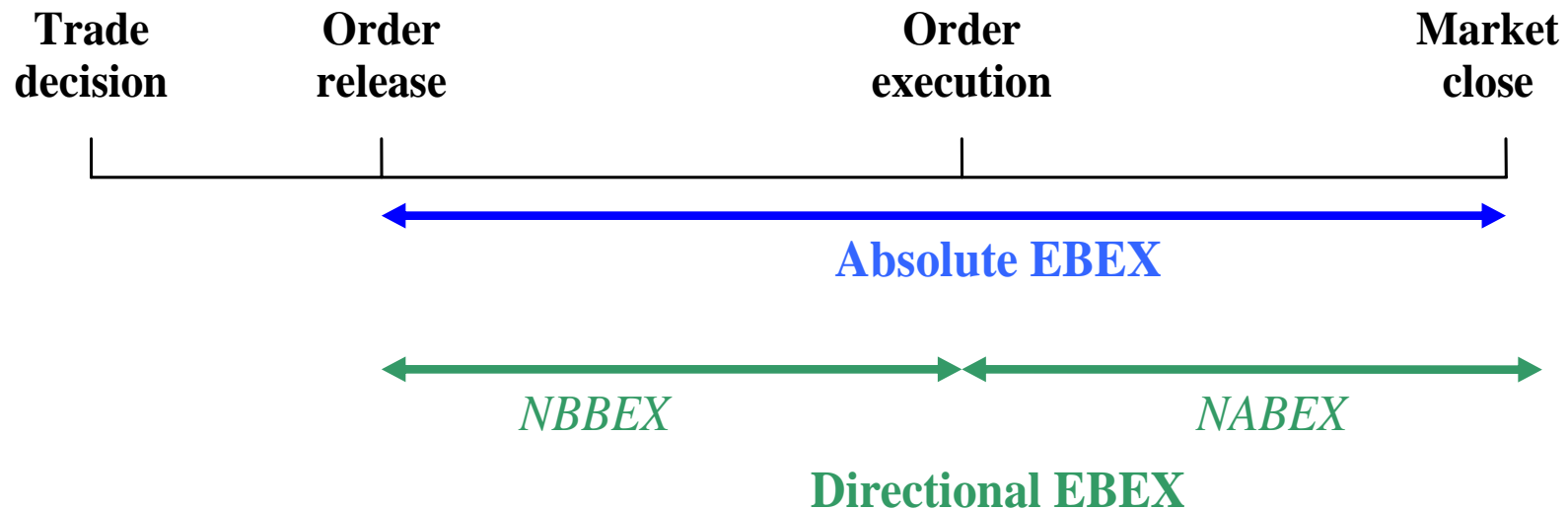
Principles behind EBEX indicators

- The price is still the key component of the quality of execution
- The best reference for assessing *ex post* the quality of a price is the universe of all the trades executed on the available markets, under similar timing
→ **PEER GROUP ANALYSIS**

Principles behind EBEX indicators

A simple question to a simple problem

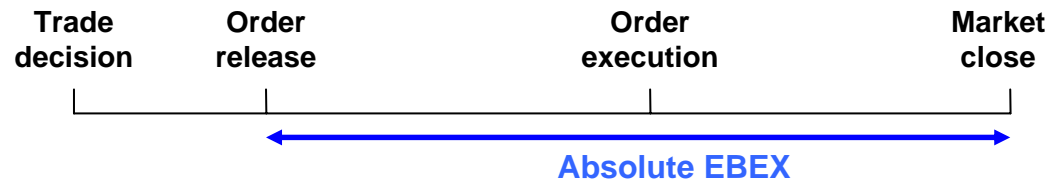
Given a transaction handed over to a broker, trader or algorithm and executed for a given price at times that are recorded under given constraints, to what extent have other brokers, traders or algorithms executed comparable volumes to this transaction either before or after this transaction at a better price?



Presentation of the EBEX indicators

Absolute EBEX: definition

Measures the quality of execution as part of a peer group review



For sell orders:

$$EBEX_{abs,i} = 1 - \frac{\sum_{n=1}^N V_{n,day}^{P > AP_i}}{(S_i)} \bigg/ \frac{\sum_{m=1}^M V_{m,day}}{(S_i)}$$

For buy orders:

$$EBEX_{abs,i} = 1 - \frac{\sum_{n=1}^N V_{n,day}^{P < AP_i}}{(S_i)} \bigg/ \frac{\sum_{m=1}^M V_{m,day}}{(S_i)}$$

Presentation of the EBEX indicators

Absolute EBEX: interpretation

The closer to 0 $EBEX_{abs}$ is, the worse the execution !

Among all the “similar” trades of the interval, most got a price better than the trade price of the broker. Terrible performance.

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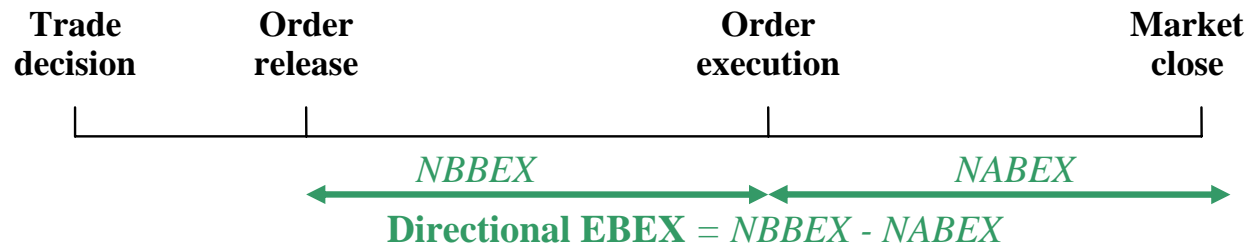
The closer to 1 $EBEX_{abs}$ is, the better the execution !

Among all the “similar” trades of the interval, few got a price better than the trade price of the broker. Excellent performance.

Presentation of the EBEX indicators

Directional EBEX: definition

Indicates how the broker could have traded over time to provide a better execution



For sell orders:

$$NBBEX_{i,j} = \frac{\sum_{n=1}^N V_{n,j}^{P>AP_i}}{\sum_{m=1}^M V_{m,j}} \frac{(S_i)}{(S_i)}$$

$$NABEX_{i,t} = \frac{\sum_{n=1}^N V_{n,t}^{P>AP_i}}{\sum_{m=1}^M V_{m,t}} \frac{(S_i)}{(S_i)}$$

Interpreting EBEX – a preliminary study

- Sample composition: Euronext stocks – 3 898 orders
- Sample period: January to March 2005
- Information for each order:
 - isin code
 - trade direction : Buy/Sell
 - traded volume and price
 - release time-stamp: release date + release time
 - trade time-stamp: trade date + trade time
 - broker identification code

Interpreting EBEX – a preliminary study

- **Release time-stamp**

date and time when the broker receives the order

- **Trade time-stamp**

date and time of the order execution

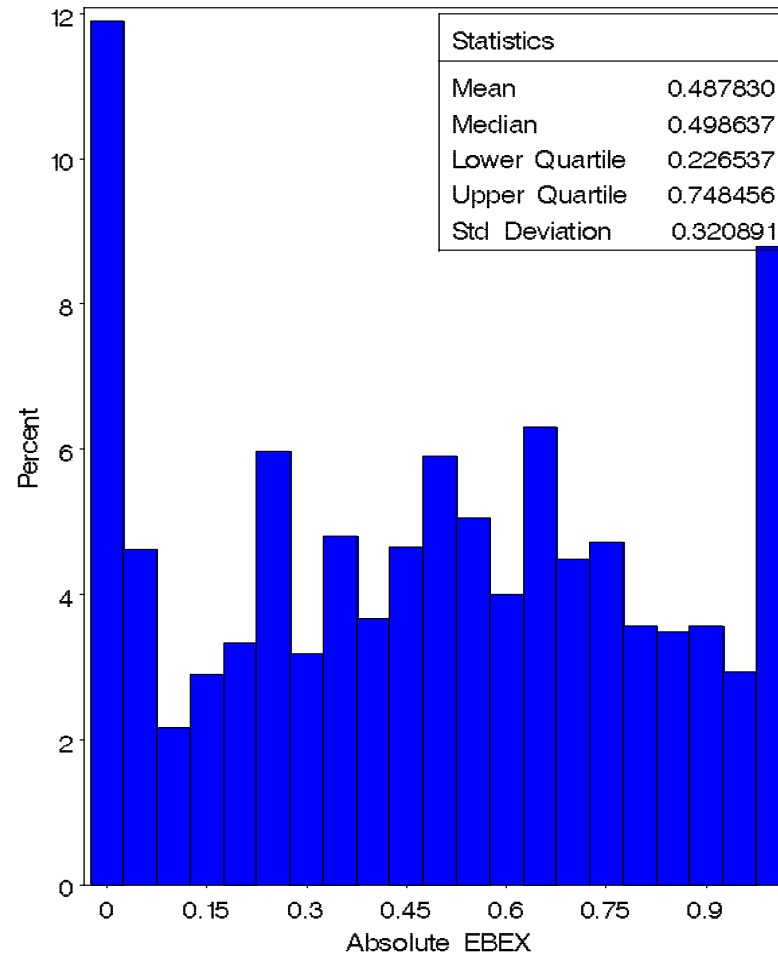
- **Orders are sent and filled within the day**

- **Public Euronext-wide market data are used to compute EBEX indicators**

the Euronext order book is the market of reference (block trades and off-market trades are not considered in this study)

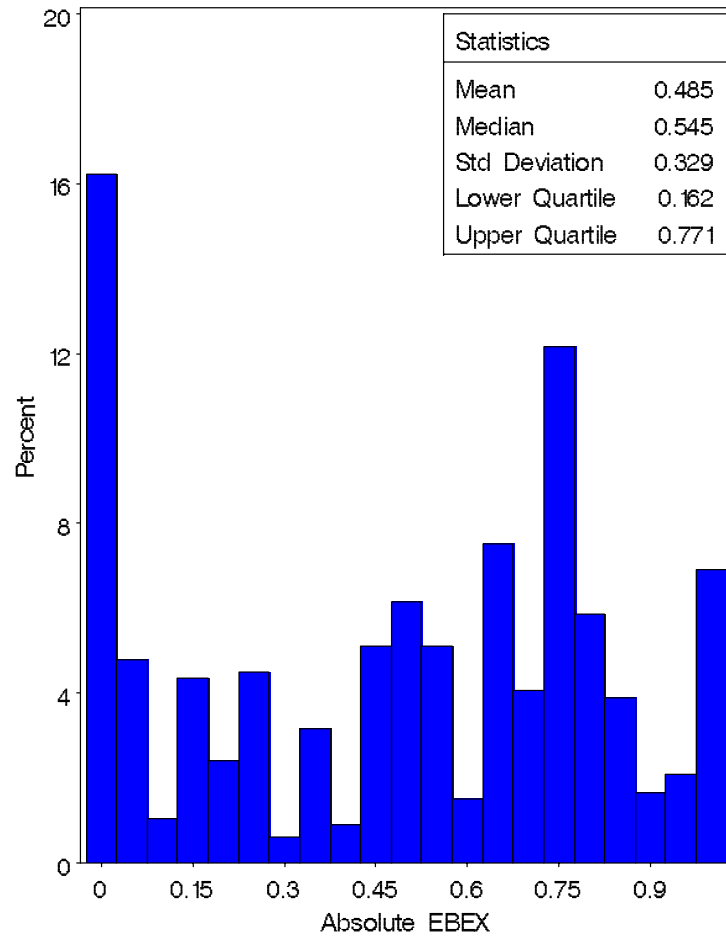
Interpreting EBEX – a preliminary study

Overall performance: Absolute EBEX

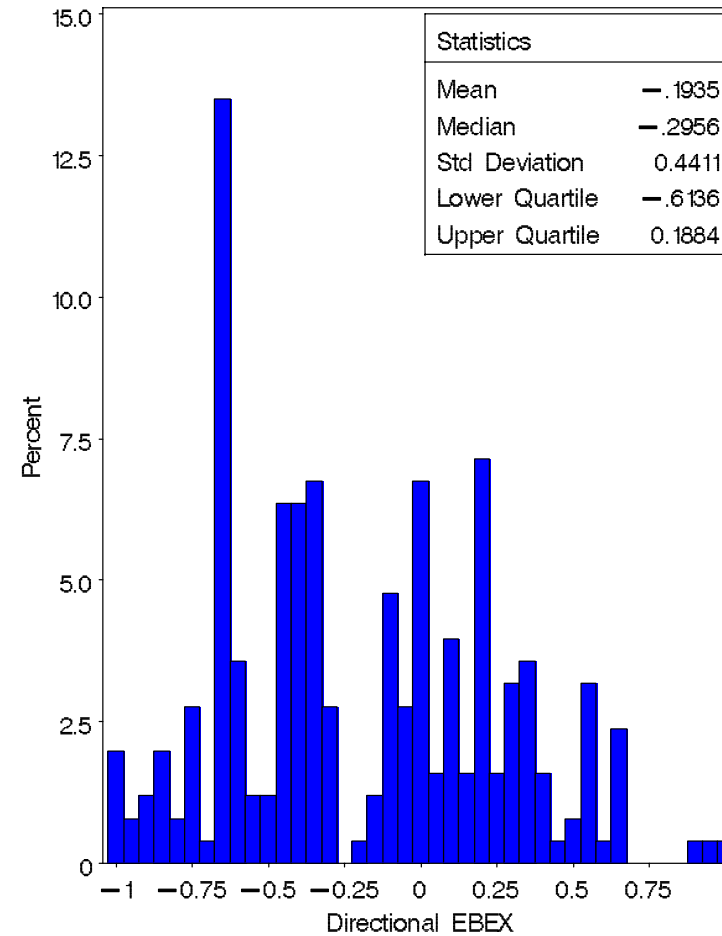


Interpreting EBEX – a preliminary study

Overall performance: Broker performance (broker 1)



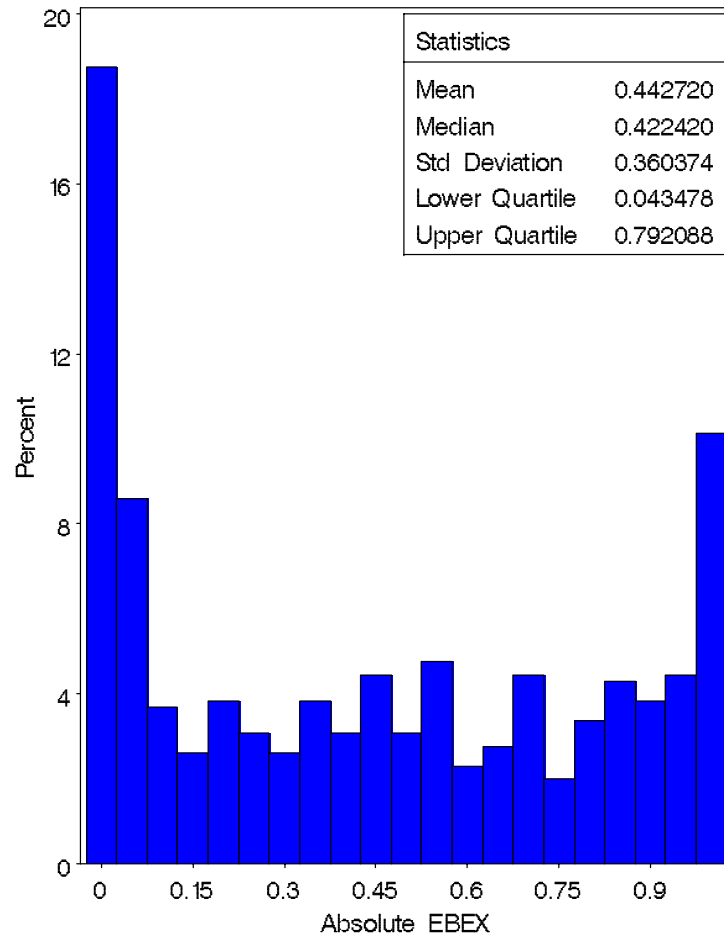
Sample: 666 orders



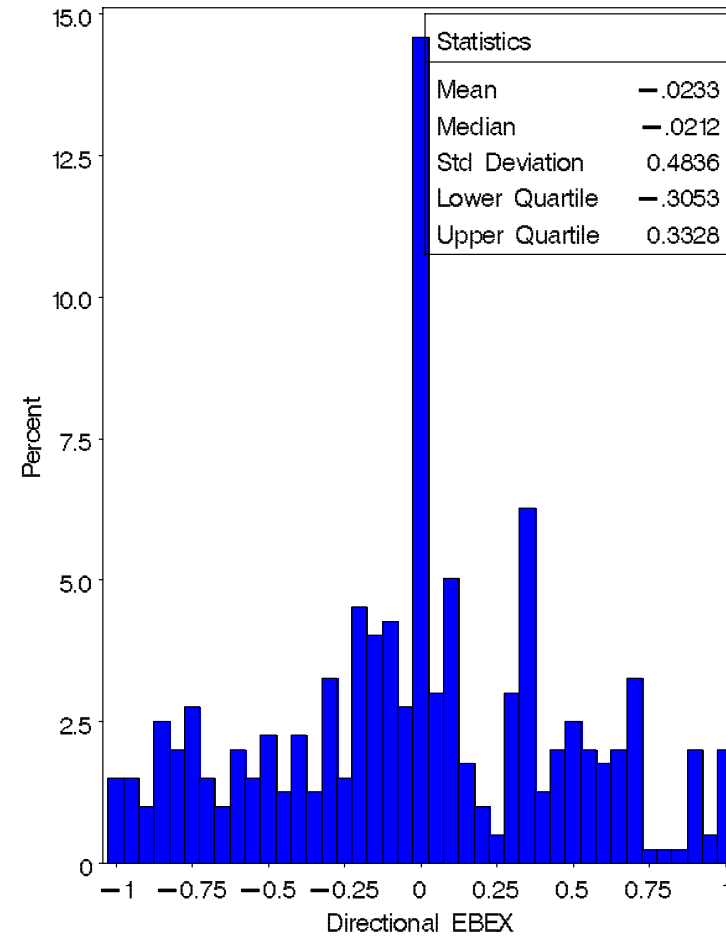
Sample: 252 orders

Interpreting EBEX – a preliminary study

Overall performance: *Broker performance (broker 2)*



Sample: 651 orders



Sample: 400 orders

Conclusion

- EDHEC proposes a pair of indicators assessing execution quality for an intermediary in a peer group analysis
- No benchmark or specific indicator per trade is needed, so easy comparison of a large universe of trades
- Absolute EBEX provides information about the quality of execution
- Directional EBEX provides information about the possible justification of the execution quality

Conclusion

- Both indicators cannot be gamed
- Absolute EBEX, by varying from 0 to 1, can be easily used to give clear objectives to an intermediary

Open questions & further developments

- How can we ensure that a complete universe of trades is used for the peer group comparison?
- How can we link the absolute EBEX score to a cost measure for the client?
- How can we add in such an analysis the possible constraints set by the client?