The Finance Hive
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***Best Execution** needs to be approached as a **process**. For that process to be truly effective it needs to **take a view beyond the FX execution hedging and funding requirement** that is generated subsequent to the purchase or sale of a security by the investment manager, i.e. the potential impact of executing a security transaction at a specific point in the trading day needs to **take into account the FX liquidity available at that time**.*

Listening to the buy-side participants in the "Best Execution" roundtables it became clear that there are varying opinions on how to best evidence "Best Execution". Although regulation doesn't specify how market participants should prove best execution beyond the requirement that "investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients"[1] it defines seven factors for asset managers to consider in achieving best execution but stops short of detailed guidelines about what actually constitutes the sufficient steps necessary to fulfil the requirement.

Asian market participants are very aware of Best Execution requirements with related regulations recently out from Australia and further consultation papers being circulated by Hong Kong and Singapore regulators. There is a willingness from Asia-based buy-side participants to learn how to use TCA to achieve better trading outcomes rather than simply implement it to meet regulatory requirements.

This general guideline allows each asset manager to define their own Best Execution Policy, with three primary objectives in mind: **to define a logical and detailed process across the lifecycle of the execution, to implement a monitoring mechanism that ensures and evidences adherence and to refine the best execution process based on the information gathered through the monitoring mechanism**

In addition, each asset manager has unique trading requirements, therefore, each asset manager will need to individually determine which aspects and components (and the appropriate weighting of each) are relevant to their Execution Policy.

With this in mind, it would suggest that Best Execution needs evidencing or tagging from the origin of the FX exposure and can then be aggregated based on instrument. For example, if a USA based asset manager decides to liquidate or move into a non-US equity position at a time of day when that particular currency is less liquid, the resulting FX hedge could have a significant impact on the over-all financial outcome of the trade. So, in this instance it could be challenging to evidence that the FX

[1] MiFID II – Article 27 (1) / FCA COBS 11.2A (https://www.handbook.fca.org.uk/handbook/COBS/11/2A.html)

component was able to achieve 'Best Execution' unless the firm's process built-in the context for the FX trade into their policy. This would have to consider:

- Who the user(s) is
- Direction of flow
- What time of day
- Market activity at the time including measures of FX volatility, momentum and liquidity
- Instrument type (e.g. all spots or spots v. outrights)

Best Execution can therefore be viewed as 'strategy dependent' – do you need to hedge an order right now or can it be time-dependent? Can you trade off time for spread capture? - and market activity dependent – how is the market behaving? i.e. is there significant volatility? Is there momentum? What liquidity appears to be available? And some asset managers may not have much discretion as to the timing of the FX trade thus potentially losing alpha. These are elements that you will need to build into your Best Execution policy framework.

In Asia, local market participants have unique challenges around the timing of trades, especially for illiquid pairs and NDF trades. This includes both voice and eFX trades. NDF RFQ's can sometime take minutes for a quote vs. milliseconds for OTC spot. These delays provide a challenge for TCA for those operating outside of the core G10 currencies.

FX Best Execution needs to be enshrined as a 'continuous improvement process:'
define the policy, evidence the policy and then refine the process based on analysis of subsequent transactions.

The core of best execution lies in creating a robust framework within which the execution process is managed. Firms need to measure execution outcomes and improve their execution methodology where possible through a cycle that drives continual improvement. This means that investment firms must ensure that their internal processes, reporting and controls are well documented and fit for purpose and they must continuously validate on an ongoing basis.

Staff training, new governance procedures and effective oversight need to be part of the process. Access to data analytics systems and systems that provide proven TCA reporting need to become part of the process. And it is not enough to just have reporting tools…investment firms must actively use these tools to continually optimise their trading practice as part of their best execution continuous process improvement.

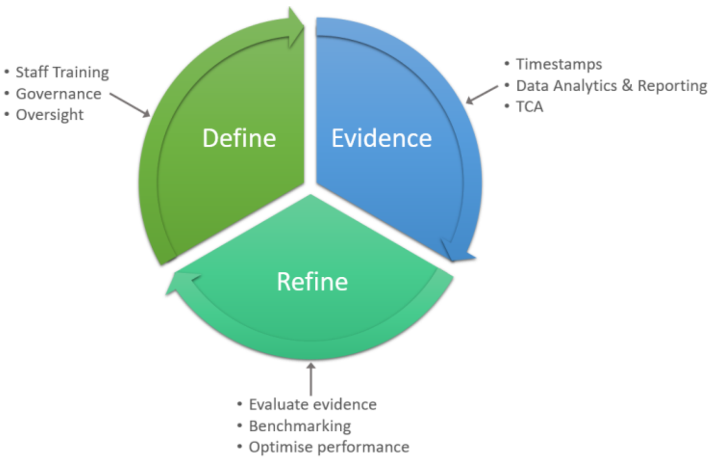

Figure 1: Best Execution Process

Workflow Solutions

FX Connect and related services from State Street can provide workflow solutions to help you automate your Best Execution process as follows:

- With FX Connect, we provide seamless integration to several 3rd party TCA specialists providers including BestX, ITG and Elkins McSherry which allows us to provide tailored solutions for our clients' specific needs when measuring TCA.
- FX Connect provides reporting to monitor all trading activity
- FX Connect supports a variety of execution modes including bank algo, RFS, Slice Trading and competitive RFQ
- Integration with our post-trade product, Trade Services, provides for certainty in settlement as it provides real-time trade-matching and confirmation

Furthermore, it is clear that, at present, there is ***significant variation in the adoption of best execution*** *across the spectrum of participants in the FX market and across regions globally, there is* ***variation in terms of the sophistication/usefulness of tools such as TCA platforms*** *that are available to support a participant's best execution requirements as well* ***variation in market participants understanding of the definition of best execution itself.***

While there are many options available for buyside traders to evaluate price quality, tools that ensure that all trade execution types have the same level of evaluation can often become a challenge. Some brokers may not have the technical ability to participate in electronic request for stream executions. Some execution methods, like algorithmic pricing sessions, voice or portfolio sessions, do not provide multiple competitive quotes but can potentially demonstrate a better outcome for the underlying asset owner through netting or minimizing market impact.

And having the required time-stamps across the lifecycle of the trade can be inconsistent across execution venues. All of these variables create complexity when applying standard TCA analysis to trades.

As a result, when looking at TCA providers, there are a number of factors that every buyside institution needs to consider.

- Firstly, the level of pre-and post-trade TCA analytics that are available: does the TCA provide depth of analytics and breadth of data and exposure to provide a comprehensive TCA?
- The level of integration is another key consideration. The TCA provider needs to be aware of the entire lifecycle of the exposure rather than just at the point of execution, which means the analytics provider must be integrated enough into the execution and pre-and post-trade allocation platform(s) to capture the trade lifecycle.

In general, there are many available options for asset managers to evaluate price quality but keeping the evaluation consistent across execution styles and products is a challenge, and one that can be made easier by trading platforms and 3rd party TCA providers who can provide the flexibility and scope to provide an overall view.

Large institutional orders are particularly vulnerable to indirect costs which are harder to plan for; these are incidental costs of execution and may include slippage based on the timeliness of execution, adverse market impact due to information leakage, and the opportunity cost that can result when credit and balance sheet utilization are considered.

There are some challenges around confidence in the data used for TCA partly due to lack of a 'tape' in the FX OTC market. And forward point data is especially challenging. But there are reliable sources of FX market data available including Currenex_Now which provides a real-time tick-by-tick, streaming, order book data feed.

In Asia, buy-side participants expressed a general preference to use independent TCA services/data rather than those provided by banks and participants expressed the hope that, over time, the industry would standardize on specific TCA metrics. There was a call for TCA benchmarks to be established and a general interest in the concept of a data 'Community Pool' (anonymised data from buy-side market participants) given the lack of decent NDF and EM market data to facilitate TCA.

Conclusions

Before the arrival of MiFID II, best execution for a great many market participants meant achieving the best available price for the asset manager, at any given moment. Now, asset managers need to consider price, costs, speed, likelihood of execution and settlement and the size and nature of trades, as well as other relevant factors to comply with best execution standards.

Asset owners are also keeping a close eye on their managers, not just in terms of performance but increasingly in terms of their trading costs. These underlying investors will unlikely be satisfied with best execution policies that only rely on a select few counterparties for liquidity and fail to include broader context from the market to evaluate execution outcomes.

Asset managers now need to navigate a complex and continually shifting set of factors to determine their overall execution quality. This is no small task, and one made even harder by the requirement to monitor outcomes and to prove that trades were sent to the market in compliance with the asset manager's own set of rules and processes.

Even TCA, which in itself is a well-established practice in markets like equities, is a complex puzzle in FX. However, platforms like FX Connect that have been specifically designed to address these complexities, allowing for flexible execution as well as post-trade processing and monitoring in one system, help ensure that many of the aspects related to fulfilling best execution requirements have been extensively addressed.

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