

EUROPEAN ASSET MANAGEMENT ASSOCIATION
FÉDÉRATION EUROPÉENNE DES FONDS ET SOCIÉTÉS D'INVESTISSEMENT

TRADE QUALITY BEST PRACTICE
A Discussion Paper

Preamble

This paper aims to provide a basis for discussion on principles and guidelines as to how good quality execution of transactions effected will generally be achieved in the interest of investors and (institutional) clients by investment management companies.

Introduction

The European Asset Management Association (EAMA) and the Fédération Européenne des Fonds et Sociétés d'Investissement (FEFSI) recognise the increasing discussion of the concept of Best Execution amongst regulators, consultants, service providers and investors. As the development of a single European market requires a common interpretation of "Best Execution", there is a need to agree underlying principles across member states in order to enable market participants to efficiently provide cross-border services.

EAMA and FEFSI believe that this paper will help to find a European approach to "Best Execution". It describes measures and procedures that are prerequisites for an investment manager, be it retail or institutional to provide good quality execution and will give some guidance to allow for a common understanding of the concept of "Best Execution". It is not intended to pre-empt the role of European regulators, but to provide a contribution to the discussion that reflects the practical experiences of investment professionals from several European countries.

Background

The investment management firm has a fiduciary duty of best execution towards all investors whose money it manages. Any deviation from this duty will need to be disclosed to the investors. The investment management firm will also usually have regulatory obligations.

An investment management firm will always have a strong incentive to obtain best execution in the interest of investors as this will enhance the performance of assets under management and lead to increasing confidence of investors and (institutional) clients in their investment and the investment manager.

Published market prices are not always reliable indicators of prices at which it is possible to effect transactions, especially when transacting large volumes in illiquid securities or when market liquidity is generally low.

The cost of executing transactions does not just include the commission payable to a broker dealer

acting as agent, but also the “bid-offer spread”¹, market depth and trend that may create positive or negative risk during the period of execution, market impact, as well as all relevant taxes and settlement fees and costs.

Definitions

Good quality execution means

- a) effecting transactions decided on as part of the investment strategy in the interests of the underlying client portfolio or investment fund
- b) Having in place a process to make reasonable efforts to optimize net execution price considering available markets and venues
- c) minimising the risk of opportunity and other costs in executing those transactions.

Good quality execution is an integral part of the investment process. It therefore needs to be integrated into a firm’s investment process. It should be analysed in conjunction with that process.

Good quality execution of orders requires

- a) careful timing
- b) use of available market information
- c) compliance with the specific constraints of the managed portfolio (account or fund) as specified in the prospectus or mandate

Soft commission means commission on transactions effected by an investment management company through a broker in exchange for which the broker provides brokerage, research or related services to the investment management company.

Soft commission includes commission paid for both proprietary and third party research and other services relevant to the investment process of the investment management company.

Soft commission does not include commission paid to brokers under client instructions as regards selection of brokers.

Scope

These best practice recommendations apply to bond, equity, derivative and foreign exchange transactions. It may currently be easier to assess the quality of execution in equity markets because of the ready availability of data but the obligation applies equally to transactions in other asset classes.

Client instructions as regards selection of brokers, or constraints on broker selection arising from the client’s choice of custodian, mitigate the duty of best execution to the extent of the constraints imposed.

These best practice recommendations apply to the relationship between the asset manager and its clients although it is also in the brokers’ best interests to help asset managers provide good quality execution.

¹ The difference between the buying and selling prices of a security at a given time.

Elements of Good Practice

Achieving good quality execution of transactions will generally involve all the following elements each of which are examined in separate sections:

1. Procedures for selection of approved brokers
2. Order management process
3. Transaction cost analysis
4. Management of conflicts of interest
5. Disclosure of costs, effect of client constraints and conflicts of interest

1 Procedures for selection of approved brokers

Investment management firms will normally use various criteria, including execution capability, quality of research, efficiency of settlement, settlement risks and financial strength in developing an approved broker list and determining how much business they will do with each firm.

The quality of execution by brokers used by investment management firms to effect transactions should be monitored on a continuous basis and the allocations reviewed regularly in the light of such monitoring. This requirement includes brokers that are affiliated to the investment management firm and who should be treated on an arm's length basis.

Soft commission and commission recapture arrangements should be monitored closely to ensure that best execution is being achieved.

2 Order management process

An investment management firm should have a process for the execution of orders in place with specified individuals responsible for each stage of the process.

The execution of transactions is a function, which demands skilled, dedicated staff.

Effecting high volumes of transactions is a complex task. An order management system will generally be required to maintain control and is also a prerequisite to perform transaction cost analysis.

A transparent process for dealing with errors that is regularly monitored by senior management should be an integral part of the order management system.

The order execution process should generate an audit trail. The audit trail should in particular specify

- a) when the portfolio manager originated the order
- b) when the portfolio manager gave it to a dealer
- c) when the dealer passed it to a broker
- d) when the broker informed the dealer of the execution price

The times of all amendments to orders should also be noted.

The order execution process should be able to explain all costs incurred in executing an order.

An investment management firm should have procedures in place to monitor broker selection,

order routing, quality of execution and correction of errors.

When a portfolio manager gives an order to a dealer he/she should clearly specify the time scale for effecting the transaction.

3 Transaction Cost Analysis

Currently available systems that provide transaction cost analysis can provide investment management companies with useful information that may assist in ex post reviews of the quality of execution.

Currently available systems that provide transaction cost analysis can also provide useful information for those who are interested in a benchmark for quality of execution.

However, such information needs to be interpreted with care, and due to major differences in their methodology it is dangerous to use them for comparison with other firms. For this reason it would be helpful if the providers of systems for measuring transaction costs made the methodology that they use publicly available.

4 Management of conflicts of interest

An investment management firm should not remunerate an individual portfolio manager in proportion to the volume of transactions which he / she is responsible for originating.

An investment management firm should disclose in writing to its clients its policies on dealing with affiliated brokers (if applicable), and how it manages conflicts of interest that arise therefrom.

Client instructions as regards selection of brokers can give rise to conflicts of interest. Clients should be regularly advised in writing of the effects of such conflicts of interest.

5 Disclosure of costs

An investment management firm should principally be ready to disclose the total cost that are incurred when transactions are executed on behalf of the fund or the clients account. For UCITS, this requires the existence of standardized procedures to measure and compare transaction costs. Currently this is not the case so that transaction costs for the time being cannot be included in the TER. UCITS manager should, in any case, however disclose guidelines about services bought when executing transactions.

In the context of institutional investor portfolios, an asset management should be prepared to provide a breakdown of transaction costs where this is requested by the client. As part of its regular client reporting procedures, an asset management firm should also disclose to its client:

- a) the turnover level of the client portfolio (and how it is calculated)
- b) the total expense ratio of the client portfolio and how it is calculated
- c) its order routing practices (in general terms)