Buy-Side Technology
Trading technology for investment managers

Regular NMS Feature
By Stewart Eisenhart

Targeting transparency

Relying on counterparties for your own regulatory needs is not a great idea. Yet as the US financial services industry prepares for the SEC's rollout of its Regulation National Market System (Reg NMS) this year, it appears as though many buy-side firms have taken that very approach. The impact of Reg NMS on the operations and IT infrastructures of US exchanges, broker-dealers and third-party connectivity and technology providers has been anticipated and well-reported in the months and years since the SEC first unveiled the proposed regulation in late 2004. Less clear, however, is what – if any – direct effects the regulation will have on buy-side operations and technology requirements. *By Stewart Eisenhart*

Designed to increase efficiencies and foster a more level competitive landscape in US equities, Reg NMS hones in on best execution practices, just as the Markets in Financial Instruments Directive (Mifid) regulation does in Europe. The regulation's focus on best execution in turn requires greater transparency in an increasingly fragmented market, facilitated through greater connectivity and automation within and between counterparties.

But buy-side and hedge fund managers are hardly strangers to the idea of best execution –the effort to define and achieve it according to their fiduciary responsibilities to their investors has become an ongoing and evolving operational and technical issue beyond the particular requirements of Reg NMS.

Furthermore, the bulk of buy-side firms are typically connoisseurs rather than developers of advanced trading and connectivity technologies, meaning that the burden of modifying those technologies to comply with Reg NMS has fallen largely on the exchanges, brokers and third-party vendors who set up those trading venues and brought those tools to market.

In short, how Reg NMS will impact the buy side in any direct way remains unclear. The industry has grappled for some time now with challenges mirrored by the regulation's tenets regarding best execution, transparency and trading processes. Any assumptions of being off the regulatory hook, however, may prove premature.

Choosing wisely

Investment management industry sources indicate that while exchanges, brokers and trading technology vendors have so far felt the effects of Reg NMS much more acutely, managers should not assume their sell-side and vendor counterparties' efforts will guarantee their own compliance.

Michael Crockett, senior equity trader at Dallas-based equity manager Brazos Capital Management, says buy-side firms would best utilise their time in anticipation of Reg NMS by making sure their electronic trading and transaction cost analysis tools can adequately perform in a fragmented trading environment.

"With all the fragmentation now, the key concern for us is which systems actually allow us to touch the largest pools of liquidity? Do I need access to all providers?" Crockett says.

"At this point, probably not, but the trick is going to be how orders will be routed and which providers will put in the infrastructure and make a clear run at getting orders routed to the different exchanges."

The trader explains that managers' responsibilities regarding Reg NMS for now primarily entail ensuring their DMA and order routing tools can properly function according to their investment goals.

"The onus is more on the exchanges and brokers right now because under NMS they are the ones putting up the markets, and I need to ensure that my orders are actually getting routed and filled under what the regulation stipulates," Crockett says.

Jeffrey Wallis, partner at SunGard's Consultancy Services advisory unit, also recommends careful evaluation of existing relationships with technology providers; sounding a familiar theme, he emphasises that Reg NMS compliance, like fiduciary responsibility, cannot be transferred to third parties.

"The buy-side community needs to look carefully at its partnerships, not to the point where they have to understand every nuance of the rule and how each third-party provider is meeting them, but managers do need to have a compliance programme in place to make sure they are partnering with the right vendors," Wallis says.

"The burden of responsibility is not transferred to your third parties, and you still have a liability and fiduciary responsibility in overseeing what your technology partners are doing."

Sell-side obligation

Although managers have the responsibility to ensure their third-party partnerships can meet Reg NMS requirements, some industry participants note that these duties are nothing new to managers already adopting more sophisticated front-end tools in order to pursue returns in more challenging markets and establishing more thorough, transparent best execution processes to meet their investors' more exacting demands. Besides, most of the grunt work required for Reg NMS compliance has been, and will continue to be, tackled by sell-side and vendor firms.

Matt Simon, analyst at financial IT consultancy Tabb Group, expects that reliance on sell-side counterparties for Reg NMS-compliant systems will prove the most common approach for the majority of US investment managers. "The question for buy-side players regarding Reg NMS is, are they aware of what their brokers are doing on their behalf to implement the right technologies and make sure they are compliant?" says Simon. "In this sense, Reg NMS entails a sell-side obligation."

According to the analyst, some managers have taken active roles in understanding how the regulation will affect equities markets in general, while others expect little direct impact on their own operations.

"One group is really active and interested in understanding the way the market structure will unfold, and the other group is expecting its brokers to take care of that for them. These managers will be more hands-off, and will direct orders to particular brokers when the managers feel it is appropriate and that those brokers have the right technology to understand how a given trade will work out.

"It is an interesting mix," Simon continues, "because this is a regulation that the buy side is taking itself away from and is viewing as a sell-side responsibility."

Crockett at Brazos validates that viewpoint, noting that internal compliance with Reg NMS will not necessitate significant investments at his firm right now.

"As far as any onus being on the buy side, I just do not see that making much sense," Crockett says. "All the tools we use, whether DMA or alternative trading systems or reserve liquidity books, have got to be compliant with Reg NMS, but the development of that technology is not driven from our side… As far as our investment is concerned, I just do not see much of a direct impact right now."

Bigger shops, bigger impact?

One segment of the buy side potentially facing a more significant direct impact of Reg NMS, though, consists of more sophisticated firms exercising direct control of their trade executions and order flows.

Operating in some ways like sell-side shops, these managers cannot rely as heavily on their brokers when the time comes to prove best execution.

Brad Bailey, senior analyst at financial consultancy Aite Group, anticipates the regulation more substantially affecting these managers' trading operations, but also echoes other sources in noting that many of Reg NMSs requirements are already being addressed through separate initiatives across the buy side. "It is somewhat paradoxical that managers who have taken more responsibility for running their trading operations electronically now face an increased burden of responsibility from a regulatory point of view," observes Bailey.

"What buy-side firms will have to do for Reg NMS is not too different from the fiduciary responsibilities they have now, but managers who have taken more direct control of their trading will not be able to pass the buck to their brokers when it comes to showing best execution," Bailey argues. "For those large firms with sophisticated trading tools in place, they are looking at various platforms to enable them to keep an eye on various execution venues and exchanges."

The analyst identifies several operational areas and capabilities at these firms likely impacted by the regulation:

• Firms will need access via their EMS or OMS platforms to top-of-book best prices at execution venues as well as smart order routing functionality

• Pre-trade analytical tools related to execution goals and in some cases able to examine market data from multiple venues

• Post-trade tools to discern how they are benchmarking their trades

"A lot of this functionality will come from specific pre- or post-trade processes managers are already using, or from execution or order management systems," concludes Bailey.

Moot point

Bill Hobbib, vice-president of marketing at StreamBase Systems, a data processing and analysis software developer with asset management and hedge fund clients, also sees a greater Reg NMS impact for managers using their own trading tools.

"Some firms are being serviced by their brokers and assume that their providers will handle issues around best execution, but other managers are doing things themselves," Hobbib says, adding that managers running their own execution, routing and algorithmic functions will have to prove best execution more on their own.

Simon at the Tabb Group acknowledges that managers with more sophisticated in-house trading operations may have to take more direct responsibility for proving compliance with Reg NMS, but argues that even these firms would be better served through sell-side and third-party technology relationships when operating in a post-Reg NMS environment.

"Institutional managers may want to take a step back and reconsider taking on these technologies themselves, because the brokers have really been spending a lot of time and effort figuring out these issues," Simon says.

"For institutional managers to start tackling this just is not in their pedigree… they should stick to providing their clients with best execution by making the right investment decisions, not focusing on nuances of technology," the consultant contends.

Bottom line: best execution

Ultimately, whether or not Reg NMS significantly affects buy-side operations and infrastructures will not prove the key point; more crucially, the regulation underscores the need for managers to achieve, monitor and prove best execution either on their own or through their broker relationships. Typically thought of as synonymous with best price, however, best execution only gets harder to prove depending on its definition – alas, Reg NMS does not appear to tidy up that perennial can of worms, a quality it shares with its European cousin, Mifid.

Patrick Keough, director of buy-side technology consultancy InvestTech's OMS and compliance practice, points out that Reg NMS narrowly defines best execution as best price, but says that once managers apply different metrics to the concept – speed, intent of the portfolio manager or market impact, for example – things get thorny.

"For ordinary electronic market trading through ECNs and algorithmic or DMA means, a lot of that compliance will actually shift to the broker counterparties," says Keough.

"It is when managers trade away from exchanges through dark pools or crossing networks, anything excluded by Reg NMS, that they will have to prove their best execution compliance by a definition other than price, and that is going to be tricky.

"In order to prove you have achieved best execution not based on price, you need some way of trapping the intent of your portfolio manager or you need to trap the market quote data at the time of the trade, which is something that buy-side firms certainly do not do right now," Keough continues.

Even in instances where best execution constitutes best price, the transparency required to accurately assess whether best execution has been achieved on a given trade will be all the more vital in equity markets governed by Reg NMS.

So argues Brazos Capital Management's Crockett, who explains that his firm's current internal TCA process will only become more instrumental once the regulation goes online.

"That is one of the key metrics – when NMS goes online, how will I know if I am getting the best price? This is one tool we will continue to use, but will be that much more critical," Crockett says.

"Transparency is a key component here because I ultimately have to go back to my clients and show not only explicit costs, but implicit costs of trading as well to show that we are doing what we need to be doing."
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Salient points - Reg NMS is expected to have little direct impact overall on buy-side firms' trading operations compared to those of broker-dealers and exchanges

• Managers exercising more direct control of their trading operations will have to more actively prove Reg NMS compliance than managers relying more on their counterparties

• Reg NMS pushes the issue of best execution further on the buy side, but managers will still have to maintain their own internal processes for defining and measuring that concept