

Prospects

Not Going Away

The Financial Services Authority has been deliberating and consulting on a range of issues associated with commissions and best execution for months and in some areas years. As the wheels of regulation have ground remorselessly on, some in the industry have convinced themselves that maybe in the end nothing will change and the practices of the past will be continued into the future. The reality of the position however, is that while the precise destination in some areas of commission unbundling and best execution may not yet be finalised, the general direction is clear both in the U.K and Europe.

Gains in efficiency should accrue and a ratcheting up of average quality in all areas will occur as the weak and mediocre participants are removed from the process

This direction will inevitably lead to some major changes in what buy side and sell side traders are seen to be doing and how they are seen to be doing it. While real changes to the way business is in fact done may take longer, they could be even more dramatic in their effect on markets and participants over time. Anyone who doubts the determination and commitment of the regulators to see such changes implemented, cannot have been listening to their public pronouncements. The end of 2004 now looks like the latest date by which progress must be demonstrated with at least some changes in place.

In the short term, the U.K. fund management industry and others affected by the proposals appear to have been tactically successful. The discussion of both best execution and commissions has moved into the arena of transparency and disclosure while avoiding the threat of quantitative prescriptive measurement and rebates to clients. This is the minimum that

the industry should have expected to concede given the difficulty of defending obfuscation and lack of disclosure if there is nothing to hide. Even an objection based on cost is undermined when the costs of disclosure are likely to be very small.

However, the fact that this is all the regulators are asking to see, means that their response, if what they expect is not forthcoming, is likely to be swift and harsh.

So what does the industry need to do before December 2004. In the area of commission unbundling, fund managers will need the ability to allocate commissions between execution and research. Managers will want to be able to achieve this in a variety of ways from trade by trade allocation to a standard set of rules. These rules will need to allow for commissions to be allocated based on type of trade, client, broker, market etc. Some managers may choose to build this into their order management system (OMS). The good news for GSCS clients is that we will be delivering before the end of 2004 the ability to accomplish the necessary allocation within our institutional trade execution review capability. Reporting will be on-line and allow consolidation for specific clients as well as analysis by broker, portfolio manager and trader.

Obviously any analysis that allows institutional clients such as pension funds to review money spent on execution and research will facilitate discussions, internal and external, about the amount being spent and the value of services received. Clients however, even armed with information, are unlikely to be the principal drivers of behavioural change. A far more powerful influence is likely to be competition among different brokers.



In terms of best execution we expect firms to increasingly formalise how they define different types of trade, how each of these types of trade is handled (including approval of and selection from appropriate counterparties and use of alternative execution venues) and how the success of the strategy can be measured using one or a range of different benchmarks of performance.

The regulators in particular should be very satisfied with their efforts and more importantly the likely outcome

Of course GSCS clients can already define any number of different transaction types and review on-line measures of all of these types against one or more of a large number of different benchmarks of their own choosing. Results can be compared by security, broker, country, size of transaction, trader, portfolio manager and so on. Our fund management company clients can therefore establish almost any relevant execution strategy and see immediately whether they have complied with it. They can also look at the extent to which the strategy has been successful in delivering effective execution. This effectiveness can be reviewed at the level of an individual transaction, for any particular client or more generally and against individually appropriate benchmarks.

Transparency and disclosure in terms of commissions and execution will encourage many brokers to offer unbundled services whether voluntarily to gain competitive advantage, or in recognition of an inability to compete in all areas. The areas of focus for brokers in the future, whether dealing, broking, research or investment banking related, are sufficiently numerous to allow many to survive. Over time however, they will probably be much different in form and function from what exists today. With the sales process unbundled, research will be more effectively directed at those individuals who might use it, with buy-side traders only having to deal with firms that really offer trading expertise. Sales traders may well become obsolete in this process.

The overall outcome will be greater specialisation by all parties involved, companies and individuals, buy-side and sell-side. Gains in efficiency should accrue and a ratcheting up of average quality in all areas will occur as the weak and mediocre participants are removed from the process. This result will benefit both investment and trading, resulting in improved investment returns achieved at lower total costs. Those that lose their jobs may not be happy, but everyone else, not least the end clients, should benefit. The regulators in particular should be very satisfied with their efforts and more importantly the likely outcome. The process may be long and at times arduous, but will be worth it in the end.

Contacts

For further information about GSCS and its transaction cost measurement services please contact:

Robert W.A. Kay, Managing Director, Global Securities Consulting Services Ltd., 2 Station Road, Chertsey, Surrey KT16 8BE
Tel: 01932 568488. Fax: 01932 564290. e-mail: rkay@gscs.co.uk.