

# Contents

|   |            |
|---|------------|
| <b>Acknowledgements</b>   | <b>xi</b>  |
| <b>Preface</b>  | <b>xii</b> |
| <b>Forward</b>  | <b>xiv</b> |
| <br>  |            |
| <b>1 Introduction</b>   | <b>1</b>   |
| <b>Part I Best Execution</b>                                    | <b>5</b>   |
| What is best execution – an introduction to the concept         | 5          |
| <b>2 Is this Regulation Necessary?</b>                          | <b>7</b>   |
| 2.1 Why should best execution be regulated?                     | 7          |
| 2.2 State or self-regulation?                                   | 9          |
| 2.3 The state as provider of standardisation                    | 11         |
| Conclusion  | 12         |
| <b>3 Fundamental Issues</b>                                     | <b>14</b>  |
| 3.1 To whom should the standards apply?                         | 14         |
| 3.2 Assessing execution   | 15         |
| 3.3 The approach: “conceptual” or “prescriptive”?               | 15         |
| 3.4 The scope: single or multiple markets?                      | 17         |
| 3.5 The details: what factors constitute best execution?        | 17         |
| 3.6 Price and non-price dimensions                              | 18         |
| 3.7 Speed of execution  | 19         |
| 3.8 Certainty of execution                                      | 19         |
| 3.9 Market impact   | 20         |
| 3.10 Non-standard settlement                                    | 21         |
| 3.11 Counterparty risk limits                                   | 21         |
| 3.12 Other issues   | 23         |
| 3.12.1 Internalisation  | 23         |
| 3.12.2 Order routing vs price matching                          | 24         |
| 3.12.3 Price improvement  | 24         |
| 3.12.4 Limit orders   | 26         |
| 3.12.5 Soft commissions, bundling and the misaligned incentives | 26         |
| 3.12.6 Statistical disclosure of execution quality              | 28         |
| Conclusion  | 30         |

|          |   |           |
|----------|---|-----------|
| <b>4</b> | <b>Putting it Together: Elements of a Sound Best Execution Policy</b> | <b>31</b> |
| 4.1      | Elements of an effective best execution policy                        | 31        |
| 4.2      | The enforceability/flexibility dilemma                                | 31        |
| 4.3      | Enforcement: visibility and clarity                                   | 32        |
| 4.4      | Determining the benchmark   | 33        |
| 4.5      | Calculating the benchmark   | 34        |
|          | 4.5.1 Flexibility – a matter of choice                                | 35        |
|          | 4.5.2 Practicality  | 38        |
|          | Conclusion  | 39        |
| <b>5</b> | <b>Comparing Approaches</b>   | <b>41</b> |
| 5.1      | Overview  | 41        |
| 5.2      | Best execution in the US markets                                      | 41        |
|          | 5.2.1 The regulatory environment                                      | 41        |
|          | 5.2.2 Order handling (Rules 11Ac1-4 and 11Ac1-1)                      | 46        |
|          | 5.2.3 Disclosure (Rules 11Ac1-5 and 11Ac1-6)                          | 48        |
|          | 5.2.4 The treatment of soft commissions and payment for order flow    | 48        |
|          | 5.2.5 Price improvement   | 49        |
|          | 5.2.6 Enforcement and guidance  | 49        |
| 5.3      | Best execution in the United Kingdom                                  | 51        |
| 5.4      | Introduction of a multiple exchange environment                       | 51        |
| 5.5      | The “relevant market” condition                                       | 52        |
| 5.6      | Board Notice 542  | 53        |
| 5.7      | FSMA and the Conduct of Business Sourcebook                           | 53        |
|          | 5.7.1 Restructuring the best execution obligation                     | 55        |
|          | 5.7.2 Provision of information on firms’ execution arrangements       | 56        |
|          | 5.7.3 Review of execution arrangements                                | 56        |
|          | 5.7.4 Monitoring execution quality                                    | 56        |
| 5.8      | The FSA’s statutory requirements                                      | 57        |
| 5.9      | European Union regulation   | 59        |
|          | Summary   | 63        |
|          | Conclusion  | 64        |
| <b>6</b> | <b>A Legal Approach</b>   | <b>66</b> |
| 6.1      | Fiduciary responsibility and the “shingle theory”                     | 66        |
| 6.2      | Cases and decisions   | 67        |

|                |  |            |
|----------------|--|------------|
| 6.2.1          | Newton vs Merrill Lynch                                    | 67         |
| 6.2.2          | In re Geman  | 67         |
| 6.3            | ICE securities   | 69         |
| 6.4            | Limitations  | 70         |
| 6.5            | Competition issues   | 70         |
|                | Conclusion   | 73         |
| <b>7</b>       | <b>Technological Considerations</b>                        | <b>74</b>  |
| 7.1            | The best execution process                                 | 75         |
| 7.1.1          | Price consolidation  | 75         |
| 7.1.2          | Net price calculation                                      | 80         |
| 7.1.3          | Order routing  | 83         |
| 7.1.4          | The National Market System                                 | 87         |
| 7.1.5          | NASDAQ SuperMontage <sup>®</sup>                           | 89         |
| 7.1.6          | The role of regulation                                     | 91         |
|                | Conclusion   | 92         |
|                | <b>Best Execution: Conclusions</b>                         | <b>94</b>  |
| <b>Part II</b> | <b>Market Integration</b>                                  | <b>97</b>  |
|                | Introduction   | 97         |
| <b>8</b>       | <b>Liquidity, Market Fragmentation and Price Formation</b> | <b>99</b>  |
| 8.1            | What is liquidity?   | 99         |
| 8.2            | Liquidity begets liquidity                                 | 100        |
| 8.2.1          | The price formation process                                | 100        |
| 8.2.2          | Fragmentation  | 102        |
| 8.2.3          | Breaking the law of one price                              | 102        |
| 8.2.4          | A challenge to the assumption                              | 104        |
|                | Conclusion   | 105        |
| <b>9</b>       | <b>Fragmentation and Concentration</b>                     | <b>106</b> |
| 9.1            | Concentration rules in Europe and the United States        | 106        |
| 9.1.1          | Internalisation  | 107        |
| 9.2            | Alternative Trading Systems (ATSS)                         | 112        |
|                | Conclusion   | 115        |
| <b>10</b>      | <b>Clearing and Settlement</b>                             | <b>116</b> |
| 10.1           | The nature of clearing and settlement arrangements         | 116        |
| 10.1.1         | Horizontal and vertical models                             | 118        |
|                | Conclusion   | 119        |

|                   |  |            |
|-------------------|--|------------|
| <b>11</b>         | <b>Old Solutions to New Problems: Historical Attempts to Integrate Markets</b>   | <b>120</b> |
| 11.1              | The integration of the US markets  | 120        |
| 11.2              | Rules  | 121        |
| 11.3              | Pan-European markets   | 126        |
|                   | Conclusion   | 128        |
| <b>12</b>         | <b>Making Integration Work: The European Case</b>                                | <b>129</b> |
| 12.1              | Treaty of Rome   | 129        |
| 12.2              | Constructing a market system   | 132        |
| 12.2.1            | Consolidated price montage   | 132        |
| 12.2.2            | Consolidated tape  | 133        |
| 12.2.3            | Order routing  | 133        |
| 12.3              | Overcoming inertia - best execution as a necessary element of market integration | 134        |
| 12.4              | Is a "super-regulatory" necessary?   | 135        |
|                   | Conclusion   | 138        |
|                   | <b>Market Integration: Conclusions</b>   | <b>139</b> |
| <b>Part III</b>   | <b>Making Market Integration Work</b>  | <b>141</b> |
| <b>13</b>         | <b>State vs Market - Who Regulates the Integrated Market?</b>                    | <b>143</b> |
|                   | Conclusion   | 146        |
| <b>14</b>         | <b>Conclusions</b>   | <b>147</b> |
| <b>Appendix A</b> | <b>Selected Best Execution Terminology</b>                                       | <b>150</b> |
| <b>Appendix B</b> | <b>Proposed Best Execution Policy</b>  | <b>151</b> |
|                   | <b>Further Reading</b>   | <b>153</b> |
|                   | <b>Selected Bibliography</b>   | <b>154</b> |
|                   | <b>Index</b>   | <b>157</b> |