Client Update
Questions Stemming from FINRA's Best Execution Guidance

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On November 20, 2015, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 15-46 entitled "Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets" (the "Notice").[1] Broker-dealers and investment advisers must consider best execution with respect to their trading activities in all types of securities.[2] Both FINRA and the Securities and Exchange Commission ("SEC") have recognized that best execution determinations are not solely about price. Rather, execution quality reviews must consider all facts and circumstances. Accordingly, both regulators have typically guided market participants to focus not on an order-by-order analysis, but to conduct a "regular and rigorous review" execution quality that involves a statistical analysis of routing decisions and trading results during a relevant time period.

The Notice starts out by reiterating this and other longstanding notions about best execution, before breaking new ground on two issues. First, it introduces the concept of applying an order-by-order analysis of execution quality in certain situations, including for large-sized orders and for trades executed internally by a broker-dealer. Second, it discusses best execution for fixed income trades in more detail than previous statements from either FINRA or the SEC, with a focus on electronic trading platforms for these securities. FINRA's stated rationale underlying its new pronouncements is the rise of electronic trading.

Below, we summarize the Notice with a focus on these two aspects and then pose several key questions that remain unanswered but will be important for

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1 *Available at* http://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf.

2 Kirsch, Broker-Dealer Regulation (PLI 2d Ed. 2015) at ch. 19 (by MacHarg, Schneider et al.).

broker-dealers to consider in this context. We expect that best execution committees will consider new policies in light of the new guidance.

DISCUSSION

The Notice first discusses best execution with respect to equities and listed options and then considers it for fixed income securities. FINRA acknowledges the differences between both the rule sets and the historically developed methods of trading in these different marketplaces. It also briefly talks about the potential impact of payment for order flow on best execution, an issue that has received substantial attention.[3] There is also a short discussion of directed orders and the lesser standard of review that applies when a broker-dealer follows the more detailed customer instructions present in these situations.[4]

Equities and Options Best Execution. Perhaps the key sentence in the discussion of best execution for equities and options reads as follows: "FINRA believes that, given developments in order routing technology, order-by-order review of execution quality is increasingly possible for a range of orders in all equity securities and standardized options." The sentence lays out the technological premise that flows through the rest of the analysis, and uses it to justify a requirement that broker-dealers move away from the regular and rigorous review to an order-by-order best execution analysis. FINRA, however, does not provide authority for this principle or an explanation as to what an order-by-order review would entail or how best execution might be demonstrated using such an analysis. For example, the Notice does not specify the factors that one might use for determining whether best execution was satisfied with respect to a particular order, or what comparison would be appropriate in conducting such a review. And with no citation, there is no source material from which a broker-dealer best execution committee might glean an understanding of this order-by-order principle.

FINRA identifies two principal situations in which order-by-order analysis might be, in its view, required: large-sized (block) orders and internally executed

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3 *E.g.*, Permanent Subcommittee on Investigations, *Subcommittee on Investigations to Examine Conflicts of Interest, Investor Loss of Confidence, and High Speed Trading in U.S. Stock Markets* (June 16, 2014), *available at* http://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-on-investigations-to-examine-conflicts-of-interest-investor-loss-of-confidence-and-high-speed-trading-in-us-stock-markets.

4 The discussion does not address whether an order entered using an algorithm constitutes a directed order and there is no discussion of the distinct requirements that apply to "held" versus "not held" orders.

orders. With respect to block orders, the Notice states that "regular and rigorous review alone (as opposed to an order-by-order review) may not satisfy best execution requirements, given that the execution of larger-size orders 'often requires more judgment in terms of market timing and capital commitment'" (footnote omitted). No interpretive gloss is provided with respect to this statement, and the reader is left to wonder what an order-by-order review would entail for a block trade.

The Notice next discusses internalization, which, it acknowledges, was seemingly addressed in Supplementary Material .09 to FINRA Rule 5130, which concerns best execution. In the Notice, FINRA reads that interpretation to mean only that the *decision* about routing out versus routing internally is subject to the regular and rigorous review standard. That is not, apparently, the case with respect to the internally routed orders themselves: "Orders that a firm determines to execute internally are subject to an order-by-order best execution analysis." There is no clarification concerning what is special about internally routed, as opposed to externally routed, orders or what an order-by-order analysis would entail.

Instead of providing a discussion of what FINRA expects in an analysis of individual orders in any context, the Notice proceeds to remind its readers of the usual best execution requirements concerning (i) regular and rigorous review, (ii) adoption of policies and procedures and (iii) the factors potentially relevant in a standard best execution analysis. It is left for each broker-dealer best execution committee to interpret this new order-by-order principle and how to adapt. The Notice further admonishes broker-dealers who route all of their orders to executing brokers to obtain the execution data and analytics used by their executing brokers as the means for conducting best execution reviews.

Fixed Income Best Execution. The Notice then tackles fixed income trading. The discussion here outlines the different styles of fixed income electronic trading platforms, including those that offer executions and those that function using a request for quote (RFQ) or similar method. "As the availability of electronic systems . . . increases, firms need to determine whether these systems may provide benefits to their customer order flow, particularly retail order flow, and help ensure they are meeting their obligations under the rule with respect to ascertaining the best market for their customer transactions." The remainder of this section of the Notice nicely lays out the facts and circumstances in the fixed income markets that can make best execution evaluations more challenging than in equity and options markets. FINRA's acknowledgement of these difficulties, and discussion of their roots, adds useful information to the issues facing broker-dealers assessing execution quality for fixed income trading.

In the discussion of fixed income markets, FINRA notes both Supplementary Material .03 and Supplementary Material .06 to Rule 5130. The former, in addressing fixed income securities, notes that accessibility of quotations is one of a nonexhaustive list of factors in assessing best execution and that broker-dealers are not relieved of responsibility simply because a quote is not accessible. The latter deals with all security types and requires firms to have policies and procedures for handling situations where there is limited quote and pricing information for a security. While recognizing the wider variety of liquidity profiles in fixed income markets, FINRA nevertheless reminds firms that the best execution duty persists.

In addressing the proliferation of electronic platforms for fixed income trading, the Notice states: "The duty of best execution does not necessarily require a firm to access every available platform that trades fixed income securities, especially given the differences in pricing information and execution functionality offered by different systems." FINRA ends the notice with three examples of situations involving an executing broker using or seeking to use such platforms to obtain quote or pricing information and executing customer orders. The examples are designed to illuminate FINRA's thinking about how a broker-dealer may assess such platforms in order to determine which platforms to access and whether it should join additional platforms in order to source liquidity.

Questions for Best Execution Committees. In light of the principles articulated in the Notice, we believe broker-dealer best execution committees might ask the following questions, among others, as they seek to implement the new guidance and principles articulated in the Notice:

- What does order-by-order best execution analysis mean? That is, do we need to determine for each trade whether a better price was available? And if so, how would we conduct such an analysis?
- For large-sized orders, does the analysis differ depending on whether the order was routed or executed in block size or as a series of child orders?
- Does internalization of orders include agency crosses, or only principal trades made by the broker-dealer?
- If a broker-dealer operates a fixed income trading platform, under what circumstances must it consider routing orders to another liquidity provider or platform?
- What factors will fixed income traders use to determine the fungibility of different securities when seeking to use those similar securities as a basis for evaluating pricing?

- How often, and on what basis, will a best execution committee evaluate fixed income platforms that the firm does not utilize to determine whether to start accessing other platforms and/or replace existing platforms with new platforms?

CONCLUSION

FINRA's new guidance in the Notice provokes significant questions as it seeks to provide direction on best execution. Broker-dealers have long asked their best execution committees to tease out the complexity associated with this important facet of the business. With FINRA's new considerations in mind, the next several committee meetings should prove interesting.

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Please do not hesitate to contact us with any questions.