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The Third Rail of the Financial Services Industry: Trade Execution, Best Execution and Beyond

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The third rail of the financial services industry that no one wants to talk about is trade execution, particularly as it relates to fiduciary responsibility. This is understandable because the financial services industry is largely built around commission sales. The financial advisor is principally compensated based on their ability to sell investment products, and the industry's business model is largely based on the spread between the bid and ask price of common stocks. When you consider that a pre-decimalization spread of one-eighth of a point translates into 12½ cents per share, or twice the maximum commission an advisor can charge, it becomes clear that trade execution has historically been a most significant source of brokerage firm revenues ... over and above today's 60% or more of the advisor's gross revenues that the firm retains. So, any discussion of best execution, securing the best price for a security at the lowest possible cost, is a sensitive issue, not just because best execution is an important fiduciary responsibility but because it goes to the core culture and economics of the industry.

SO, ANY DISCUSSION OF BEST EXECUTION, SECURING THE BEST PRICE FOR A SECURITY AT THE LOWEST POSSIBLE COST, IS A SENSITIVE ISSUE, NOT JUST BECAUSE BEST EXECUTION IS AN IMPORTANT FIDUCIARY RESPONSIBILITY BUT BECAUSE IT GOES TO THE CORE CULTURE AND ECONOMICS OF THE INDUSTRY

Thanks to innovation and courageous regulatory stewardship, the financial services industry is changing in profound and fundamental ways that no longer presumes the principal means of advisor compensation is brokerage commissions. For advisors who wish to engage their investment and administrative counsel for a fee, who are fulfilling their fiduciary responsibilities and are demonstrably acting in their clients' best interests, brokerage commissions are an expense that must be managed and minimized on their client's behalf. Thus, unlike in commission sales, for fiduciary advisors, brokerage commissions are not a profit center; it is a cost center – an expense that must be managed. In wrap fee programs, trade execution costs are part of the wrap fee so there is an effort to keep trade execution costs down, but it is not necessarily true that it is in the best interests of the trading desk serving wrap fee programs, which are compensated by the spread, to secure the best price. So, the question becomes: Should the fiduciary obligation of best execution and the advisor's fiduciary responsibility depend upon the actions of a trading desk of which they have no control? The problem is that the advisor cannot seek best execution when the advisor engages a money manager on their client's behalf because it is the asset manager's responsibility to find best execution. This is the crux of the problem when one brings up the topic of best execution as it applies to the wrap space. Institutional managers who also have a wrap business call the wrap business "directed business" and put it at the end of their trade rotation. Furthermore, within the wrap universe of accounts, because the managers have too much difficulty stepping out to other broker dealers for trade execution, they tend to do the bulk of the trades at the sponsor where the account resides. The problem with this is that by the time a large wrap manager trades through all the sponsors, they may have shown the trade 30 times before the last client's order is filled. This situation is further complicated by the fact that many managers feel that they have an obligation to trade exclusively through the sponsoring firm that directed them the assets. Clearly, this does not encourage best execution.

The term "best execution" is something of a misnomer. People are really speaking more about trade rotation. Is it fair? How is it defined? Who is included in the rotation? More importantly, who is excluded? None of this has been defined within the industry which, in light of today's regulatory environment, is not good for the advisor, their firm and/or the money

manager. The industry does not need any unnecessary controversy. The institutional market offers an easily executed solution that would immediately remedy these issues. In the institutional market, volume weighted average pricing (VWAP) is considered best execution and is something that an objective third party, like the Money Management Institute, could electronically publish

VWAP at the end of each day for common stocks could be easily assessed by consumers, advisors, money managers and regulators as to whether the trade prices actually achieved in trade execution were VWAP or higher/lower than VWAP. VWAP isn't a disadvantage for anyone and leaves room for enterprising trading desks to beat – thus competitive market forces are engaged in the consumers' best interests.

Would it not then be logical to assume if trade execution costs are higher and securities' prices are lower, that the firm's trading desk is putting their own interests ahead of that of the investor? Would it not be true that by not using VWAP, if an investor were to discover after the fact that their advisor's firm has not been acting in their best interests, that the hard-won trust vested in the financial advisor would be lost? Would it then be fair for investors to conclude that NASD member brokerage firms that do not acknowledge fiduciary responsibility should be viewed in the context of maximizing commissions and trading profits while minimizing the role and counsel of the financial advisor, while SEC registered investment advisors who acknowledge fiduciary responsibility seek to minimize commissions and maximize the role and counsel of the advisor? While there is merit in all these generalizations, none are absolutely true; but is it fair, however, for the consumer to ask whether it is possible for an advisor to fulfill their fiduciary responsibility within a commission brokerage firm and to request substantiating documentation, such as that which Smith Barney is creating for their top investment management consultants?

Traditionally, institutional investors have maintained that an acid test for fiduciary responsibility is how trade execution is treated and whether advisors are being compensated for the engagement of their investment and administrative counsel and the values they address and manage, or whether the advisor is paid for the clerical function of trade execution? If the fiduciary responsibility of the financial advisor is not acknowledged and the advisor's supporting firm denies any investment advice is being rendered, then, by definition, there is little or no value associated with their advisor's counsel – the advisor is simply facilitating trade execution. If there is no investment advice, how can there be any value added? The client, in essence, is forced to become their own counsel, relying on their own limited judgment as to investment merit. Thus, there is no rational justification for a premium to be associated with the clerical trade execution function, unless it is accompanied with advice. Yet, it is possible that firms requiring their advisors to get Series 65 licenses acknowledge their advisors are providing investment advice and not simply supervising trade execution practices of the money managers to whom their advisors have directed their business. Again, this is readily resolved by VWAP becoming a matter of policy.

THUS, THERE IS NO RATIONAL JUSTIFICATION FOR A PREMIUM TO BE ASSOCIATED WITH THE CLERICAL TRADE EXECUTION FUNCTION, UNLESS IT IS ACCOMPANIED WITH ADVICE

If VWAP becomes a proxy for best execution in determining the price achieved of a security, then trade execution cost becomes a wholesale versus retail pricing issue. If the advisor, their firm, their trading desk and the money manager are acting in the client's best interest, wholesale trade execution always wins over retail. Thus, trade execution indeed becomes an acid test for fiduciary responsibility. The advisor is compensated for addressing and managing a broad range of investment and administrative values on their client's behalf, one of which is trade execution at minimal cost. So, how can an institution pay two cents per share for trade execution, when a mutual fund with far larger scale and far superior technology pays twice or three times that, while electronic crossing networks (ECN's) not only give away trade execution for free to institutions with large order flows, but the ECN actually pays for the order flow? Is best execution 2¢ per share, 5¢ per share or better than free? In folios, the normal spread between the bid and ask price is split with the buyer and seller in the form of a better price for both. Wouldn't folios, then, be best execution – the best price at the lowest cost? Isn't it indisputable that, even if our nation's largest brokerage firms should have the best technology and the largest order flow, if this scale does not translate into better pricing for the consumer, then the greater the cost of trade execution, the less likely the advisors of these firms are fulfilling their fiduciary responsibilities? This is the advisor's conundrum. It is clear that best execution is required, yet the advisor is at the mercy of the support infrastructure their firm provides. Investment advisors operating under the umbrella of the Investment Advisor Act of 1940 are prohibited from favoring one client over another. This is the essence of the best execution or "rotation" dilemma. One client cannot consistently get a better price than another. Because the advisor is in no position to dictate their firm's policy, this question arises: Will regulatory enforcement force the issue or will free market forces be harnessed so the investor's and the advisor's best interests are being served?

Whether it's Wall Street, Wal-Mart or discount brokerage, there is the irreversible trend inherent in free markets for enterprising firms to add value by creating the most efficient means of distributing products and services at the lowest possible cost to the consumer. The consumer invariably responds. As an electronic crossing network (ECN), Charles Schwab has an extremely low cost structure that would be highly profitable just working from the spread, even if they were to charge nothing for trade execution. Schwab's innovation was to introduce institutional cost structures to the retail market – and at $10 per trade, the marketplace responded. Schwab simply raised the question with advisors and investors, if our nation's leading brokerage firms are not structured to acknowledge and support the advisor's fiduciary responsibility, why should the investor pay

several hundred dollars for a trade when it can be accomplished for $10 or less? Schwab doesn't represent that it acknowledges the fiduciary responsibility of advisors who use their services, nor does it support advisors in fulfilling their fiduciary responsibilities. In fact, Schwab does not even act as a broker/dealer. Schwab only works with advisors who are RIA's not engaged in commission sales. Given neither Schwab nor our largest commission brokerage firms acknowledge or support advisors in the fulfillment of their fiduciary responsibility, wouldn't $10 per trade be more attractive to the consumer and the fiduciary advisor than several hundred dollars per trade? Schwab is essentially saying the brokerage industry can't have it both ways. It can't charge a premium for trade execution while denying that their advisors render investment advice, thus precluding them from the possibility of adding value. Only by acknowledging and supporting the fiduciary responsibility of its advisors can the brokerage industry maintain its pricing and margins. This is why consumers rate discount brokerage firms so highly. Consumers want advisors to act on their behalf, to address and manage the full range of investment and administrative values required by regulatory mandate, and to fulfill their fiduciary obligations. The RIA's who use Schwab, Fidelity, AmeriTrade and T.D. Waterhouse acknowledge their fiduciary responsibilities and are accordingly addressing and managing the full range of investment and administrative values necessary to fulfill their fiduciary responsibilities. At major brokerage firms, this acknowledgement of fiduciary responsibility and its associated high level of counsel would violate internal compliance protocol. The regulatory question is: When a money manager distributes the proceeds derived from trade execution to the advisors' clients, is everyone getting the same price? And if they are not, what is the decision-making process for this? Furthermore, in the case where some clients are going to be treated inequitably on a given trade, what mechanism is in place to make certain that this uneven distribution is not done intentionally?

The innovation in the free markets of offering institutional pricing at the retail level does not stop at Schwab. There are electronic crossing networks emerging that are intent on "out Schwabing Schwab." They will offer unlimited product access, custody, clearing, trade execution and reporting for the greater of five basic points (or $50,000) for advisors who have at least $100 million under advisement. This pricing clearly goes beyond best execution and relies heavily upon the spread. By extension, given it is conceivable that trade execution could be eventually offered for free, could it be that "best execution" has or will become an outdated idea? Ultimately, with the emergence of ECN's and folios, trade execution cost will approach zero, which will radically alter the role of today's dominant brokerage firms. Only through acknowledging, supporting and facilitating the fulfillment of fiduciary responsibilities of their financial advisors can today's largest brokerage firms maintain their present market position.

ULTIMATELY, WITH THE EMERGENCE OF ECN'S AND FOLIOS, TRADE EXECUTION COST WILL APPROACH ZERO, WHICH WILL RADICALLY ALTER THE ROLE OF TODAY'S DOMINANT BROKERAGE FIRMS

Now you can see why best execution is the third rail of the financial services industry, as the fear of the fiduciary liability associated with the advisor's counsel has crippled the industry's ability to acknowledge that advice is even being rendered. This, in turn, has made it impossible for the industry that supports a high 90% of all financial advisors to create the processes, technology, and support infrastructure necessary to add value and fulfill fiduciary responsibility. If the investing public understood its working relationship with our industry's largest financial services firms – no investment advice is rendered; advisors are only making investors aware of their investment alternatives – it is up to the investor to determine investment merit based on their own limited knowledge and experience. Advisors and their firms are not accountable for their investment recommendations – the investor would demand a radical change in the relationship. All advisors want to act in their clients' best interests, and all investors want an advisor to demonstrably act in their best interests. Should any of us, then, wonder why the investing public's faith and trust in the financial services industry has been shaken? In the absence of institutional support from their firms, the advisor is forced to take the personal initiative to create their own supporting processes, technology and infrastructure within their practice necessary to fulfill their fiduciary responsibility. The processes and technology exist to empower the financial advisor to fulfill their fiduciary responsibility, and there is a regulatory mandate for advisors to fulfill their fiduciary obligations. Only by the courageous regulatory enforcement of public policy will today's dominant financial services firms acknowledge and support the advisor's fiduciary responsibility.

The SEC, under Chairman William Donaldson, is taking steps that would unleash free market forces that would lead to an unprecedented level of professional investment and administrative counsel being provided to the financial service consumer. Consumer advocates, the investor, the advisor, the money manager, and the industry all win. Working with the NSCC/DTCC, the SEC is attacking the issues of marketplace inefficiencies, lack of disclosure and absence of accountability by focusing on the free flow of client-permissioned information among custodians (see, "DTCC Fills Technology Leadership Vacuum," *Senior Consultant*, December 2003, http://www.SrConsultant.com/Articles/2003-12-DTCC-Tech-Leadership.pdf). The free flow of real-time, client-permissioned information on account holdings via the web makes possible continuous, comprehensive counsel implied by fiduciary responsibility and breathes life into the existing next generation of real-time, web-based tools, processes, technologies and methodologies necessary to add value and to fulfill fiduciary responsibility. Advisors have not had access to these technological innovations because it is culturally and politically inexpedient to even speak within their firms about fiduciary-related issues (see "The Web Effect: Reinventing the Financial Services Industry and Its Pricing By Democratizing

Access," *Senior Consultant*, June 2004, http://www.SrConsultant.com/Articles/2004-06-The-Web-Effect.pdf). Yet, it is possible today for an advisor to bring this enabling technology within their practice, establish a division of labor and create a value proposition that is far superior to that possible by utilizing their firm's resources; and they can do so less expensively than participating in their firm's limited advisory (wrap fee) programs (see "How Are Top Advisors Growing Their Business in Today's Difficult Market?" *Senior Consultant*, April 2003, http://www.SrConsultant.com/Articles/2003-04-Top-Advisors-Grow.pdf).

With the free flow of client-permissioned, real-time data among custodians, the raw data should be available for advisors to make investment recommendations in the context of all the client's holdings. Only then is it possible for the advisor to determine if their recommendation improved overall portfolio returns, reduced risk or enhanced the tax efficiency, liquidity and cost structure of the client's holdings as a whole. By the NSCC/DTCC serving as a centralized non-profit utility that provides a common protocol that facilities the free transferability of accurate, reliable, real-time information on all client holdings among custodians (as it does now for stocks, bonds, mutual funds and annuities), it drops the bottom out of account aggregation costs and places heretofore unprecedented focus on the professional management of that information. By extension, fiduciary responsibility will become the metric against which the resulting counsel will be measured and failure to give best execution to a client is a fiduciary breech. Whether NASD member brokerage firms acknowledge the fiduciary responsibility of their advisors or not, the larger financial services industry will because it is in the best interests of the consumer, and the marketplace will respond.

If you are a separate account manager dealing with 30 NASD firms, each having a different operations protocol that precludes you from achieving scale, you will now have only one operating protocol from the NSCC/DTCC. If you are a practicing financial advisor who is paying $50,000 to $125,000 a year for account aggregation services essential to your adding value, the cost of these services drops more than half and are now financially accessible to far more advisors. If you are an investor, your advisor can actually make an investment recommendation in the context of all your holdings, and they will actually know whether or not their recommendation improved your return, reduced your risk exposure or enhanced the tax efficiency, liquidity and cost structure of all your holdings as a portfolio. As an advisor, you will actually be able to tell your clients how their portfolio is performing in real-time relative to its benchmark and market indices, rather than having to wait for several weeks after the end of each quarter. The investor wins, the advisor wins, the money manager wins and the industry wins. Funny how efficiently the free markets work. All that is required is that the clients' best interest to be always put first.

So, even though trade execution, best execution and fiduciary responsibility are the third rail of the financial services industry that no one wants to talk about, consumer advocacy groups, investors, enterprising advisors and regulators – all with the common goal of acting in the investors' best interests – can work together to find a solution. Working alone, the consumer advocate, the investor, the advisor and the regulator are not nearly as effective as working together. We all should applaud the work of the SEC with the NSCC/DTCC, as it becomes an important utility that unleashes market forces that will greatly elevate the role and counsel of the financial advisor. ■

Notes

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