ACCLINATE

Implementation of an Outsourced Trading Solution

Second Edition 2025

In 2019, we published a paper on the keys to implementing an outsourced trading solution. This second edition has been updated to reflect changes in the trading landscape and to include our learnings in the interim.

It is important to note that our conviction in outsourced trading has only strengthened since 2019. This is based on the successful implementations we have been involved in and the continued challenging operating environment faced by investment managers.

"We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten. Don't let yourself be lulled into inaction."

-Bill Gates

While they may not admit it, many investment firms suffer from the inaction discussed above. Despite the fact that well-known secular changes in the industry have started to impact operating margins at many firms, strong capital market returns have enabled a significant number to delay decisions and change that we believe will be critical to their success, or potentially, survival in the years ahead.

Focusing on what is core to an investment firm's success, and assessing each internal group's role in delivering this, should be the primary focus of leadership teams within the industry. Delivering operational efficiency and leverage will never be more important than in the years ahead.

Outsourcing is not a new topic when discussing operational efficiency. We have seen successful implementations of back and middle office outsourcing over the past decade and longer, as well as the outsourcing of such functions as technology, compliance and human resources. Historically, however, many firms have been reluctant to look at where outsourcing may affect the front office more directly.

In this paper we will discuss a topic that has been around for many years, but where implementation has increased more recently – outsourced trading. The paper will touch on factors to consider when deciding to outsource, and when evaluating outsourced providers. We will also illustrate the tangible benefits of outsourced trading through an implementation example.

Trading **environment**

Historically, most investment firms conducted trading in house. Our research shows that this decision has led many firms to employ a minimum of three people to ensure adequate coverage during peak volumes, address staff shortages and potentially provide after-hours coverage of non-U.S. markets. These people may be dedicated solely to trading, be part of operations and/or also take on additional responsibilities.

As we think about the current environment, it is important to look at the evolution of trading and its impact on traders, as this is a critical factor when discussing outsourcing. The role of a trader has changed over the years given the increasing fragmentation of liquidity and technological advances in the level and types of trading platforms. The role has also been impacted by the regulatory landscape and increased administrative demands being placed on traders.

The changes in the macro and microenvironment for traders, as well as the increased level of market efficiency, particularly in equity markets, has resulted in many firms questioning whether trading should be a core area in their business or whether it is something that can be outsourced.

Making **the decision** to **outsource**

For firms considering outsourcing their trading, we believe there are a series of key questions to consider:

- **Would outsourced trading be effective given the firm's investment process?**
  Consideration should be given to the asset classes managed, investment strategy, number of holdings and position sizes within portfolios, portfolio turnover and assets under management. We believe that many investment managers, particularly those that primarily invest in publicly traded equities and derivatives, as well as certain fixed income sectors may be better served through an outsourced solution.

- **Does outsourcing align with best execution?**
  First and foremost, investment firms are paid to act in a client's best interest and maximize investment returns. Ensuring best execution in trading is a fundamental part of this. We do not believe that best execution should be a concern given the size, scale and expertise of many outsourced providers, the breadth and quality of their execution capabilities and their ability to effectively report on best execution. In fact, we believe that the underlying clients of investment firms will benefit from improved execution.

- **Are there genuine cost savings and can the firm implement an outsourcing project effectively?**

- **Client perception. How would clients, investment consultants and intermediaries react to a firm outsourcing trading?**

- **How do I establish a credible list of outsourced trading partners to choose from?**

- **Would outsourcing align with the firm's culture and how would the human impact be managed?**

We will discuss many of these topics later in this paper.

Choosing **an outsourcing partner** and setting the relationship up for **success**

We believe there are several critical factors to consider should an investment manager decide to move ahead with a more thorough analysis of outsourcing and identifying a partner.

- **Business structure**

  The starting point is to ensure that the outsourced trading provider is free of conflicts of interest and is not engaging in proprietary trading or investment banking activities.

  In addition, it is critical that a full enterprise risk analysis is completed with a focus on the stability of the firm, its governance culture and its business continuity capabilities. An understanding of the net capital position and errors and omissions insurance coverage are also important. Investment firms place a high degree of focus on their business continuity capabilities and trading is a key component of this. Ensuring your comfort with the capabilities of your outsourced trading partner is something clients will value highly.

- **Execution capabilities**

  It is critical that your outsourced partner is unconflicted in terms of flow. Attention should be paid to ensuring that there are no internally developed algorithms, ownership of any trading pools, or pledges to any pools that could introduce potential conflicts.

  Strong consideration also needs to be given to the breadth of trading venues utilized across algo suites, ECNs, ATS', dark pools, and market makers.

  The next component to analyze is the depth of resources allocated to the outsourced trading efforts. This would include number of people, their experience, and their geographic locations which becomes increasingly important when the manager has global or non-U.S. strategies.

  The final element of analysis is something that should not be underestimated. In an era of rapid technological change, it is critical for your partner to have the culture and the capital to continually invest in its business.

- **Execution capabilities**

  The implementation of an outsourced solution can take different forms as described below. It is also possible that some managers start with a component offering and view it as the first step on the path to full outsourcing down the line. This can be particularly important for investment managers that employ one trader currently and are considering longer-term succession plans.

  - Execution capabilities
    An investment firm no longer does any trading in-house.
  - Component outsourced trading
    An investment firm retains some trading in house. For example, a U.S. based investment firm managing global equity strategies continues to trade in U.S. markets but outsources trading in EMEA and APAC. Additional examples include, a manager that outsources only a specific asset class, such as fixed income, or a manager with a single trader that uses an outsourced provider when they require additional resources.

- **Assessment of full infrastructure beyond trading**

  In a fully outsourced or component outsourced solution, the assessment of the trade clearing, settlement, reporting and support processes and resources becomes an important element of the evaluation. This is the case as both offerings likely involve the outsourcing of all trading activities through settlement.

  We would also recommend conducting due diligence on the outsourced provider's internal compliance team, their resources and their oversight responsibilities.

- **Managing the relationship**

  We would advise investment managers to be very clear up front, both internally and with their outsourced partner, on how they will manage and monitor the relationship with their partner and how they will measure success. This clarity at the beginning will limit the potential for misunderstandings down the line.

  A simple way to achieve this is to have a well-documented service level agreement with clear metrics and regularly scheduled partner meetings with appropriate representation on both sides.

Implementation of **an outsourced trading** and settlement solution

For the purposes of the analysis included below, we have made the following assumptions:

- Northern Trust's Integrated Trading Solutions (ITS) is the selected outsourced offering.
- The investment firm is primarily focused on long only public equity strategies, as well as managing fixed income portfolios.
- The firm manages commingled funds and separately managed accounts.
- The manager has decided to adopt a fully outsourced model for equity trading and leverages the platform on a supplemental basis for municipal and high yield fixed income securities.
- The fully outsourced model incorporates the outsourcing of all trading activities through settlement.

The areas we will cover in the case study are:

- Client impact and perception
- Unbundling commissions
- Maintaining confidentiality and anonymity
- Operational model for managing trades via an outsourced desk
- Managing Foreign Exchange (FX) exposure
- Compliance oversight and reporting
  - Transaction cost analysis
  - Reporting – Commission Sharing Arrangements
  - Reporting - Markets in Financial Instruments Directive II (MiFID II)
- Identification of potential cost savings
- Managing the human impact

Client impact and perception

Most importantly, with the right process and outsourced trading partner, we do not believe that best execution will be impacted by outsourcing, and the clients of investment managers will not see an increase in commission fees. In fact, we believe clients will benefit from lower costs and improved execution.

Investment managers should consider how to manage the perception their clients and intermediary partners have of change to address any concerns effectively. It is important that the investment manager can demonstrate how they came to a decision to outsource, the evaluation process they followed, and how the success of the model is measured and managed.

Over the past five years of real world experience, we have not seen a negative perception or loss of investors due to a move to an outsourced trading model. In fact, we have observed U.S. investment firms that have outsourced trading be hired by sophisticated institutional investors as well as being recommended by large investment consultants and other asset allocators. In our discussions with institutional investors and investment consultants, the most common view seems to be that outsourced trading is a logical move as long as the outsourced partner is credible, outsourcing is enhancing efficiency within the firm's investment process, and most importantly there is no negative impact on best execution.

When messaged correctly, the investment firm can emphasize that outsourcing enables strategic investments to enhance the potential for strong returns. We believe this will be viewed as positive by clients and prospects.

In discussions with the founder of a firm that has outsourced trading he commented that *"When establishing the business model for our firm, utilization of outsourced services was paramount to establishing a successful practice in light of ongoing fee compression. Along these lines, we decided to structure our trading operations around an outsourced model. We are pleased with our decision from an operational perspective. Furthermore, we are pleased with the due diligence reception to our model as we have been fortunate to have been appointed a sub-advisor to a leading mutual fund platform and also have been put on the approved list by a number of consultants, which has resulted in new business from public plans, foundations and family offices."*

This evidence supports our view that potential client perception challenges can be overcome with proper communication and should not discourage managers from evaluating outsourced trading.

Unbundling **commissions**

MiFID II regulations enacted in Europe have mandated an unbundling of execution costs and research costs within each trade. This directive mandated that research costs be "unbundled" from trading commissions, requiring investment managers to pay for their research out of their P&L rather than using client funds. While many U.S. based investment managers are not required to be compliant with MiFID II, the changing market framework has allowed some managers the potential to negotiate research costs directly with the sell-side by unbundling commissions. Given the pressure the sell side is under, investment managers are in a position of strength and some brokers have shown a willingness to work with managers in this regard.

While there was some consideration of a shift in the U.S. regulatory environment to more closely resemble MiFID II, this directive mandated that research costs be "unbundled" from trading commissions, requiring investment managers to pay for their research out of their P&L rather than using client funds. The SEC issued a no-action letter in 2017 to address the conflicts of the MiFID II directive with U.S. regulation and allow for broker-dealers to accept separate payments from European investment managers. However, this no-action letter expired in 2023, presenting challenges for broker-dealers to provide research to European clients and highlighting that the regulatory environment in the U.S. is unlikely to mandate unbundling. Since then, guidelines have been altered to allow for paying for research via trade commissions. This only further promotes the need to be able to attribute commissions where needed to meet client requirements for research attribution. Many large bulge bracket research providers have continued to require that payment for research be facilitated, at least partially, through bundled trading commissions.

Northern Trust's ITS platform is built on flexibility, with the ability to integrate with a client's Commission Sharing Arrangement (CSA) platform for unbundled research payments, and with the ability to manage bundled commission arrangements on behalf of clients.

Maintaining confidentiality and anonymity

Implementation of an investment manager's strategy in a confidential and discreet trading manner is generally very important. This is built into the outsourced trading relationship as the outsourced provider is trading in its own name with no disclosure of the underlying manager's (or client's) name/s.

Operational **model**

So, how does outsourced trading work in practice? Below, we will take you through the various steps and highlight the responsibilities the investment firm retains.

- **Investment guidelines and trade order management system**

  The investment manager retains responsibility for ensuring all client guidelines are coded correctly in the manager's chosen trade order management system.

  We have observed that managers looking at outsourced trading may also evaluate their trade order management systems at the same time as they assess their overall cost structure. There continues to be an expanding choice of order management systems with several cloud-based platforms being offered at significantly lower price points than some well-known market participants.

  When evaluating an outsourced trading provider, their familiarity and experience with many order management systems is important to consider. The right partner may add significant insight into the advantages and disadvantages of different order management systems.

- **Trade execution**

  In the new operating model, the investment firm would submit the trade orders electronically to the outsourced trading desk. This action could be performed by someone who previously worked on the internal trading desk, or a member of the portfolio management or operations teams. We will discuss in greater detail the transition of internal traders later when we look at the human impact of outsourced trading.

  The outsourced trading desk will then work the order appropriately. Effective communication between the manager and outsourced trader is essential, as their two-way flow of information allows for the sharing of manager's trading preferences and market insights from the outsourced trader, which will help shape positive outcomes.

  The outsourced trader will send electronic confirmations of all trades to the manager.

- **Trade affirmation and settlement**

  We have found that sending the trades already allocated by client account allows for a more operationally efficient trade cycle. The reason for this is that once executed, the outsourced trader can send the related SWIFT message to the client's custodian in a timelier manner and allow for more streamlined management of the overall process.

The outsourced trading desk will be responsible for:

- Trade capture
- Trade validation and enrichment
- Trade matching (via CTM/FIX)
- Trade settlement and fails management
- Trade communication to custodians and third parties

Managing **Foreign Exchange (FX)** exposure

For managers engaged in trading non-U.S. securities, an outsourced trading desk may allow you to manage FX exposure in a straight-through-processing manner. One of the main advantages of having your outsourced trader conduct FX transactions is that the timing of the FX can be more closely aligned with the timing of the trade or at a specific time requested by the manager. This potentially reduces any impact from exchange rate movement between the time of the equity trade and when the FX trade is executed.

This capability is part of the Northern Trust ITS platform.

Compliance **oversight and reporting**

The outsourced trading provider should have a dedicated, independent compliance function performing oversight, advisory, monitoring, surveillance and reporting activities.

- **Transaction Cost Analysis (TCA)**

  A key component of this oversight and monitoring relates to TCA. The outsourced trading desk will provide TCA to the manager in the format and schedule agreed upon. This could be monthly or quarterly depending on the manager's preferences.

  As TCA continues to evolve, ensuring the TCA solution meets the needs of the manager is critical. We have included below some of the tools managers should have access to:

  - Performance monitoring
  - Broker evaluation
  - Trading venues
  - Bespoke analysis on market timing, alpha decay and alpha improvement

  Northern Trust utilizes third party TCA providers for this purpose which we believe provide robust, comprehensive data and analysis.

  We have heard from the Chief Compliance Officer of a firm evaluating outsourced trading solutions that their firm would benefit from more robust transaction TCA and best execution reporting versus their current provider.

- **Reporting: Commission Sharing Arrangements (CSAs)**

  Investment managers should ensure that the outsourced provider has an open architecture platform to allow the manager to pay for its research of choice, as well as a streamlined process to allow it access to posted commissions and research payments.

  Northern Trust's solution in this regard is a commission management portal through Commcise Sell which provides managers with the required flexibility to direct commissions for research.

- **Reporting: MiFID II**

  For those managers required to meet the specific obligations of the MiFID II directives, it is imperative that the required reporting and analysis is conducted by the outsourced trading provider in a streamlined fashion and presented to the manager for review on a monthly basis.

  Northern Trust has built this capability into its solution.

Identification of **potential cost savings**

When analyzing potential cost savings of outsourcing, the largest impact will likely come from staffing and compensation. Our analysis is based on discussions with firms of various sizes in different geographies around the U.S. as well as consideration of other available data. Our focus was on firms managing long-only strategies with assets under management of less than $50bn. Within the table below, we have provided a range of compensation in each of the cases outlined that we feel is representative of firms of different sizes and locations.

As you can see, beyond the staffing costs, there are several other areas where costs can be reduced or eliminated from a trading infrastructure and oversight perspective. Many of these, for example TCA or the Bloomberg SWIFT add on, are firmwide costs and will not vary in the different cases.

We have included a single estimate for trade errors. In reality, we have found this number differs significantly by firm and between different years.

While the actual dollar numbers may vary significantly by manager, we believe the model below is something that can be used as a base for an individual manager's analysis.

		Case 1 ($k)	Case 2 ($k)	Case 3 ($k)
Staffing	Compensation - Head Trader	350	500	650
	Compensation - Senior Trader	250	350	450
	Compensation - Junior Trader	100	125	150
	Compensation - Operations/Trading Assistant	80	100	120
	Combined Benefits (assumed 20% of compensation)	156	195	274
Trade desk infrastructure	Bloomberg – Terminals	80	80	80
	Bloomberg - SWIFT add on	50	50	50
	Bloomberg – Terminals	80	80	80
	SWIFT - licensing and transactions	50	50	50
	OMS - licenses	50	50	50
	Market data – Feeds	7	7	7
	Hardware - Computer & Phone	3	3	3
	Office furniture and space	10	10	10
	Business Continuity	5	5	5
Trade support and settlement	Technology platform	50	50	50
Compliance oversight	Transaction Cost Analysis	50	50	50
Miscellaneous	Trade errors	25	25	25
Total		**1,316**	**1,650**	**2,074**

Beyond those areas listed above, there will also be reduced demands on several other departments within the investment firm:

- In a fully outsourced or component outsourced solution, the assessment of the trade clearing, settlement, reporting and support processes and resources becomes an important element of the evaluation. This is the case as both offerings likely involve the outsourcing of all trading activities through settlement.
- The human resource team may also benefit given that turnover and hiring within the trading team would be eliminated, or at a minimum decline.
- Marginal reduction in IT resources required to support the trading desk.

Managing **the human impact**

The trading desk has often been a center of activity at many investment firms. Many portfolio managers have grown up in the business with a consistent internal trading team. It is important that the portfolio managers are comfortable with the change to an outsourced model and that they build strong relationships with their assigned trader/s at the outsourced firm.

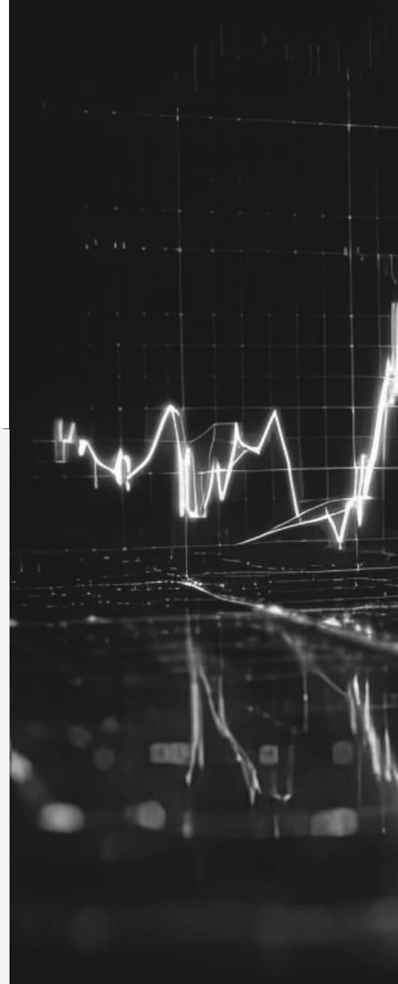
For the internal trading team, the human impact is most significant as there will likely be job losses. We do believe that retaining one member of the trading team to manage the outsourced relationship makes sense for some firms if the person’s time can be maximized with other responsibilities. We have seen examples where the person who is retained can take on further vendor analysis/management responsibilities in areas that affect the investment team. We believe over time that this will become more important as firms increasingly look at ways that investment management focused fintechs can help their businesses.

While the growth of outsourced trading is undoubtedly a threat to internal trading teams, ironically the outsourced trading firms may be where traders find the greatest job opportunities in the years ahead. Many of these outsourced firms are growing, need to add talent and value the experience and insight of individuals from the buy-side. In some cases, depending on the economics of individual outsourcing transactions, it may be possible that a member of the trading team from the firm that has decided to outsource, moves to the outsourced provider and is their assigned trader in the new environment.

Conclusion

In this white paper, we have aimed to outline a framework for evaluating outsourced trading and demonstrated what trading looks like at a firm that decides to outsource.

Given our experience of working within the investment management industry, we believe that the current and growing financial pressures face by many firms highlight the need to focus on core business functions and pursue efficiencies where possible. In our view, a thorough analysis of the potential benefits of outsourced trading is something that many firms should include as part of their assessment.



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Acclinate works with investment managers to help them to thrive in today's environment. Acclinate was founded by Martin Coughlan CFA, CAIA in 2019. Martin spent over two decades working at global investment firms in senior leadership positions.

Acclinate provides asset managers and wealth advisors/platforms with actionable ideas and solutions concerning business and competitive strategy, product development, distribution execution, talent acquisition, technology enablement, and operational efficiency. Acclinate's activities cover two main areas – consulting and technology solutions.

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