Discussion Paper

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Financial Services Authority

Implementing MiFID's best execution requirements

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The Financial Services Authority invites comments on this Discussion Paper. Please send us your comments to reach us by 17 August 2006.

Comments may be sent by electronic submission using the form on the FSA's website at (www.fsa.gov.uk/pubs/discussion/dp06_03_response.html).

Alternatively, please send comments in writing to:

Ric Garvey
Institutional Business Policy
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 9758
Fax: 020 7066 9734
E-mail: dp06_03@fsa.gov.uk

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1 Overview

1.1 The Markets in Financial Instruments Directive (MiFID) will introduce unified European requirements for the best execution of client orders in all MiFID financial instruments[1]. These provisions differ from current UK requirements but are broadly in line with the approach we proposed in Consultation Paper 154 (CP154) *Best Execution* (October 2002).

1.2 In the UK, the policy underlying a best execution requirement is well-accepted: by requiring execution intermediaries to seek the best possible deals for their clients, best execution protects investors and fosters market efficiency.

1.3 In CP154, we proposed that FSA rules on best execution should acknowledge more directly than they do now[2] that execution quality can depend on factors other than price, such as order type, size, settlement arrangements and timing, as well as any other conditions set by the customer. We also proposed that a standard for best execution should reflect costs of execution including explicit costs charged directly to the client, implicit costs that can result if a trade moves the market price for an instrument and the opportunity cost of not dealing. CP154 was, on the whole, favourably received by UK industry and its influence on MiFID is clear.

1.4 Under MiFID Article 21, a firm must take all reasonable steps to obtain the best possible result, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. In support of this process-based approach, a firm is also required to:

- have effective arrangements for complying with Article 21;
- have an 'execution policy' explaining the factors the firm will consider when executing orders and providing information about the 'execution venues' it will use;
- inform clients about its execution policy and obtain their consent;
- assess the execution venues in its execution policy at least yearly and consider including other execution venues;
- monitor the effectiveness of its execution arrangements; and
- if requested, show that a client's order has been executed in line with the firm's execution policy.

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[1] MiFID's best execution requirements can be found in MiFID Article 21, which is set out in Annex 1 to this paper. References in this Discussion Paper to 'Articles' are (unless otherwise indicated) references to Articles in MiFID Level 1.

[2] Chapter 7.5 of our Conduct of Business (COB) Sourcebook is framed in terms of a requirement to take reasonable care to ascertain the best price available and to execute at a price no less advantageous, unless it would not be in the customer's best interest to do so. The chapter also includes more detailed rules and guidance (including exceptions to this general rule).

1.5 The MiFID draft implementing measures[3] (published by the European Commission on 6 February 2006 and referred to in this paper as 'Draft Implementing Measures') impose requirements analogous to those under Article 21 on investment firms providing the service of portfolio management or reception and transmission of orders for execution.

1.6 In addition to the best execution requirements, other provisions in MiFID are likely to affect current UK market practice. For example, under current UK rules, a firm that executes transactions can agree with its intermediate customers (including expert private customers classified as intermediate customers) that it will not provide best execution. There are also exclusions from best execution for certain spread betting, venture capital and stock lending activities. In contrast, MiFID does not provide a mechanism for Member States to exempt particular products or activities from best execution requirements. Although certain clients (eligible counterparties) may transact without any conduct of business (COB) protections[4], MiFID does not permit clients to waive selected elements of the COB protections, such as best execution[5]. As a result, clients may be less able and less inclined to forego best execution and firms may need to set up best execution arrangements in markets where they do not provide best execution now.

Purpose of the Discussion Paper

1.7 In discussion with us, firms and trade associations have said that implementing Article 21 will present some significant challenges:

- understanding how MiFID's new concepts and terminology work in practice;
- working out how the requirements apply to firms in a chain of execution, each of which has some influence over the manner in which client orders are executed; and

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[3] MiFID comprises two levels of European legislation. 'Level 1', a Directive of the European Parliament and Council, was adopted in April 2004. In several areas, including best execution, this Level 1 Directive provides for its requirements to be supplemented by 'technical implementing measures' adopted by the European Commission, so-called 'Level 2' legislation. The Commission has developed draft legislative proposals for Level 2, published on 6 February 2006 – we set out the relevant provisions in Annex 2. As this paper goes to press, the Draft Implementing Measures are being considered by the European Parliament and by Member States in the European Securities Committee ('ESC') under the Lamfalussy process. The ESC is due to deliver its opinion on them in early June 2006. Following a vote in the ESC, the European Parliament will have one month to check that the Draft Implementing Measures are not *ultra vires*. They will then be formally adopted by the Commission. The Commission's current view is that this will probably happen during summer 2006. Proposals from the European Commission may be found at: http://europa.eu.int/comm/internal_market/securities/isd/mifid2_en.htm

[4] See Article 24 set out in Annex 1. Certain investment firms may enter into transactions with eligible counterparties without being obliged to comply with COB protections, including best execution. We refer to this again in Chapter 3.

[5] In addition, MiFID Level 1 Articles 14(3) and 42(4) suspend the COB provisions for transactions concluded between members or participants of a multilateral trading facility (MTF) or regulated market, provided that the transactions are conducted under the rules of the MTF or regulated market. However, members and participants must provide COB protections to their clients when they execute client orders through the systems of an MTF or regulated market.

- in markets where firms currently rely largely on waivers or exclusions, providing best execution arrangements where none existed before.

1.8 We have set the following objectives for this Discussion Paper (DP):

- to explain, in plain language, the Article 21 requirements;
- to focus discussion on key challenges for implementation;
- to identify possible options to meet those challenges;
- to outline, for further discussion with industry, an additional option for providing best execution in dealer markets[6], based on the use of benchmarks; and
- to invite comments on the potential costs and benefits of different options for complying with the new MiFID requirements, to inform proposals for implementation[7] and future Level 3[8] discussions.

1.9 We have included several questions which are intended to draw out other implementation issues that firms expect will be particularly difficult to address without further clarification from regulators.

1.10 Our broad intention here, as with other aspects of MiFID implementation, is to develop through dialogue and consultation an approach to implementation that is as simple and low cost as possible.

Questions

1.11 We have invited responses to a number of questions about issues raised in this DP. We list these questions within the relevant chapters and again in Annex 3. It would help if you used the same numbers in your responses.

Audience

1.12 This paper should be of interest to firms that provide the services of execution of client orders, reception and transmission of client orders for execution and/or portfolio management (portfolio managers, hedge fund managers, introducing brokers, executing brokers and some dealers), as well as the buy-side and users of execution

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[6] Throughout the DP, we refer to investment firms that execute client orders by dealing on own account as dealers.

[7] We plan to publish the *Reforming COB Regulation* CP in October 2006.

[8] At 'Level 3', the Committee of European Securities Regulators (CESR) is charged with promoting supervisory convergence and best practices. CESR may adopt nonbinding guidelines to facilitate coherent implementation and uniform application of Level 1 and Level 2 by Member States. It can also adopt common standards on matters not covered by EU legislation (but these standards have to be compatible with Level 1 and 2 legislation). Once the Level 2 measures are stable (and separately from its work on transposition) CESR will start preparatory work to identify in more detail priorities and timelines for MiFID Level 3 work. It is likely that best execution will be one of the topics identified. We will actively contribute to this CESR programme, to help deliver convergent implementation of the MiFID requirements.

services. In addition, we suggest information vendors and operators of regulated markets and MTFs should read this paper.

1.13 This paper may also prove a useful resource for implementation discussions at the European Commission and in the Committee of European Securities Regulators (CESR). The paper draws on the work undertaken by CESR in preparing its advice to the European Commission on Draft Implementing Measures, and including the responses to consultation undertaken by CESR.

The DP chapters

1.14 This DP has three further chapters: Execution Policy and Arrangements; Dealer Markets; and Review and Monitoring.

Chapter 2: Execution policy and arrangements

1.15 This chapter discusses the MiFID requirements to create and operate effective execution arrangements, including an execution policy. We consider the specific requirements to create an execution policy and to select execution venues for that policy. We also consider what other matters a firm should cover in its execution arrangements.

1.16 We also examine how the best execution requirements may apply to the diversity of market structures and business models adopted by firms. We draw on the work of CESR and present a framework for determining how the requirements could apply, which takes account of a firm's position in any chain of execution. For example, we contrast the position of a portfolio manager that delegates to an intermediary all control over how its orders are executed with the position of the intermediary. We invite comments on whether this framework is helpful and whether there are other approaches.

1.17 A key issue is whether the arrangements a firm must put in place under MiFID allow a firm to direct all its client orders to one execution venue. A firm may prefer to use a single execution venue in several situations. For example, a firm may find it impracticable to access more than one execution venue or intermediary; it may wish to use an affiliated executing broker; or it may wish to execute client orders by dealing on own account. We consider the circumstances in which execution arrangements limited to a single execution venue might be reasonable.

Chapter 3: Dealer markets

1.18 With the implementation of MIFID, firms (including dealers) may wish to transact on terms that attract the COB protections, including best execution[9]. Some dealers have told us that they intend to avoid MiFID's COB requirements entirely by restricting

[9] There is another important issue that this paper does not address: what are the circumstances in which an investment firm may deal on own account without also being viewed as executing client orders? This is a complex issue with wider implications than best execution. We do not cover this issue here. Rather we concentrate on exploring options for complying with the Article 21 requirements, where a client is seeking best execution and a firm is willing to transact on that basis.

themselves to executing orders only for those clients that are classified as 'eligible counterparties'. MiFID does not prevent this. Others have said that restricting themselves in this way is unlikely to be attractive from a commercial perspective[10]. Some in the industry have suggested that dealers wishing to provide best execution could place an intermediary between themselves and their clients, with that intermediary polling multiple dealers to find the best result. These are clearly options available under MiFID. We have considered whether there are other options for dealer markets in view of the potential market failures which best execution requirements address.

1.19 To inform our policy thinking, we commissioned IBM Business Services (IBM) to analyse whether an execution model based on benchmarks was feasible in dealer markets in the UK and, if so, to identify the criteria by which such a model could be evaluated. IBM's report provides a detailed examination of how benchmarks might be used as a means of satisfying best execution requirements. IBM are publishing their report, *Options for Providing Best Execution in Dealer Markets*, at the same time as our DP[11].

1.20 We outline for industry consideration and comment, a new option referencing dealer prices to robust benchmarks. In developing this option, we have drawn on some, but not all, of the concepts and analysis developed by IBM.

1.21 We invite comment about the parameters that might be useful in judging the validity and feasibility of this alternative approach and whether this benchmark model is likely to addresses potential conflicts of interest for dealers providing best execution. We set out how this execution model might work in relevant retail markets – financial spread betting and contracts for differences (CFDs).

1.22 A firm that executes client orders by transacting against its proprietary capital has a potential conflict between its own interests and its obligation to act in the best interest of its clients in obtaining the best possible results because any improvement in price the firm achieves for its client comes out of its own profit. This conflict may damage the client, particularly if an information asymmetry prevents the client from recognising whether a firm is acting in its best interests and particularly where the firm is unlikely to suffer reputational damage from acting in this way.

1.23 In addition, dealer markets may be less transparent than other markets and less transparency tends to lead to information asymmetry not only between dealers and their clients but also between dealers. Executing brokers have traditionally checked prices on available execution venues before executing their client orders. But in dealer markets, if the main competing execution venues are other dealers, it may be difficult or impossible to check competitors' prices before executing client orders. So, a dealer may need to find other ways to validate its prices if it wishes to provide best execution.

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[10] For example, feedback from investment firms and Trade Associations indicates that once MiFID is implemented, portfolio managers, in particular, may be more reluctant to deal with firms that refuse to provide best execution.

[11] IBM's report is available on their website.

Chapter 4: Review and monitoring

1.24 In Chapter 4, we examine the requirements to review a firm's selection of execution venues and to monitor the effectiveness of its execution arrangements and policy. MiFID also requires an investment firm to be able to show to clients, upon request, that it has executed their orders in line with its execution policy.

1.25 To satisfy these requirements, firms will need information on execution quality of different execution venues and information that will enable them to determine whether their own execution has been effective. We invite comments from industry on the challenges of these new requirements and, in particular, about the nature of the data and other information that they will need. There may be commercial opportunities for data vendors and others.

1.26 We also ask how the UK initiative on data aggregation may help firms to access data efficiently and cost-effectively.

1.27 We comment on how MiFID's requirements for review and monitoring may apply differently where there is a chain of execution and suggest this should depend on how much reliance a firm places on other firms to execute its client orders.

Next steps

1.28 The period for comment on this paper runs until 17 August 2006. The feedback will inform our approach to implementing Article 21. We plan to publish a Feedback Statement (FS) for this DP and for our draft Handbook text to appear in the *Reforming COB Regulation CP*, planned for October 2006.

1.29 Both this DP and the *Reforming COB Regulation* CP form part of FSA's consultation programme on MiFID. MiFID is due to be implemented by 1 November 2007.

Consumers

1.30 This paper is important for consumers because MiFID's best execution requirements are intended to produce the best possible results for the execution of their orders to buy and sell financial instruments covered by MiFID. The rules work in two ways: directly on the firm and also by providing clients and prospective clients with information about how the firm goes about executing client orders.

1.31 The information for clients is intended to help consumers make informed choices and gives firms an opportunity to distinguish themselves from their competitors.

1.32 The new MiFID requirements also benefit consumers by requiring firms to take all reasonable steps to obtain the best possible result for their clients, and by specific requirements on how a firm must do this.

1.33 Finally, MiFID provides that a firm must show (on request from the consumer) that it has executed the consumer's order in line with the firm's execution policy.

2 Execution policies and arrangements

Introduction

2.1 In CP154, we explored how best execution requirements should respond to market fragmentation – that is, increasing competition among execution venues. A key principle was that best execution is more than achievement of the best price. Price is significant – but execution quality can depend on other factors as well. So, in CP154, we concluded that the overall result to the client is what really matters.

2.2 Today, markets are no less fragmented; competition among execution venues remains vigorous. MiFID itself may increase market fragmentation by requiring Member States to remove 'concentration rules' – rules which require trades to be executed on particular markets, typically the main national securities exchange[12].

2.3 In this environment, effective best execution requirements will remain a significant part of consumer protection delivered through COB requirements. They prevent a firm from exploiting information asymmetries between itself and its clients which could otherwise operate to disadvantage its clients, damage market confidence and impair the efficiency of the price formation process. Best execution requirements provide a mechanism that tries to correct this potential market failure by, among other things, requiring firms to direct their order flow to execution venues that allow them to obtain the best possible result for their clients' orders on a consistent basis.

2.4 MiFID establishes a new standard, which aims to protect investors, enhance market efficiency and improve price formation. Its requirements are broadly in line with the proposals set out in CP154. Article 21 recognises that best execution is about more than price. It also requires firms to have arrangements for obtaining the best possible results, to monitor the effectiveness of those arrangements and to provide information to clients.

2.5 The framework established by Article 21 is reasonably high level. It does not prescribe in detail how its requirements apply to the diverse circumstances in which client orders are executed. And there are new concepts and terminology. Industry has told us that this new framework presents challenges. Firms are unsure what they should do in order to comply. They are also worried that different regulators will apply these rules differently. At the same time that firms are considering these issues, European regulators also will be working together to achieve supervisory convergence.

2.6 To assist firms and further our European work, in this chapter we explore some of the key new concepts and elements of the regulatory framework, including:

- how best execution requirements apply to chains of execution;
- the emphasis on process in the new requirements; and

[12] The existing UK safe harbour in COB 7.5.6 for certain transactions executed on SETS will also be inconsistent with MiFID (we said in CP154 that we would remove it).

- the factors that a firm will need to consider to identify the execution results that will be best for its clients and what steps it should take to obtain them.

The chain of execution

2.7 Firms that, for example, manage client portfolios or receive and transmit client orders for execution can be regarded as having positions in a chain of execution. Although these firms may not finally conclude the orders, they may nevertheless control some aspects of the transaction that bear upon execution quality. Many select the intermediary that concludes the client order. And some exercise further control over the execution process by instructing their execution intermediaries on how or where to execute.

2.8 We reproduce below the diagrams that the Committee of European Securities Regulators (CESR) set out in its second 2005 consultation paper on best execution[13]. We think these diagrams are helpful in illustrating some of the possible divisions of responsibility in execution chains[14].

Example 1

2.9 A firm may exercise full control over how its client orders are executed, including the selection of the execution venue. For some types of trading, firms may do this on a case-by-case basis, for example, for large institutional orders. This type of arrangement is represented by Figure 1 below.

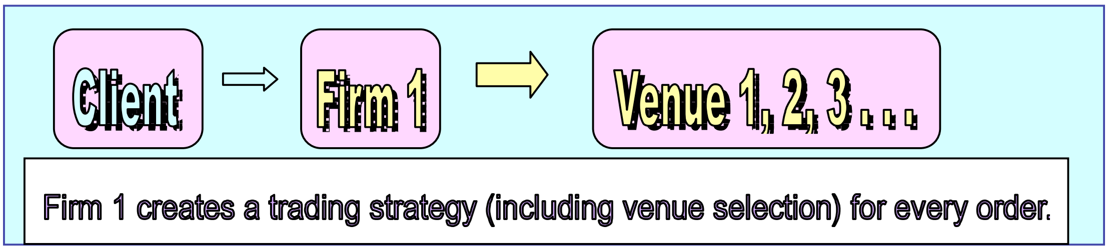

Figure 1

Example 2

2.10 For other types of trading, a firm that retains full control over how its client orders are executed, including selection of execution venue, might determine its trading strategy and/or execution venue choice as a more fixed aspect of its execution model, rather than order-by-order. Depending on the circumstances, it might not be reasonable for this decision to be reviewed for every order the firm receives. This type of arrangement is represented by Figure 2.

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[13] Ref.: CESR105-164, CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial, Second Consultation Paper, March 2005.

[14] In these diagrams 'client' refers to the consumer / end user / owner / position holder and would not, typically, be a firm.

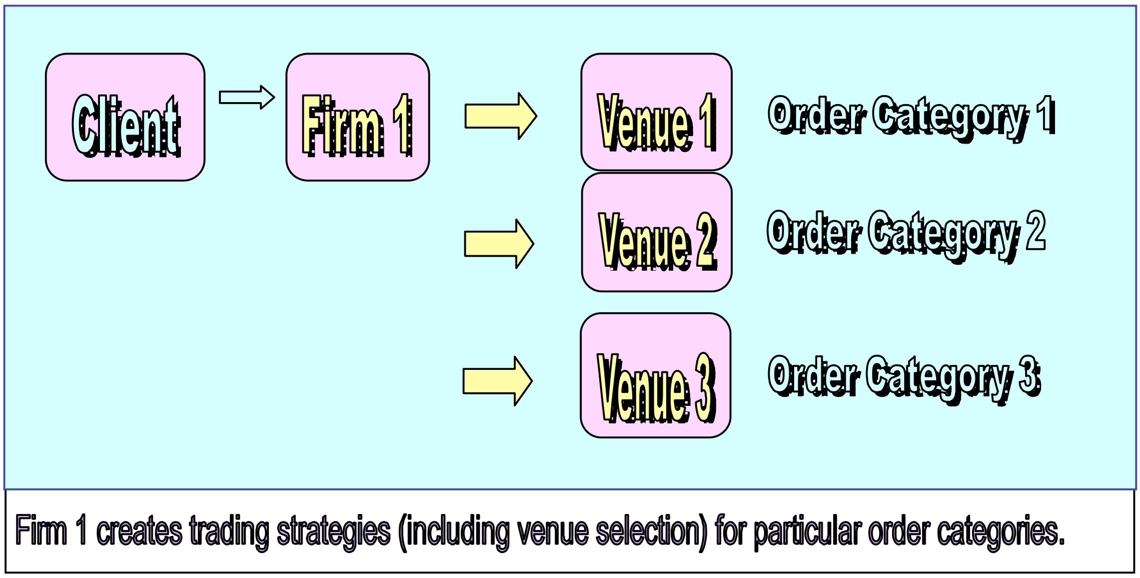

Figure 2

Example 3

2.11 Even when a firm arranges for the execution of client orders indirectly via one or more intermediaries, it may retain significant control over how its client orders are executed. For example, it may instruct an intermediary to use a specific execution venue, to execute immediately or to trade patiently. Many large portfolio managers, for example, retain this level of control over the trading process. A broker also may retain a high level of control when it transmits client orders to a local firm solely to access execution venues that the instructing firm cannot access directly. Split control also occurs in intra-group relationships. These types of arrangements are represented by Figure 3 below.

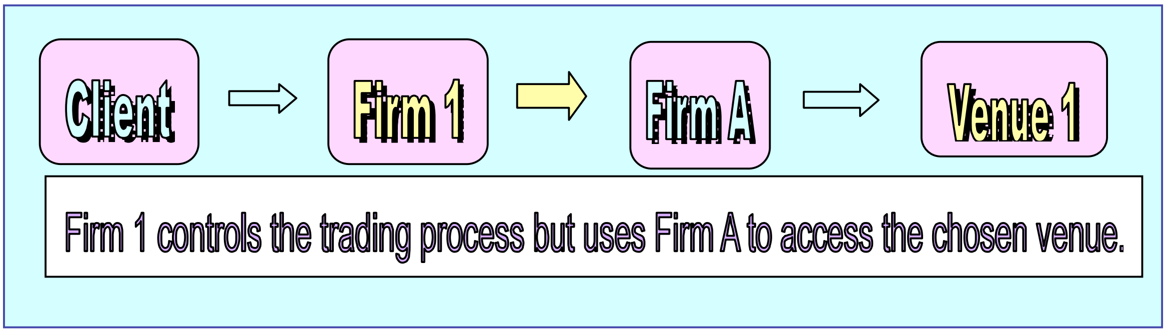

Figure 3

Example 4

2.12 We understand that it is also common for a firm to give substantial or complete control over the trading process to another execution intermediary. (This type of arrangement also may be found in intra-group relationships). See Figure 4 below.

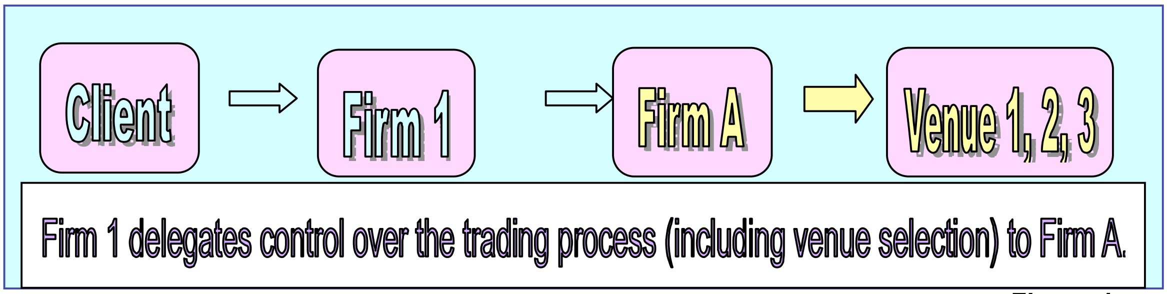

Figure 4

2.13 These diagrams illustrate just four of the many possible arrangements that firms may make for executing client orders. Many firms use one or more of these approaches, executing some orders themselves, using the execution facilities of intermediaries for others and, for a third category of orders, giving control over the trading process to other intermediaries. And there are many different aspects of execution that firms can choose either to control or delegate.

2.14 Although it is appropriate that the high-level MiFID requirements for best execution apply to all the firms in a chain of execution, it could be inappropriate to apply the requirements in the same way to each link in the chain. For example, we do not see why portfolio managers should monitor all the steps that their execution intermediaries take on their behalf in executing their client orders[15]. Rather, each firm's execution policy and arrangements should reflect the nature of the particular services and activities that it performs.

Reception and transmission of orders for execution

2.15 Under MiFID, the investment service of reception and transmission of orders includes 'bringing together two or more investors thereby bringing about a transaction between those investors'. This definition could extend to services that do not involve or lead to the execution of orders on behalf of clients and, for which the best execution requirements would serve no purpose. The best execution requirements apply only to firms that receive and transmit client orders *for execution*[16]. So:

- a broker that receives and transmits client orders to another firm for execution is subject to the best execution requirements;
- an investment adviser that transmits client orders for units in a collective investment scheme, typically, can only execute such orders in one place at one price; technically best execution applies, but as the firm has no discretion over execution venue or price, it should be applied proportionately, taking this into account; and
- a corporate finance firm that is appointed by the vendors of a company to find a buyer is unlikely to need to comply with the requirements because there is no 'order' from a client to be executed.

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[15] The MiFID Draft Implementing Measures support this view, see Recital 63 set out in Annex 2.

[16] See Article 45 of the Draft Implementing Measures set out in Annex 2.

Q2.1: Do you agree with the above analysis which takes a flexible approach to the application of the requirements to firms in a chain of execution, depending on the nature of the activities they perform and the degree of control over the execution of the client orders?

Article 21: A process approach

2.16 Under MiFID, for client orders, the execution method chosen must be the most favourable to the client. Article 21 does not actually demand that firms achieve the best possible result in every case. Rather, the focus is on having a reasonable process for obtaining the 'best possible result'. As we discuss later in this chapter, the other requirements in Article 21 can be seen as supporting this emphasis on process[17].

The execution arrangements and execution policy

2.17 A firm's execution arrangements elaborate its operating processes and procedures for executing client orders. Article 21 and the Draft Implementing Measures guide firms as to some of the topics to be covered but they are not exhaustive and leave it to firms to devise their own particular operating arrangements and principles. We suggest that it is likely that a firm's arrangements will be more extensive than, although consistent with, its policy.

2.18 Key issues for a firm to address in its arrangements and policy are:

- its approach to the factors included in Article 21(1);
- the basis on which it selects execution venues (or intermediaries) for its execution policy;
- information on the execution venues where it executes client orders; and
- whether client orders may be executed outside a regulated market or MTF.

2.19 A firm's execution policy will set out certain core elements of its execution arrangements. Article 21(3) requires that a firm's execution arrangements include:

- 'information on the different venues where the firm executes its client orders';
- 'the factors affecting the choice of execution venue'; and
- 'at least. . . those venues that enable the investment firm to obtain on a consistent basis the best possible result'[18].

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[17] See, for example, the requirements in Article 21 for firms to establish and implement effective arrangements, monitor the effectiveness of those arrangements and correct deficiencies, provide clients with information on those arrangements and demonstrate upon client request that the firm has complied with its execution policy.

[18] See Article 21(3) set out in Annex 1.

2.20 On the second element, the Draft Implementing Measures provide that a firm must articulate in its execution policy not only the factors that affect its choice of execution venues but also the relative importance that the firm assigns to those factors[19].

Relevant factors

2.21 Article 21(1) requires a firm to take account of all relevant considerations when considering how to obtain the best possible result for its clients. We suggest Article 21 does not presume that there is one right answer – the importance and significance of the factors may vary between clients and instruments. And it may be possible for there to be more than one way to execute a particular order and achieve best possible result. We discuss below some issues in relation to these factors.

2.22 **Price.** Price is an important factor for a firm to consider whenever it is possible to execute orders at more than one price. Price is always likely to be relevant, but the best price in a given market at a given moment may not represent the best possible result for many reasons, some of which are suggested by the other factors in Article 21. The Draft Implementing Measures recognise price as particularly important for retail clients[20].

In the context of selecting execution venues for an execution policy, price refers to whether an execution venue generally offers prices that are as good as, or better than, its competitors. For portfolio managers and firms that receive and transmit orders, price also is likely to be a relevant factor in selecting intermediaries to execute their client orders.

2.23 **Costs.** Most obviously, the best price may not offer the best result for a client if it comes with high costs. Costs can be both explicit and implicit. Explicit costs could include transaction costs (for example, settlement costs) and the costs of accessing particular execution venues (for example, costs of the necessary software / hardware to link to an execution venue). Implicit costs result from how a trade is executed (for example, immediately or patiently, in a block, aggregated with other trades, or in segments at different execution venues). A trade may appear more expensive in terms of explicit costs but may be less expensive when implicit costs are considered. For example, a broker that works a large order patiently, preserving the client's confidentiality, may achieve the lowest total costs (and the best net price)[21].

In the context of selecting execution venues for an execution policy, costs refer to whether an execution venue imposes, or its use results in, charges that are higher or lower than its competitors'. For portfolio managers and firms that receive and transmit orders, an execution intermediary's fees and charges are likely to be relevant factors insofar as they differ from those of an alternative intermediary.

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[19] See Recital (56) to the Draft Implementing Measures set out in Annex 2.

[20] See Article 44(3) and Recital 60 of the Draft Implementing Measures set out in Annex 2.

[21] Unlike explicit costs, the impact of implicit costs can only be precisely assessed after a trade is completed and even then, implicit costs are difficult to quantify. Ahead of a trade, a judgment needs to be made about likely implicit costs. No consensus has emerged yet on how this should be done. MiFID does not prescribe how firms should measure implicit costs.

2.24 **Size.** The best price in a market usually represents an opportunity to trade in a particular size (that is, number of relevant securities, contracts, units or the like), which may not match the size that the client wishes to trade. Where the client wishes to execute a larger size, if part of the order is executed at the indicated size, the price for subsequent executions may become less favourable (that is, the market may move). On the other hand, if the client wishes to execute a smaller size, the same price may not be available.

In the context of selecting execution venues in an execution policy, size can refer to the order sizes that an execution venue typically accepts.

2.25 **Speed.** Obviously, prices change over time. The frequency with which they do varies with different instruments, market conditions and execution venues. If a firm considers that the cost of an adverse market movement is likely to be great, speed of execution may be very important. For large orders and orders for less liquid instruments, under certain market conditions other considerations may outweigh speed.

In the context of selecting execution venues in an execution policy, speed can refer to how quickly an execution venue tends to complete an order. When choosing another intermediary, a portfolio manager or firms that receive and transmit orders interested in speed may consider whether that intermediary can achieve speedy execution when required.

2.26 **Likelihood of execution.** The best price may be illusory if the execution venue in question is unlikely to complete the order.

In the context of selecting execution venues for an execution policy, the depth of trading opportunities at an execution venue - and thus, the likelihood that the execution venue will be able to complete the client order - may be relevant.

2.27 **Likelihood of settlement.** Best price also can be illusory if the execution venue offering that price cannot settle according to the customer's instructions.

2.28 **Nature of the order.** The particular characteristics of an order, such as buy, sell, limit order, facilitation order, programme trade, stock loans, are always relevant to how it is executed. So any order constraint may be an important aspect of arrangements to obtain the best possible result.

In the context of selecting execution venues for an execution policy, a firm that needs to execute these types of orders may consider whether and how well an execution venue performs.

2.29 **Any other consideration relevant to execution of the order**. This catch-all category clarifies that firms may consider other matters, provided that they relate to execution. For example, some OTC derivative contracts can be closed ahead of contract maturity by agreement between the two counterparties, whereas a derivative trade on a regulated market can usually be traded throughout the contract life. So, early termination could be a relevant factor.

Q2.2: Do you agree with our views on the relevance of the specific factors in Article 21?

Q2.3: What additional costs will the requirements to have an execution policy and execution arrangements impose on your firm?

Q2.4: Do you agree that price and cost are the most important factors for retail clients?

The 'relative importance' of the factors

2.30 MIFID recognises that while the factors it specifies are likely to be the most important in achieving best execution, it is for the firm to determine the relative importance of these and other factors. The Draft Implementing Measures add to this, listing four criteria to be considered by firms[22].

- the characteristics of the client, including the status of the client as retail or professional;
- the nature of the client order;
- the characteristics of the relevant financial instruments; and
- the characteristics of the execution venues to which an order can be directed.

Our understanding is that many firms already consider these matters.

How many execution venues?

2.31 A key issue for firms is whether they can satisfy MiFID requirements if they include only one execution venue in their execution policies. The question is relevant for:

- firms that can minimise their execution costs significantly by directing all their order flow to a single intermediary or a single execution venue;
- firms that wish to use the execution services of affiliates; and
- firms seeking to execute transactions in dealer markets.

2.32 The test, under MiFID, will be whether, in each of these circumstances, the firm will be able to obtain the best possible results on a consistent basis with only one execution venue. MiFID does not rule this out.

2.33 A firm wishing to use only one execution venue or intermediary will need to demonstrate how this satisfies the requirement for taking 'all reasonable steps'. Depending upon the circumstances, it might be able to do this by demonstrating it has considered including additional execution venues but concluded that, for its business, using only one execution venue or broker (possibly an affiliated broker) enables it to obtain consistently the best possible result for the execution of its client orders. For example, this may be a reasonable approach where a firm's client orders are particularly homogeneous. In such a situation, the chosen execution venue might, for

[22] See Article 44(1) of the Draft Implementing Measures set out in Annex 2.

example, represent the principal pool of liquidity for the instruments concerned. Chapter 3 discusses the issues further in the context of dealer markets.

Dealing on own account to execute client orders

2.34 Article 21 applies to a firm when executing client orders. Some have suggested that a firm that deals on own account, because it is dealing as principal, cannot be subject to Article 21. However, MiFID's definition of systematic internaliser (a firm that deals on own account when executing client orders) makes it quite clear that this suggestion is not consistent with the approach in MiFID[23].

2.35 The Draft Implementing Measures reinforce this point, indicating that dealing on own account with clients by a firm should be considered as the execution of client orders.

2.36 The interaction between the investment activity of 'dealing on own account' and the investment service of 'execution of orders on behalf of clients' raises some difficult questions. 'Dealing on own account' can refer to a firm that uses a proprietary position to fill a client order as well as a firm engaged in purely proprietary trading. But whether or not firms are also dealing on own account, if they are executing orders on behalf of clients, they will need to comply with best execution requirements in Article 21[24].

Client instructions

2.37 MiFID recognises that clients may have particular views about how their orders should be executed and expressly allows firms to respond to these requirements. Article 21(1) provides specifically that firms must follow 'specific client instructions'. However, that provision should not be taken as providing a means for avoiding the best execution requirements. It would not be consistent with the policy objectives of Article 21 for that provision to be regarded as permitting firms (via its terms of business or otherwise) to obtain instructions from clients and to circumvent the best execution requirements.

2.38 Client instructions are likely to address only some aspects of execution. So, even if a firm receives a specific client instruction regarding say, execution venue selection, that firm would need to follow relevant provisions of its execution policy and arrangements for those aspects of the transaction that are not governed by the instruction[25].

Information to clients

2.39 Article 21(3) requires a firm to provide to its clients and potential clients 'appropriate information' about its execution policy. In order for this information to be useful to clients it should include sufficient detail to enable them to make meaningful choices

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[23] Of course, firms are not subject to best execution when they are dealing with other market participants in a regulated market or MTF. See MiFID Article 14(3) and Article 42(4) of MiFID.

[24] As we mention in Chapter 1, there may be a prior question on whether, in the particular circumstances, the firm is executing orders for clients. See Recital 58 of the Draft Implementing Measures set out in Annex 2.

[25] See Recital 57 of the Draft Implementing Measures set out in Annex 2.

about the nature and quality of the execution arrangements. Information about the relevant importance of the factors in Article 21(1), including trade-offs among those factors, is likely to be central[26].

2.40 The Draft Implementing Measures provide that a firm also must disclose to retail clients the execution venues in its execution policy on which it places 'significant reliance'[27]. This allows a firm to focus its disclosure of those execution venues that matter most. It also means that client consent can be focused on the most important aspects of a firm's execution arrangements.

2.41 Article 21(3) also requires that a firm obtain prior consent of its clients to its execution policy[28].

Q2.5: What information will be appropriate in order to enable clients to be sufficiently informed about the execution arrangements of the firm and how will this differ as between retail and professional clients?

UCITS management companies

2.42 Historically, the UCITS Directive limited the ability of UCITS management companies to provide portfolio management services. They could only engage in the management of collective investment undertakings (CIUs). They are now also allowed to provide the service of managing portfolios of investments[29]. This allows them to compete with services offered by MiFID portfolio managers (for example, managing assets owned by individuals).

2.43 As managers of UCITS, UCITS management companies will be exempt from MiFID[30]. However, the UCITS Directive will apply certain provisions of MiFID to UCITS management companies when they manage portfolios of investments[31]. These provisions include Article 19. So, the Draft Implementing Measures (that impose obligations on portfolio managers under Article 19(1) that are analogous to those under Article 21 and 22(1)) are also likely to apply to UCITS management companies when they manage portfolios of investments.

2.44 It would seem that, for purposes of best execution, UCITS management companies present the same issues as other types of portfolios managers.

Q2.6: Are there any best execution issues unique to UCITS management companies?

[26] The second paragraph of Article 21(3) states 'Member States shall require that investment firms provide appropriate information to their clients on their order execution policy'. See also Articles 46(2) and 46(3) of the Draft Implementing Measures set out in Annex 2.

[27] See Article 46(2)(b) of the Draft Implementing Measures set out in Annex 2.

[28] The second paragraph of Article 21(3) states that 'Member States shall require that investment firms obtain the prior consent of their clients to the execution policy'.

[29] See Article 5(3) of the UCITS Directive, which was inserted by Directive 2001/107/EC of 21 January 2002.

[30] See Article 2(1)(h) of MiFID.

[31] See Article 5(4) of the UCITS Directive, as amended by Article 66 of MiFID.

3 Dealer markets

Introduction

3.1 Article 21 applies to the execution of client orders in financial instruments, which include fixed income securities, derivatives and other instruments that are traded over-the-counter (OTC). Other aspects of MiFID will change the way firms conduct business with their clients. One possible consequence is that clients (in particular, portfolio managers) that presently trade in OTC markets without best execution may be more likely to seek those protections once MiFID is implemented.

3.2 In this chapter we:

- explain why clients (in particular portfolio managers) may be more likely to seek best execution;
- outline, for further discussion with industry, an additional option for satisfying MiFID best execution requirements through execution arrangements in dealer markets, which use benchmarks as reference prices;
- seek industry views on possibilities for industry to develop benchmark reference prices; and
- outline how the benchmark model could be applied in retail markets for CFDs and financial spread bets.

Regulatory framework

3.3 Two particular aspects of the MiFID regulatory framework may make it more likely that clients will seek best execution for their orders:

- client classification thresholds; and
- absence of waivers and opt-outs from particular conduct of business requirements.

Client classification

3.4 The MiFID approach to client classification is similar but not identical to our existing approach. There are two types of client under MiFID: retail and professional. In certain circumstances, some clients (such as many financial service companies) can agree to be treated as 'eligible counterparties' and subject to a light-touch regulatory regime that does not require the firm they deal with to comply with the best execution requirements.

3.5 But under MiFID, the criteria for classification as a retail client are more widely drawn than those for classification as a private customer under existing FSA rules. And as the criteria for permitting a client to move to a higher category are more restrictive under

MiFID than existing FSA rules, it will be more difficult for retail clients to be treated as professionals[32]. It is likely that some clients who are currently classified as intermediate customers will be retail clients under MiFID.

3.6 In general, retail clients will need to be provided with the protections afforded by the various COB requirements in MiFID, including best execution. MiFID also provides COB protections to professional clients but they may be reclassified and thereby forego those protections. Eligible counterparties do not get any of the COB protections from a firm unless they request them and the firm agrees to provide them. These choices can be made transaction-by-transaction or for all transactions.

3.7 The flexibility in these provisions means that firms providing the service of portfolio management, which ordinarily would be classified as eligible counterparties, may request treatment as professional clients to obtain COB protections, including best execution (from, in particular, dealers).

3.8 MiFID is unlikely to preclude a firm from doing business only with eligible counterparties – and some firms may wish to adopt this as their business model. But firms (including dealers) that seek to do business with retail or professional clients, will need to provide best execution for such customers.

3.9 As explained in Chapter 1, this DP does not examine whether there are circumstances in which a firm may deal on it own account without being viewed as executing client orders.

Changes to current FSA waivers and opt-out provisions

3.10 We have in the past created exclusions from best execution requirements for certain spread betting firms. MiFID does not allow Member States to grant exclusions from particular requirements. So, these firms will need to provide best execution to their retail and professional clients. We understand that retail clients are particularly active in this market, so MiFID presents particular challenges. We discuss possible options below.

3.11 Under existing UK rules, intermediate customers may agree with a firm that best execution will not be provided. Some intermediate customers, including expert retail customers who have opted up to intermediate customer status, take advantage of this and some firms, for example those operating in certain dealer markets, purport to operate only on this basis. Intermediate customers that will not be classified as eligible counterparties under MiFID must be provided best execution once MiFID is implemented.

Q3.1: Do you agree that under MiFID there may be demand from retail and professional clients for best execution in relation to financial instruments typically available from dealers? If so, how significant is this likely to be?

[32] MiFID uses both qualitative and quantitative thresholds. Our current regime uses only a qualitative assessment of the experience and understanding of the customer.

Implementation challenges and options for dealers

3.12 Dealers have told us that, as a result of these provisions MiFID will present new challenges for them.

3.13 The impact of MiFID would seem to be that firms operating as dealers in OTC markets have at least the following options:

- not to provide best execution at all, conducting business only with eligible counterparties under Article 24;
- to provide best execution through intermediaries, for example, interposed agency brokers; or
- to effect transactions on a MTF or a regulated market.

3.14 Some have suggested that a dealer subject to Article 21 could comply by operating on a request-for-quote basis and then deem any resulting orders as 'instructions' to deal at the quotes provided[33]. We do not consider this to be consistent with the provision in Article 21 on client instructions but rather an avoidance device.

3.15 We have considered whether there are other options for dealer markets where dealers wish to provide best execution. We looked first at the market failures which the best execution requirements address.

3.16 A dealer provides liquidity to the markets by dealing on its own account. That is, by trading its inventory and managing the risks associated with being either long or short in the financial instrument. Best execution requirements in MiFID require a firm, when executing a client (retail or professional) order to take all reasonable steps to provide the best possible result on a consistent basis. In economic terms, this could create a misalignment between a firm's incentive to maximise its profits and the firm's commitment to provide best execution to clients. In regulatory terms, this is a conflict of interests. Where there is a information asymmetry between the firm and its clients, there is scope for the firm to favour its own interests over the interests of its clients and to deliver less than best execution.

3.17 In considering how the dealer's conflict can be managed, it is important to bear in mind that MiFID best execution requirements serve two policy objectives. These are investor protection and market efficiency. Typically, information asymmetry weakens the position of an investor in relation to its counterparty. This is the case in many dealer markets – although the degree of asymmetry varies across products and markets and between different sized firms and retail and professional clients. Market efficiency is enhanced where a buyer and a seller seek to trade at the keenest price that suits their circumstances. The MiFID requirement to take all reasonable steps to obtain the best possible result promotes market efficiency.

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[33] See Article 21(1) set out in Annex 1.

Managing the conflict through the use of benchmarks

3.18 We considered that it might be possible for a dealer to manage its conflict of interest by referencing its price to other available prices in the market. That is, be based on, or linked to, an external price (such as the best visible bid and offer).

3.19 To inform our policy thinking we commissioned IBM to analyse whether an execution model based on benchmarks was feasible in dealer markets in the UK and, if so, to identify the criteria by which such a model could be evaluated. IBM's report, *Options for Providing Best Execution in Dealer Markets*, sets out their analysis and findings. They concluded that an execution model incorporating benchmarks was feasible for a range of dealer markets in the UK, with differing degrees of confidence along a spectrum of liquidity. We have drawn on IBM's work in developing a benchmark execution model which we set out in the rest of this chapter. We are seeking further discussion with industry on whether it could be a useful additional option for firms.

3.20 A benchmark model of execution would use a benchmark reference price as a proxy for other available prices in the relevant market and reference its price to that benchmark. For example, the dealer could execute at a price which was 'x' basis points above (or below) the benchmark reference price for that particular type of client order. In this way, the client would gain confidence that the dealer is providing the best possible result rather than trading in favour of his own book to the disadvantage of the client because the dealer's price would be referable to an externally verifiable price.

3.21 In this model, the dealer can be regarded as a single execution venue. For the single execution venue model to satisfy Article 21, the execution venue must offer the best possible result for the execution of client orders on a consistent basis. In an agency context, there is usually a separation between a firm executing a client order and the execution venue where it executes that order. In dealer markets, this may not be the case. A firm that executes client orders by dealing on own account is, for the purposes of best execution, an execution venue. If a dealer includes only itself in its execution policy, it must ensure that it provides the best possible result on a consistent basis. By referring its price to an external benchmark price (a proxy for other available prices), the dealer could be taking reasonable steps to deliver the best possible result for the client.

3.22 Where in a particular dealer market there is a dominant execution venue that attracts a large pool of liquidity then it is likely that execution venue could provide suitable benchmark prices.

Possible characteristics of a robust benchmark model

3.23 We suggest that a robust benchmark model for executing client orders which is likely to satisfy MiFID's best execution requirements would need to:

- use benchmarks which draw on externally verifiable reference prices; and
- identify as accurately as reasonably possible the best possible result on a consistent basis for the financial instrument.

3.24 A benchmark reference price not drawn from an externally verifiable source is unlikely to satisfy clients that the firm's conflicts are being managed. In addition, for a benchmark reference price to be a reliable proxy for other available prices it must have integrity – that is, be an accurate reflection of real prices for the relevant instrument. A benchmark reference price that is not an accurate reflection of real prices provides the dealer with an opportunity to price in its own favour. This is unlikely to satisfy Article 21.

3.25 Ideally, a benchmark reference price would be drawn directly from a relevant pool of liquidity. In some markets, there is price information, but it is not readily available and therefore may not be suitable as a benchmark reference price. Relevant pools of liquidity exist for some OTC markets, including liquid fixed income securities and interest rate swaps and certain other derivatives. These markets have a number of dealer-to-client (B2C) e-trading platforms which may provide appropriate benchmark reference prices. When the transactions on the B2C platforms are of a comparable size and nature to those the dealer is executing with its clients, then the B2C prices may provide an externally verifiable reference price that will also identify with a high degree of accuracy the available market price for the relevant client order.

3.26 We understand there is information available – both pre- and post-trade – on prices of instruments that are reasonably liquid. Where there are lower levels of liquidity, by definition, less information will be available. In such cases, it may be possible to reference a benchmark price for a different instrument that is more liquid. For example, a cash price could be referenced to the future or forward price or vice versa. But we are less clear about the criteria necessary for an indirect benchmark to have sufficient integrity, particularly where such a benchmark price is less directly relevant to the particular type of instrument. This is discussed further below.

Mid-price or bid / offer price as benchmark

3.27 We seek the views of firms on whether the benchmark reference price should be best bid (or offer) or the mid-price at the pool of liquidity. We understand that many of the MTFs provide this information.

Q3.2: Do you consider that the benchmark execution model may provide a useful additional approach by which dealers may be able to satisfy the best execution requirements? If so, in what markets will it be of most use?

Q3.3: What would be the likely costs of this approach?

Q3.4: What particular characteristics of reference prices make them suitable benchmarks for particular instruments or in particular circumstances?

Constructing dealer prices from indirectly relevant benchmark reference prices

3.28 A benchmark for one type of product, order size or the like may also be relevant as a benchmark reference price for similar, although not identical orders. For example, a benchmark reference price for a large size order may be a relevant benchmark reference price for a much smaller size order. In these circumstances, a dealer is likely to wish to trade at a price that is greater (or less) than the benchmark. As it is not exactly the same, the dealer may wish to construct a price which is based on the benchmark reference price, but which is extrapolated to the particular type of client order. The constructed price will be the relevant price for best execution purposes. The standard in Article 21 – that the dealer must take all reasonable steps – would require the dealer to have confidence that its method of constructing prices was likely to provide the best possible result. The process of construction should not be subjective (in order to manage the conflict).

3.29 We understand that for some financial instruments, the relevant benchmark reference price may be the current price of a different financial instrument, or even possibly, a financial or economic indicator (exchange rate; interest rate; or an index). Here, the benchmark reference price would be the available price in the reference asset or instrument. If that reference price was extrapolated to obtain the best execution price, then the reference price should be disclosed.

Q3.5: Do you agree that a dealer could construct its prices by extrapolating from indirectly referable benchmark prices and thereby satisfy MiFID's best execution? Please give examples for specific financial instruments.

Q3.6: In what circumstances could financial or economic indicators or indices be relevant benchmarks?

Charging for best execution

3.30 If it wished, a firm could charge its clients a separate fee for best execution. For example, a dealer could charge a commission for providing best execution. Firms in other contexts – for example, agency brokerage – charge the client for the financial instrument and add a separate commission. An agency broker does not need to compare its commission to the commission charges of any other firm to establish best execution.

Q3.7: Would dealers consider charging clients an additional fee or commission for providing best execution?

Disclosing benchmark reference prices

3.31 We propose that dealers using a benchmark model should inform their clients about the benchmark reference price and the dealer's constructed price (if different). Firms may reasonably disagree on the values to be attributed to factors relevant to the constructed price such as credit risk or ability to unwind a position. This will be relevant information about the firm's execution arrangements and clients may select dealers on these criteria.

3.32 In OTC markets, trading in some derivatives involves a bilateral contract that continues until the position is closed – for example, an interest rate swap. This type of contract involves credit risk for both parties (managed in some cases by margin arrangements). Also, when the client wishes to close the position ahead of contract maturity, then the client can only achieve this via a second transaction with a dealer. If the client is not an eligible counterparty then the dealer would need to provide best execution for this subsequent transaction[34].

3.33 For derivatives that are traded on a regulated market, there are transparent market prices and closing the position is straightforward. However, it is unlikely that the contract in question could be traded on a different exchange.

3.34 There are also some aspects of a dealer's price which reflect the dealer's view of the client. For example, client credit risk, counterparty limits and prudential issues may legitimately differ among firms. In a market that trades net, these factors could be included in the dealer's price.

Spread limits

3.35 Under a benchmark execution model, we consider it should be possible for firms to operate with limited intervention by traders. We consider this should be feasible, for example, under arrangements where a firm agrees with its clients a spread limit. In this situation, a firm would have an execution policy which tells clients that the firm's price will be not more than 'x' basis points away from the benchmark reference price[35]. The benchmark reference price would be disclosed to the client but in this situation, the client knows that it will not pay more (or receive less) than the agreed spread limit. But, as Article 21 requires firms to obtain the best possible result, firms would have to be able to demonstrate that 'x' was likely to give that client the best result on a consistent basis unless it was expressed as a commission.

Internal benchmarks

3.36 For some OTC markets there may be few pools of liquidity, such as e-trading platforms, which provide sufficient externally verifiable information about available prices which could be useful in constructing a benchmark reference price. This may be the case for bespoke derivative products, for example. We explore here whether a dealer may be able to satisfy Article 21 for such products and for other infrequently traded instruments in the absence of external price sources, by using an internal benchmark.

3.37 In using an internal benchmark, a dealer would still need to meet the Article 21 standard to take all reasonable steps to provide the best possible result. An internal benchmark would need to be robust enough to manage the conflict between the dealer's interest in maximising its profits, on the one hand, and providing the best possible result to the client on the other. An internal benchmark would allow the firm to include a client-specific commission or spread.

3.38 Firms routinely value their inventory for risk management purposes. IBM proposed that a valuation model used by a firm for its risk management or P&L purpose may

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[34] An alternative to closing an existing bilateral contract is for the client to enter into a second contract which has the effect of hedging the existing position.

[35] Where 'x' could be zero for particular types of orders for example, or something greater than zero for orders with other characteristics or to account for specific characteristics of the client.

provide the basis for an execution model based on an internal benchmark. IBM discussed other ways of constructing an internal benchmark.

3.39 However, we have strong reservations about whether, in using an internal benchmark, a firm could adequately manage its conflicts. But we are interested in the views, particularly of clients of dealers, as to whether they would find such an approach helpful. In many cases, dealers making prices in these products will take into consideration factors other than the cost to construct. Their own risk management will be an important influence – which they may be unwilling or unable to manage out of the price.

Q3.8: Are there any circumstances in which an execution model which uses internal benchmarks could be sufficiently robust to satisfy the best execution requirements? If so, what?

Proprietary 'flow' information and acting in the best interest of the client

3.40 Two factors that currently influence the prices offered by a dealer are the position of its book and trade flow information. This information is 'proprietary' to the dealer. Information on trade flow can have significant value as an indicator of market movements.

3.41 A challenge for dealers providing best execution is whether proprietary information presents too great a conflict with requirements to provide the best possible result.

3.42 The position of a dealer's book will also influence the prices at which it will want to trade. It is common for a dealer's spread around a market price to be asymmetrical. The challenge for the dealer using a benchmark model will be how to respond to a client who wants to execute an order where the dealer's desired price is unlikely to be best price in the market (for example, because the dealer would prefer to sell rather than buy). We suggest that a dealer could, in these circumstances:

- be ready to deal at the benchmark price even though this may be away from the dealer's preferred price;
- deal at the benchmark price plus a commission; or
- decline to deal on a best execution basis.

Possible sources of external benchmark reference prices

3.43 We are interested to hear from the industry on available or potentially available benchmarks. We have identified some possible options:

- multi-dealer to client (B2C) e-trading platforms;
- inter-dealer (IDB) platforms;
- iBoxx and iTraxx (for bonds and credit derivatives respectively);

- trade association benchmarks (such as BBA[36] LIBOR); and
- synthetic or specifically constructed benchmarks, drawing on available other prices or other relevant information.

3.44 For trade association benchmarks there is a precedent in BBA LIBOR – an industry benchmark interest rate for inter-bank loans. It is used by firms to construct prices for certain financial instruments. The BBA LIBOR benchmark is a synthetic benchmark, constructed from banks' pricing arrangements, that has gained market integrity and broad acceptance because it has multiple inputs and is externalised.

Q3.9: What are your views on the possible benchmarks identified in paragraph 3.43? Are there other potentially available benchmarks?

Q3.10: Would trade associations be willing to develop such benchmarks for the purposes of best execution? If so for what products / instruments?

Application of the benchmark execution model in the retail market: financial spread bets and CFDs

3.45 Financial spread betting firms and firms providing CFDs offer products to clients by taking proprietary positions. Financial spread bet products are manufactured by the firms who sell them to clients. The prices of the products are set by the firm and, while the pricing is typically linked to the market prices of the underlying instruments, they need not be. In any event, the prices offered to clients will include an element of remuneration / revenue for the firm. Financial spread bets are CFDs. In this section, we consider best execution for these types of products.

3.46 Trading in financial spread betting products and CFDs has been growing, most notably by retail clients, as they offer a number of advantages:

- margin trading
- no commission
- short trading (as well as long)
- on-line dealing
- mechanisms to limit risk
- no stamp duty (for equities)
- out of hours trading
- for spread bets, no capital gains tax

3.47 Most financial spread bets are linked to an underlying instrument or investment such as a share price or an index. CFDs are usually based on equity instruments but the structure can be, and is used for, many other underlying instruments.

3.48 There are three components of the price of a financial spread bet or equity CFD:

- the price of the underlying instrument;

[36] BBA refers to the British Banking Association.

- the charges added by the firm (usually by means of a mark-up or mark-down to the price of the underlying) or the firm will be remunerated by means of commission; and

- the cost of financing – the cost of maintaining the position over time. This cost does not (usually) affect directly the price quoted by the firm prior to execution.

3.49 When executing, a firm may (but will not necessarily) acquire the underlying instruments as a hedge against the financial spread bet sold to the client. Similarly, an equity CFD can be constructed by a firm acquiring (although not necessarily) the underlying equities and then adding a CFD wrapper.

3.50 A client who purchases a financial spread bet does not necessarily obtain rights to acquire the underlying instruments, only the cash differences arising between purchase and sale prices. The transaction in the underlying instruments is one step removed from the client's direct interest. However, even if the client is directly interested in only the wrapper, he has a legitimate economic interest in the contents of the wrapped product.

3.51 The benchmark execution model could be used for financial spread bets and CFDs in the following way. The firm selling the spread bet is analogous to a dealer executing a client order in a dealer market. The dealer could source a relevant pool of liquidity for the underlying and use this as the benchmark reference price (provided it satisfied the relevant criteria described above). The price for the spread bet could be a price constructed from this benchmark reference price plus other charges. The firm may not always acquire the underlying financial instruments. The firm might have an alternative method to hedge the risk or may choose not to hedge but to take a risk position. Whether or not the firm chooses to acquire the underlying, the client should not receive a price which is in any way less favourable than if the firm were to acquire the underlying financial instruments seeking to obtain the best possible result on a consistent basis.

3.52 This approach would protect clients and facilitate market efficiency.

3.53 Firms offering financial spread bets and equity CFDs may be able to satisfy the requirements of Article 21 in this way. Such firms would need to disclose appropriate information to clients on their order execution policy such as:

- an explanation of the way in which the firm's prices for financial spread bets and CFDs are constructed including details of the charges applied by the firm to the price of the underlying (the benchmark reference price);

- an explanation of how the price of the underlying is determined, including confirmation that the firm seeks to identify the best possible result on a consistent basis for the underlying financial instruments (irrespective of whether the firm actually acquires the underlying financial instruments);

- details of the financing charges that are applied for margined positions; and

- other information to enable the client to check and confirm the pricing calculations.

3.54 This approach has potential for other structured products that are manufactured from two or more financial instruments. Best execution for a structured product would mean applying best execution to each of the component financial instruments, regardless of whether the dealer actually acquired the financial instruments. The price of the structured product would be the combination of the best execution prices of the components plus any charges or remuneration applied by the firm. This process manages the conflict between the dealer's objective of making profits and the requirement to deliver best execution.

3.55 Disclosure to clients would need to be sufficiently comprehensive to allow them to see how the structured product was priced.

3.56 In presenting this benchmark execution model, we have focused above on the specifics of how dealers may construct prices to meet the requirements of Article 21. Of course, dealers executing client orders must comply with all of the other requirements of Article 21 as well.

Q3.11: Do you agree that the benchmark execution model can work for financial spread bets and CFDs?

4 Review and monitoring

Introduction

4.1 MiFID does not prescribe particular requirements for market access or require firms to deliver the best possible result for every order. It leaves firms free to establish their own arrangements, so long as they meet the standard of taking all reasonable steps to obtain the best possible result. There are two particular requirements to ensure that a firm's arrangements meet that standard. A firm must:

- assess, on a regular basis, whether the execution venues in its execution policy allow it to obtain the best possible execution results for its clients on a consistent basis (the requirement to review)[37]; and
- monitor the effectiveness of its execution arrangements in order to identify and, where appropriate, correct any deficiencies[38] (the requirement to monitor).

4.2 These requirements are important controls, making Article 21 self-enforcing.

4.3 In this chapter we discuss:

- what the requirements to review and monitor mean for firms;
- how the two requirements differ;
- the key challenges facing firms when reviewing and monitoring; and
- the data that will help firms review and monitor.

4.4 As with the other requirements in Article 21, the review and monitoring requirements will apply to firms that execute client orders, manage client portfolios or receive and transmit client orders for execution. As we said in Chapter 2, our view is that what is required will depend on the nature of a firm's arrangements and its position in any chain of execution.

The requirement to review

4.5 Article 21(4) requires an investment firm to assess regularly whether the execution venues included in its order execution policy provide the best possible result for its client orders. The Draft Implementing Measures supplement this by providing that a firm must review its execution policy and its execution arrangements at least yearly[39]. Article 46(1) of the Draft Implementing Measures also clarifies that more frequent review may be appropriate if there is a material change (for example, if a significant new execution venue emerges).

[37] See Article 21(4) set out in Annex 1 and Article 46 of the Draft Implementing Measures set out in Annex 2.

[38] See Article 21(4) set out in Annex 1.

[39] See Article 46 of the Draft Implementing Measures set out in Annex 2.

4.6 The review requirement is likely to be an important driver of market efficiency. It reinforces the requirement to direct execution business to the most appropriate execution venues, rewarding those execution venues that provide the best execution opportunities. In conducting its review, a firm should look beyond its existing arrangements at other execution venues it could potentially access. The objective of the review is to identify changes in execution arrangements and policy that could improve the quality of the execution service the firm provides to its clients.

4.7 The criteria for assessing execution venues should relate to the factors in Article 21(1) and the relative importance the firm assigns to them[40]. A review of execution venues will be facilitated by appropriate execution data. We discuss data availability below.

Material changes

4.8 The Draft Implementing Measures require a firm to review its execution arrangements whenever there is a material change that affects its ability to obtain the best possible results for the execution of its client orders. Whether a change is material will be a different judgement for each firm, because materiality will depend on the nature and size of a firm's business. For example, it may be reasonable to expect a retail broker to review its execution venues if a dealer it does not use significantly increases its presence in a market relevant to the retail broker.

4.9 On the other hand, a portfolio manager with an extensive list of brokers may not need to review its execution policy just because another broker begins offering execution services. In this case, if the impact of the new entrant is likely to be small, action before the next review date may not be justified.

The requirement to monitor

4.10 Monitoring 'effectiveness' is likely to mean checking whether a firm's arrangements are effective in helping it obtain the best possible result for its client orders.

4.11 We suggest two areas that a firm may need to monitor in order to establish the effectiveness of its execution arrangements and execution policy:

- **Compliance with the firm's own execution policy and arrangements.** If a firm does not execute its client orders in accordance with its execution policy and arrangements, it will not be possible to test their effectiveness. In addition, monitoring compliance with its execution policy positions a firm to demonstrate, when requested, that it has executed client orders in accordance with its execution policy[41]; and

- **Whether the firm is actually obtaining the best possible result for its clients and if not, why not.** We suggest two comparisons are likely to be relevant:

[40] See Article 46(2) of the Draft Implementing Measures set out in Annex 2.

[41] See Article 21(5) set out in Annex 1.

- comparison of the execution quality a firm obtains from the execution venues in its execution policy with similar transactions on the same execution venue (to test whether the firm's judgements about how to execute its client orders are working as well as they might to deliver the best possible result for its client orders); and

- comparison of the execution quality a firm obtains with similar transactions executed at the other execution venues in the firm's execution policy (to test whether the firm is choosing the 'best' execution venue among the execution venues in its execution policy).

Monitoring best possible result

4.12 In CP154, we suggested the *process* for monitoring execution quality may involve:

- deciding on coverage (size and nature of the sample of transactions to be selected for monitoring and evaluation);

- selecting comparative data against which to measure the execution quality of the sample;

- deciding how items in the sample will be evaluated against comparable transactions, for example, determining the relevant assessment criteria;

- identifying 'outliers' (client transactions that appear out of line with comparative data); and

- investigating, evaluating and explaining outliers.

4.13 In a survey undertaken for CP154, *frequency* of monitoring ranged from daily to quarterly, although some firms did not monitor at all. We suggest the frequency of monitoring should reflect the volume and frequency of a firm's activity and so enable trends to be identified that merit closer examination by the firm.

4.14 In response to CP154, some firms suggested we should not mandate sampling as the preferred methodology for execution quality monitoring. MiFID leaves decisions about the choice of monitoring methodology to firms.

Correcting deficiencies

4.15 Article 21(4) requires a firm, where appropriate, to correct deficiencies identified by its monitoring. In particular, monitoring may indicate that a firm's arrangements for directing orders to a particular execution venue are not adequate and should be corrected.

Review and monitoring in different contexts

4.16 As discussed in Chapter 2, best execution requirements will apply to firms providing the services of execution, order reception and transmission for execution and portfolio management. We recognise that it may be appropriate for these different types of firms to have different approaches to review and monitoring.

4.17 We suggest that the principles for monitoring by firms such as brokers that select execution venues, also apply to portfolio managers and brokers when they select other firms to undertake some (or all) aspects of the execution process. However, the precise application of those principles may vary depending on the nature of service offered to clients, for example, where a firm sits in a chain of execution.

Firms that execute client orders

4.18 A firm which selects execution venues for the execution of its client orders will need to monitor the execution quality it obtains from the execution venues included in its execution policy. These execution venues are likely to be regulated markets, MTFs and dealers.

4.19 For example, a retail broker whose execution arrangements provide that it will execute its client orders at one of three dealers will need to review at least annually whether these execution venues continue to provide the best possible result to its clients on a consistent basis. As part of this review, a firm probably will need to compare execution quality delivered by its existing dealers with execution quality available elsewhere. The purpose is to assess whether the firm should connect to any other execution venue. The firm also may need to consider execution venues other than dealers.

Portfolio managers and receivers and transmitters of orders

4.20 Portfolio managers will need to monitor the execution quality they obtain from the firms or execution venues that they use. Firms that receive and transmit client orders for execution rather than executing themselves, must monitor the execution quality obtained.

4.21 For example, a portfolio manager that uses only one firm (executing intermediary) may need to compare the results that firm has delivered with the results delivered by other firms in the market and with any information that may be available about transaction quality in the market as a whole. The results of the review may justify the portfolio manager's use of a single execution intermediary or it may suggest that the portfolio manager should change firms or add additional firms.

4.22 To take another example, a portfolio manager's execution arrangements might include other firms, direct access to regulated markets and/or MTFs and direct access to dealers (for example in the fixed income market). In this case, the portfolio manager will need to assess whether any of these execution venues provide the best possible results on a consistent basis. And this review should include consideration of brokers, dealers, MTFs, regulated markets and other execution venues not included in the execution arrangements. Some portfolio managers already conduct a type of review by means of broker voting systems, which compares the quality of the service provided. But this process often includes considerations other than execution quality (for example, quality of research) and may not extend to intermediaries or execution venues that the firm does not currently access.

4.23 In general, as we suggested in Chapter 2, MiFID should not require the arrangements and policies of portfolio managers to duplicate the steps taken by the firms they use to execute their client orders[42]. Similarly, in relation to monitoring, such firms should need to monitor the effectiveness of their arrangements, in particular, covering the decisions they take that affect execution quality.

4.24 If a portfolio manager does not deal through an executing broker, instead preferring to access a regulated market, MTF or dealer directly, then the portfolio manager's monitoring is likely to mirror that of an executing broker.

Dealers

4.25 Dealers that execute client orders in any MiFID financial instrument will be subject to MiFID best execution requirements, except where their clients are eligible counterparties and best execution need not be provided[43]. We outlined in Chapter 3 an execution model for dealers that wish to execute client orders and provide best execution by referencing robust benchmark prices. We discuss here what the review and monitoring requirements might mean for dealers providing best execution using that model.

4.26 We believe that a dealer providing best execution to its clients will be able to monitor compliance with its execution policy. It should also be possible for dealers to monitor the judgements they make about the best possible result and how to obtain it for their clients. For example, a dealer that implements a benchmark execution model could monitor whether its execution arrangements are providing for the best possible result on a consistent basis. Monitoring execution quality in this context might mean monitoring prices given to clients against the benchmark price at the time the trade was executed.

4.27 Our understanding is that in certain segments of the bond market, firms can access pre-trade data to facilitate monitoring. For example, The Bond Market Association's (BMA) recently published, *2005 Review of Electronic Transaction Systems* states:

4.28 'Of the 54 respondents to the Association's 2005 trading system survey, 50 provide users with some form of pricing information before trade execution. A number of trading platforms make their transaction information available to market participants who do not trade on their platforms, either directly or through third-party data vendors.'[44]

4.29 In relation to the review requirement, as we said in paragraph 4.6 above, a firm reviewing its execution venues should look at execution venues it could potentially access across the whole market. For a dealer using a single multi-dealer platform to get benchmark prices for liquid debt securities, this could mean reviewing other pools of

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[42] See Recital 63 of the Draft Implementing Measures set out in Annex 2.

[43] As we mentioned in Chapter 1, dealing on own account that does not involve the execution of client orders will not be subject to best execution requirements either.

[44] *eCommerce in the Fixed Income Markets: The 2005 Review of Electronic Transaction Systems*, The Bond Market Association, December 2005.

liquidity to ensure that its benchmark continues to have integrity – that is, it continues to provide the best possible result on a consistent basis. There are a number of multi-dealer platforms currently operating in the fixed income market and it may be reasonable to expect a dealer to review other platforms, or other pools of liquidity. The BMA's report is again helpful:

4.30 'A majority of electronic platforms allow users to view prices of executed transactions. Of the 54 respondents to the 2005 survey, 27 platforms allow their users to view at least the last traded price for a security or product and most of those allow users to view all recent transactions. Of those respondents who publish data on trades executed on their platforms, 20 make those data available to market participants who do not necessarily trade on the platform and 26 make the data available to data vendors for redistribution. An even larger majority of electronic trading platforms – 40 respondents in total – publish executable quotations'.

4.31 Multi-dealer platforms are not limited to government or corporate bonds. The range of financial instruments traded on electronic platforms (Inter-dealer and Dealer to customer platforms) include[45]:

- interest rate swaps
- CDS index tranches
- credit default swaps
- securitised derivatives
- exchange-traded funds
- futures
- exchange-traded options
- floating-rate notes
- OTC options
- forward FX
- structured notes
- FX options
- mortgage-backed securities
- asset-backed securities

4.32 The BMA's 2005 survey also reports on some future trends for electronic trading, including the growth of trading in OTC derivatives (particularly credit default swaps) on electronic trading systems and a magnified effect of enhanced price transparency on how bonds are traded. The range of instruments traded on electronic platforms, and available pricing information, should be helpful for dealers wanting to provide best execution to clients in OTC markets. This information should also be helpful to portfolio managers in providing best execution to their clients.

Q4.1: Do you agree with our analysis of the requirements to review and monitor?

Q4.2: On monitoring: do you agree with the comparisons suggested in paragraph 4.11? If not, how would you assess the effectiveness of your arrangements? Will firms monitor their trading on a daily, weekly or monthly basis?

Q4.3: On reviewing: do you conduct qualitative or quantitative reviews of brokers, regulated markets or MTFs now? If so, how frequently?

[45] See *eCommerce in the Fixed Income Markets: The 2005 Review of Electronic Transaction Systems*, The Bond Market Association, December 2005.

Q4.4: Please estimate and explain any incremental costs that you will incur to comply with these requirements.

Q4.5: Do you agree with our analysis of how the requirements to review and monitor might apply in dealer markets? In particular, will dealers be able to compare and evaluate benchmarks?

Data availability

4.33 Information on execution quality will be essential for a meaningful assessment of execution venues and whether client orders were executed in line with a firm's execution policy. Transparency varies across markets and instruments, ranging from very transparent in liquid instruments to opaque for customised derivatives.

MiFID transparency requirements

4.34 MiFID introduces pre- and post-trade transparency requirements for trading in equities on regulated markets, MTFs and OTC in EEA Member States[46]. This has the potential to provide a useful source of information for firms.

4.35 MiFID also introduces new transparency requirements for certain firms that are 'systematic internalisers' - that is, firms that, on an organised, frequent and systematic basis, internalise equity trades. For certain liquid shares admitted to trading on EEA regulated markets, systematic internalisers must provide firm bid and offer quotes on a continuous basis. Subject to certain waivers, their quotes must represent a binding price for trades up to certain size thresholds.

4.36 MiFID also introduces requirements for post-trade transparency for EEA regulated markets, MTFs and systematic internalisers in shares admitted to trading on EEA regulated markets.

4.37 MiFID will require all such trading venues to publish specified information about completed transactions in shares, including price, volume and the trading venue where the trade was executed.

4.38 Trading venues will have considerable flexibility and choice in reporting channels. While competition in this area may bring many benefits, it also creates a risk that equity trade data will fragment. If information does fragment, it may be difficult for firms to access relevant information for review and monitoring.

4.39 We are considering options for facilitating the consolidation of this information. One possibility is that firms could report their trade information to certain entities that would monitor the integrity of the information published to the market and arrange for its consolidation. This proposal will be considered in more detail in the *Implementing MiFID for firms and markets CP*, planned for July 2006.

[46] See Articles 27, 28, 29, 30, 44 and 45 of MiFID.

4.40 If data on equity trades is consolidated, there may be commercial opportunities to analyse the information and extract key indicators relevant to firms seeking information on execution quality.

4.41 For instruments other than equities, MiFID does not introduce the same transparency requirements. There may be commercial opportunities for entities to consolidate or aggregate the information and extract data on key indicators sought by firms.

4.42 Where dealers wish to use benchmarks as reference prices, pre- and post-trade information, at the least, could be very relevant to the construction of robust benchmarks with a degree of integrity. In general, the more 'real-time' the information used for the benchmark price, the higher the integrity. Of course, size of the liquidity pool would also be relevant – as discussed in Chapter 3.

Q4.6: Have you considered what data you will need to review and monitor?

Q4.7: Have you considered any changes that may be needed to order management systems to capture data for monitoring?

Q4.8: Will execution venues provide data to firms to demonstrate their execution quality and compete for order flow?

Demonstrating best execution to clients

4.43 Article 21(5) requires a firm to be able to show to its client, at the client's request, that it has executed the client's order in line with its execution policy.

4.44 Firms have told us that they are concerned about the implications for data retention associated with Article 21(5), specifically that they will be required to retain data on every transaction executed. For example, a retail broker's execution policy may be to connect to five dealers and execute client orders at the dealer showing the best price. Would the broker need to store the quotes at the time of the trade from all five dealers? Firms are concerned that without this information it may not be possible for the broker to demonstrate that execution was in line with its execution policy.

4.45 We are interested to hear from firms other approaches to demonstrating that client orders have been executed in accordance with a firm's execution policy.

Q4.9: What other approaches do you suggest to demonstrate that client orders have been executed in accordance with a firm's policy?

Further work by the European Commission

4.46 The Draft Implementing Measures call upon the European Commission to study the execution quality information that execution venues provide to determine whether further regulation in this area is necessary[47].

[47] See Article 44(5) of the Draft Implementing Measures set out in Annex 2.

4.47 Execution venues, firms, information providers, trade associations and other relevant organisations may want to consider what strategies should be developed to facilitate accessible, comparable and consolidated execution quality data.

Q4.10: Is there a role for an industry-led initiative to address these issues?

Annex 1

MiFID Level 1 measures

Article 19(1): Conduct of business obligations when providing investment services to clients

1. Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm acts honestly, fairly and professionally in accordance with the best interests of its clients and complies, in particular with the principles set out in paragraphs 2 to 8.

Article 21: Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

2. Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.

3. The order execution policy shall include, in respect of each class of instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue. It shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders.

Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. Member States shall require that investment firms obtain the prior consent of their clients to the execution policy.

Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the investment firm shall, in particular, inform its clients about this possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement or in respect of individual transactions.

4. Member States shall require investment firms to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate,

correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Member States shall require investment firms to notify clients of any material changes to their order execution arrangements or execution policy.

5. Member States shall require investment firms to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy.

Article 24: Transactions executed with eligible counterparties

1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1) in respect of those transactions or in respect of any ancillary service directly related to those transactions.

2. Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Community legislation or the national law of a Member State, undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations.

Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 19, 21 and 22.

3. Member States may also recognise as eligible counterparties other undertakings meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other undertaking as determined by the law or measures of the Member State in which that undertaking is established.

Member States shall ensure that the investment firm, when it enters into transactions in accordance with paragraph 1 with such undertakings, obtains the express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. Member States shall allow the investment firm to obtain this confirmation either in the form of a general agreement or in respect of each individual transaction.

4. Member States may recognise as eligible counterparties third country entities equivalent to those categories of entities mentioned in paragraph 2.

Member States may also recognise as eligible counterparties third country undertakings such as those mentioned in paragraph 3 on the same conditions and subject to the same requirements as those laid down at paragraph 3.

5. In order to ensure the uniform application of paragraphs 2, 3 and 4 in the light of changing market practice and to facilitate the effective operation of the single market, the Commission may adopt, in accordance with the procedure referred to in Article 64(2), implementing measures which define:

a) The procedures for requesting treatment as clients under paragraph 2;

b) The procedures for obtaining the express confirmation from prospective counterparties under paragraph 3;

c) The predetermined proportionate requirements, including quantitative thresholds that would allow an undertaking to be considered as an eligible counterparty under paragraph 3.

Article 66: Amendment of Directive 85/611/EEC

In Article 5 of Directive 85/611/EEC, paragraph 4 shall be replaced by the following:

4. Articles 2(2), 12, 13 and 19 of Directive 2004//EC([1]) of the European Parliament and of the Council of…… on markets in financial instruments (*), shall apply to the provision of the services referred to in paragraph 3 of this Article by management companies.

Recital 33

It is necessary to impose an effective 'best execution' obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. This obligation should apply to the firm which owes contractual or agency obligations to the client.

Annex 2

Draft MiFID Level 2 implementing measures published on 06.02.06

Recitals

[Best execution]

(56) When establishing its execution policy in accordance with Article 21(2) of Directive

2004/39/EC, an investment firm should determine the relative importance of the factors mentioned in Article 21(1) of that Directive, or at least establish the process by which it determines the relative importance of these factors, so that it can deliver the best possible result to its clients. In order to give effect to that policy, an investment firm should select the execution venues that enable it to obtain on a consistent basis the best possible result for the execution of client orders. An investment firm should apply that policy with a view to obtaining the best possible result on an order-by-order basis. For retail clients this means obtaining the best possible result in terms of the total consideration, representing the price of the financial instrument and the costs related to execution.

(57) When an investment firm executes an order following specific instructions from the client, it should be treated as having satisfied its best execution obligations only in respect of the part or aspect of the order to which the client instructions relate. The fact that the client has given specific instructions which cover one part or aspect of the order should not be treated as releasing the investment firm from its best execution obligations in respect of any other parts or aspects of the client order that are not covered by such instructions.

(58) Dealing on own account with clients by an investment firm should be considered as the execution of client orders, and therefore subject to the requirements under Directive 2004/39/EC and this Directive and, in particular, those obligations in relation to best execution.

(59) The obligation to deliver the best possible result when executing client orders applies in relation to all types of financial instruments. However, given the differences in market structures or the structure of financial instruments, it may be difficult to identify and apply a uniform standard of and procedure for best execution that would be valid and effective for all classes of instrument. Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments. For example, transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues.

(60) For the purposes of ensuring that an investment firm obtains the best possible result for the client when executing a retail client order in the absence of specific client instructions, the firm should take into consideration all factors that will allow it to deliver the best possible result in terms of the total consideration, representing the price of the financial instrument and the costs related to execution. Speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs may be given precedence over the immediate price and cost consideration only insofar as they are instrumental in delivering the best possible result to the retail client.

(61) It should be considered that an investment firm structures or charges its commissions in a way which discriminates unfairly between execution venues if it charges a different commission or spread to clients for execution on different execution venues and that difference does not reflect actual differences in the cost to the firm of executing on those venues.

(62) The provisions of this Directive as to execution policy are without prejudice to the general obligation of an investment firm under Article 21(4) of Directive 2004/39/EC to monitor the effectiveness of its order execution arrangements and policy and assess the venues in its execution policy on a regular basis.

(63) This Directive is not intended to require a duplication of effort as to best execution between an investment firm which provides the service of reception and transmission of order or portfolio management and any investment firm to which that investment firm transmits its orders for execution. Accordingly, without derogating from the obligation of the first firm to its client to deliver best execution, it is intended that the first firm should, when transmitting orders to other entities for execution, take all reasonable steps to select entities that are most likely to deliver the best possible result in the execution of those orders. An investment firm which transmits orders to another firm for execution should also monitor the execution quality delivered by the other firm and take the necessary steps to correct any deficiencies when they arise. Subject to the proper fulfillment of these duties, the first firm should be entitled to rely on the ability of the second firm to deliver best execution.

(64) The best execution obligation under Directive 2004/39/EC requires investment firms to take all reasonable steps to obtain the best possible result for their clients. The quality of execution, which includes aspects such as the speed and likelihood of execution (fill rate) and the availability and incidence of price improvement, is an important factor in the delivery of best execution. Availability, comparability and consolidation of data related to execution quality provided by the various execution venues is crucial in enabling investment firms and investors to identify those execution venues that deliver the highest quality of execution for their clients. This Directive does not mandate the publication by execution venues of their execution quality data, as execution venues and data providers should be permitted to develop solutions concerning the provision of execution quality data. The Commission should submit a report by 1 November 2008 on the market-led developments in this area with a view to assessing availability, comparability and consolidation at a European level of information concerning execution quality.

SECTION 5

BEST EXECUTION

Article 44
(Articles 19(1) and 21(1) of Directive 2004/39/EC)
Best execution criteria

1. Member States shall ensure that, when executing client orders, investment firms take into account the following criteria for determining the relative importance of the factors referred to in Article 21(1) of Directive 2004/39/EC:

(a) the characteristics of the client including the status of the client as retail or professional;
(b) the nature of the client order;
(c) the characteristics of financial instruments that are the subject of that order;
(d) the characteristics of the execution venues to which that order can be directed.

For the purposes of this Article and Article 46, ‘execution venue’ means a regulated market, a MTF, a systematic internaliser acting in its capacity as such, or a market maker or other liquidity provider.

2. An investment firm satisfies its obligation under Article 21(1) of the Directive to obtain the best possible result for a client to the extent that it executes an order following specific instructions from the client.

3. Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, which shall include all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

4. Member States shall ensure that investment firms do not structure or charge their commissions in such a way as to discriminate unfairly between execution venues.

5. Before 31 October 2008 the Commission shall present a report to the European Parliament and to the Council on the availability, comparability and consolidation of information concerning the quality of execution of various execution venues.

Article 45
(Articles 19(1) of Directive 2004/39/EC)
Best execution: application to portfolio management and reception and transmission of orders

1. Member States shall require investment firms, when providing the service of portfolio management, to comply with obligations analogous to those imposed under Articles 21 and 22(1) of Directive 2004/39/EC when carrying out transactions that result from decisions to deal, as if references in those Articles to executing orders were references to carrying out transactions that result from decisions by the investment firm to deal in financial instruments

on behalf of its client.

2. Member States shall require investment firms, when providing the service of reception and transmission of orders, to comply with obligations analogous to those imposed under Articles 21 and 22(1) of Directive 2004/39/EC when receiving and transmitting client orders, as if references in those Articles to executing orders shall be treated as references to transmitting orders to another entity for execution.

Article 46
(Article 21(3) and (4) of Directive 2004/39/EC)
Execution policy

1. Member States shall ensure that investment firms review annually the execution policy established pursuant to Article 21(2) of Directive 2004/39/EC, as well as their order execution arrangements.

Such a review shall also be carried out whenever a material change occurs that affects the firm's ability to continue to obtain the best possible result for the execution of its client orders on a consistent basis using the venues included in its execution policy.

2. Investment firms shall provide retail clients with the following details on their execution policy in a durable medium and in good time prior to the provision of the service:

(a) an account of the relative importance the investment firm assigns, in accordance with the criteria specified in Article 44(1) of this Directive, to the factors referred to in Article 21(1) of Directive 2004/39/EC, or the process by which the firm determines the relative importance of those factors;

(b) a list of the execution venues on which the firm places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of client orders.

3. Investment firms shall include in the execution policy a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions.

Annex 3

Summary list of questions

Chapter 2 questions

Q2.1: Do you agree with the above analysis which takes a flexible approach to the application of the requirements to firms in a chain of execution, depending on the nature of the activities they perform and the degree of control over the execution of the client orders?

Q2.2: Do you agree with our views on the relevance of the specific factors in Article 21?

Q2.3: What additional costs will the requirements to have an execution policy and execution arrangements impose on your firm?

Q2.4: Do you agree that price and cost are the most important factors for retail clients?

Q2.5: What information will be appropriate in order to enable clients to be sufficiently informed about the execution arrangements of the firm and how will this differ as between retail and professional clients?

Q2.6: Are there any best execution issues unique to UCITS management companies?

Chapter 3 questions

Q3.1: Do you agree that under MiFID there may be demand from retail and professional clients for best execution in relation to financial instruments typically available from dealers? If so, how significant is this likely to be?

Q3.2: Do you consider that the benchmark execution model may provide a useful additional approach by which dealers may be able to satisfy the best execution requirements? If so, in what markets will it be of most use?

Q3.3: What would be the likely costs of this approach?

Q3.4: What particular characteristics of reference prices make them suitable benchmarks for particular instruments or in particular circumstances?

Q3.5: Do you agree that a dealer could construct its prices by extrapolating from indirectly referable benchmark prices and thereby satisfy MiFID's best execution? Please give examples for specific financial instruments.

Q3.6: In what circumstances could financial or economic indicators or indices be relevant benchmarks?

Q3.7: Would dealers consider charging clients an additional fee or commission for providing best execution?

Q3.8: Are there any circumstances in which an execution model which uses internal benchmarks could be sufficiently robust to satisfy the best execution requirements? If so, what?

Q3.9: What are your views on the possible benchmarks identified in paragraph 3.43? Are there other potentially available benchmarks?

Q3.10: Would trade associations be willing to develop such benchmarks for the purposes of best execution? If so for what products / instruments?

Q3.11: Do you agree that the benchmark execution model can work for financial spread bets and CFDs?

Chapter 4 questions

Q4.1: Do you agree with our analysis of the requirements to review and monitor?

Q4.2: On monitoring: do you agree with the comparisons suggested in paragraph 4.11? If not, how would you assess the effectiveness of your arrangements? Will firms monitor their trading on a daily, weekly or monthly basis?

Q4.3: On reviewing: do you conduct qualitative or quantitative reviews of brokers, regulated markets or MTFs now? If so, how frequently?

Q4.4: Please estimate and explain any incremental costs that you will incur to comply with these requirements.

Q4.5: Do you agree with our analysis of how the requirements to review and monitor might apply in dealer markets? In particular, will dealers be able to compare and evaluate benchmarks?

Q4.6: Have you considered what data you will need to review and monitor?

Q4.7: Have you considered any changes that may be needed to order management systems to capture data for monitoring?

Q4.8: Will execution venues provide data to firms to demonstrate their execution quality and compete for order flow?

Q4.9: What other approaches do you suggest to demonstrate that client orders have been executed in accordance with a firm's policy?

Q4.10: Is there a role for an industry-led initiative to address these issues?

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: http://www.fsa.gov.uk