

CESR: Best Execution Consultation Paper

The Markets in Financial Instruments Directive bulletin series

March 2007 Vol.2

This is the second paper in the series tracking the CESR MiFID developments.*

Overview

- Overarching best execution requirement is essentially the same under L1, Art 21 and L2D, Art 45: therefore, the requirement applies both to investment firms and portfolio managers/RTOs.
- Best execution 'arrangements' under L1, Art 21 and best execution 'policy' under L2D, Art 45 both require a comprehensive execution approach.
- This bulletin summarises some of the key areas of interest.

Outstanding issues

- 'We have not attempted to be comprehensive in this report... it is possible that CESR will do further work on best execution should other issues emerge where such work would be useful for supervisory convergence' (Para 11, Page 4).
- CESR has applied to the European Commission for its view on the scope of application: this relates, inter alia, to certain types of transaction which do not clearly fall within or outside scope (Para 12, Page 4).
- CESR paper includes 'calls for evidence' in terms of i) quality of execution venues and ii) data retention implications of L1, Art 21(5).
- Level of disclosure to professional clients left to the discretion of investment firm?

Consultation process

- Consultation closes on 16 March 2007: an open hearing is to be announced.
- An addendum to the Best Execution paper may follow if Commission's view is received in time (Note: announced at Open Hearing on 2/2/2007).

Details of consultation paper

1.0 Need to determine role in the chain of execution

- 'MiFID's best execution requirements should be applied as necessary to take account of the particular function performed by each firm in the chain', Para 65, Page 16.
- Eligible counterparties have to 'ensure that any entities with which orders are placed or to which the investment firm transmits order for execution have execution arrangements that enable the investment firm to comply with L2D, Art 45'.
- 'In considering whether an investment firm has complied with the requirements, it will be relevant to examine the role performed by the firm, particularly where there is a chain of execution', Para 66, Page 16.
- 'CESR considers that the reference to 'arrangements' in Art 45(5) is intended to refer more generically to the execution approach of the intermediary', Para 69, Page 16.

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- Portfolio manager/RTO using an intermediary subject to L1, Art 21 can ‘providing certain conditions are met, be able to place a high degree of reliance on that intermediary in order to comply with its own best execution obligations under Art 45(5)’. Para 72, Page 17.
- Where a portfolio manager/RTO specifies that a transaction should be carried out on a particular venue, this constitutes a ‘specific instruction’. Para 73, Page 17.
- No prohibition on using third country venues, but portfolio managers/RTOs would need to satisfy themselves that these venues have execution arrangements or standards of execution quality which allow compliance with L2D, Art 45. If not, firm cannot use these third country venues.
- ‘When best execution responsibilities overlap, an investment firm will have to determine whether its best execution obligations are owed under Art 45 or Art 21 and how far the best execution standard delivered by an intermediary at the following point in the chain goes in satisfying the best execution requirements that apply to itself’. Para 75, Page 17.

2.0 Establish best execution arrangements:

‘These requirements operate to ensure that a firm has control over its execution practices and procedures’ (Para 17, Page 6).

‘CESR therefore considers that the execution arrangements are the means that an investment firm employs to obtain the best possible results, including its strategy, practices and procedures, while the execution policy may be understood as a statement of the most important and/or relevant aspects of those execution arrangements.’ (Para 20, Page 6).

‘We would expect the Art 45 ‘policy’ of a portfolio manager or RTO to include similar elements to those contained in the Art 21 ‘execution policy’” (Para 21, Page 6).

2.1 Art 21 investment firms’ venue selection process:

- Identify all possible venues for each (type of) trade in specific financial instruments (Para 38, Page 10).
- The selection of venues to be included in the execution policy should be based on quality of execution from the investment firm’s perspective. Costs of accessing (other) venues (when these would then be passed onto the client) can be taken into account during this selection process (however, investment firms should consider indirect access). [It is possible, depending on the circumstances, to choose one venue if only one venue will ensure best execution.]
- In respect of routine orders from retail clients, make a selection of appropriate venues, based on ‘total consideration’ implications, including associated costs to the investment firm.
- Identify whether there are situations where retail clients may place non-routine orders (e.g. large order in illiquid share) and adopt appropriate approach.
- In respect of professional clients, make selection of venues based on all relevant factors, appropriately weighted, to the type of client/trade/financial instrument. (Note: ‘CESR considers that in most circumstances price and cost will merit a high relative importance in obtaining the best possible result for professional clients, although there will be circumstances where other factors will be more important’, Para 29, Page 8).
- Note: a choice between venues included in the best execution policy still has to be made based on net outcome for retail client at the time of trade.

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2.2 Portfolio managers/RTOs venue selection – ‘take all reasonable steps to obtain best possible result’

- Need to examine execution approaches prior to selection and keep under review as appropriate.
- Can route orders through one venue if terms advantageous for clients (e.g. orders could be routed through an affiliated firm).
- But still need to monitor and review the quality of execution, and take appropriate action to correct deficiencies.

2.3 Content of best execution policy

- Fully describe approach to carrying out orders (from order origination to execution/settlement).
- Set out venues used and the role of execution quality and any other factors in choosing them:
 - Information on each venue per class of financial instrument (appropriate differentiation between, for example, equities, debt, exchange-traded/OTC derivatives, expected/required: ‘A firm’s execution policy will at least need to address the different classes of instruments for which it handles orders’, Para 44, Page 11).
 - Firms ‘may wish’ to distinguish its policy by client or order type.
- Explain how different factors affect the approach.

2.4 Appropriate disclosure:

- Appropriate aspects of execution policy – in an appropriate manner.
- ‘Disclosure of the (execution) policy is only required insofar as it will be relevant for the client and types of orders that the client may send to the firm’ (Para 50, Page 12).
- Describe and explain the execution approach, setting out venues used.
 - List of execution venues on which firm places ‘significant reliance’.
 - Information on each venue per class of financial instrument (Para 42, Page 11).
- Relative importance firm assigns to factors (or the process by which it determines relative importance).
- ‘Therefore the question arises as to whether firms may be obliged to provide more information to professional clients than would be provided to retail clients under L2D, Art 46(2)’, Para 55, Page 13.
- Disclosure in a comprehensible form:
 - in ‘durable medium’ or by means of website under conditions established in L2D, Art 3(2).
 - in a single document?
 - possibly contained in the retail client agreement, where required.
 - Firms need to ascertain for themselves the level of disclosure appropriate for professional clients.

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2.5 Client consent (L1, Art 21 only)

- Prior consent to execution policy: prior express consent when executing orders outside a regulated market or MTF.
- Prior consent could be tacit (e.g. clients place orders after receiving information) but competent authorities may require evidence.
- Prior express consent can be i) by signature in writing or equivalent means (electronic signature), ii) by a click on a webpage, iii) orally by telephone (conversation would need to be recorded) and iv) in person (appropriate record kept).

2.6 Ability to demonstrate compliance with best execution policy on request by client (L1, Art 21 only).

2.7 Monitoring: 2 aspects

- Monitor compliance with best execution approach (policy/arrangements) and correct deficiencies.
- Monitor whether execution approach secures best execution, if not correct deficiencies.
 - Compare similar transactions i) on the same venue and ii) on different venues.
 - 'Monitoring methodology is at the discretion of firms', Para 86, Page 20. Sampling could suffice but must reflect size and nature of transactions.

2.8 Review:

- 'The reference to 'execution quality' of the execution intermediary in L2D, Art 5(5) refers to the quality of the results that the intermediary has delivered in comparison with the results that were possible', Para 79, Page 19. Needs to be assessed in the context of the weighted factors applicable.
- Portfolio managers/RTOs have to use execution venues whose arrangements enable them to comply with L2D, Art 45: they have to monitor the execution quality on a regular basis: but also examine the execution approaches prior to selection and keep under review as appropriate.
- L1, Art 21 firms should 'assess' at least annually or when a material change occurs whether they need to make changes in their execution arrangements. Same type of obligation for portfolio managers/RTOs under L2D, Art 45. 'Analogous reviews, even though they are worded differently', Para 81, Page 19.
- Will depend on particular execution approach, and position in any chain of execution.
- 'Such reviews look beyond a firm's current execution approach'... 'Firms should also review their approach generally to see whether they could usefully make any changes to improve overall performance.' Para 83, Page 19.
- Need to reassess factor weighting in relation to selected venues.
- 'What is material will depend to a large extent on the nature and scope of any change.' Para 84, Page 19.

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2.9 Differing contexts for monitoring and review

- Firms in different points in the chain of execution may need different approaches to review/monitoring obligations.

3.0 Calls for evidence:

3.1 Information on execution quality

- CESR currently working on providing input to the Commission for its assessment on availability, comparability and consolidation of information on execution quality, required by L2D, Art 44(5).
- ‘Core of information that any firm would find useful’?

3.2 Data retention under L1, Art 21(5) – demonstrating compliance with execution policy on client’s request

- Information on available prices/quotes for every transaction?
- Demonstrate that firms follows its policies and procedures?
- ‘It will be important for regulators to take a convergent view on this debate’, Para 95, Page 24.

Contacts

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