

ABI's response to CESR consultation on Best Execution under MIFID

March 2007

1. The Italian Banking Association, which with over 800 associates represents the Italian banking system, welcomes the CESR's decision to provide an interpretation of the key points of the new *best execution* regulations, in order to encourage actual pan-European harmonization of rules and opportunities for competition among intermediaries.
2. As a matter of fact, the ABI considers the *best execution* issue as essential for investor protection, market efficiency, and competition among intermediaries. Therefore, the ABI regards extremely fitting for the CESR to continue working on other aspects of *best execution* that were not discussed in the *consultation paper* in hand, such as for example, the application of the regulations to financial tools and/or special operations and services (for example: repo, securities loan, UCITS).
3. Before getting involved in the issues for which the CESR requested a specific contribution, we believe it necessary to point out the need for a univocal interpretation, also in order to guarantee uniform application among the Authorities who are members of the CESR, of the nature and type of the investment firms' "best possible result" obligations when executing client orders. In particular, it should be made clear whether obligations referred to in art. 21 of the MIFID and of the second level rules require the investment firm, once client purchasing order is received, to search among the trading venues selected in his/her own execution policy for the one that allows to achieve the best possible result (total consideration in case of retail clients), or if the investment firm fulfils his/her duty by executing client order in any of the selected trading venues.

Execution policies and arrangements

Question 1: Do respondents agree with CESR's views on:

- *the main issues to be addressed in an (execution) policy? Are there any other major aspects or issues that should ordinarily be included in an (execution) policy?*
- *the execution policy being a distinct part of a firm's execution arrangements for firms covered by Article 21?*
- *the execution policy under Article 21 being a statement of the most important and / or relevant aspects of a firm's detailed execution arrangements?*

4. The MIFID does not explain in detail the contents of the *execution policy*; this is acknowledged by the CESR in its *consultation paper* (cf. par. 22). However, we believe that EU Community legislation provides hints on the contents of the *execution policy*, and on its connection with the *execution*

arrangements, which seem to differ compared with the interpretation provided by the CESR in its *consultation paper*.

5. As a matter of fact, the CESR, in its *consultation paper*, considers the *execution policy* as part of the *execution arrangements* (cf. par. 20). In particular, the *execution policy* would be a document (*statement*) containing the most important and relevant aspects of the *execution arrangements*, of which it would be a part, and should: 1) describe the investment firm's approach in order execution/communication; 2) list locations of foreclosures/negotiators, their execution quality, and any other factor that was relevant in their selection; 3) explain how different execution factors determine the best possible result; 4) explain why the investment firm's approach will achieve the best possible result.
6. The CESR draws this interpretation from art. 21, paragraph 2 of the MIFID, which provides for the following "*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.*"
7. However, art. 21 of the MIFID, paragraph 3, clarifies that, "*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*".
8. Furthermore, paragraph 4 of the same article provides for the following, "*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*".
9. In addition, art. 46, paragraph 1 of Directive 2006/73/CE, determines that, "*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*".
10. Accordingly, from reading the legislation it seems possible to deduce that the *execution policy* is a separate issue from the *execution arrangements*, and it is merely made up of a list of all execution locations selected by an investment firm, and by the order of priority of execution factors.

11. Besides, the above-mentioned art. 46 of Directive 2006/73/CE specifies that investment firms must provide retail clients with information concerning, “a) *an account of the relative importance the investment firm assigns, in accordance with the criteria specified in Article 44(1), 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; (c) a clear and evident notice that any specific instructions from clients could prevent them from adopting measures that they reckon and apply in their execution strategy to achieve the best possible result in the execution of orders concerning the aspects of such instructions.*”
12. Furthermore, art. 21, paragraph 5 of the MIFID provides for, “*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.*”
13. Accordingly, employing the interpretation provided above, we would obtain a quasi-coincidence between the execution policy contents and the information on the matter to be provided to retail clients, involving slighter inside organization charges and greater straightforwardness in client relations, as well as slighter compliance costs in the event of a client asking proof of execution policy compliance.
14. Similar observations are obviously also true for the policy concerning an RTO, that, to make things easier, will be designated “transmission policy” throughout the present document.

Question 2: For routine orders from retail clients, Article 44(3) requires that the best possible result be determined in terms of the “total consideration” and Recital 67 reduces the importance of the Level 1 Article 21(1) factors accordingly. In what specific circumstances do respondents consider that implicit costs are likely to be relevant for retail clients and how should those implicit costs be measured?

15. On first analysis, we did not determine situations in which implicit “non-monetary” costs (such as, for example, *market impact* or *implementation shortfall*) can be so relevant for retail investors to become more important than other execution factors, and above all “monetary” ones (viz. price and explicit costs). Besides, measuring such implicit costs on small amount orders can produce non-significant results.

Question 3: Do respondents agree with CESR's views on the use of a single execution venue?

16. We consider sound the CESR's approach according to which it is possible to provide for a single execution venue in someone's own execution policy, or a single negotiator in the event of a transmission policy, as long as the investment firm previously performed an evaluation of all possible alternatives, on the basis of which the single selected venue/negotiator guarantees the best possible result for a client on a long-term basis.
17. In addition, we noticed that on markets such as the Italian one, where concentration obligation has in actual fact directed cash and cash equivalents on shares on the main regulated national market, the possibility of indicating a single venue appears, at least in the period immediately following the coming into force of the MIFID, very plausible.
18. Furthermore, we consider sound the CESR's opinion according to which price and costs should be important criteria when applying the policy to professional clients also, even if other execution factors could be considered priorities on the basis of a particular type of client.
19. We also agree with the distinction made by the CESR between direct execution costs, which vary depending on the execution venue, and the bank's own commissions, which should be essentially consistent regardless the trading venue where the order is executed (exception made if showing different costs paid by the investment firm).
20. Nonetheless, it would be fitting for the CESR to provide guidelines on how to consider certain special types of costs, for example annual memberships to execution venues and/or central custodians. In particular, it is not clear if these must be considered among bank's own commission or among direct order costs (for example, by performing a historical allotment on the basis of past performance).
21. Furthermore, we confirm the interpretation provided by the CESR according to which in the periodic selection of execution venues to add in the execution policy (or negotiators for the transmission policy), the investment firm must consider only direct execution costs, while when choosing the venue on which to execute a single order, in case of retail clients, the investment firm must consider the combination of direct costs and his/her own commission.

Question 4: Do respondents agree with CESR's views on the degree of differentiation of the (execution) policy?

22. We agree with the CESR's opinion on the fact that the differentiation level of the execution/transmission policy must be sufficient to allow clients to be adequately informed on services offered by investment firms; for example, where applicable, for each financial tool category, order type/size, type of client and/or structure of reference venues.
23. Nonetheless, we consider right to leave up to the investment firm to choose the level of differentiation of his/her own execution policy, or the drawing up

of more policies, each directed towards specific targets on the basis of differentiation criteria (clientele, orders, financial tools, markets, etc.) to be determined in light of the characteristics of investment firm activity.

Disclosure

Question 5: Do respondents agree that the 'appropriate' level of information disclosure for professional clients is at the discretion of investment firms, subject to the duty on firms to respond to reasonable and proportionate requests? On the basis of this duty, should firms be required to provide more information to clients, in particular professional clients, than is required to be provided under Article 46(2) of Level 2?

24. We agree with the CESR's approach on the fact that the adequate level of information to provide professional clients must be left up to investment firm evaluation.
25. Besides, concerning the requirement to respond to requests for additional information, we also believe that, to the extent that these requests are reasonable and fair, the information provided for in art. 46(2) should be considered as an acceptable limit in most cases.
26. We would also like to mention the possibility for the CESR to clarify how an investment firm should behave if a professional client asks to be treated like a retail client, maybe with reference to specific operations, and the execution policy prepared for the professional clientele, previously approved by the client, should differ from that for retail clientele. In particular, it is not clear if the investment firm will have to continue applying the "professional" policy previously approved by the client, or if the investment firm will have to apply the "retail" policy, forwarding it first of all to the client for approval.

Consent

Question 6: Do respondents agree with CESR on how "prior express consent" should be expressed? If not, how should this consent be manifested? How do firms plan to evidence such consent ?

27. We agree with the CESR's approach according to which, to obtain a client's explicit approval, it is necessary for the client to sign, even by computer, or clicking on a web page, or for the client to express approval by phone, as long as the investment firm has a system to record phone calls.
28. Regarding the option of using client implicit approval, we ask of the CESR to determine possible methods to provide the client with the execution policy, apt, in the event of a request from competent Authorities, to prove client awareness of the contents of the information provided by the investment firm, in order to encourage supervisory convergence in this area as well.

Chain of execution

Question 7: Do respondents agree with CESR's analysis of the responsibilities of investment firms involved in a chain of execution?

29. We agree with the CESR's interpretation, according to which each investment firm is responsible as regard to his/her own role in the chain; with reference to the RTO, this translates into the requirement to select the "best" intermediary and monitor execution quality and *execution arrangements* on a regular basis.
30. Furthermore, we agree with the CESR's "functional" interpretation of art. 45, paragraph 7, according to which an investment firm offering both negotiation and collection/management services must apply either negotiator or collection/management best execution regulations according to the service that is actually being provided, in other words according to his/her role in the "chain".
31. With regard to this, we also believe that an intermediary offering both trading and RTO services (for example, who performs orders on domestic shares directly, but uses a broker for executing foreign shares orders), and thus must draw up both an *execution policy* and a *transmission policy*, can draw up and forward to the client a single document containing both policies.

Execution quality data

32. In first place, it is necessary to find an agreement with the CESR on the importance that the information on execution quality has in allowing investment firms to comply with *best execution* requirements. Among other things, in the ABI's response to June's European Commission consultation on the opportunity of extending transparency requirements to non-equity markets as well, we pointed out the connection between information availability and selection and monitoring of *execution venues*.

Question 8: What core information and/or other variables do respondents consider would be relevant to evaluating execution quality for the purposes of best execution?

33. We think that the necessary *core information* to evaluate execution quality of *execution venues* must in fact be the "execution factors" provided for by art. 21 of the MIFID (price, costs, prompt execution, probability of execution and of settlement, order size/nature) on the basis of which the investment firm must select the *venues*.

34. In view of this, it would be fitting to ensure that *trading venues* provide this information, and that their release is performed following reasonable commercial conditions.

Other issues

35. We would like to mention that the requirement determined by art. 21, paragraph 5, of the MIFID, involving an investment firm to prove the compliance of his/her execution strategy to the client, is quite generic and does not require the investment firm to keep record of all potential prices available in the various venues added into his/her *policy*.
36. Besides, the interpretation according to which an investment firm is merely required to show compliance with his/her own procedures (for example, of having referred the order to an electronic system for the selection of the best *venue*) seems perfectly plausible and sound.
37. Among other things, such an interpretation would have the advantage, on one side to significantly reduce expenses charged to investment firms in terms of memorizing information, and, on the other side, to avoid significantly reducing investor protection, since the investment firm will in any case have to monitor the effectiveness of his/her own procedures pursuant to the MIFID regulations (as was correctly emphasized by the CESR in paragraphs 85-86).
38. On the other hand, should there be a stricter interpretation of requirements to prove compliance with an investment firm's own execution strategy, which would require keeping record of detailed information on the venues included in the policy, we consider fitting to explicitly admit the possibility for investment firms to employ third parties who guarantee historical logging of the necessary information. Investment firms will thus have access, in case of need, to the necessary information to prove compliance with their own execution policies.