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**CESR's Draft Technical Advice on Possible Implementing Measures  
of the Directive 2004/39/EC on Markets in Financial Instruments in relation to:  
Aspects of the Definition of Investment Advice and of the General Obligation to Act  
Fairly, Honestly and Professionally in the Best Interests of Clients; Best Execution; and  
Market Transparency**

**Second Consultation Paper (March 2005)**

**Comments of UBS Investment Bank**

UBS Investment Bank (UBS-IB) is pleased to comment on certain proposed implementing measures on best execution addressed in CESR's second consultation paper (March 2005). This draft technical advice will, in part, form the basis for the final advice CESR will give to the European Commission on 30 April 2005.

UBS-IB is the investment banking business group of UBS, employing over 16,000 people in offices located throughout 30 countries. UBS is a global, integrated investment services firm with offices in over 50 countries worldwide. The business of UBS is managed through four main business groups and its Corporate Centre.

UBS-IB has particular concerns regarding the application of CESR's best execution proposals to the derivative and over-the-counter (OTC) markets and, accordingly, submits the following comments on Chapter 3, Best Execution.

**Applying an exchange-based markets model to the OTC markets**

**Article 21.1 and paragraph 1 of Article 21.3 state, respectively:**

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.

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

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| of client orders. |
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In the Second Consultation Paper, CESR would require an investment firm to assess the relative importance of the factors of price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order according to the following criteria:

- (i) the characteristics of its clients;
- (ii) the characteristics of the orders to be executed on behalf of its clients
- (iii) the characteristics of the financial instruments of those orders; and
- (iv) the characteristics of the execution venues to which those orders can be directed.

The CESR proposals on best execution, indeed the Level 1 text itself, all refer to a model of best execution based on agency transactions in exchange-traded products. This is evident from the heavy reliance upon the existence of a fiduciary relationship between a firm and its client and the requirement for disclosure, review and monitoring of execution venues to define the best execution obligation.

#### *Executing client orders in the OTC markets*

UBS-IB recognises an obligation to provide best execution when executing orders to clients to whom it owes a fiduciary duty. In many instances, however, UBS-IB transacts with clients in circumstances where (i) there is no 'order' and (ii) there is no fiduciary relationship between it and the client.

For example, in the bond and FX markets in which a firm actively holds itself out as willing to buy and sell on a continuous basis, application of a best execution obligation serves no discernible policy. In that instance, the return of a firm is not based on a mark-up, but on taking risk positions and earning a spread for taking such risk through its dealings with other market participants. The same reasoning also applies where a firm sells a structured note and hedges it over a period of months. Because both buyer and seller make informed commercial judgements about the probability of realising a profit or incurring a loss on their own capital, each firm is genuinely "on risk".

For this reason, such transactions do not, in our view, qualify as "client orders" and, consequently, the seller does not owe a fiduciary duty to the buyer. In the absence of a fiduciary duty, there can be no obligation of best execution running from the seller to the buyer. This is appropriate because neither policy aim of the best execution obligation, namely, investor protection and facilitating price formation and market efficiency, would be served by such an unwarranted extension. For regulators to hold otherwise edges close to a substitution by regulators of their commercial judgement for that of firms.

Moreover, in the majority of fixed income and FX business, firms such as UBS-IB do not take client orders. Instead, UBS-IB quotes two-way prices, and the client is free to deal at those prices or not, either as a buyer or as a seller. UBS-IB itself has no way of determining whether a client requesting a quote is acting as a buyer or a seller. Thus, UBS-IB is in the position of providing continuous bid / offer prices without the benefit of receiving this important market information from its clients.

This transaction does not, as suggested above, meet the definition of a client order. On the other hand, UBS-IB does take limit orders and agrees that, in such circumstances, it has "agency-type" obligations even though its legal capacity may remain as principal. In this case, UBS is guided by internal Codes of Conduct, regulatory guidance and the principles of fair dealing and fair treatment of the customer set out in Article 19.

UBS-IB believes that greater clarity of the scope of this Article should be provided, including definition of the term 'client order' and confirmation that there is no intention to extend the scope of the Article to genuine risk activities such as market making.

#### *Disclosing, reviewing and monitoring of execution venues in OTC markets*

As mentioned above, a market maker in a quote-driven market receives a quote request from a client who, in turn, selects the most competitive quote from a number of quotes provided by different market makers. A wholesale client typically has access to more information about market quotes in the European bond markets than any one firm, based on its access to an array of market data vendor systems, MTFs and direct market access to the relevant market makers. Because the client is making an informed decision on its choice of execution venue, requiring a firm to disclose, review and monitor execution venues in its best execution policy becomes redundant. UBS-IB believes the best execution obligation must accord with a fiduciary duty and, assuming a fiduciary duty, must further place a firm in a position of superior market knowledge. This would accord with the policy of promoting investor protection underlying the Markets in Financial Instruments Directive (MiFID). Typically, neither characteristic is present in a wholesale OTC quote-driven market transaction.

Specifically, the best execution obligation of a firm is a proxy for the client acting in its own best interest with full knowledge. Where instead the client is acting for itself with full knowledge of the respective market positions of each firm, the client becomes directly responsible for its own best execution, aided by the availability of detailed best execution policies provided by each firm pursuant to Article 21. Given the foregoing, the disclosure, review and monitoring of execution venues is not a suitable yardstick by which to measure the application of best execution within quote-driven OTC markets and should not apply. Nor, more generally, should the best execution obligation apply where a firm does not have a fiduciary relationship. Even in those instances where a firm does have a fiduciary relationship with a client, the best execution obligation should be disappplied if the client possesses superior market knowledge to such firm.

#### **Structuring the "best execution" obligation for the OTC markets**

Article 21.4 states:

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.

#### *Identifying costs for OTC markets*

In the second paragraph, Box 2 of the Second Consultation Paper, CESR states that:

For purposes of the advice under Article 21, "execution venue" means the entity that finally concludes a client order and may include regulated markets, MTFs, systematic internalisers, investment firms and other entities that deal on own account and equivalent entities in third countries. When an investment firm deals on own account to execute a client order or crosses client orders, then the firm itself is the execution venue.

Hence, UBS-IB will need to consider not only how to construct and apply a best execution policy to its OTC client orders, but also how to create a best execution policy that can assist market participants in assessing UBS-IB quality of execution among competing "execution venues". These market participants will be under an affirmative obligation to their own clients to assess regularly their execution venues using the following factors:

- immediacy;
- order volume;
- quality of service at execution venue;
- price;
- client preference; and
- costs.

In its explanatory text, CESR states that respondents singled out costs as a primary consideration in selecting and reviewing venues. This emphasis is reflected in CESR's recommendation that:

The costs to be taken into account in seeking the best possible result for the client include: access costs, transaction fees, currency expenses, settlement costs and, where relevant, implicit costs [*i.e.*, market impact and implementation shortfall]. [parentheticals added]

Costs are a principal factor for a firm determining which execution venues to maintain or include in its order execution policy. Costs will, by extension, be a principal factor for a firm designated as an "execution venue" in creating its best execution policy. Yet CESR again derives relevant costs from an exchange-based markets model. The cost components of trade execution for equities and other exchange-based markets are fundamentally different from those in the OTC markets due to:

- absence of credit risk;
- payment of market execution commission; and
- matching of client orders.

In the exchange-based markets, price and costs are separately quantified and allocated. A client must then judge the overall value of a transaction by assessing both price and transaction costs together.

This is starkly different from the OTC markets, of which the FX market is a particularly cogent example. In that market, the cost of processing the transaction is embedded in the bid / offer price. Price and costs are, unlike exchange-based products, represented in a single unit, with costs being fixed rather than variable. This means that if the cost of an FX transaction is, for example, €150, then this fixed cost will represent a larger proportion of a small transaction but will be much less significant for a large transaction. Unlike the equities market, the FX market is volume-driven rather than price-driven.

In short, the price component of best execution for exchange-based products comprises an amalgam of the (i) executed price; and (ii) amount of market execution commission, whereas dealers in OTC markets quote an "all-in" price when trading products. This "all-in" price represents a total price reflecting an assessment of:

- execution cost;
- market risk;
- credit charge;
- operational / transactional fees;
- liquidity; and
- profit.

Moreover, it has been stated that minimising relevant costs is a legitimate criterion in assessing best execution because the customer ultimately bears all the costs of trading. But it should be noted that it is invariably the market makers who bear the risks. These risks are different and, in some respects, more pronounced for firms operating in the OTC markets.

An OTC environment does not have the continuous liquidity, which is perceived to be an advantage of the exchange-traded markets, because the depth of liquidity can vary dramatically within a trading day and by product. This depends on unpredictable flows based on the quite dissimilar needs, objectives, assumptions and views of market participants. Thus, a large transaction will create significantly greater liquidity cost for the liquidity provider, as compared with a smaller transaction. The liquidity risk subsequently borne by a firm is expressed in economic terms in the OTC markets through the imposition of liquidity costs on clients.

One potential cost that firms operating in both exchange-based and OTC markets share to varying degrees is market impact, referred to by CESR as an "implicit cost". Under certain circumstances, the very process of obtaining quotes in respect of an OTC product will run counter to the client's interests because of the need for discretion. For example, requesting quotes on large orders or on illiquid underlyings will release price-sensitive information into the market. This often has the unintended effect of driving the price away from the current market, resulting in an implementation shortfall. For this reason, it is very common for clients to elect not to put a structure out to tender but to rely instead on negotiating a price with a single product provider. In response to question 56 on page 23, this is an example of a situation in which a firm seeking a quote would satisfy the requirements of Article 21 while using only one execution venue. Put another way, for a client to approach more than one execution venue in this scenario would positively militate against the client receiving best execution.

In view of the above, UBS-IB would encourage CESR to be as open and flexible as possible in setting the standards for selection and reviewing execution venues. Such standards must be integrally related to the nature of the business being conducted to avoid impeding its efficient operation.

#### *Comparing costs / pricing of exchange-based and OTC markets*

UBS-IB believes that the fundamental principles of cost / pricing transparency, consistency of result and firm accountability underlie the twin objectives of price formation and investor protection. Given the many dimensions of both exchange-

based and OTC markets, these principles provide a governing framework although maximum flexibility and tailoring to the respective markets is still required at the level of implementing measures.

This is illustrated by CESR's comments on p. 24 of the Second Consultation Paper, in which it states that:

CESR also wishes to make clear that Article 21 does not regulate the amount of the commissions that a firm itself charges to its clients. CESR does not consider these charges to be "costs" for purposes of Article 21 and Article 21 does not require firms to consider how the impact of their own commissions on the total result to the client compares with the commissions charged by their competitors.

Given the above, UBS-IB would ask CESR to confirm that the same logic applies to those OTC businesses that do not charge separate commissions but rather embed such commissions in the bid / offer spread. CESR is right to take this approach with respect to commissions and spread generally, as markets--while different--are self-regulating in this respect. For example, overcapacity in the FX industry has placed costs under significant downward pressure, which is expected to continue.

CESR should, however, be very much aware that embedded fees in an OTC market do not translate into a lack of fee transparency. The intense competition in the FX market, for example, would imply that market participants, and in particular the liquidity providers, understand the embedded costs of dealing at a reasonably detailed level.

More problematic are structured OTC derivatives and money market products that have no obvious benchmark. Best execution will, as a result, be particularly difficult to document for these products, and virtually impossible to evidence using pricing and cost models that are derived from, and are readily applicable to, exchange-based products. Money market loans, for example, are priced according to a firm's credit spread plus transaction costs plus capital underpinning, which criteria do not correspond to the selection and review factors for execution venues (e.g., immediacy, order volume, quality of service, client preference, etc.) proposed by CESR. For this reason, CESR must give market participants adequate scope and flexibility to interpret and to assess what comprises "best execution" for these disparate products. This is necessary for fulfilment by a firm both of the selection and review criteria for execution venues as well as of the best execution obligation itself.

Finally, CESR must give weight to another differentiating factor in pricing between the two markets in drawing up a common set of criteria for selection and review of execution venues, and that is perceived value. Specifically, OTC markets are structurally different to an exchange-traded environment because the liquidity providers have quite different market views that affect the base price of the instrument. In an exchange-traded environment, the action of arbitrageurs will restore pricing imbalances to a perceived consensus price. However, in OTC markets, market participants typically have very dissimilar needs, positions, views and expectations, all of which translate into a range of dealable prices. An OTC market does not herd participants into tending toward an observable consensus on the price of a commodity. This is an indicator of the value of the transaction to UBS-IB as against a calculation based purely on costs.

### *Conclusion*

UBS-IB urges CESR to consider carefully the key economic drivers in each OTC product class in providing its best execution guidelines under MiFID. The general application of an exchange-based markets model of best execution to a wide array of financial instruments is inherently problematic. UBS-IB deals extensively in both the exchange-based and the global OTC markets and, in its view, only a thorough understanding of these markets and their particular products can engender a uniformly successful application of the MiFID.

We trust you find these comments helpful. In the event that you would like to discuss them in greater detail, UBS-IB would welcome the opportunity for a bilateral dialogue with CESR on this important and complex topic.

Yours faithfully,

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