

CESR/07-050b: BEST EXECUTION UNDER MIFID – ABI RESPONSE TO CESR CONSULTATION PAPER

1. Members of the Association of British Insurers are large institutional investors managing own funds worth some £1.2 trillion as well as third party funds, with substantial holdings across main EU markets. Our members have a strong interest in the integrity and efficiency of the financial markets and in promoting the confidence of the investing public.
2. We have been involved in the UK debate about implementing best execution provisions and have so far commented on several policy papers from the FSA on the subject. We are also a member of MiFID Connect, a group that brings together 11 trade associations to discuss domestic implementation issues.

General comments

3. We are grateful for the opportunity to respond to CESR's consultation on Best Execution under MiFID. We support CESR's objective of promoting supervisory convergence and consider its role at Level 3 to be crucial.
4. In particular, our members are pleased that CESR has chosen to address some of the practical implementation issues which have, until now, been somewhat overshadowed by the debate on scope. Firms need clarity about execution policies, chains of execution and reviewing and monitoring requirements if they are to stand a chance of being compliant by November 2007 deadline.
5. Overall, we support CESR's interpretation of best execution provisions. As portfolio managers, our members agree that the overarching obligations under Article 45 and Article 21 are very similar. We understand that the Commission's interpretation of scope is imminent and may result in portfolio managers being under Article 21 for some trades.
6. There are, however, several areas where we would welcome further clarification, or where we think CESR's needs to consider more explicitly and in more detail the application of best execution to portfolio managers. We address these in our answers to individual questions below.
7. More generally, we would like CESR to base any guidance it may produce on the premise that best execution under MiFID is conceived as a process, rather than a transaction-by-transaction requirement, and as an obligation to take 'all reasonable steps', rather than deliver an

absolute result. This seems to us to be absent from the consultation paper.

Execution policy 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?**

8. We agree with CESR's summary of the main issues to be included in execution policies. We would add, however, that the way in which these issues are combined, prioritised or elaborated upon in individual policies should be left to the discretion of firms. We would not expect CESR's guidance to go beyond the flexibility inherent in MiFID provisions. Its role should simply be to identify the main parameters of a best execution policy in order to ensure a common understanding across the EU.
9. We would prefer the wording in paragraph 22.b) not to suggest that *all* venues or entities have to be included in execution policies. The provision seems disproportionate in the context of portfolio management, where execution venues are mainly brokers, rather than regulated markets or MTFs.
10. Some of our larger members can use more than 100 counterparties. Although the bulk of trading will be directed to a relatively small number of brokers (and these should, of course, be included in the policy), there will also be many temporary ones, sometimes only used once.
11. If a firm's execution policy is meant to be a statement of the most important aspects of its detailed arrangements, then excessive detail about execution venues is, in our view, unnecessary. We do not see how listing every single one of the entities used by a portfolio manager – and updating the policy every time they are added or removed, with all the costs of doing so - will in any way add to investor protection or market efficiency. We would therefore urge CESR to take this into account when developing any guidance.
12. We agree that for firms caught by Article 21, their execution policy is a distinct part of execution arrangements. We also agree that it is a statement of the most important and / or relevant aspects of a firm's detailed execution arrangements.

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 to for retail clients and how should those implicit costs be measured?

13. We do not believe CESR should be aiming to prescribe a set of circumstances under which implicit costs should be taken into account – for retail or professional clients.
14. If a firm is taking 'all reasonable steps', then it will naturally consider any implicit costs in weighing up what would constitute the best possible result for the client. But, as far as we are aware, there is no accepted methodology for measuring those costs and they are not objectively quantifiable prior to the trade.
15. We agree that in most circumstances price and cost will merit a high relative importance in obtaining the best possible result for a professional client but we would not be in favour of CESR producing additional guidance on this topic.
16. In particular, paragraph 30 seems to us to be narrower than MiFID Article 44 provisions which, in addition to the type of client, also list characteristics of orders, financial instruments and execution venues and leave it up to firms to decide how they should be taken into account. Article 21.1 is also drawn more broadly and the relevant factors include price, costs, speed and so on but also any other consideration relevant to the execution of the order.

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

17. We agree with CESR's views on the use of a single execution venue. It would be helpful if any guidance from CESR stated that the definition of a venue includes regulated markets and MTFs, as well as broker-dealers, as highlighted in our answer to Question 1.
18. It is conceivable that a very small portfolio manager may choose to use a single counterparty, as the costs of transmitting orders to more than one venue would be disproportionate. This should be acceptable under MiFID, as long as the firm monitors and reviews the broker's performance on a regular basis to ensure that it is getting the best possible result.
19. At the other extreme, a very large portfolio manager trading in a particularly illiquid product over the counter may only be able to find one dealer willing to commit liquidity.

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

20. Overall, we agree with CESR's views on the degree of differentiation of execution policy and the factors on which the appropriate differentiation depends.
21. We would, however, like to comment on your conclusions in paragraph 46, as we believe they highlight a bias present in the consultation paper as a whole. CESR appears to have based its description of execution process and arrangements almost entirely on agency broking, rather than portfolio management. As a result, many of the issues discussed do not apply our members in the way intended by CESR.
22. This is most evident in description of execution services in paragraph 46. In reality, whether a portfolio manager goes to a broker or transacts over the counter, what his clients are buying is not the service of order execution but that of portfolio management. Execution has an impact on the value of portfolios but, from a client's perspective, it is not separable from the main service of portfolio management in any meaningful way. A decision about how to execute an order is always predicated on an investment decision. (And, in a way, the 'client' of the buy-side dealing desk is the fund manager making investment decisions). A client does not use a portfolio manager in the same way or for the same reasons he or she would use a broker.
23. It is therefore somewhat misleading to talk about promoting market efficiency by enabling clients to compare execution services from different firms. If, as seems likely, the Commission's interpretation of scope is likely to mean Article 21 policies and arrangements for UK portfolio managers, any guidance produced by CESR should aim to take this into account and consider in more detail the way they do business and the services they provide to clients.

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 that what is deemed appropriate should be left to the discretion of the firm. It is helpful that CESR states that firms do not need to disclose their detailed execution approach to clients. We do not believe that excessively detailed information disclosure leads to increased investor protection.

25. In the case of professional clients, we do not think more guidance is needed from CESR than what is already in MiFID. Firms have a duty to respond to proportionate and reasonable requests, so there is no need to set a mandatory requirement. In any case, what is appropriate in one context by definition may not be appropriate in another.

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?

26. We agree with CESR's description of how 'prior express consent' can be expressed.

Chain of execution

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

27. We agree that the roles played by firms in the chain of execution can be different and that the nature of the obligation will vary accordingly. In particular, we strongly agree with paragraph 72 and CESR's assertion that portfolio managers can rely to a large extent on the decisions that the intermediary makes on their behalf, provided the intermediary complies with Article 21.
28. We also support the view expressed in paragraph 74 which states that entities not subject to Article 21 can also be used, provided that portfolio manager can satisfy itself that they have execution arrangements or standards of execution quality that allow it to comply with Article 45.
29. We would add that chains of execution can be less linear than CESR's description suggests. A portfolio manager may place an order with a broker who can take a part of it on its own book, execute a part over-the-counter and send another part to an exchange. In some cases, a portfolio manager may not know at the time of placing an order how and where it would be executed, and should be able to rely on the broker, irrespective of how that broker may choose to extend the chain of execution.
30. In paragraph 68 CESR states that in order to comply with obligations under Article 45, portfolio managers must not only monitor the execution quality of the entities they use but also examine the execution approaches of those entities prior to selecting them. We agree, and we believe any such review should be commercially driven.

31. We are not sure what circumstances CESR has in mind when it talks about the overlapping best execution responsibilities in paragraph 75.

Review and monitoring

32. We agree that the requirements to monitor and review are crucial components of achieving the objectives of investor protection and market efficiency. However, we are not convinced that CESR's description adds clarity to an already complicated topic.
33. First, it is not clear to us what the substantive difference between reviewing and monitoring is and it would be useful if CESR could clarify it. They both seem to include a requirement to assess the effectiveness of the firm's existing execution approach and also look at other available venues.
34. Most of our members already have various procedures for monitoring and reviewing their execution arrangements. Some of the controls currently used do not stem directly from but contribute to the monitoring and reviewing obligations.
35. For example, it is standard practice to have in place a clear segregation of duties between fund managers and in-house dealers. Any anomalies in prices or other factors which contribute to providing the best possible result for clients are thus more likely to be detected. Most firms also conduct counterparty polling at least annually, where brokers are assessed both from a fund manager's and trading desk's perspective (i.e. on the basis of execution quality, advice, research ideas and so on).
36. There are also controls designed specifically with best execution in mind. Most firms, for example, use compliance monitoring to evaluate transactions against firm's internal arrangements and policies. Most use sampling as a way of checking for discrepancies. There are also occasional annual reviews of end-to-end arrangements and policies and their ongoing delivery of best possible result for the client.
37. Member feedback suggests that these arrangements should be sufficient to ensure the quality of execution for their clients. They would be opposed to a more prescriptive approach as monitoring and reviewing should be commercially driven.
38. We believe CESR should extend the second part of its description of monitoring in paragraph 85 so that it encompasses more than just the notion of comparability. This is because - outside the liquid and transparent equities markets - meaningful comparable transactions may not always be available. A decision about whether something constitutes the best possible result may therefore be impossible to make on a transaction-by-transaction basis – and MiFID does not

request it either. Instead, it will be made over time and it will partly be based on the knowledge and experience of individuals and teams involved.

39. CESR assertion that the choice of monitoring methodology is at the discretion of firms is very welcome. We understand this to mean that the method of testing can be proportionate to the market in question as what works in liquid equities may not be suitable for OTC derivatives. We also take sampling to be just one of the possible approaches to monitoring. It would be useful if CESR could confirm this.
40. This flexibility is important both in order to allow the competitive pressures to contribute to delivering best execution, and also to avoid disadvantaging smaller firms who may not be in a position to purchase the sophisticated monitoring and reviewing systems.
41. Ultimately, the quality of execution attained by our members is reflected in the performance of funds they manage. That competitive pressure is enough of a motive to monitor performance. The variety of controls in place, coupled with the experience, skill and judgment of portfolio managers and their dealing desks, preclude the need for detailed or prescriptive guidance.

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?

42. We believe CESR should postpone its call for evidence on execution quality data until MiFID has been implemented by all member states and the post-MiFID market has taken shape.
43. In terms of data retention, we believe the same test of reasonableness that informs best execution obligation as a whole should apply in this context - firms should not be required to keep excessive amounts of data on every single transaction.