Association Française des Entreprises d'Investissement

LES PROFESSIONNELS DE LA BOURSE ET DE LA FINANCE

FEDERATION BANCAIRE FRANCAISE

CONSULTATION CESR
Best execution under MiFID
–
Observations of AFEI and FBF

1. The French Association of Investment Firms (AFEI) represents investment service providers active in France. Its members include more than 120 investment firms and credit institutions authorised to provide investment services. Approximately one-third of AFEI members are subsidiaries or branches of foreign institutions.

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorised as banks and doing business in France, i.e. more than 500 commercial, cooperative and mutual banks. FBF member banks have more than 25,500 permanent branches in France. They employ 500,000 people in France and around the world, and service 48 million customers.

AFEI and FBF have contributed actively to numerous discussions, working groups, consultations relating to the Markets in Financial Instruments Directive (MiFID). AFEI and FBF welcome CESR's initiative to consult market participants on the very important and difficult question of the Best execution under MiFID.

2. Before answering the specific questions included in CESR's consultation paper, AFEI and FBF wish to make three general comments on the approach taken by CESR.

First, we feel not only that CESR has failed to clarify some of the issues but that it may even have created confusion on some particular questions.

Second, we are concerned that CESR should not provide an interpretation which goes beyond MiFID. In general, we do not think that CESR should issue guidance on best execution where the effect of such guidance would be to restrict the flexibility owed to firms under MiFID for each matter that are not already defined in MiFID.

Third, AFEI and FBF wish to emphasise the importance of the issue of scope of best execution. However, we wonder if a further CESR consultation on this particular matter is strictly necessary, as the Commission will shortly respond to CESR's questions by providing its legal interpretation on scope. While we appreciate the opportunity to comment on CESR's CPs, we are concerned about the shortage of time left for firms to prepare for the implementation of MiFID on 1 November 2007.

I. - Execution Policy and Arrangements

Content of an (execution) policy

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?

3. AFEI and FBF agree in part with CESR's analysis concerning the elements that should be included in the execution policy. However, they wish to make the following observations concerning paragraphs 17 to 22 of the consultation document.

➢ ***Presentation of the investment firm's best execution requirements***

4. The wording of §17 of the CESR document seems to say that the investment firm's requirements under Article 21 (Directive 2004/39/EC) and Article 45 (Directive 2006/73/EC) make distinctions with regard to best execution requirements.

We believe that the present wording should be modified to state clearly that Article 45 draws distinctions with regard to Article 19.1, concerning the requirement to act in the client's interests, whereas Article 21 deals with best execution requirements.

Supporting this recommendation is the fact that investment firms performing an RTO service do not "execute" their clients' orders, but transmit them to a third party for execution. Therefore, they can have a "transmission" policy, but not an "execution" policy.

➢ ***Paragraph 22, concerning the policy's content***

5. Paragraph 22 states:

> *22. While MiFID does not explicitly detail the precise content of an (execution) policy, CESR understands that MiFID does prescribe the main issues that the (execution) policy must address. It must:*
>
> *a) describe the investment firm's execution approach for carrying out orders for execution from the time that an order originates to the time that it is executed or settled, as the case may be;*
> *b) set out the execution venues or entities the firm uses and the role of execution quality and any other factors in selecting them;*
> *c) explain how different factors influence the firm's execution approach for carrying out client orders;*

d) explain why the firm's execution approach for carrying out client orders will deliver the best possible result for the execution of those client orders.

6. There are several problems with the wording of this paragraph:

- First, it does not make sufficiently clear that the execution policy is the key "arrangement" to ensure compliance with the requirements of Article 21 of the Level 1 Directive; that is, to try to obtain the best possible result "in most cases" and not in each case, order by order.

- Second, it does not emphasise that a fundamental aspect of best execution requirements is the "reasonable" nature of the steps to be taken. This notion of "reasonable" is particularly important because it means that best execution is a best-efforts obligation rather than an absolute obligation. The term "reasonable" should thus appear in the CESR document here, in §22.

- Last, the end of phrase a), "*from the time that an order originates to the time that it is executed or settled, as the case may be*", goes beyond the wording of Level 2, which is inopportune. It should therefore be struck out.

7. Also, point b) of §22 raises a specific problem by implying that investment firms will be required to list precise information on all execution venues rather than simply designating them by, for example, a generic name or common characteristics. However, this interpretation, which CESR confirmed during the open hearing on 7 March, makes updating more complex for investment firms.

- Market members, which often operate in multiple markets in several countries (in Europe and elsewhere), would be required not only to amend this list each time their membership agreements change but also to inform their clients of these modifications. In a post-MiFID environment, where "reshuffling" of execution venues is entirely conceivable, such a requirement is far from negligible.

- Order receivers/transmitters and portfolio managers subject to a best selection requirement would face a similar problem. In fact, it is probably greater, since the number of entities they will be able or be required to choose is much larger than the number of venues.

8. That CESR should want to impose such a burdensome requirement is even less understandable given that such a list would be of no interest to most clients.

In fact, clients' main concern is to be certain that the choice of order execution systems and market members is made objectively and efficiently, something made plain in the statement of selection criteria on which the policy is based.

So, investment firms should supply this type of information to clients who request it.

AFEI and FBF also emphasise that in any event, investment firms must provide sufficient information on their execution policy to allow the client to give informed consent to the terms of the policy. Thus, the reason for requiring them also to list all venues by name is not clear.

9. AFEI and FBF therefore propose modifying the paragraph as follows: "*set out the factors in selecting the execution venues or entities by the firm*".

10. The wording of §24 of the CESR documents, "the firm is deemed to have complied with…", is less clear than the Directive (Article 44), which states that "an investment firm satisfies its obligation", such a weakening could lead to litigation with clients.

- ***3) Opinions requested by CESR in Question 1***

In the last two bullet points, CESR asks about:
• *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?*

11. AFEI and FBF consider that the link between these two paragraphs is ambiguous insofar as the first establishes the policy's independence (from other best execution arrangements), while the second indicates that the policy is the most important part of the best execution arrangements.

AFEI and FBF agree with the CESR's analysis in the final paragraph (i.e. that the policy is an integral part and the core of the execution arrangements) and accordingly recommend deleting the phrase, "the execution policy being a distinct part of a firm's execution arrangements for firms covered by Article 21".

Factors and criteria

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?

12. AFEI and FBF totally agree with CESR's analysis in §26, to wit, that "Responsibility for assessing the relative importance of the factors, taking into account the above criteria, lies with the investment firms".

13. AFEI and FBF also agree with CESR's analysis, to wit, that "implicit costs are unlikely to be a consideration for most retail orders as the majority of these are likely to be average sized orders in liquid instruments".

The circumstances in which implicit costs could be a consideration, "even" for retail clients are, for example, and as CESR pointed out, situations where the investment firm has to handle large orders of low-liquidity instruments. It needs to be made clear, however, that the concept of "large orders" should be gauged directly in relation to the liquidity of the financial instrument and not in relation to the order's

absolute value: when liquidity is low, even an order for a relatively small nominal amount (and accessible to a retail investor) can result in a large shift in the market, thus generating a significant implicit cost.

There are other situations in which factors other than the total cost could be a consideration. For example, where the investment firm has to rely on a back-up to deal with a technical obstacle, likelihood of execution may take precedence over total price. In this case, the price will certainly be higher than it would have been if the firm had not sought back-up; but without backup, the order would not have been executed.

Last, it should be remembered that in relation to certain clients categorised as "retail" but who in fact have the same expectations as professional clients (private banking, small and midsized businesses, or institutional clients that have opted down, etc.), market impact and other implicit transaction costs can take precedence over total price.

14. AFEI and FBF do not consider that it would be helpful for CESR to set out a prescriptive set of circumstances in which implicit costs are likely to be relevant. This is ultimately a matter for each firm to determine, based on its trading experience and expertise and taking into account the characteristics of the client and the order. MiFID's provisions are clear and specific enough.

Professional Clients

15. CESR says in §29: "While MiFID only directly addresses the concept of "total consideration" in the context of retail clients, CESR considers that the concept is relevant for the assessment of best execution for professional client orders too, because in practice it would be difficult to disregard the importance of the net cost of a purchase or the net proceeds of a sale in any evaluation of best execution. Since the best execution requirements are intended to drive market efficiency and ensure client protection generally, 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."

Although AFEI and FBF agree that the price factor can also be potentially important for professional clients, too, the wording proposed by CESR at this stage is not acceptable because it is inconsistent with the wording of the Directive. We would point out that the Level 2 Directive explicitly provides that "total price" is the predominant factor for retail clients only. This satisfies a very precise requirement, since it is unanimously recognised that factors other than price or cost – e.g. speed, likelihood of execution or market impact – may be of decisive importance to professional clients.

16. Also, AFEI and FBF wonder about the wording of §30, which says that investment firms must structure their execution policy "in a manner that is appropriate to a particular type of client". This seems to imply that there could be as many policies as clients. This is absolutely not the meaning of the Level 1 Directive, which refers only to "each category of financial instruments". This would also be contrary to the notion officially set forth in §26, that "Responsibility for assessing the relative importance of the factors, taking into account the above criteria, lies with the investment firms".

Also, if CESR's aim is to require investment firms to apply narrowly segmented execution policies, AFEI and FBF are totally opposed to such an interpretation, which goes far beyond the meaning of the

Directive. In any case, since the paragraph is in a section concerning professional clients, CESR should not underestimate the substantial commercial import of this issue. Investment firms that will have to introduce execution policies will be operating in a highly competitive environment, and this will be a strong incentive to respond positively to their clients' requests or demands. It is likely, therefore, that the market will bring about a relatively narrow segmentation of execution policies all by itself.

17. Last, and as secondary matter, CESR's example concerning hedge funds is inappropriate. It introduces an element of uncertainty as to whether hedge funds qualify as eligible counterparties, whereas in our view, they certainly do.

Inclusion of the firm's fees and commissions when deciding between execution venues

18. AFEI and FBF approve of CESR's clarification to §36, namely, that the aim of the disclosure requirements is to allow the client to distinguish between the financial instrument's price and the commission charged for execution at the given venue.

19. More generally, while AFEI and FBF agree with CESR's analysis concerning the inclusion of investment firms' fees and commissions when deciding between execution venues, we would nevertheless point out, insofar as necessary, that CESR's reasoning must not obscure the fact that the Directives consider "total price" to be the predominant factor for retail clients only.

We therefore believe that CESR should clarify its position, for example, by including the footnote on page 7 ("This discussion relates to price and costs only and is without prejudice to other factors that may contribute to the best possible result for the execution of client orders") in §34.

Possibility of a single execution venue

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

20. AFEI and FBF fully agree with CESR's analysis in §39, notably when its says that "there may be circumstances in which only one particular execution venue or entity will deliver the best possible result on a consistent basis for some instruments or orders […]".

21. In §38, CESR states: "MiFID establishes a competitive regime for the execution of client orders. It promotes competition between the different trading venues that are willing to offer trading services as much as it favours the emergence of new trading venues. In this respect, it is in the MiFID spirit as reflected in Article 21, that whenever there is more than one trading venue that offers execution relevant services investment firms should consider their inclusion in its execution policy. The tests for the inclusion of the different venues in the execution policy (requirements to include those venues that enable the investment firm to obtain the best possible result on a consistent basis) have, therefore to be analysed against that background."

In the case in point, AFEI and FBF wish to reiterate the comment concerning point 22b relating to the list of venue names, which is absolutely unadvisable in an execution policy (see no. 7).

22. AFEI and FBF consider that CESR goes beyond MiFID in asserting that investment firms "should consider their inclusion in its execution policy". In fact, the Directive requires that the policy be regularly monitored for efficiency and be reviewed on an annual basis. There should be no question that the new venues are to be monitored or that the decision to actually include them in the policy is always up to the investment firm.

23. Moreover, by stating in §39 that the investment firm should consider the advantages of "indirect" access to a venue that had been ruled out, CESR is too prescriptive and goes beyond MiFID.

24. Last, in §40, CESR should make clearer the fact that in such cases, “within corporate groups”, “the appropriate action” is to be taken at the level of the Group.

Differentiation of the policy

25. CESR states in §46 that "the level of differentiation in a firm’s (execution) policy should be sufficient to enable the client to make a properly informed decision about whether to utilise the execution services offered by the firm". AFEI and FBF agree with this analysis.

26. CESR also says that this description should be sufficiently detailed with regard to "relevant categories of instruments, orders, clients and markets" that the investment firm deals with.

Concerning financial instruments, CESR also says (§44) that "a firm’s execution policy will at least need to address the different classes of instruments for which it handles orders. Examples of such classes are equities, debt instruments and derivatives (which would need to be further distinguished between exchange-traded and OTC products, if appropriate)." While Article 21.3 of Level 1 and Article 45.5 of Level 2 do indeed provide that the policy shall address each class of instruments, the notion of "class" must be understood here in a broad sense. AFEI and FBF consider that only the three largest classes are concerned, i.e. (1) equities, (2) debt instruments, and (3) derivatives. Investment firms should not be required to make more distinctions between instruments than these three large classes.

The distinction between "exchange-traded" and "OTC" derivatives is ill-advised because:

- this distinction concerns not the class of instruments (derivatives), but the way they are traded (In that case, why not make the same distinction for debt instruments?); and
- it interferes with the current debate over the scope of application.

Similarly, concerning the "type" of client (§45), the Directives do not require that any distinction be made between a policy for a retail client or for a professional client

Concerning the distinction according to the type of order (§45), CESR must emphasise that this is merely an option left to the discretion of the investment firm, since it is not provided for in the Directives.

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

27. This differentiation should take into account, in accordance with the Directives, the three major classes of financial instruments, the classification of clients as either retail or professional, and the various execution venues chosen by the investment firm in its policy.

Apart from these aspects, firms should have the flexibility to determine their own approach. The scope for flexibility should not be reduced by minimising firms' discretion through CESR guidance.

II. - Disclosure

Professional clients

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?

28. Regarding the first question, AFEI and FBF agree with CESR's view 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".

29. Regarding the second question, the answer is no, because AFEI and FBF consider that it is inappropriate to demand more information than that already required by the Directive.

III. – Consent

Prior consent and express consent

30. CESR's view is that "'prior consent' may . . . be tacit and result from the behaviour of the client such as the sending of an order . . . , whereas 'prior express consent' must be actually expressed by the client". It is then additionally explained that "'prior express consent' . . . may be provided by signature in writing or an equivalent means . . . or orally by telephone or in person".

AFEI and FBF consider that this wording expresses a misconception of the difference between tacit consent and express consent. Tacit consent is understood as consent resulting from a lack of any expressed opposition from the client beyond a pre-established deadline. Express consent supposes some positive sign of consent, which can of course be a signature or some other equivalent means, but

also some other act such as, for example, placing an order after being informed that it will be handled differently and how it will be handled differently.

31. Consequently, AFEI and FBF would like CESR show more flexibility, at least with regard to professional clients. It should be recalled that this provision concerning express consent, which was initially proposed by France, was included with a view to eliminating the concentration rule in the equity market. The aim was to ensure that clients were clearly aware of the possible impact of executing their orders outside a regulated market. However, it would not be useful to extend this notion, since some markets like the bond market already operate to such an extent outside of organised markets that many clients do not even imagine that their orders could be executed any way other than bilaterally. Getting "express" consent from these clients (in a form other than the placing of an order) could, in practice, require extremely burdensome administrative procedures whose usefulness would then have to be clearly weighed against what was at stake.

AFEI and FBF therefore consider it necessary that, in the case of professional clients, any positive sign of willingness should be understood as "express" consent.

32. By the same token, CESR should also make provision for a "grandfathering" mechanism by which "old" clients, i.e. those who have done business with the firm before 1 November 2007 and who had already made several transactions outside a regulated market or a multi-lateral trading facility, would be deemed already to have given their "prior express consent" with these previous transactions.

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?

33. AFEI and FBF do not agree with CESR's views on prior express consent (see comments above).

IV. – Chains of Execution

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

34. CESR’s analysis concerning relationships between firms in chains of execution is not completely clear. This part of the document should make plain that each investment firm in the chain has its own responsibilities to its own clients. Also, this section does not seem sufficiently to recognise that investment firms may belong to the same group.

35. CESR says in §68, ". . . portfolio managers and RTOs must not only monitor the execution quality of the entities they use, but also examine the execution approaches of these entities prior to selecting them and keep these approaches under review as appropriate."

AFEI and FBF believe that the end of the phrase (underlined above) should be deleted, since it could be construed to mean that an RTO has a duty to see that a broker or a venue changes its execution policy if its execution service no longer meets the RTO's requirements. When this is the case, it should perhaps be the RTO that changes its policy (for example, by no longer using the broker), but it should be clear in CESR's paper that the RTO has no obligation to get the broker to modify its execution policy. (This recommendation is supported by the fact that the RTO and the broker will have a contractual relationship.)

For example, if a market is insufficiently liquid, a member of this market can decide not to send its orders to the market any longer, but it is inconceivable that this member should order the market to change its own operating and execution procedures.

IV. – Review and Monitoring

Differing contexts for monitoring and review

36. CESR's analysis on monitoring and review is not completely clear.

AFEI and FBF consider that the requirement to monitor applies to checking both compliance with the policy and its efficiency. Its purpose is to reveal shortcomings in the execution of orders in relation to the defined policy and, if need be, to correct these shortcomings. Is the policy actually being applied? Is execution quality satisfactory? Are the venues selected by weighting the factors and criteria decided in the policy? Monitoring must therefore be regular, in accordance with Article 45.6 of Level 2.

The purpose of the obligation to review is to look critically at the policy itself as it is defined: Is the definition of my policy, i.e. the weighting of factors and criteria that I have determined, producing the "right" results, the best possible results? This review must be done at least once a year and whenever a material change occurs, in accordance with Article 45.6 of Level 2.

37. AFEI and FBF consider that CESR's views in their present form do not clarify this point and could even be a source of confusion. For example, the second bullet point of §85 poses a question related to the requirement to review ("whether a firm is actually obtaining the best possible result under the policy") in the section related to monitoring (§85, "requirement to monitor").

AFEI and FBF also observe that this is not an immediate concern, since investment firms will not have to deal with this issue until several months after the implementation of the Directive on 1 November 2007.

V. - Execution Quality Data

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?

Call for evidence

38. AFEI and FBF consider that the call for evidence concerning execution quality data is premature at this stage.

In our view, CESR should wait until MiFID has been implemented and its impact can be assessed before conducting further studies into MiFID which are not required at this stage. It is particularly important not to distract firms' attention from the priority of preparing for the implementation of MiFID.

VI. – Other issues

Data retention implications of Article 21(5) of Level 1 (demonstrating compliance)

Call for evidence

39. AFEI and FBF want to emphasise that the conditions for demonstrating that the execution policy has been followed should be reasonable in relation to the objective.

In this regard, Article 21.5 of the Directive may create an ambiguity, as it requires that investment firms "demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy". Based on this provision, it seems conceivable that clients might try to get their financial services providers to supply data on market conditions at the time an order was executed, going back as far as five years, to demonstrate that the investment firm had executed it in the best possible manner, having regard to its policy.

40. With regard to this issue, AFEI and FBF would point out the following:

- Such an obligation would exceed the requirement of Article 21.5 of the Directive. Demonstrating through an audit trail, for example, that all phases of the execution policy have been followed does not require also demonstrating that the best possible result was obtained for an order in the market at the moment it was executed.

- Such an obligation would necessitate in any case clarifying exactly which data must be retained: executions done in different trading systems included in the execution policy at the time the client's order was handled, the best bids/asks in these trading systems (with or without market depth), etc.

- Even assuming that a very large quantity of data were retained, it would still be necessary to "scientifically" prove that this was adequate to reconstruct the prevailing market conditions when the order was executed.

- The cost of such a requirement seems exorbitant in comparison with the benefit that might be derived from it. Shouldn't we remember that clients almost never make complaints about the execution of an order more than six months afterwards, in the case of retail clients, or a few days afterwards for professional investors?

41. With the prospect of future work on this issue, the following ideas, which will need to be discussed in depth with professionals as well as tested against "practical" and "technical" realities, appear worthy of consideration:

- Implementation of the best execution policy is expressed through internal procedures and systems specific to each investment firm. Under these circumstances, the investment firm should be able to demonstrate to its client that the order has been executed in accordance with the procedure that it has implemented: showing that the transaction has been executed with the procedure demonstrates that the transaction is in compliance with the policy.

- According to the weight given to the various criteria in the policy, proving that the execution of orders is in compliance with the policy is the same as demonstrating that the criteria under consideration have been satisfied (for example, if the predominant criterion is likelihood of execution and settlement, then the proof of the policy's application will be that the orders have been executed and settled). If need be, support can be provided with certain data retained or supplied by a third part (e.g. price as the predominant criterion).

- The investment firm could give clients information on the way it reviews its execution policy each year. In particular, the investment firm could provide information on the criteria it applies to ensure that the execution systems obtain the best possible results for clients.

Other solutions can be envisaged that depend mainly on investment firms' ability to agree with their clients on the elements of proof that can be provided to demonstrate that the best execution rule is being respected. Experience will show whether some of these elements of proof can be selected for general application, for example, in a code of conduct prepared by professional organisations.

Other issue not mentioned in CESR's CP: the client's specific instruction

While we understand from the CESR document that a request to execute an order in a selected market is a specific instruction, CESR should also to note that Value Weighted Average Price orders (VWAPs, used in Euronext markets) are "specific instructions given by the client".

With a VWAP order, an investor asks an investment firm to execute a principal transaction in equity securities with it, at a pre-arranged price equivalent to the weighted average market price for the security in question.

In the two cases above, the client clearly restricts the investment firm's freedom in executing these orders, which is totally consistent with the definition of "specific instruction". AFEI and FBF ask CESR to kindly confirm this point.