

RESPONSE

Best execution under MiFID

CESR Public Consultation - Ref: CESR/07-050b

1. The European Banking Federation (EBF)¹ welcomes the opportunity to comment on CESR's public consultation on best execution under MiFID. The **EBF considers best execution to be one of the cornerstones of the forthcoming MiFID regime** since it brings together the fundamental elements of MiFID, appropriate protection of investors and a competitive pan-European trading environment.
2. Whilst welcoming CESR working in this area to provide clarity through Level 3 guidance on how to implement the best execution regime, **we remind CESR that the timing of such guidance has now become critical.** We strongly believe that CESR's guidance on the most important elements of MiFID (e.g. best execution, the passport, transaction reporting, inducements etc.) **must be finalised by the end of the first quarter of 2007.** This would provide industry with a degree of certainty which would allow firms to proceed with their implementation plans. After CESR has published guidance on these most critical aspects of the MiFID regime, further guidance should only then be issued (after due consultation with the market) in 2008 and after the date for MiFID implementation has passed.

I. General remarks

3. We welcome CESR's consultation paper on best execution under MiFID for its generally **pragmatic approach and clarity of thought.** Supportive of CESR's statements in paragraphs 8 and 10 of the consultation paper, we strongly believe that CESR's Level 3 work should focus on regulatory convergence and not on the creation of new requirements for investment firms and credit instructions through the guidance it proposes.
4. The banking community favours the approach of those Member States and their supervisors that are committed to the direct / intelligent "copy out" approach to the MiFID Level 1 and Level 2 Directives. This allows investment firms to develop approaches to be in full compliance with MiFID that appropriately reflect the client composition and the business carried out by respective institutions. This is especially important when it comes to best execution, as **CESR rightly recognises in paragraph 18, since the policy driven approach to fulfilling best execution allows firms the space to differentiate themselves commercially through their best execution arrangements and policies.** This approach facilitates competition within the industry with the end result being an improved service, as a product of that competition, for the client.

The banks' view of best execution under MiFID

5. European **rules around best execution are welcome** since they provide an important degree of transparency and assurance for clients about how their orders are executed with their interests in mind.
6. MiFID establishes that **best execution should be policy driven**. This means that firms fulfil best execution by having regard to their house policy before executing an order. The EBF believes that policy-driven best execution allows clients to have the best possible result for an order irrespective of its nature in relation to prevailing market conditions. CESR rightly recognises (paragraph 20) that the execution policy should be a summary of the detailed arrangements needed to meet the MiFID requirements, rather than a document where all the detailed arrangements are set out in full.
7. Conversely, best execution should under no circumstances be driven by processes, which would be required to achieve best execution on an order by order basis. By its very nature, how best execution is achieved for clients will vary from case to case, product and client. This is why we believe **it is of the utmost importance that best execution remains the responsibility of the firm towards its client**. It should suffice therefore that firms satisfy their supervisors that they are compliant with MiFID's best execution requirements by having in place an appropriate policy document and if called for demonstrating through a representative sample of trades that best execution obligations have been met.

Scope of CESR's consultation paper

8. We note that the consultation paper does not deal with the scope of the obligation pending receipt of the European Commission's interpretation of the scope of the obligation under MiFID. **The EBF considers that it is important, however, to note that the consultation paper as drafted considers best execution very much from the perspective of cash equities** and that many of the approaches proposed by CESR would not work, or would need to be significantly adapted, if applied to fixed income dealer markets or to structured products.

II. Specific remarks

Execution Policies 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?*
9. Firstly, in respect of paragraph 22 items a) to d), **we note that only items b) and c) can be found in the MiFID implementing Directive, Article 46 (2).** Information in respect of item a) will generally provided as part of a firm's general terms of business. However, what CESR sets out in d) is too detailed for the purposes of the best execution policy and so should not be included in the document.
 10. Notwithstanding the statement above, we agree with CESR's views on the main issues to be addressed in an execution policy. Members consider it to be very important that there is **reference made to the understanding that a firm is expected to achieve the best possible result on a consistent basis and not in every case.** This would help clarify matters greatly as we fear that some CESR members will seek to promote a view of best execution having to be demonstrated in every case, which ultimately goes against what is set out in MiFID.
 11. We also agree with CESR when it would consider the execution policy being a distinct part of a firm's execution arrangements for firms covered by Article 21.
 12. We remind CESR (paragraph 22) that it is generally understood that the best execution policy document and its contents are the responsibility of the bank. For example, banks may consider it appropriate to have one policy for order execution and another policy for order transmission.
 13. We do not agree with CESR where it states that **an execution policy should explain how different factors influence the firm's execution approach for carrying out client orders.** We believe that this requirement goes beyond what is set out in Level 2 and that an exhaustive explanation of the factors that influence the firm's approach for carrying out client orders would be of little added value to the client itself. A statement of the firm's professionalism and integrity, where it works in the best interests of the clients, would be a more appropriate inclusion on the contents of the best execution policy.

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?

14. We agree that **implicit costs² 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. When assessing the costs for retail clients, recitals 71, 72 and Article 44 (3) paragraphs 1 and 2 of the implementing Directive must be taken into account. These provisions make the total price the most important factor when executing orders on behalf of retail clients, so emphasis on implicit costs would be out of line with the MiFID directive itself.
15. Furthermore, **consideration of implicit costs (i.e. in the retail and professional contexts) ought not be relevant** since costs relating to best execution should be costs which are capable of being known at the time that the transaction is executed and should be actual costs for which payment will have to be made by the client. Market impact is not a cost for which payment is made by the client.
16. Furthermore, **we argue that measuring implicit costs in general would always involve a subjective judgment where pure ‘total consideration’ issues may be over-ridden.** For example, it would be doubtful if a scientific approach to measuring implicit costs could be applied to a large order in an illiquid security directed to an order book system as off set against the potential price disadvantage to the client as the market reacts to the order.
17. We also remind CESR that **factors other than cost are equally valid considerations** in fulfilling the requirement to perform best execution both in the retail and professional space. Speed and the likelihood of execution are two such important considerations that assume a particular significance in non-equity markets and with regard to large portfolio trades.

Professional clients

18. While MiFID only directly addresses the concept of “total consideration” in the context of retail clients, CESR considers (paragraph 29) 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 next cost of a purchase or the next proceeds of a sale in any evaluation of best execution.
19. **We do not consider that the “total consideration” concept should be given the weight CESR attributes to it in the professional context.** Professional clients are, by definition, able to assess their own execution requirements and supervisors should, generally, seek to avoid interference or overly zealous regulation in this sphere. As we mention above, factors other than “price” and “cost” will play a much bigger part in transactions between firms and professionals, particularly in non-equity markets but also with regard to large portfolio trades. The ability to execute the transaction in a way which least disturbs the market becomes much more important in such circumstances, either because of the size of the transaction or, in other circumstances, because of low liquidity in the security.

² We assume that in this context implicit costs mean those costs related to the likelihood of execution and settlement, the size and the nature of the order, market impact and any other implicit transaction costs (Recital 67 of the implementing Directive). Therefore, in some situations, e.g. some orders from high net worth individuals or small companies categorised as “retail”, market impact and other factors could be equally or more important.

20. As we set out clearly in our general remarks, the MiFID best execution requirements can only be realistically fulfilled if best execution is a policy driven undertaking. **In paragraph 30 CESR states that “investment firms should weight the factors in a manner that is appropriate to a particular type of client.” The EBF has some reservations.** In stating this CESR moves away from the policy driven approach the MiFID text points to and creates an interpretation that best execution would have to be proven on a case by case basis. Instead the firm’s best execution policy should sufficiently accommodate a best execution for all types of client taking into account all circumstances.

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

21. CESR introduces a two step approach to the selection of venues in paragraph 32 and 33. Paragraph 32 could be read as the investment firm should not focus on the overall price of using a venue but only on the execution quality of a venue. If this is the case then it is too narrow. The price of access to and/or membership of a venue is very important when selecting venues due to the fact that price is an important factor when providing best execution for (retail) clients. Hence, **the investment firm should also consider the overall cost for the firm and thereby for the client of having access to relevant venues when selecting these.**
22. CESR considers (paragraph 34) that a firm’s execution policy should include those venues likely to provide the best prices on a consistent basis. However, best execution requirements should also ensure the best possible net result for a client, which means that varying costs to be borne by the client according to the competing venue chosen, where they exist, should be taken into account so that the client pays the lowest possible net cost (or receives the highest possible net proceeds). This is a helpful indicator of CESR’s thinking.
23. **We agree with CESR (paragraph 37) insofar as it considers that firms are free to set their fees or commissions at whatever level they choose,** provided that no venue is unfairly discriminated against.

Possibility of a single execution venue or entity

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

24. It is possible for a **firm’s policy to include only one execution venue in respect of a particular product,** provided the firm has taken all reasonable steps to identify those venues which enable it to obtain the best possible result on a consistent basis in respect of that products.
25. Furthermore, we would agree with CESR where it considers (paragraph 39) that **it may be reasonable in some circumstances to decide against connecting to potential execution venues that offer a price improvement, because of the costs of access.**

26. We note however, **in common with the majority of the consultation paper, CESR's approach is mainly relevant for shares.** CESR's paper should also reflect the OTC-market where a product could be tailored so there is not a relevant execution venue to use to for comparison but it would be most appropriate to wait for the Commission's interpretative communication in this respect.

Differentiation of the policy

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

27. We agree 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 by the firm. The practical details and the extent to which firms make such a differentiation should be left to firms, and their clients, to judge by means of competition in the market.

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?

28. We agree that **it is up to firms to determine what level of information disclosure is appropriate for professional clients**, in line with Recital 44 of the implementing Directive. MiFID does not require investment firms to consult professional clients to determine what level of disclosure is appropriate for such clients.
29. The **level and type of information that a firm must provide to a client about its policy will vary depending on the firm, product and client type.** The way in which this requirement is met is at the discretion of the firm, and firms may therefore choose to include the additional information required for retail clients in their policies.
30. However, **firms should not 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. Such a requirement would be super-equivalent under MiFID, and super-equivalence in this area would not be justified.

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?

31. Some EBF members fully agree with CESR on how “prior express consent” should be expressed. Other members consider that a client’s agreement to deal is sufficient to imply “prior express consent.” Clearly this is **a requirement that is dependent on national requirements relating to contract law** and as a consequence what would be acceptable will vary according to national legal traditions. CESR should not prescribe detail that goes beyond what is required by MiFID in this area.
32. However the suggestion (paragraph 61) that firms should demonstrate **tacit consent** can only be taken to mean that the firm can demonstrate that it issued the execution policy to the client, and that the client subsequently gave an order. This clarification would be helpful.

Chains of execution

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

33. **We consider that CESR’s “chains of execution” analysis is quite helpful and is a good attempt to grapple with the complex situations which can arise during the execution process.** The paper focuses on a linear chain e.g. client to RTO to broker to execution. CESR should also recognise that at times a larger order will be broken down into smaller parts and executed across a range of different venues. This also needs to be taken into account.

Review and monitoring

Requirement to monitor

34. We support CESR’s approach to the monitoring methodology it sets out (paragraph 86). **We believe that it is right that is at the discretion of firms and that it is not necessary for these purposes that a firm review every transaction.** Sampling, with regard to the size and nature of the transactions would be an appropriate alternative to reviewing individual transactions.

Differing contexts for monitoring and review

35. We agree with CESR when it considers (paragraph 87) that firms that sit at different points in the chain of execution may need to take different approaches to their review and monitoring obligations.
36. However, **the third bullet point of paragraph 87 is not, we feel, a matter for regulation.** If a firm dealing on its own account having undertaken its own due diligence, chooses to execute an own book transaction with an investment firm, then that execution will in any event have to be consistent with the client’s own execution arrangements and objectives. Indeed, it is highly unlikely that for anything other than a liquid security the investment firm would be able to access details of the execution quality available from competing venues. Simply, that is not the way the market works. Obviously firms will, from their own commercial

viewpoint, do whatever they can to ensure that they are competitive in the market, or they will not get any business.

Execution quality data³

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?

37. If, as CESR states in paragraph 38 on the consultation paper, “MiFID establishes a competitive regime for the execution of client orders” it follows that clients already have the opportunity to evaluate execution quality, because firms operate in a competitive market.

38. We regret CESR’s inclusion of on the comparison with SEC Rule 11Ac1-5 for two principled reasons:

- best execution is and should be the responsibility of the firm. Fulfilling best execution in comparison with certain rules moves away from this approach and therefore should be strongly discouraged; and
- it is important to note that Rule 11Ac1-5 was replaced by Rule 605 of Reg. NMS. Reg. NMS covers common stock, and potentially other securities that fall under the SEC Rule 3a-11 definition of equity securities, but it does not cover bonds. Therefore, we do not, in any event, believe that CESR’s comparison with a SEC rule is a useful or appropriate one.

Call for evidence on execution quality data

Respondents are asked to describe the execution quality information that is available commercially and what additional information may be needed. Respondents are also asked to comment on what key information competent authorities should expect firms to be considering when evaluating their own execution performance as well as the execution quality of the venues and entities to which they have recourse.

Other issues

Call for evidence on demonstrating compliance with best execution

Developments in respect of data consolidation, pre- and post-trade transparency and execution quality data will also be relevant for demonstrating compliance. CESR is interested in receiving suggestions and feedback from industry on possible implementation approaches in this area with a view to promoting supervisory convergence on these important points after implementation of MiFID.

³ The issue of what execution quality data is appropriate is dependent in part upon the scope of the obligation. For the purposes of responding to this section of the consultation paper we have focused on execution quality data available with regard to equity markets (while recognising that the best execution obligation is not limited only to those markets).

39. In paragraph 2 we urged CESR to focus **on the immediate priorities to facilitate the smooth and timely implementation of MiFID by 1 November 2007**. Despite an encouraging start to its MiFID Level 3 guidance, we feel that CESR still has much work to do in respect of its own thinking on key issues (such as inducements) and following the European Commission's anticipated interpretative communications on key aspects of the MiFID regime, the scope of best execution being one such aspect.
40. Therefore, and in light of the fact that the two issues on which CESR has now called for evidence warrant separate papers in due course, **we do not feel it appropriate that CESR's calls for evidence in such a way at this time**. We restrict ourselves to stating that at this juncture the EBF has a strong preference for CESR converging around a view of best execution being fulfilled on "a consistent basis" and the second view expressed in paragraph 95, that is Article 21(5) requires only that the firm demonstrates that it followed its policies and procedures. We do however look forward to providing CESR with the evidence in due course in response to the respective separate papers we encourage CESR to bring forward.