



THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-050b

Best execution under MIFID

Public consultation

February 2007



INDEX

Introduction	Page 3
Execution Policy and Arrangements	Page 6
Disclosure	Page 12
Consent	Page 15
Chains of Execution	Page 16
Review and Monitoring	Page 19
Execution Quality Data	Page 22
Other issues	Page 24



Background

1. Directive 93/22/EEC of 10 May 1993 on investment services (ISD) brought about the minimum harmonisation necessary to secure mutual recognition of authorisation and prudential supervision across the Member States. Directive 2004/39/EC of 21 April 2004 (hereafter Level 1) and its Implementing Directive 2006/73/EC (hereafter Level 2) will significantly enhance harmonisation and underpins uniform standards of investor protection throughout the Community (together, hereafter MiFID).
2. MiFID's best execution requirements are an important component of these investor protection standards. Article 21 of Level 1 sets out the requirements for investment firms that execute client orders for MiFID financial instruments. The requirements that apply to investment firms that receive and transmit orders to third parties (hereafter RTO's) or manage portfolios and place orders for execution with third parties (hereafter portfolio managers) are set out in Article 45 of Level 2 under Article 19 of Level 1.
3. There is an overarching requirement under Article 21 of Level 1 and Article 45(4) of Level 2 for investment firms subject to MiFID's best execution requirements to take all reasonable steps to obtain the best possible result for the execution of client orders, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. To implement this overarching requirement, MiFID imposes several obligations on investment firms.
4. Investment firms that execute client orders (i.e. those subject to the Article 21 best execution requirements) must:
 - o put in place "arrangements" including an "execution policy" so as to take all reasonable steps to obtain the best possible result for the execution of their client orders;
 - o obtain client consent to the execution policy; and
 - o be able to demonstrate on a client's request that they have executed the client's order in compliance with their execution policy.
5. Investment firms that receive and transmit client orders or place orders with entities for execution in the course of managing portfolios for clients (i.e. those subject to the Article 45 best execution requirements) must implement a "policy" to achieve the best possible result for client orders.
6. The overarching best execution requirement to deliver the best possible result is the same under Article 21 and Article 45. While the steps required to reach that standard are referred to as "arrangements" under Article 21 and "policy" under Article 45, these steps are similar in that they require firms to have a comprehensive execution approach¹ to achieving the best possible result.
7. All investment firms must also:
 - o disclose "appropriate information" to clients about the firm's (execution) policy²;
 - o monitor their compliance with the execution approach and correct deficiencies;

¹ We use the term "execution approach" hereafter to refer broadly to the overall "arrangements" under Article 21 of Level 1 together with the "policy" under Article 45 of Level 2. For further detail see paragraph 17, below.

² We use the term "(execution) policy" hereafter to refer to the "execution policy" under Article 21 of Level 1 together with the "policy" under Article 45 of Level 2.



- monitor whether their execution approach is allowing them to obtain the best possible results for clients and, if not, correct deficiencies; and
- review their execution approach as a whole and the execution venues or entities they use on a regular basis, whenever a material change occurs and at least annually, to ascertain whether the approach is delivering the best possible results for the execution of client orders.

Implementation Issues

8. Discussions in the CESR Implementation Forum suggest that many Member States and competent authorities will implement MiFID's best execution requirements by introducing the terms of the Directives directly into their legislation or rulebooks. By copying-out, there will be harmonised Level 1 and Level 2 requirements. However, important questions remain such as how competent authorities will interpret and supervise compliance with these rules in practice.
9. Consistent with its Level 3 responsibilities, CESR has a role to play in promoting supervisory convergence in respect of best execution. CESR members have agreed views on a range of issues which are outlined in this consultation paper. CESR is now publishing this paper for comment by investors, the financial services industry and other stakeholders.

Objectives

10. The objective of this paper is supervisory convergence and not the making of new rules. However, as these are new Directives, CESR recognises that setting out agreed approaches to supervision will inevitably involve CESR expressing its views on the meaning of some of the central concepts and terms.
11. We have not attempted to be comprehensive in this paper. Rather, we have selected key areas on which firms and regulators need clarity in order to proceed. Given the important role of best execution requirements in promoting market efficiency and investor protection, it is possible that CESR will do further work on best execution should other issues emerge where such work would be useful for supervisory convergence.
12. This paper does not address questions of scope of application of the best execution requirements that the industry has presented in several Member States. CESR has written to the Commission on some of these issues asking for its view. CESR will consult market participants on these issues and related aspects after having received the response from the European Commission.
13. Furthermore, there are some types of transactions that do not fall clearly within or outside the service of execution of client orders and so it is not clear whether best execution requirements applies. CESR is minded to postpone consultation on these issues until the European Commission has responded on the issue of the scope of best execution.
14. The main issues in this paper are:
 - contents of execution policy and arrangements
 - disclosure to clients
 - client consent
 - relationships between firms in chains of execution



- review and monitoring
- execution quality data

Public Consultation and Timetable

15. Comments are invited on all aspects of this paper but where we anticipate that feedback will be particularly useful, we have directed stakeholders to some issues for particular comment. Given that the issues this paper addresses are likely to attract a broad range of interest, we intend to hold a public hearing to provide stakeholders with an early opportunity to comment. The date of the hearing will be communicated. This would be in addition to any written feedback that stakeholders may submit to CESR. CESR also invites stakeholders to provide input to the following **calls for evidence**:
 - a) Execution quality data (see paragraph 94);
 - b) Demonstration of compliance with best execution requirements (see paragraph 96).
16. The consultation period will close on **16 March 2007**.



Execution Policies and Arrangements

17. An investment firm subject to Article 21 of Level 1 must have an "execution policy" and effective "arrangements" for complying with the overarching "all reasonable steps" requirement in Article 21(1). A firm subject to Article 45 of Level 2 must have a "policy" for complying with the overarching "all reasonable steps" requirement set out in Article 45(4). Both of these requirements, although worded differently, are intended to ensure that the firm has a comprehensive approach to meeting the requirement to take all reasonable steps to obtain the best possible result for the execution of its client orders. These requirements operate to ensure that a firm has control over its execution practices and procedures. For example, the requirement to have arrangements and/or a policy (depending on the role of the firm in the execution process) helps to ensure that the firm's execution practices and procedures are understood both by the relevant persons within the firm (including compliance staff) and by the competent authority. They also form the basis for disclosure requirements.
18. Article 21 of Level 1 requires firms that execute client orders to establish an execution policy, provide appropriate information about that execution policy to clients and obtain client consent to the execution policy. These requirements are intended to provide investor protection and promote market efficiency by encouraging clients and potential clients to review certain key information about a firm's execution arrangements in the form of the execution policy. This enables clients to compare execution services from different firms and select the one that best suits their needs based on differences in their execution strategies, objectives or processes. Article 21(5) further reinforces this investor protection objective by requiring firms to demonstrate compliance with the execution policy upon client request.
19. In comparison, portfolio managers and RTOs are required to establish and implement a policy and disclose appropriate information about that policy but there are no requirements in Article 45 of Level 2 for client consent or demonstration of compliance to clients.
20. Next, we consider what a competent authority would expect to see in an investment firm's Level 1 Article 21 "execution policy". CESR has not considered what specific content a firm should include in its execution arrangements, beyond what is required for the execution policy. Article 21(2) suggests that the Article 21 "execution policy" is an aspect of the firm's overall "execution arrangements". CESR therefore considers that the execution arrangements are the means that an investment firm employs to obtain the best possible results, including its strategy, practices and procedures, while the execution policy may be understood as a statement of the most important and/or relevant aspects of those execution arrangements.
21. As the Article 45 "policy" (implying procedures for implementation) is analogous to the Article 21 "execution arrangements" and the Article 21 "execution policy" is both an aspect and a summary of the firm's overall "execution arrangements", we would expect the Article 45 "policy" of a portfolio manager or RTO to include similar elements to those contained in the Article 21 "execution policy" discussed below.

Content of an (Execution) Policy

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 out³ 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;⁴
- 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.

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?

Factors and Criteria

23. The requirement that the investment firm shall take all reasonable steps to obtain the best possible result for its clients includes having regard to the following factors referred to in Article 21(1) of Level 1:
 - price;
 - costs;
 - speed of execution;
 - likelihood of execution;
 - speed of settlement;
 - likelihood of settlement;
 - size of the order;
 - nature of the order;
 - any other consideration relating to the execution of the order.
24. Whenever there is a specific instruction from the client, however, the firm must carry out the order in accordance with that specific instruction and the firm is deemed to have complied with the best execution requirement to the extent of that instruction⁵.

³ In this paper, we use the term "carrying out" to encompass (i) executing a client order, (ii) when providing the service of portfolio management, placing an order with an entity for execution that results from a decision to deal in financial instruments on behalf of a client, and (iii) when providing the service of reception and transmission of client orders, transmitting client orders to other entities for execution. The Commission has recently confirmed its intention to give this meaning to the term "carrying out" that is used in Articles 47, 48 and 49 of Level 2 on client order handling.

⁴ Article 21(3) of Level 1 provides that the execution policy must include information about the execution venues that the firm will use. The requirement for a "policy" under Article 45(5) of Level 2 also includes a requirement to identify execution entities that enable the firm to comply with the overarching requirement under Article 45(4) of Level 2 to take all reasonable steps to obtain the best possible result. In particular, under both Article 21 and Article 45 a firm must list the execution entities it uses.

⁵ See Article 21(1) of Level 1 and Article 44(2) Level 2.



25. According to Article 44(1) of Level 2, the investment firm must take into account the following criteria in order to determine the relative importance of the above factors:
- the characteristics of the client including the categorisation of the client as retail or professional;
 - the characteristics of the client order;
 - the characteristics of the financial instrument that is the subject of the order;
 - the characteristics of the execution venues to which that order can be directed.
26. Responsibility for assessing the relative importance of the factors, taking into account the above criteria, lies with the investment firm. However, Article 44(3) of Level 2 stipulates that where the firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the "total consideration, representing the price of the financial instruments and the costs related to execution, which shall include all expenses incurred by the client which are directly related to the execution of the order...".
27. An investment firm that provides an execution service for retail orders in listed shares for example, will focus on the net cost (or net proceeds in the case of a sale) of executing the order on the venues available, and will direct the order to the regulated market, MTF or systematic internaliser providing the best possible result in terms of total consideration, in the absence of a specific instruction from the client. Recital 67 of Level 2 provides that speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs may be given precedence over the immediate price and cost factors "only insofar as they are instrumental in delivering the best possible result in terms of the total consideration to the retail client." This may be justifiable for a particularly large order in a relatively illiquid share, for example. However, 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.

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?

Professional Clients

28. Whereas the directive requires "total consideration" to be heavily weighted in the case of orders from retail clients, investment firms are fully responsible for determining the weight they attribute to the Article 21(1) execution factors in their execution policies and arrangements in the case of orders from professional clients.
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.
30. Investment firms should weight the factors in a manner that is appropriate to a particular type of client. For example, a firm that provides an execution service to a client for whom speed is paramount, such as a hedge fund taking advantage of arbitrage opportunities



(assuming that the hedge fund is classified as a client and not as an eligible counterparty), will prioritise the factors that deliver speedy execution. Alternatively, a firm may choose to attach more weight to the size of orders it is asked to execute, even where no specific instruction is given to the firm to trade patiently or carefully. It is possible that certainty of execution may be given a high weighting for highly structured derivative instruments.

Inclusion of the Firm's Fees and Commissions When Deciding Between Execution Venues

31. In respect of price and costs, Article 44(3) of Level 2 distinguishes between the selection of venues to be included in the investment firm's execution policy and the choice for a particular transaction or type of transaction between two or more venues that have been included in the firm's execution policy⁶.
32. When selecting venues to be included in its execution policy, an investment firm should not take into account the fees and commissions that it will charge its clients. At this stage the firm is to focus on the potential of the venues to enable the firm to deliver the best possible result for its clients on a consistent basis. In other words, it should focus on the quality of execution available on the various venues.
33. When choosing a venue (from among the venues included in the firm's execution policy that are capable of executing such orders) to execute a particular client order, the fees and commissions charged to the clients by the investment firm will be a relevant component of costs. This corresponds to the "total consideration" test for the execution of retail client orders.
34. CESR understands the rationale behind this two-step approach to be that best execution requirements should drive market efficiency by ensuring that orders are executed on those venues providing the best execution quality, in terms of available prices. A firm's execution policy should therefore 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 clients, 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)⁷.
35. For example, if a firm has included a regulated market and a systematic internaliser in its execution policy (or is itself a systematic internaliser) because both those venues are likely to provide the best possible result on a consistent basis, the firm will need to take into account not only the prices displayed by those two venues, but also any difference in fees or commission it charges the client for executing on one venue rather than the other. The systematic internaliser may be less attractive in terms of total consideration even though it displays a better price than the regulated market, in circumstances where the higher fees and commissions to be charged to the client are such that they outweigh the favourable price differential.
36. MiFID disclosure requirements regarding a firm's fees and commissions ensure that investors are able to distinguish the price of the instrument on a particular venue from the fee or commission charged by the firm for access to that venue⁸.
37. Article 44(4) of Level 2 does not allow investment firms to structure or charge their commissions in such a way as to unfairly discriminate between execution venues. In this

⁶ See also Recitals 71 and 72 of Level 2 for clarification of this point

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.

⁸ See Article 19(3) of Level 1 and Articles 33 and 40 of Level 2.



respect, a firm will not be able to charge a different fee for execution on different venues unless the difference reflects a difference in the cost to the firm, nor will it be able to direct all its orders to an affiliated firm within its corporate group on the basis that it charges its clients a much higher fee for access to other venues that is unwarranted by higher access costs (see Recital 73 of Level 2), nor will it be able to refrain from connecting to any of the venues included in its execution policy in the least costly manner. 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

38. 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.
39. It is conceivable that even after the entry into force of MiFID 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 and orders. For other types of instruments or orders, there may be a variety of potential execution venues but the costs of accessing more than one of them directly (to the extent that such costs would be passed on to clients) may outweigh any price improvement an alternative venue might offer. It may therefore be reasonable in some circumstances to decide against connecting to such venues, but in such cases the investment firm should consider the advantages of indirect access (that is, transmitting its client orders to another execution intermediary rather than executing those orders itself).
40. The situation is similar for investment firms providing the services of portfolio management or order reception and transmission. Article 45 of Level 2 does not prohibit these firms from selecting one particular investment firm for their policy but this would have to be justified by reference to the overarching requirement under Article 45(4) to take all reasonable steps to obtain the best possible result. For example a portfolio manager or RTO may achieve a more advantageous total consideration for its clients by directing all orders to an affiliated firm within its corporate group if that affiliated firm can provide the best possible result on a consistent basis and enable the portfolio manager to charge lower fees or commissions. Such firms are still required to monitor and review the quality of execution provided and to take appropriate action to correct any deficiencies, in addition to having to fulfil the overarching requirement to take all reasonable steps to obtain the best possible result for client orders.

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

Differentiation of the Policy

41. Article 21(3) of Level 1 states that "The order execution policy shall include, in respect of each class of instruments, information on the different execution venues where the investment firm executes its client orders...". Similarly, in respect of achieving the best possible result in the context of portfolio management and order reception/transmission, Article 45(5) of Level 2 states that "The policy shall identify, in respect of each class of instruments, the entities with which the orders are placed or to which the investment firm transmits orders for execution."



42. MiFID therefore requires that both the execution policy of a firm that executes client orders and the policy of a portfolio manager or RTO reflect any significant variations in its execution approach for each class of instrument. It follows that appropriate information about these significant variations should be included as part of the information that MiFID requires these firms to disclose to their clients.
43. In CESR Level 2 discussions, many stakeholders asked whether an investment firm would need to create different policies (or different segments of an overall policy) in order to address different types of trading and dealing. If so, how much detail should a firm's (execution) policy include about how it executes or transmits client orders or manages a client's portfolio?
44. Appropriate differentiation will depend on the types of clients a firm serves, the instruments for which it handles orders and the relevant market structures and execution venues available for those instruments. For example, it may be appropriate to have one execution approach for domestically listed shares and another for shares not listed domestically; or it may be appropriate to have differing execution approaches for domestically listed shares that are actively traded on the local exchange and domestically listed shares for which liquidity is mostly elsewhere. 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 derivatives and OTC products, if appropriate).
45. In addition to differentiation by class of instrument, an investment firm may wish to distinguish its policy by client or order type. For example, small retail orders in liquid shares may be well-suited to a highly automated, high-volume process, whereas a firm may wish to give closer scrutiny to large institutional orders in the same instruments, including in some instances case-by-case assessment of the measures to be taken with a view to obtaining the best possible result.
46. In short, CESR considers 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. In order to do this, the (execution) policy will need to provide a sufficiently detailed description of the execution approach that the firm takes in order to obtain the best possible result for the relevant categories of instruments, orders, clients and markets that it deals with.

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

Disclosure

47. MiFID requires investment firms providing best execution to provide appropriate information about their (execution) policy to their clients. For firms executing client orders this is related to the requirement under Article 21 of Level 1 to obtain the client's consent to the execution policy.

A firm is required to inform its clients:

- a) about the appropriate aspects of the execution policy (content);
- b) in an appropriate manner (presentation).

The content requirements are intended to enable the client to act in an enlightened manner while the presentational requirement is a means of ensuring that the information is effectively assimilated by the client.

Content

48. Article 19(3) of Level 1 requires all investment firms to provide "appropriate information" about "execution venues" to their clients.
49. Article 21 of Level 1 and Article 45 of Level 2 require investment firms to provide their clients with "appropriate information" about their (execution) policies. Clients wishing to select a firm to deal with from among a competing group need to have sight of the relevant firms' (execution) policies in order to evaluate whether a particular (execution) policy is suitable. By requiring *ex ante* disclosure of the (execution) policy, MiFID addresses clients' information needs.
50. By requiring disclosure of information on the firm's (execution) policy rather than its detailed execution approach, MiFID aims to strike a balance between requiring firms to disclose a lengthy trading manual (which would be of limited utility to clients) and a description that is too high level to facilitate client understanding of a firm's execution process. Recital 44 of Level 2 states that information given to clients must be "appropriate and proportionate" and "take account of the status of a client as either retail or professional". So disclosure of the (execution) policy is only required insofar as it will be relevant for the client and types of orders that client may send to the firm. For example a typical retail client will not require information on how the firm executes trades in instruments that are seldom purchased by retail clients.
51. As pointed out in paragraph 22, a firm's (execution) policy must describe and explain the firm's execution approach, setting out the execution venues or entities the firm uses and the impact of the Article 21(1) factors on the firm's execution approach.
52. For firms executing client orders, Article 46(2) of Level 2 requires that retail clients be provided with the following details of the firm's execution policy in good time prior to the provision of the service:
- the relative importance the firm assigns to the Article 21(1) factors, or the process by which it determines relative importance;



- a list of the execution venues on which the firm places significant reliance in meeting its best execution obligations,
 - a warning to the client regarding the use of specific instructions.
53. For portfolio managers and RTOs, Article 46(2) does not apply but the second subparagraph of Article 45(5) requires that investment firms provide "appropriate information" on the policy. CESR considers that these firms must disclose, at least to retail clients, for each class of instrument, the entities with which orders are placed or to which orders are transmitted for execution, as mentioned in the first subparagraph of this same provision.
54. As clients of firms subject to Article 21 of Level 1 have to consent to the firm's execution policy, firms need to ensure that the execution policy disclosure is sufficient for consent to be valid. Clients of these firms are given additional *ex post* information rights under Article 21 of Level 1 that clients of portfolio managers and RTOs do not enjoy under Article 45 of Level 2. Under Article 21(5) of Level 1, firms must demonstrate on request that a client's order has been executed in accordance with the firm's execution policy. This requirement assists clients in assessing whether the service received from a particular firm is satisfactory.
55. There will be circumstances in which both retail and professional clients may consider it necessary to obtain information about a firm's (execution) policy that is not provided automatically under MiFID. Recital 44 of Level 2 refers to information requests and indicates that firms should supply additional information provided the request is "reasonable and proportionate". However, Recital 44 also acknowledges that "less stringent specific information requirements" should apply for professional clients than for retail clients. Therefore, the question arises as to whether firms may be obliged to provide more information to professional clients than would be provided to retail clients under Article 46(2) of Level 2.

Presentation

56. Article 19(3) of Level 1 requires all firms to provide their clients with appropriate information about their execution venues. This information must be provided in a comprehensible form. This could be facilitated by concentrating all disclosure on the (execution) policy in a single document, for example.
57. For retail clients of firms executing client orders, Article 46(2) of Level 2 stipulates that a firm provide certain specified information about its execution policy, either in a durable medium (Article 3(1)) or by means of a website under certain conditions (Article 3(2)). Other information that may be disclosed by the firm is not subject to these disclosure requirements. However, where a retail client agreement is required under Article 39 of Level 2, such disclosure could be incorporated into the agreement.

Professional clients

58. While Article 46(2) of Level 2 specifies the disclosure requirements for retail clients, there is no equivalent provision relating to what "appropriate information" must be provided to professional clients. Recital 44 of Level 2 states that "Professional clients should, subject to limited exceptions, be able to identify for themselves the information that is necessary for them to make an informed decision, and to ask the investment firm to provide that information." CESR therefore considers that it is up to firms to determine what level of information disclosure is appropriate for professional clients, through appropriate consultation with such clients if necessary.

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?



Consent

Prior Consent and Express Consent

59. Article 21(3) requires investment firms to "obtain the prior consent of their clients to their execution policy" and Article 21(4) requires them to "obtain the prior express consent of their clients before proceeding to execute their orders outside a regulated market or an MTF."
60. CESR understands that "prior consent" may, at least in some jurisdictions, be tacit and result from the behaviour of the client such as the sending of an order to the firm after having received information on the firm's execution policy, whereas "prior express consent" must be actually expressed by the client. In any event, sufficient information must be provided to the client to enable him to give informed consent to the policy itself.
61. Competent authorities are empowered to require evidence from firms that tacit consent has been given by clients and may, under Article 50(1)(a) and (b) of Level 1, "have access to any document" and "demand information" from firms in this regard. In particular a firm may be asked to show that it has supplied clients with the appropriate information on its execution policy.
62. CESR considers that where "prior express consent" is required, it may be provided by signature in writing or an equivalent means (electronic signature), by a click on a web page or orally by telephone or in person (with appropriate record keeping in each case).

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 ?

Chains of Execution

63. Portfolio managers and RTOs typically operate by placing orders with or transmitting orders to other RTOs or investment firms that execute client orders (collectively "intermediaries"). In this way, a "chain of execution" can form, with some aspects of the execution being performed at different points in the chain.
64. A chain of execution can take many forms and be more or less long. A portfolio manager or RTO setting out to buy or sell financial instruments on behalf of a client may select an intermediary that executes the order or may select an intermediary that passes the order along to another intermediary who will arrange for the order to be executed.
65. Where different investment firms have different functions in a chain of execution, MiFID's best execution requirements should be applied as necessary to take account of the particular function performed by each firm in the chain. Where in the chain of execution an investment firm is treated as an eligible counterparty and therefore is not owed a duty of best execution, it must nevertheless ensure that any entities with which orders are placed or to which the investment firm transmits order for execution have execution arrangements that enable the investment firm to comply with article 45 of the level 2 Directive.
66. MiFID imposes the best execution requirement on investment firms in different ways depending on the investment service the firm is providing. Where a firm is executing client orders (for example brokers and dealers) Article 21 of Level 1 imposes requirements. For firms which are not executing client orders, Article 45 of Level 2 imposes requirements when they place orders with other entities for execution. The overarching obligation under both Articles is the same – to take all reasonable steps to deliver the best possible result for their clients, although there are differences in the detailed requirements under Article 21 or Article 45. And, in considering whether an investment firm has complied with the requirements, it will be relevant to examine the role performed by the firm, particularly if there is a chain of execution.
67. Article 21 of Level 1 does not impose an analogous requirement on an investment firm that executes client orders to examine the "execution arrangements" of its execution venues. A firm that executes client orders is required to use execution venues that are likely to achieve the best possible result on a consistent basis – so it will be concerned with the results that the execution venues deliver.
68. Article 45(5) of Level 2 requires portfolio managers and RTOs to use entities whose execution arrangements will enable the portfolio manager or RTO to comply with its own obligations under Article 45, and Article 45(6) requires portfolio managers and RTO's to monitor the execution quality of those entities on a regular basis. CESR's view is that, in order to comply with Article 45, 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.
69. It might be argued that the reference to "execution arrangements" in Article 45(5) of Level 2 restricts portfolio managers and RTOs to the use of intermediaries that comply with Article 21 of Level 1 by putting in place "execution arrangements" within the meaning of this provision. However, CESR considers that the reference to "arrangements" in Article 45(5) is intended to refer more generically to the execution approach of the intermediary.
70. The distinction that MiFID draws for best execution purposes between firms that execute client orders and portfolio managers and RTOs is designed to reflect the different functions



they typically perform. This is confirmed by Article 45(7) of Level 2 which states that when a portfolio manager or RTO "executes the orders received" Article 21 of Level 1 will apply. Therefore, a firm that provides the investment service of "portfolio management" may also be providing the investment service of execution of client orders when it carries out transactions for its client portfolios; and if so, Article 45(7) confirms that it will be subject to Article 21.

71. Accordingly, the requirements with which a firm must comply depend on whether the service it is providing is to be characterised as execution of client orders (in which case best execution applies under Article 21), or as portfolio management (without execution) or reception and transmission of orders (in which case the Article 45 provisions apply).
72. A portfolio manager or RTO that uses an intermediary subject to Article 21 in executing the portfolio manager or RTO's orders will, provided certain conditions are met, be able to place a high degree of reliance on that intermediary in order to comply with its own best execution obligations under Article 45(5). Such reliance is possible under MiFID as Recital 75 of Level 2 provides that the directive is not intended to require a duplication of effort as to best execution between a portfolio manager or RTO and the investment firm to which orders are transmitted for execution⁹. CESR understand that the portfolio manager or RTO may therefore rely to a large extent on the decisions that the intermediary makes on behalf of its clients, provided the intermediary complies with Article 21. However, this does not relieve the portfolio manager or RTO from all best execution obligations, since these firms remain subject to the requirements under Article 45 of Level 2.
73. However, a portfolio manager or RTO may sometimes wish to specify aspects of the execution service. For example, it may specify that a particular type of order must be executed on a venue that it chooses (for example a venue which the portfolio manager or RTO can only access through an intermediary). In such cases, where Article 21 applies to the executing intermediary in respect of the transaction, the intermediary could regard this as a "specific instruction" in which case the portfolio manager or RTO naturally will not be able to rely on the intermediary for this aspect of the execution it obtains.
74. MiFID portfolio managers and RTOs (or indeed investment firms who execute orders) are not prohibited from using third country intermediaries or venues that are not subject to MiFID's best execution requirements. For the purposes of complying with Article 45, the portfolio manager or RTO should satisfy itself that those intermediaries or venues have execution arrangements or standards of execution quality that will allow it to comply with Article 45 (or, in the case of an executing firm, Article 21). If the portfolio manager or RTO cannot satisfy itself of this, it cannot discharge its Article 45 obligations and therefore cannot use such intermediaries or venues.
75. Where best execution responsibilities overlap, an investment firm will have to determine whether its best execution obligations are owed under Article 45 or Article 21 and how far the best execution standard delivered by an intermediary at the following point in the chain goes in satisfying the best execution requirements that apply to itself.
76. In assessing compliance with the best execution requirements, competent authorities should therefore consider the function of the relevant investment firm in the chain of execution, paying due regard to the respective responsibilities of each firm. Portfolio managers and RTOs that transmit orders to an intermediary may rely on the latter to provide best execution to the extent this is warranted but remain subject to the requirements under Article 45 of Level 2

⁹ Recital 75 of Level 2 provides: "The Directive is not intended to require a duplication of effort between an investment firm which provides the service of order reception and transmission or portfolio management and any investment firm to which that investment firm transmits its orders for execution."



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



Review and Monitoring

77. Article 21 of Level 1 and Article 45 of Level 2 both require an investment firm to monitor whether its execution approach is allowing the firm to obtain the best possible result for the execution of its client orders.
78. Article 45 of Level 2 also requires portfolio managers and RTOs to evaluate the execution quality of the entities in their policy. This would seem to have the same purpose as the requirement in Article 21(3) of Level 1 that firms include in their execution policies at least those execution venues that deliver the best possible result on a consistent basis.
79. It is CESR's understanding that the reference to the "execution quality" of the execution intermediary in Article 45(5) of Level 2 refers to the quality of the results that the intermediary has delivered in comparison to the results that were possible. There may be several different aspects or "qualities" of an intermediary's execution performance, including price, costs, speed and likelihood of execution and settlement, each of which may be measurable or otherwise capable of being assessed and compared against other venues. An investment firm will take account of these different aspects of execution performance in accordance with the relative importance it has assigned to these factors in its execution policy.
80. Article 21 of Level 1 requires firms executing client orders to review or "assess" on a regular basis whether the execution venues they use are providing the best possible result for their clients or whether they need to make changes to their execution arrangements. Article 46 of Level 2 clarifies that these reviews should occur at least annually and whenever a material change occurs.
81. Article 45 of Level 2 requires portfolio managers and RTOs to review their policies annually and whenever a material change occurs. Since the policy must include the entities that the firm uses for the execution of its client orders, it appears that Article 45 and Article 21 require analogous reviews, even though they are worded differently.
82. How an investment firm meets these requirements will depend on its particular execution approach, as well as its position in any chain of execution.

Requirement to Review

83. The requirement to review is an important driver of market efficiency as it requires that firms put procedures in place to ensure that execution business is directed to the most appropriate execution venues. Such reviews necessarily look beyond a firm's current execution approach and must be carried out at least annually. Firms should also review their approach generally to see whether they could usefully make any changes to improve overall performance. More specifically, firms should consider whether the relative importance they have assigned to the factors has led them to deliver the best possible result for their clients or whether they should reconsider this aspect of their execution approach.
84. Level 2 also requires firms to review their execution approach whenever a material change occurs that could affect their ability to obtain the best possible result for the execution of their clients' orders. What is material will depend to a large extent on the nature and scope of any change. A large firm that uses many execution intermediaries, for example, would not have to review its approach just because of the entrance of an insignificant new market



participant. Conversely a firm using only one venue might have to review its approach if a major new venue entered the relevant market.

Requirement to Monitor

85. The monitoring requirement relates to the effectiveness of an investment firm's current approach in delivering the best possible result for its client orders. Where deficiencies are identified, a firm must act to correct them. There are two areas that a firm may need to monitor to establish the effectiveness of its execution policy and arrangements (under Article 21) or policy (under Article 45):

- Compliance with the execution approach: a firm cannot check the effectiveness of its execution approach or, in the case of a firm executing client orders, demonstrate compliance to its clients in accordance with Article 21(5) of the Level 1 Directive, without ensuring that it is following its execution approach;
- Whether a firm is actually obtaining the best possible result under the (execution) policy:

This can be established by comparing similar transactions

- (i) on the same venue, in order to test whether a firm's judgement about how orders are executed is correct, or
- (ii) on different venues chosen from among those in the firm's (execution) policy, in order to test whether the 'best' venue is being chosen for a given type of transaction.

86. The monitoring methodology is at the discretion of firms. CESR considers that it is not necessary for these purposes that a firm review every transaction and that other approaches, such as sampling, could suffice. Sampling must however reflect the size and nature of the transactions performed and the firm must appropriately assess and compare the relevant available data.

Differing Contexts for Monitoring and Review

87. Portfolio managers and RTOs select firms to undertake all or part of the execution process. As shown above, Article 45 subjects these firms to similar review and monitoring principles as firms that execute client orders. However, firms that sit at different points in the chain of execution may need to take different approaches to their review and monitoring obligations. So, where best execution obligations apply:

- *Firms executing client orders:* will need to review in order to ascertain whether the venues they use are delivering the best possible result for execution of their client orders, and decide whether to connect to execution venues excluded from the current execution policy. The execution quality being delivered by the venues currently included in the execution policy must be monitored.
- *Portfolio managers and RTOs:* will need to review in order to ascertain whether the results from firms they use achieve a better result than the results that are being delivered by other firms in the market. If a portfolio manager's policy includes other firms as well as direct access to markets and/or firms dealing on own account then these would need to be reviewed relative to one another as part of the review process. Such firms will also need to monitor the execution quality they obtain from the firms and/or venues that are included in their policy to ensure they are delivering the best possible result under the current policy.



- *Firms dealing on own account with clients:* will need to review their own execution quality relative to other execution venues they (or their clients) could potentially access.

All of these firms also must in addition monitor the impact of their own actions on the execution quality they achieve.



Execution Quality Data

88. At the centre of MiFID's best execution provisions are requirements to use execution venues or entities that allow the investment firm to obtain the best possible result for the execution of its client orders.¹⁰ Level 2 also calls upon portfolio managers and RTOs to monitor the "execution quality" of the entities they select for their policies.¹¹ The monitoring and review requirements mean that firms will also need to assess their own execution quality.
89. To facilitate compliance with these requirements, information on execution quality will be essential. But transparency varies across markets and instruments, ranging from very transparent in liquid instruments to opaque for customised derivatives. MiFID introduces pre- and post-trade transparency requirements for systematic internalisers trading equities admitted to trading on a regulated market and other transparency requirements for the trading of equities on regulated markets, MTFs or OTC across EEA Member States. While the implementation of MiFID may lead to fragmentation of data, the likely increase in data availability in response to MiFID's implementation should assist firms in meeting their review and monitoring obligations.
90. CESR is currently working on the consolidation of transparency information, an issue that the European Commission and Parliament have identified as relevant in the MiFID context as reflected in Recital 76 of Level 2:

"Availability, comparability and consolidation of data related to execution quality provided by the various execution venues is crucial in enabling investment firms and investors to identify those execution venues that deliver the highest quality of execution for their clients."

91. Article 44(5) and Recital 76 of Level 2 call upon the Commission to assess, at a European level, the availability, comparability and consolidation of information on execution quality. This suggests that there may be some core information that any firm would find useful regardless of the particularities of its execution approach. Recital 76 to the Level 2 Directive suggests that this information could include "aspects such as speed and likelihood of execution (fill rate) and the availability and incidence of price improvement."

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?

92. Because clients require different types of execution service, firms are likely to assign different priorities the Article 21(1) factors. As a result, the concept of the "best possible result" is likely to vary between firms depending on the prioritisation of the aforementioned factors.
93. The United States provides an example of one possible approach. SEC Rule 11Ac1-5 requires firms to report how often their prices fall outside of the US national best bid and offer. The SEC also requires firms to report their speed of execution. While the SEC recognises that other factors are relevant, they have made a conscious choice to highlight speed and price quality. See <http://www.sec.gov/rules/final/34-43590.htm#seciia1>.

Call for evidence

¹⁰ See Article 21(4) of Level 1 and Article 45(5) of Level 2.

¹¹ See Article 45(6) of Level 2.



94. In light of the many uncertainties around execution quality statistics, CESR is issuing a call for evidence. 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

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

95. An investment firm that is subject to Article 21 must demonstrate on a client's request that it has executed that client's orders in accordance with its execution policy. Firms have indicated that they are concerned about the implications of this requirement for data retention, specifically that they will be required to retain data on available prices or quotes for every transaction. Other firms take the view that Article 21(5) requires only that the firm demonstrate that it followed its policies and procedures by, for example, showing that an order was routed to an electronic system that checks relevant venues for the best net price, in accordance with the information provided to its clients. It will be important for regulators to take a convergent view on this debate.

Call for evidence

96. 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.