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BRIEFING

SUMMARY APRIL 2006

MiFID: best execution

This briefing examines the best execution obligation contained in the Markets in Financial Instruments Directive and the draft level 2 directive published by the European Commission in February 2006. It is based on the current text of the draft level 2 directive and is therefore liable to change.

The state of play

The European Commission regards the obligation to provide best execution as 'central to the structure and logic' of the Markets in Financial Instruments Directive (MiFID). It considers that this obligation forms a fundamental element of investor protection and is necessary to mitigate possible problems associated with market fragmentation.

The best execution obligation is contained in article 21 of MiFID and the draft level 2 directive published by the Commission in February 2006. The Financial Services Authority (FSA) is to publish a discussion paper in April.

The duty of best execution

Article 21 requires firms to 'take all reasonable steps to obtain, when executing orders, the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature' or any other relevant considerations.

The duty is modified in its application to discretionary portfolio managers and order passers. The draft level 2 directive (recital 63) suggests that such firms can discharge the best execution obligation by selecting entities most likely to deliver best execution so long as they also monitor the execution quality delivered by those entities and correct any deficiencies. Subject to this, they are entitled to rely on those firms to deliver best execution.

Widening the scope of the duty

The scope of the duty of best execution will be broadened. The duty applies whenever an investment firm executes a 'client order', whether the client is professional or retail. It will no longer be possible to contract out of the duty of best execution. The duty does not apply when dealing with eligible counterparties, but note the MiFID definition of eligible counterparty, which means that more hedge funds, large corporates and special purpose vehicles will be caught unless the counterparty's member state recognises such undertakings as eligible counterparties and a firm upgrades them accordingly.

The meaning of 'client order' will be key in defining the scope of the best execution obligation. The draft level 2 directive (recital 58) extends the scope of the duty to principal trades (in addition to agency trades, quasi-agency trades and discretionary trades, which are currently covered by the FSA rules). However, this arguably exceeds the scope of what the level 2 measures may cover, as prescribed by article 21(6) of MiFID, which may provide a basis for lobbying for amendment. To the extent it is able, it is to be hoped that the FSA will issue guidance confining the scope to the current position of agency, 'quasi agency' and discretionary orders.

Best execution policy

Article 21 also requires a firm to establish and implement an order execution policy to enable the best possible result for client orders. The policy must include information on different execution venues and the factors affecting the firm's choice of venue. Where the order is for a retail client, the best possible result is to be determined by reference to the total consideration payable. This means the price and the costs of execution,

ie all expenses incurred directly related to the execution such as execution venue fees, clearing and settlement fees and other fees paid to third parties, but excluding the firm's own costs.

Where the order is for a professional client, the firm's policy must address the relative importance of the factors listed in article 21 (or the process by which the firm makes that determination). The firm should consider the nature of the order and the characteristics of the client, of the financial instruments concerned and of the execution venues to which the order can be directed, ie a regulated market, multilateral trading facility (MTF), systematic internaliser (SI) or other liquidity provider. The firm must select the execution venues that enable it consistently to achieve the best possible result for the execution of client orders. It is not clear whether the FSA will give guidance on choice of execution venues but industry standards are likely to emerge.

Article 21 requires an investment firm to monitor the effectiveness of its order execution arrangements and policy and to correct any deficiencies. The firm must assess regularly whether the chosen execution venues provide for the best possible results and must, on request, be able to demonstrate to the client that it has executed its order in accordance with the firm's policy. It must also obtain clients' consent to:

- the best execution policy (this may be general and may be implied by conduct); and
- the ability to execute orders away from a regulated market or MTF (this must be express but may be obtained generally rather than on a transaction by transaction basis).

Non-equity market compliance

For many firms, applying the duty of best execution to equities will not present significant difficulties. However, this may not be the case for other instruments such as bonds and over-the-counter (OTC) derivatives. If principal orders remain within the scope of the obligation, it will mean that, together with the fact that firms will no longer be able to contract out of best execution, the duty will have greater application to non-equity markets. However, an important exemption applies where there is a specific instruction from the client. This is likely to be helpful in the case of structured or bespoke transactions involving equities, debt instruments and derivatives where the client instructs the firm to enter into the transaction at the given price.

To the extent that the duty of best execution does apply, a firm's execution policy will take into account the differing characteristics of relevant markets. The Commission recognises that different standards will apply depending on the circumstances relevant to the order concerned so that a bespoke OTC transaction may not be comparable to a transaction in shares executed on a regulated market. Away from the equity markets, where data are widely available, firms are likely to find it more difficult and time consuming to obtain the information needed to determine a best execution policy for fixed income and OTC derivative markets where it will be less easy to identify execution venues, there are fewer objective benchmarks and there is less transparency more generally. Although data vendors may aggregate and produce price data, it is less clear whether they will publish data on execution quality.

There are particular challenges for a firm that is an SI. As there is no carve out from the best execution obligation (unlike for MTFs), a firm that is an SI must route an order to another SI if necessary to secure best execution. This may be particularly difficult to apply in practice given many firms' automated trading systems. Again, the meaning of client order will be key here and if principal trades are excluded the position may be less problematic. A firm may also be able to rely on a specific instruction from the client.

There are also a number of practical difficulties regarding monitoring the effectiveness of the firm's policy. First, while many firms will already have in place procedures to monitor best execution in the equities markets, such procedures are far less common in non-equity markets and are likely to be more difficult to establish, given the predominantly OTC nature of the fixed income and derivative markets. Second, the extension of the scope of the duty beyond price makes best execution more difficult to measure. Firms are likely to consider the overall picture in the design of their policy and to rely on sampling for determining and monitoring the policy (although the policy must be applied on a case by case basis).

Next steps

Firms should:

- consider lobbying for an amendment to recital 58 of the draft level 2 directive to exclude principal trades;
- review the forthcoming FSA discussion paper and in

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particular guidance on the definition of client order and make appropriate representations; and

- begin to consider the application of the extended obligation to their business.

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