



The Committee of European Securities Regulators

CESR is an independent Committee of European Securities Regulators. The role of the Committee is to:

- Improve co-ordination among securities regulators;
- Act as an advisory group to assist the European Commission, in particular in its preparation of draft implementing measures in the field of securities;
- Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.

Promoting supervisory convergence

In the run-up to the implementation deadline for the Markets in Financial Instruments Directive (MiFID) on 1 November 2007, CESR devoted a lot of energy to setting recommendations and guidelines to help regulators take a consistent view of MiFID. With MiFID now in force, CESR's focus has shifted to matters of co-ordination and convergence of supervisory outcomes.

As part of its work to promote supervisory convergence, CESR has produced a series of supervisory briefings on the key elements of MiFID. They have been designed for supervisors, summarising the key elements of the rules and explaining the associated objectives and outcomes. The contents of these briefings are not exhaustive and do not constitute new CESR policy.

As well as an accessible introduction to the rules, the briefings also include indicative questions that supervisors could ask of themselves or a firm to assess a firm's approach to applying the rules. Naturally these questions are not intended to be exhaustive or to cover every possible situation, but can serve as a useful starting point when supervisors are deciding on areas of supervisory focus.

The briefings don't promote any particular way of supervising the rules, and are designed to be used in the way that best fits with a given supervisor's own methodology, whether this means distributing the briefings internally, or passing them to external bodies, such as auditors.

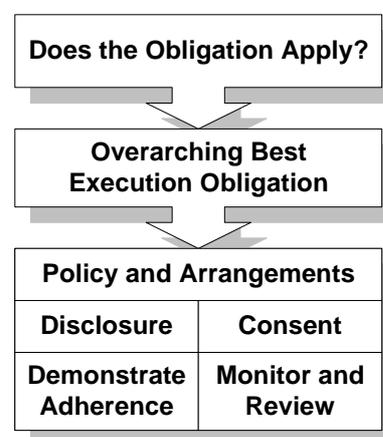
CESR believes that promoting convergence of supervisory outcomes can help promote market integrity and market confidence, whilst also minimizing the potential for client detriment and reputational risk, and has designed these briefings to support these goals.

This supervisory briefing builds up from the CESR Q&A Best Execution under MiFID CESR/07-320¹.

Best Execution

The best execution requirements are an important component of MiFID's investor protection standards as they are designed to promote both market efficiency generally and the best possible execution results for investors individually.

The overarching MiFID best execution obligation requires investment firms to take *all reasonable steps* to obtain, when executing orders on behalf of clients, the *best possible result* for their clients, taking into account the *execution factors* - price, costs, speed, likelihood of execution and settlement, size and nature of the order or any other consideration relevant to the execution of the order.



¹ http://www.cesr-eu.org/index.php?page=document_details&id=4606&from_id=53

To achieve best execution, firms must comply with more detailed rules relating to arrangements and policies, disclosure, consent, demonstrating adherence and monitoring/review.

Firms will have to put in place appropriate arrangements and supervisors will have to assess the adequacy of the steps taken and the results achieved by investment firms when executing orders for their clients.

This supervisory briefing is designed to help supervisors make these judgements and is structured around two headings: (1) the scope and (2) the detailed rules. The latter heading includes an overview of the outcomes that the rule promotes, illustrates the potential risks and provides examples of the sort of questions that supervisors could ask to test whether the outcomes are being met by firms.

1. The scope

The overarching best execution obligation

The overarching best execution obligation is established by Article 21 of the L1 Directive and is supplemented by Articles 44, 45 and 46 of the L2 Directive.

The overarching best execution obligation applies to investment firms when they execute orders on behalf of their clients² and covers all financial instruments. Investment firms that perform portfolio management or reception and transmission of orders (RTO) have a similar obligation because of their duty to act in the best interests of their clients (Article 19.1 of the L1 Directive as supplemented by Article 45 of the L2 Directive) whenever they place orders resulting from their investment decisions or transmit clients' orders for execution by other entities. There are however a number of restrictions to this scope of application.

Specific Instructions

Notwithstanding the overarching obligation, whenever there is a specific instruction from the client, the investment firm must execute the order in accordance with that instruction and does not need to apply the best execution provisions in relation to those matters that the instruction specifies. However the best execution requirements must still be applied to those parts of an order not covered by the specific instruction (Article 44(2) of the L2 Directive). Firms are not allowed to induce a client to give them particular instructions in relation to an order (Recital 68 of the L2 Directive).

Clients

Firms owe a duty of best execution to retail and professional clients. The obligation does not apply when investment firms enter into transactions with eligible counterparties, arrange transactions between such counterparties or receive and transmit orders on behalf of such counterparties.

The scope also depends on whether the firm is executing the order directly. In relation to firms that:

- **directly execute** client orders or directly execute discretionary investment management decisions to deal on behalf of clients, **all the rules apply**³.
- **transmit client** orders to other entities for execution or place discretionary investment management decisions to deal on behalf of clients with other entities for execution, the rules on **consent and demonstrating adherence** to the policy **do not apply**.

Implementing the overarching best execution obligation

The overarching obligation requires that firms take a) *all reasonable steps* to obtain, when executing orders, b) the *best possible result* for their clients, c) taking into account the execution factors.

² The document CESR/07-320 contains the European Commission's views on how to determine when an investment firm is acting on behalf of a client in executing an order.

³ The detailed rules on disclosure to clients (Article 46(2) of the L2 Directive) only apply, however, to retail clients.

Execution factors: The execution factors are a) the **price** of the financial instrument; b) - the **costs** related to execution (including settlement costs); c) the **speed** of execution; d) the likelihood that an order will be **executed**; e) the likelihood that a transaction will **settle**; f) the **size** of the order; g) the **nature** of the order; and h) any **other relevant consideration**.

To determine the relative importance of the execution factors, a firm has to take into consideration (Article 44(1) of the L2 Directive):

- the characteristics of the client including whether the client is retail or professional;
- the characteristics of the client order;
- the characteristics of the financial instrument that is the subject of that order; and
- the characteristics of the execution venues to which that order can be directed.

Best possible result: The directive constrains the meaning of “best possible result” for retail clients. In respect of orders from retail clients, firms must define the best possible result in respect of the price of the financial instrument and the costs directly related to execution, including clearing and settlement fees. They can only take into account the other execution factors to the extent that they influence price and costs (Article 44(3) and Recital 67 of the L2 Directive).

Example 1: The Scope of the Best Execution Obligation – Dealing in Quotes

The question of whether the overarching best execution obligation applies to a firm that executes an order on behalf of a client is difficult and one on which firms and supervisors will need to exercise their judgement. The key concept is whether the execution of orders is “*on behalf of clients*”. Therefore, for example executing a client order against the firm’s own proprietary position, where the firm is making decisions as to how the order is executed by for example working the order on behalf of the client will attract the overarching best execution obligation. By contrast entering into a proprietary trade where the order is not executed on behalf of the client will not attract the Obligation; this might include cases where the firm engages in proprietary trading by quoting on a request for quote basis. Fuller discussion of this issue can be found at CESR/07-320

2. The Detailed rules

The detailed rules supporting the overarching requirement cover: arrangements and policies, disclosure and consent, demonstrating adherence to the policy and monitoring/review⁴.

Arrangements and Policies

Firms must put in place arrangements for best execution and a policy which summarises those arrangements. The policy must set out the firm's strategy for complying with the overarching best execution obligation and the steps it is taking to implement that strategy (Articles 21(2) and 21(3) of the L1 Directive, Article 45(5) and Recitals 66, 72 and 74 of the L2 Directive).

The policy should also include: -

- an account of the relative importance, or the process for determining the relative importance, the firm places on the execution factors;
- how those factors affect the firm's choice of execution venues or entities to which it transmits orders;
- those venues the firm uses to execute orders or decisions to deal, and/or entities to which it transmits orders or decisions to deal for execution. Note however that the obligation to take all reasonable steps to obtain the best possible result does not mean that the investment firm's policy must include all relevant execution venues (Recital 66 of the L2 Directive).

⁴ The document CESR/07-320 provides CESR recommendations on the application of the detailed rules in the form of questions and answers.

The execution policy should be differentiated, for example by type of instrument, client or order type, to the extent necessary. The policy will need to reflect any important variations in the way that orders for different types of client and different financial instruments are executed or transmitted.

Questions

- How does the firm ensure compliance with the overarching best execution requirement?
- Where the firm directly executes client orders or decisions to deal, what are the execution arrangements that enable the firm to ensure such compliance?
- What does the execution policy, or “policy” for firms transmitting client orders or decisions to deal to other entities for execution, contain?
- Who was involved in developing the arrangements and policy for executing, or transmitting, orders or decisions to deal?
- Has the relevant staff of the firm been informed of the changes to the best execution requirements?
- What changes, if any, has compliance with the new rules made to the way in which the firm executes orders, or transmits orders or decisions to deal, for each type of client and instrument?
- What documentation, if any, does the firm have relating to executing, or transmitting, orders or decisions to deal in addition to the information contained in its policy?
- What process does the firm use to select the venues/entities included in the “policy” (for firms transmitting client orders or decisions to deal) or execution policy (for firms that execute)?
- How does the firm assess the relative importance of the best execution factors?

Disclosure and consent

Firms are required to provide appropriate information to clients about their execution policies in good time before entering into a relationship with a client (Article 21(3) of the L1 Directive and Article 45(5) of the L2 Directive). 'Appropriate' means sufficient, comprehensible information for a client to understand the service proposed and make an informed choice between the services offered by different firms. All clients must be informed if the best execution policy provides for the possibility that orders will be executed outside a regulated market or multilateral trading facility.

Firms who directly execute client orders or directly execute discretionary investment management decisions to deal on behalf of clients are required to obtain two types of consent from clients (Article 21(3) of the L1 Directive):

- **prior consent** to their execution policy: This can be tacit. A client can indicate consent by seeking to trade with a firm after having received appropriate information on the execution policy in good time before the provision of the service;
- **prior express consent** before executing orders outside a regulated market or multilateral trading facility: This requires the client to actively demonstrate consent by signature, e-mail, web-page click, telephone call, etc. Express consent is not required where the relevant financial instrument is not admitted to trading on a regulated market or multilateral trading facility.

Questions

- What information about its execution policy (for firms that execute) or “policy” (for firms that transmit orders or decisions to deal) does the firm disclose to all its relevant clients?
- Is there additional information about its execution policy which a firm that executes orders or decisions to deal, discloses to its retail clients either as a matter of course or upon request?
- Is there additional information about its execution policy which a firm, that executes orders or decisions to deal, discloses to its professional clients either as a matter of course or upon request?
- How do the firm’s clients consent to the execution policy?
- What arrangements and procedures (or what measures) has the firm set up to collect the client's prior express consent (when it is requested to do so)?

Demonstrating Adherence to Policy

Firms who directly execute client orders or directly execute discretionary investment management decisions to deal on behalf of clients must be able to demonstrate, at a client's request, that they have executed any individual order or decision to deal in compliance with their execution policy (Article 21(5) of the L1 Directive).

Questions

- If the firm executes orders or decisions to deal and has only one execution venue listed in its execution policy for a particular type of financial instrument (such as listed domestic shares), how does it demonstrate that it is able to obtain the best possible result on a consistent basis?

Monitoring and Review

The operation of the execution policy is an ongoing process and firms must both monitor and review the policy.

- Firms should monitor on a regular basis the effectiveness of their policy and correct any deficiencies identified (Article 21(4) of the L1 Directive and Article 45(6) of the L2 Directive). Monitoring is an assessment of particular transactions in order to establish whether a firm is executing orders or decisions to deal, or transmitting orders or decisions to deal, in line with its best execution policy and arrangements, and whether the particular transactions are delivering the best possible result for the client.
- Firms should review the policy annually and whenever a material change occurs which might affect their ability to meet the overarching requirement (Article 21(4) of the L1 Directive and Article 45(6) of the L2 Directive). Review is an overall assessment of the policy and arrangements to check whether a firm is taking all reasonable steps to deliver best execution.

Questions

- How often does the firm review its best execution arrangements?
- What types of occurrences does the firm consider to be a material change that would trigger a review?
- What processes has the firm put in place to monitor, on a regular basis, the effectiveness of its arrangements and policy to deliver the best possible result for its clients?
- Do firms believe they have access to sufficient information as to assess the quality of execution they are achieving?
- Do the firm's monitoring techniques vary according to instrument type or order type or client categorisation?
- What process does the firm have in place for reviewing its "policy" or execution policy and/or arrangements?

This note has been prepared by the CESR MiFID Level 3 Expert Group chaired by Mr Jean-Paul Servais, Chairman of the Executive Management Committee at the CBFA, and by its sub-Group on Intermediaries, chaired by Mrs María José Gómez Yubero, Director at the CNMV. For more information on this document or on CESR activities regarding intermediaries please contact Diego Escanero at descanero@cesr.eu.

The contents are merely illustrative and do not constitute legal advice. The MiFID legal texts are available at http://ec.europa.eu/internal_market/securities/isd/index_en.htm