



THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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## Best Execution under MiFID

### Questions & Answers

**May 2007**



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## Section 1 – Background and Scope

### *Introduction*

MiFID will introduce common standards of investor protection throughout the European Union. MiFID's best execution requirements are an important component of these investor protection standards as they are designed to promote both market efficiency generally and the best possible execution results for investors individually.

Discussions in the CESR Implementation Forum suggested that many Member States and competent authorities will implement MiFID's best execution requirements by introducing the terms of MiFID directly into their legislation or rulebooks. By copying-out, there will be harmonised Level 1 and Level 2 requirements. Beyond this, it is the responsibility of the competent authorities in each Member State to interpret and supervise compliance with these harmonised rules.

As harmonisation of regulation in the area of best execution is a key objective behind MiFID, CESR has an important role to play in promoting supervisory convergence in this area. To this end, CESR members set out their agreed views on a range of issues relating to best execution in Consultation Paper CESR/07-050b which was published in February 2007. CESR has published a separate Feedback Statement CESR/07-321 on the responses received to the Consultation Paper.

### *Objective of the Q&A*

CESR has prepared this paper in order to clarify key aspects of the CP. CESR has chosen a Q&A format in order to present its views in a user-friendly way that facilitates compliance by firms and convergence among competent authorities. This Q&A presents CESR's answers to practical questions raised by firms and competent authorities about how firms should be complying with the MiFID best execution regime. In this Q&A, CESR does not impose requirements on firms or otherwise go beyond what the Directives already require. Rather, the Q&A explains CESR's views on how firms can comply with the Directives in the particular circumstances and situations that stakeholders have raised.

### *Status of the Q&A*

Members of CESR will make use of this Q&A on a voluntary basis in their day-to-day supervisory practices. The Q&A does not constitute European legislation and will not require national legislative action.

The European Commission has participated as an observer in the course of CESR's work on best execution.

This Q&A is only intended to promote supervisory convergence and does not prejudice the role of the Commission as guardian of the Treaties.

### *Scope*

On 15 November 2006 CESR posed three questions to the European Commission in relation to the work it was undertaking on best execution:



1. In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?
2. What scope may "specific instructions" from a client cover?
3. In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?

The Commission's response is appended to this Q&A but does not form part of the Q&A itself. CESR has not addressed the scope of best execution under MiFID in this Q&A, nor has it addressed the question of how best execution applies in dealer markets.

The MiFID Level 3 Expert Group has considered the possibility of conducting a further public consultation following the Commission's reply to CESR and consulted the MiFID Consultative Working Group on this question to gain input from a wider group of stakeholders. Following this consultation, CESR considers that the Commission's reply forms a sufficient basis for implementation and that no further work is needed at the present time.

#### *Further work*

In devising its future work plan, CESR will consider reviewing how MiFID's best execution requirements are being applied as well as submissions and requests from the Commission, the Consultative Working Group and other stakeholders.



## Section 2

## Questions and Answers

### **Q1 Which provisions in MiFID relate to best execution?**

1.1 MiFID's best execution regime is set out as follows in the Directives. Article 21 of Level 1 and Articles 44 and 46 of Level 2 set out the requirements for investment firms that provide the service of executing orders on behalf of clients for MiFID financial instruments and, indirectly via Article 45(7), for investment firms that provide the service of portfolio management, when executing decisions to deal on behalf of client portfolios.

1.2 Article 45 of Level 2 (enacted under Article 19 of Level 1) sets out the requirements for (i) investment firms that provide the service of reception and transmission of orders, when transmitting orders to other entities for execution and (ii) investment firms that provide the service of portfolio management, when placing orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios. There are associated recitals in both Level 1 and Level 2 (Recital 33 of Level 1, and Recitals 66 to 76 of Level 2.)

1.3 Responses to the CP pointed out that investment firms may provide a combination of investment services to the same clients. For example, an investment firm may have the flexibility either to transmit an order on behalf of a client to another entity for execution or to execute the order itself. Similarly, an investment firm may have the flexibility to place orders resulting from its decisions to deal on behalf of client portfolios with other entities for execution or to execute such decisions to deal itself. To take account of this, the Q&A will refer to firms that "execute orders or decisions to deal" and to firms that "transmit or place orders with other entities for execution" rather than referring to "portfolio managers", "RTOs" and "investment firms that execute orders on behalf of clients." Where the Q&A means to refer only to investment firms when they execute orders on behalf of clients, it will refer to firms that "execute orders." The Q&A refers to all of these firms collectively as "firms that carry out orders."

### **Q2 What is the overarching best execution requirement?**

2. MiFID's best execution regime requires investment firms to take all reasonable steps to obtain the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to order execution. CESR considers this requirement to be of a general and overarching nature. See Q3.

### **Q3 What should firms do to comply with the overarching best execution requirement?**

3.1 The overarching best execution requirement sets a high level standard, allowing investment firms a considerable degree of flexibility on how to meet it. However, MiFID does require firms to comply with a number of specific provisions.

3.2 Firms that execute orders or decisions to deal should establish "execution arrangements" and an "execution policy" (Article 21) for complying with the overarching best execution requirement. In a similar way, firms that transmit or place orders with other entities for execution should establish



a "policy" (Article 45) for complying with the overarching best execution requirement. It follows that all of these firms should carry out orders on behalf of clients in accordance with their (execution) policies and/or arrangements.

3.3. In order to comply with the overarching best execution requirement, firms should ensure that appropriate (execution) policies and/or arrangements are effectively implemented for the carrying out of all orders. Firms however are not under an obligation to obtain the best possible result for each individual order; rather they should apply their (execution) policies to each order with a view to obtaining the best possible result in accordance with the (execution) policy.

3.4 All investment firms that carry out orders should also disclose "appropriate information" to clients about their (execution) policies and monitor and review their performance. See Q13 – Q18 and Q22-24.

**Q4 What is the content of the execution policy of a firm that executes orders on behalf of clients or decisions to deal on behalf client portfolios?**

4.1 An execution policy should set out the investment firm's strategy for obtaining the best possible result for the execution of its client orders, including the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

4.2 The execution policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when executing client orders or decisions to deal, as well as information on how those factors affect the firm's choice of execution venues for inclusion in the execution policy.

4.3 The execution policy should also set out the execution venues the firm uses. Article 21(3) states that the execution policy "...shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders". CESR understands this provision to mean that firms should include certain venues in their policy, not that the policy can omit other venues used by the firm. A firm may however in exceptional circumstances use venues not listed in its policy, for example on a provisional basis or to accommodate a client request to trade in an unusual instrument, with a view to satisfying the overarching best execution requirement. See Q13 through Q15 on disclosure about the execution policy.

**Q5 What are execution arrangements and how do they differ from the execution policy?**

5. The "execution arrangements" are the means that an investment firm employs to obtain the best possible result when executing orders or decisions to deal, while the "execution policy" may be understood as a document that describes the most important and/or relevant elements of those execution arrangements. See [Q7].

**Q6 What is the content of a policy for a firm that transmits or places orders with other entities for execution?**

6.1 The "policy" is the means that the investment firm employs to obtain the best possible result for its clients when it transmits or places orders with other entities for execution.



6.2 In particular, the policy should set out the strategy of the firm, the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result.

6.3 The policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when carrying out client orders, as well as information on how those factors affect the firm's choice of entities for inclusion in the policy.

6.4 The policy should also set out the entities the firm uses. In exceptional circumstances, however, a firm may use entities not listed in its policy (See Q4). See Q13 and Q16 on disclosure about the policy.

**Q7 How differentiated should the content of an (execution) policy be?**

7.1 The investment firm should differentiate its (execution) policy to the extent necessary to comply with the overarching best execution requirement.

7.2 The number of subsets in the (execution) policy will depend *inter alia* on the types of clients a firm serves, the types of financial instruments for which it accepts orders, and the relevant execution venues and entities available for those instruments.

7.3 A firm's (execution) policy will need at least to address the different classes of instrument for which it carries out orders. Examples of such classes are equities, debt instruments, units of collective investment schemes and derivatives (which would need to be further distinguished between exchange-traded derivatives and OTC products, if appropriate). The (execution) policy will also need to address the distinction between retail and professional clients to the extent that the firm treats each such category of clients differently. In addition to differentiating by class of instrument and client categorisation, an investment firm may wish to distinguish its policy further, for example by order type.

**Q8 Can a firm that executes orders or decisions to deal include only one venue in its execution policy?**

8.1 CESR considers that whenever there is more than one execution venue that would enable the investment firm to obtain the best possible result on a consistent basis, the firm should consider the respective merits of such venues. The firm should at least include those venues that enable it to obtain on a consistent basis the best possible result for the execution of its client orders or decisions to deal.

8.2 However, MiFID does not prohibit firms from selecting only one execution venue if the firm can show that by doing so it is able to obtain the best possible result on a consistent basis. For example, there may be circumstances where a particular execution venue will deliver the best possible result on a consistent basis for a given subset of the execution policy, or where the costs of including more than one venue in the execution policy (to the extent that such costs would be passed on to clients) would outweigh any price improvement to be gained by doing so (considered over a reasonable time frame). In such circumstances, it may be reasonable for the firm to include only one venue in its execution policy.

8.3 In order to comply with the requirement under Article 19(1) to act in the best interests of its clients, a firm should consider transmitting client orders instead of executing them itself where that



would deliver a better result for clients, provided the firm is authorised for reception and transmission of such orders.

**Q9 Can a firm that transmits or places orders with other entities for execution include only one entity in its policy?**

9. An investment firm that transmits or places orders with other entities for execution can include a single entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement. That is, where a firm transmits or places orders with a single entity for execution, the firm should determine that selecting only one entity complies with the overarching best execution requirement. In addition, the firm should reasonably expect that the entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative entities.

**Q10 How does a firm assess the relative importance of the best execution factors?**

10.1 Responsibility for assessing the relative importance of the best execution factors lies with the investment firm. A firm should take into account the following criteria when determining the relative importance of the best execution 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 or entities to which that order can be directed.

10.2 For retail clients, the best possible result is determined in terms of the total consideration. See Q11.

**Q11 What is "total consideration"?**

11.1 Total consideration is the price of the financial instrument and the costs related to execution, including all expenses incurred by the client which are directly related to the execution of the order such as execution venue fees, clearing and settlement fees, and any other fees paid to third parties involved in the execution of the order.

11.2 For example, an investment firm that provides a service to retail clients with respect to shares admitted to trading on a regulated market 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 execution venue or entity providing the best possible result in terms of total consideration. The firm may consider speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs and give them precedence over the immediate price and cost factors if they are instrumental in delivering the best possible result in terms of the total consideration to the retail client. Such implicit costs may be relevant for retail clients with respect to a large order in a relatively illiquid share, for example.

11.3 CESR considers that the concept of total consideration is relevant for the assessment of best execution for professional client orders too, because in practice a firm is unlikely to be acting reasonably if it gives a low relative importance to the net cost of a purchase or the net proceeds of a



sale. There may be circumstances, however, where other factors will be more important for professional clients and MiFID clearly allows firms flexibility in this regard.

**Q12 Can a firm take its fees and commissions into account when deciding between execution venues?**

12.1 With respect to investment firms that execute orders on behalf of clients, MiFID draws a distinction between the selection of venues to be included in the firm's execution policy and the choice between two or more venues contained in the execution policy for the execution of a particular transaction.

12.2 When selecting venues to be included in its execution policy, a firm should not take into account the fees and commissions that it will charge its clients. At this stage, the firm should focus on the potential of the venues to enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders. In other words, it should focus on the quality of execution available on the various venues.

12.3 When choosing a venue for the execution of a particular client order (from among the venues included in the firm's execution policy that are capable of executing such an order), the firm should take into account the effect of its own fees and commissions on the total consideration to the client.

12.4 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 enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders, 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 (as well as any other costs or other relevant factors). See Q13.

**Q13 Does MiFID regulate the fees and commissions a firm charges for the execution of client orders?**

13.1 Investment firms are free to set their fees or commissions at the level they choose, provided that no venue is unfairly discriminated against. A firm may not charge a different commission (or spread) for execution on different venues unless the difference reflects a difference in the cost to the firm. For example, a firm may not direct all its orders to another firm within its corporate group on the basis that it charges its clients a higher fee for access to other venues that is unwarranted by higher access costs.

13.2 MiFID contains specific disclosure requirements for retail clients regarding a firm's fees and commissions to ensure that these investors are able to compare the fee structures of different firms<sup>1</sup>. See Q14.

**Q14 What information about its (execution) policy should a firm disclose to its clients?**

14.1 An investment firm should provide appropriate information about its (execution) policy to its clients, rather than the full detail of its execution arrangements and/or policy. In this way, MiFID strikes a balance between requiring firms to disclose a lengthy trading manual which would be of

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<sup>1</sup> See Article 19(3) of Level 1 and Articles 33 and 40(4) of Level 2.



limited utility to clients and information that is too high level to enable an adequate understanding of a firm's (execution) policy by clients.

14.2 CESR considers that firms should disclose sufficient information, reflecting any relevant differentiation of the firm's (execution) policy (see Q7), to enable clients to make a properly informed decision about whether to utilise the services offered by the firm.

**Q15 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its *retail* clients?**

15.1 An investment firm executing orders or decisions to deal on behalf of retail clients should disclose the following in good time prior to the provision of the service:

- the relative importance the firm assigns to the best execution factors, or the process by which it determines their relative importance,
- a list of the execution venues on which the firm places significant reliance in meeting the overarching execution requirement,
- a warning to the client regarding the use of specific instructions.

15.2 CESR considers that where a retail client requests additional information about a firm's execution policy and such a request is reasonable and proportionate, the firm, by virtue of its duty to act fairly and professionally<sup>1</sup>, should consider honouring such a request, especially where such information is needed to enable the client to make a properly informed decision about whether to utilise, or continue utilising, the services of the firm.

**Q16 Is there additional information about its execution policy which a firm that executes orders or decisions to deal should disclose to its *professional* clients?**

16.1 An investment firm should provide appropriate information about its execution policy to its professional clients. There are no provisions within MiFID that detail what constitutes "appropriate information" for professional clients.

16.2 Firms should supply information to professional clients upon request provided the request is reasonable and proportionate. What is reasonable and proportionate will depend on the facts and circumstances of each particular situation.

**Q17 Is there additional information about its policy which a firm that transmits or places orders with other entities for execution should provide to its clients?**

17.1 A firm that transmits or places orders with other entities for execution should provide "appropriate information" on its policy to its clients.

17.2 This information should enable the client to understand the key aspects of the firm's policy. Depending on the circumstances, it may be appropriate to mention the relative importance of the factors or to describe the process used to select the entities. It will also be appropriate to mention the entities used, depending on the circumstances. For example, where an investment firm includes only a small number of entities in its policy, it may be appropriate to disclose them to clients.

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<sup>1</sup> See Article 19(1) of Level 1.



**Q18 What should a firm do if it amends its execution policy?**

18.1 An investment firm that executes orders or decisions to deal should notify its clients of any material changes to its execution arrangements or execution policy. A change is material where its disclosure is necessary to enable the client to make a properly informed decision about whether to continue utilising the services of the firm. In particular, a firm should consider the materiality of any changes it makes to the relative importance of the best execution factors or to the venues on which it places significant reliance in meeting the overarching best execution requirement.

18.2 There is no comparable requirement for firms that only transmit or place orders with other entities for execution but do not execute orders or decisions to deal.

**Q19 How should disclosure on the (execution) policy be presented?**

19.1 Investment firms should provide their clients with appropriate information in a comprehensible form.

19.2 A firm executing orders or decisions to deal on behalf of retail clients should provide the required information about its execution policy either in a durable medium or by means of a website under certain conditions<sup>1</sup>. Any such disclosure could be incorporated into the client agreement.

**Q20 How do clients consent to the execution policy?**

20.1 An investment firm that executes orders or decisions to deal should obtain the prior consent of its clients to its execution policy. CESR observes that for consent to be valid, the legal provisions of the relevant Member State relating to the giving of consent must be satisfied, without prejudice to what is said in Q14 through Q16 about the information that the firm should provide to clients.

20.2 A firm should obtain the prior express consent of its clients before executing their orders outside a regulated market or MTF.

20.3 There are no comparable requirements for firms when they transmit or place orders with other entities for execution but do not execute orders or decisions to deal themselves.

**Q21 What is the difference between "consent" and "express consent"?**

21.1 Where MiFID requires "prior express consent", CESR considers that this entails an actual demonstration of consent by the client which 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.

21.2 CESR considers that on a purposive reading of the "express consent" requirement, an investment firm does not have to obtain express consent from its clients where the relevant instruments are not admitted to trading on a regulated market or MTF.

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<sup>1</sup> See Articles 3(1) and 3(2) of Level 2.



21.3 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.

21.4 Competent authorities are empowered to require evidence from firms that tacit consent has been given by clients and may have access to any document and demand information from firms in this regard<sup>1</sup>. In particular, a firm may be asked to show that it has supplied clients with the appropriate information on its execution policy.

**Q22 In what respects and under what circumstances can a firm that transmits or places orders with other entities for execution rely on those entities to help it satisfy the overarching best execution requirement?**

22.1 MiFID clarifies that its best execution provisions are not intended to require a firm that transmits or places orders with other entities for execution to duplicate the efforts of its execution entities. Rather, a firm should determine that the entities it uses will enable it to comply with the overarching best execution requirement when placing an order with, or transmitting an order to, another entity for execution.

22.2 To this end, a firm should review the execution arrangements of the entities it wishes to use to determine whether they will allow the firm to comply with all its best execution requirements.

22.3 In determining whether an entity is likely to enable the firm to obtain the best possible result for its clients, a firm also may need to consider:

- whether the entity itself is subject to Article 21 for the relevant business, that is, whether the entity is an investment firm executing or receiving and transmitting orders on behalf of the firm and the entity has agreed to treat the firm as a retail or professional client;
- whether the entity will undertake by contract to comply with any or all of the MiFID best execution requirements in relation to the relevant business (with the result that it has contractual but not regulatory responsibilities for best execution); and
- whether the entity can demonstrate that it delivers a high level of execution quality for the kind of orders that the investment firm is likely to place with or transmit to it.

Furthermore, with respect to the relevant business, if an entity is subject to Article 21 or undertakes by contract to comply with Article 21, and the firm merely transmits or places orders with the entity for execution, taking few steps itself that affect execution quality, and the firm has determined that the entity has arrangements that will enable the firm to comply with its obligations under Article 45, then CESR considers that the firm will be able to place a high degree of reliance on that entity in order to comply with its own overarching best execution requirement. That is, in these circumstances, CESR considers that a firm would be complying with the overarching best execution requirement with respect to particular orders simply by placing them with or transmitting them to such entities. Of course, the firm would still be subject to the other requirements of Article 45, in particular the requirements to implement an appropriate policy and to monitor and review its effectiveness, including the execution quality actually delivered by such entities. And the firm could not continue to rely on an entity if its monitoring or review indicated that the entity was not, in fact, enabling it to obtain the best possible result for the execution of its client orders.

22.4 In addition, when devising its policy, a firm should consider whether it is reasonable simply to transmit or place orders with another entity for execution or whether it is necessary to exercise

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<sup>1</sup> See Articles 50(1)(a) and (b) of Level 1.



some additional control over how its orders are executed, in order to meet the overarching best execution requirement. Similarly, any actions the firm takes that may affect the quality of execution of the order should be consistent with the overarching best execution requirement. For example, where a firm gives specific instructions to an execution entity about how or where a particular transaction is to be executed, those instructions should comply with the overarching best execution requirement.

22.5 Firms are not restricted to using entities subject to MIFID for carrying out their orders. In order to be able to use an entity that is not subject to the MiFID best execution regime, in particular a non-EEA service provider, firms should ensure that the execution arrangements of such an entity allow them to comply with the overarching best execution requirement. Where the firm cannot satisfy itself that this is the case, it should not use such entities.

### **Q23 What is the requirement to review?**

23.1 Review is an overall assessment of whether the (execution) policy and/or arrangements include all reasonable steps that the investment firm could be taking to obtain the best possible result for the execution of its client orders. Specifically, the firm should consider whether it could consistently obtain better execution results if it were to:

- include additional or different execution venues or entities;
- assign a different relative importance to the best execution factors; or
- modify any other aspects of its (execution) policy and/or arrangements.

23.2 All investment firms should carry out reviews at least annually. A firm should also review its (execution) policy and/or arrangements whenever a material change occurs that could affect its ability to obtain the best possible result for the execution of its clients' orders. What is material will depend on the nature and scope of any change.

### **Q24 What is the requirement to monitor?**

24.1 Monitoring is the assessment, on a regular basis, of particular transactions in order to determine whether the investment firm has complied with its (execution) policy and/or arrangements, and whether the resulting transaction has delivered the best possible result for the client.

Monitoring may include comparing similar transactions:

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

24.2 Where monitoring reveals that a firm has fallen short of obtaining the best possible result, the firm should consider whether this is because the firm has failed to follow its (execution) policy and/or arrangements or because of a deficiency in such policy and/or arrangements, and make appropriate amendments.



24.3 All investment firms should undertake monitoring, but the monitoring methodology is at the discretion of the firm. Where monitoring every transaction would be disproportionate, other approaches, such as appropriate methodologies for sampling, may suffice.

**Q25 Will the precise nature of review and monitoring vary depending on where a firm sits in a chain of execution?**

25.1 Investment firms that execute orders or decisions to deal will need to monitor and review the steps they are taking to deliver the best possible result, as well as the performance of the execution venues they are using.

25.2 Investment firms that transmit or place orders with other entities for execution may need to take different approaches to their review and monitoring requirements, depending on how much control they exercise over the way their orders are executed. A firm may merely send orders received or decisions to deal to an entity for execution, taking few steps itself that affect execution quality and therefore relying to a high degree on the entity with respect to how orders are to be executed; alternatively, it may provide that entity with more or less extensive instructions about how the order should be executed or take steps to manage the execution of the order itself before sending the order to an entity. In the second case, the firm should monitor and review its own actions and their impact on the execution quality it is obtaining.

25.3 In any event, firms that transmit or place orders with other entities for execution should review and monitor the execution quality of the entities they use.

25.4 In addition, if a portfolio manager is empowered to either execute its decisions to deal itself or to place orders with other entities for execution, then, as part of the review process, it should compare the performance of the entities it uses with its own performance in executing its decisions to deal.

**Q26 Is CESR currently undertaking any work on execution quality data?**

26.1 No. CESR will consider any request from the Commission to examine execution quality data or any other aspect of best execution and will report such requests as and when they are received. CESR will consider whether further work is needed in relation to best execution as part of the assessment of the MiFID work programme starting in November 2007.

**Q27 What is the outcome of CESR's call for evidence on article 21(5) of the Level 1 'demonstration of compliance'?**

27.1 An investment firm that executes orders or decisions to deal should be able to demonstrate to its clients on request that such executions have been carried out in accordance with its execution policy. After November 2008, with one year of practical experience of the MiFID rules, CESR will consider whether there is a need to do further work to align the practices in this respect.



**Section 3 - Definitions**

*In the interests of clarity and simplicity, CESR has kept to the terminology used in MiFID and its implementing directive wherever possible. However CESR considers it useful to abbreviate certain of these terms and concepts in order to keep the length of this paper to a minimum and to make its contents as user friendly as possible. Non-MiFID terms have only been used where CESR considers such concepts useful aids to understanding the directive. These terms are defined here but CESR does not intend for these terms to supersede or add to the terms of the directives in any way.*

<b>Level 1</b>	Directive 2004/39/EC of 21 April 2004
<b>Level 2</b>	Directive 2006/73/EC of 10 August 2006
<b>MiFID</b>	Collectively Directive 2004/39/EC of 21 April 2004 and Directive 2006/73/EC of 10 August 2006
<b>Article 21</b>	Article 21 of Directive 2004/39/EC of 21 April 2004 (Level 1)
<b>Articles 44, 45 and 46</b>	Articles 44, 45 and 46 of Directive 2006/73/EC of 10 August 2006 (Level 2)
<b>(Execution) policy</b>	The "execution policy" under Article 21 and the "policy" under Article 45.
<b>Execute orders or decisions to deal</b>	Execute orders on behalf of clients, or execute decisions to deal on behalf of client portfolios when providing the service of portfolio management.
<b>Carrying out</b>	<p>(i) Executing an order on behalf of a client</p> <p>(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 portfolio or executing a decision to deal in financial instruments on behalf of a client</p> <p>(iii) When providing the service of reception and transmission of client orders, transmitting client orders to other entities for execution</p> <p>The European Commission has confirmed its intention to give the term this meaning as used in the context of client order handling in Articles 47, 48 and 49 of Level 2</p>
<b>Execution venues</b>	Regulated markets, MTFs, systematic internalisers, market makers or other liquidity providers or entities that perform a similar function in third countries to the function performed by any of the foregoing (last paragraph of Article 44(1) of Level 2)
<b>Entities</b>	Natural or legal persons or other entities that either transmit or execute orders in financial instruments
<b>Best execution factors</b>	The factors listed in Article 21(1) of Level 1. These factors are also referred to in Article 45(4) of Level 2.
<b>Overarching execution requirement</b>	<b>best</b> The requirement under Article 21(1) and Article 45(4) to take all reasonable steps to obtain the best possible result for the execution of client orders, taking into account the best execution factors



**Transmit or place  
orders with other  
entities for execution**

Transmit client orders to other entities for execution when providing the service of reception and transmission of orders, or place orders with other entities for execution that result from decisions to deal in financial instruments on behalf of client portfolios when providing the service of portfolio management.



**Appendix – European Commission response to CESR questions on scope**



**EUROPEAN COMMISSION**  
Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS  
Director

23.03.07

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FRANCE

**Subject : Best execution – scope issues under Mifid and the implementing directive**

Dear Eddy,

Following Arthur Philippe's request of 15 November 2006 please find the Commission services' opinion on the three issues related to best execution for which CESR asked for clarification.

Yours sincerely

David WRIGHT

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## WORKING DOCUMENT ESC-07-2007

### Commission answers to CESR scope issues under MiFID and the implementing directive

#### Issue 1 – Dealing on quotes

*In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?*

In many markets in financial instruments firms operate by providing 'quotes' (that is, prices at which they may be willing to buy or sell:

- continuously, such as for example, on a web-page or some limited access bulletin board; or
- to a particular person, such as, for example, in response to a 'request for quote' from that person, which is communicated electronically or over the phone, and then dealing with a person to whom they have made a quote.

In its consultation paper published on 31 October 2006, the UK FSA has suggested that best execution requirements do not necessarily apply to firms who operate in this way for either or both of the following reasons:

- (i) A firm operating in this way may not be providing an investment service, only performing an investment activity. That is, there is no client;
- (ii) A firm operating in this way does not receive a client order, because there can only be an order where the firm commits to do something on behalf of the client and the presumption is that there is no such commitment in this type of dealing. (An order would be, for example, where the firm commits to obtaining the best price.)

Other CESR members believe that the above-mentioned interpretation is not consistent with Art. 21 of MiFID and Art. 44 of the implementing directive because the "dealing on quotes" meets the criteria of dealing on own account. Dealing on own account with clients by investment firms should be considered as the execution of client orders and therefore is subject to the best execution requirements (Recital 69 of the implementing directive).

The interpretation according to which "dealing on quotes" does not amount to "dealing on own account" was expressly rejected in the negotiation of level 2 measures. The rationale behind was that such an interpretation runs against the approach adopted in the Level 1 regulatory framework.

According to MiFID, only eligible counterparties may be allowed to enter into transactions without benefiting of the best execution requirements. Apart from such an exception,

whenever an investment firm executes an order, it provides an investment service to a client, therefore best execution requirements apply.

Moreover, Art. 44(3) of the implementing directive expressly refers to the need of taking into account the client's nature (retail/professional) in order to achieve the best possible result.

The motive for not having exempted professional clients may be that the best execution rules not only serve the purpose of investor protection but also to foster the competition between execution venues and overall market efficiency. This is expressed in Art. 21(6) of MiFID ("fair and orderly functioning of markets") and Art. 44(4) of the implementing directive ("discriminate unfairly between execution venues").

**Commission services' response**

1. We do not consider it fruitful to distinguish between, on the one hand, cases where a service is being provided to a client and, on the other hand, those where an activity is simply being carried on *with* a person who is not a client. The Level 1 Directive provides no clear criterion for distinguishing between these two situations. It is clearly the case, for example, that carrying on the activity of dealing on own account can also involve the provision of a service to a client in some cases. This much is implicit in Recital 69 of the Level 2 Directive. Therefore, we do not believe this distinction should determine whether or not best execution is required in a particular case. Similarly, we do not believe it is useful to focus on the question of when an *order* arises. Again, this is consistent with Recital 69, which clarifies that whenever a firm deals on own account with a client there should be considered to be an order.
2. As a corollary, we believe that whenever a person or entity enters into a transaction with an investment firm, it will do so in the capacity either of an eligible counterparty, or as a retail or professional client.
3. As regards eligible counterparties, Article 24 of MiFID provides that best execution obligations under Article 21, together with conduct of business obligations under Article 19 and client order handling obligations under 22(1), do not apply. At the same time, as indicated by Recital 40 of MiFID, eligible counterparties should be considered to be acting as clients. One consequence of this is that the protections of Articles 13 and 18, relating *inter alia* to conflicts of interest and client assets, will continue to apply. As regards retail or professional clients, Articles 13, 18 and 19 of MiFID will always apply whilst the application of Article 21 will depend on what is said below.
4. In our view, the key concept to focus on in interpreting Article 21 is the execution of orders *on behalf of clients*. This is consistent with the definition in Article 4(1)(5) of MiFID, which refers specifically to a firm acting to conclude agreements to buy or sell financial instruments *on behalf of clients*, and the description of the relevant investment service in Annex I to MiFID as the "execution of orders on behalf of clients". Both provisions support the idea that the requirement that an order is being executed on behalf of a client is integral to the concept of best execution.
5. Recital 33 of MiFID provides some explanation of the concept of execution of orders *on behalf of clients*, by indicating that it will typically be present in a range of circumstances which are broadly referred to in that Recital as situations where 'contractual or agency

obligations' are owed by the firm to the client<sup>1</sup>. It is also important to note that Recital 33 of MiFID circumscribes the scope of Recital 69 of the level 2 Directive, so that the scope of best execution requirements in relation to dealing on own account is limited to circumstances covered by Recital 33 where the firm is acting on behalf of the client (and is thereby in a position to make decisions that will affect the interests of the client).

**Indicative examples of cases where a firm executes an order on behalf of a client and therefore best execution applies**

6. Applying the principles set out above, transactions based on a client's request to the investment firm to buy or sell a financial instrument for him will *always* fall within the concept of execution of an order on behalf of a client. This will include the following types:

- Executing a client order by dealing as agent for a client. In this situation, the intermediary takes a customer order and places the order, on behalf of the client, with an execution venue (such as an exchange, a systematic internaliser or another liquidity provider) for execution. For example, client A instructs investment firm B to buy 100 shares of X. The firm must then seek the execution venue that offers the best conditions for buying X shares at the time that the order is to be executed.
- Executing a client order against the firm's own proprietary position (including as a systematic internaliser), where the firm is making decisions as to how the order is executed: e.g. where it is 'working the order' on the client's behalf. For example, client A gives the same instruction as in the preceding example, but investment firm B sells 100 shares in X to client A from its own portfolio. In this case, B puts itself in competition with other relevant execution venues and can execute the client instructions by selling the shares from its portfolio, provided that in doing so it obtains the best result for the client as compared with the other execution venues surveyed.
- Executing a client order by dealing as a riskless principal on behalf of the client, including cases where the client is charged a spread on the transaction. In this type of transaction, the investment firm will typically deal as principal with its client at the same time, and on the same terms (as to instrument, time and price (allowing for any spread)), as it enters a transaction as principal with a counterparty.

**Indicative examples of transactions where a firm generally does not execute an order on behalf of a client and therefore does not owe an obligation of best execution to its client**

7. Transactions based on a specific request by the client to buy or sell a financial instrument from the investment firm, or on the acceptance by the client of an offer made by the firm to buy or sell a financial instrument from the firm, will typically not fall within the concept of execution of an order on behalf of a client unless in all the circumstances, taking into account the considerations set out in paragraph 8 below, the firm should properly be regarded as acting on behalf of the client. This class of transactions will include the following type:

<sup>1</sup> However, the reference to 'agency' in Recital 33 is not intended to equate the application of best execution obligations with the existence of an agency relationship under the applicable national law.

- Executing a client order by entering a proprietary trade with the client in those cases not covered by paragraph 6 above. This includes the case where the firm engages in proprietary trading by quoting on a 'request for quote' basis. For example, client A requests a quote from investment firm B for 100 shares of X. The firm provides a quote which the client accepts and asks to buy 100 shares at the price quoted by B. By way of further example, B is a market maker that displays its quotes and Client A "hits" the quote displayed by B.
8. However, in some cases, proprietary trades will attract the best execution obligation. The application or otherwise of best execution will depend on whether the execution of the client's order can be seen as truly done *on behalf of* the client. This is a question of fact in each case which ultimately depends on **whether the client legitimately relies on the firm to protect his or her interests in relation to the pricing and other elements of the transaction - such as speed or likelihood of execution and settlement -that may be affected by the choices made by the firm when executing the order.** The following considerations, taken together, will help to determine the answer to this question:
- whether the firm approaches (initiates the transaction with) the client or the client instigates the transaction by making an approach to the firm. In those cases where the firm approaches a retail client and suggests him to enter into a specific transaction it is more probable that the client will be relying on the firm, to protect his or her interests in relation to the pricing and other elements of the transaction.
  - questions of market practice will help to determine whether it is legitimate for clients to rely on the firm. For example, in the wholesale OTC derivatives and bond markets buyers conventionally 'shop around' by approaching several dealers for a quote, and in these circumstances there is no expectation between the parties that the dealer chosen by the client will owe best execution.
  - the relative levels of transparency within a market will also be relevant. For markets where clients do not have ready access to prices while investment firms do, the conclusion will be much more readily reached that they rely on the firm in relation to the pricing of the transaction.
  - the information provided by the firm about its services and the terms of any agreement between the client and the investment firm will also be relevant, but not determinative of the question. The use of standard term agreements to characterise commercial relationships otherwise than in accordance with economic reality should be avoided.
9. These factors are likely to support the presumption that, in ordinary circumstances, a retail client legitimately relies on the firm to protect his or her interests in relation to the pricing and other parameters of the transaction. Similarly, *prima facie* application of these factors is likely to lead to the presumption that in the wholesale markets clients do not rely on the firm in the same way.

Issue 2 - Use of Specific Instructions

*What scope may "specific instructions" from a client cover?*

Investment firms are considered to meet their best-execution obligation in respect of specific client instructions for an order or an aspect of an order.

Recital 68 clarifies that when an investment firm executes an order following specific instructions from the client, it should be treated as having satisfied its best execution obligations only in respect of the part or aspect of the order to which the client instructions relate. This provision should not be used by firms to avoid their duty of best execution. In particular, firms should not “suggest” instructions from their clients and thus avoid complying with their obligation.

**Commission services' response**

10. Recital 68 of the Level 2 Directive must be read in its entirety. In particular, the clarification that a firm should not solicit a specific instruction by expressly indicating or implicitly suggesting the content of an instruction to a client is limited to those circumstances “when the firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client”. So, a firm that ‘suggests’ instructions to a client should not be considered as avoiding best execution in all cases.
11. For example, a client chooses to use a Direct Market Access system, such that he himself selects parameters of the trade (such as the price, the counterparty, the venue, the timing and the size of trade). In such a case the dealer, while acting on the client’s behalf in providing the DMA service, will be treated as having satisfied its duty of best execution to the extent that the client has given specific instructions by means of the DMA system.

The scope for specific instructions deserves legal clarifications as regards, at least, its application in customised products.

Regarding application of the best-execution to customised products (e.g. an Over-The-Counter product), where the client indicates the particular characteristics of the product that he/she wants, can this specification of the characteristics be considered ‘specific instructions’? Or, as recital 70 of the implementing directive already provides for a differentiated approach to best execution, should this be dealt with not as a scope issue but as an issue of the relevant standard of best execution? Or, in case of complex products, should we consider that the best execution requirement applies to each of the single components of the product?

**Commission services' response**

12. Best execution applies to OTC customised instruments in those cases when the firm is considered to be acting on behalf of the client. This will depend on the factors set out in our answer to issue 1. A customised instrument should be understood as that instrument which is tailored to specific needs of a client and for which there is practically no liquidity. On the contrary, an OTC plain vanilla option on a single liquid share with a maturity of one month should not be considered as a customised instrument.
13. The fact that the client specifies what he needs in terms of exposure and protection does not necessarily exclude the application of best execution. In the first stage where an investment firm proposes to a client the elements of an OTC derivatives contract that would respond the client's needs, it is more appropriate to speak of investment advice rather than best execution. For example, a client may ask an investment firm to design an instrument that will protect him against a collapse in gas prices and a spike in the price of

electricity. The investment firm may propose a number of alternatives with different pay-off structures and advise the client to select one particular design meaning the suitability obligations apply. Best execution obligations could apply depending on the considerations set out in our answer to issue 1.

14. Ordinarily, in those circumstances where best execution applies, the identity of the instruments sought will be a matter of the information contained in the order rather than a question of specific instructions. Nevertheless there may be a level of discretion as to exactly which instruments to obtain on behalf of a client in the order.
15. In the case of complex products<sup>2</sup>, the best execution requirement (when applicable) applies to the product as a whole. Best execution for the product as a whole may conceivably be obtained even if best execution for each component, when considered in isolation, is not obtained.

### Issue 3 – Obligations on portfolio managers and order receivers and transmitters

*In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?*

Some take the view that portfolio managers execute client orders when they deal directly with execution venues, including direct access to regulated markets as well as use of MTFs, investment firms that deal on own account and other liquidity providers and counterparties.

Others take the view that portfolio managers never execute client orders, except possibly where they arrange transactions between their clients ("agency cross transactions"). For transactions in quote driven markets, some argue that portfolio managers are price takers, not makers, and that, for this reason, they are not 'executing client orders'. Rather, it is the dealer who executes.

In addition, some investment firms that provide retail brokerage services suggest that they themselves only receive client orders and transmit them to other investment firms, it is these other firms that take responsibility for executing these orders. Is there any clear line that can be drawn between reception and transmission of client orders for execution and execution of client orders? Is it possible for two firms in a chain of execution both to be viewed as executing those orders?

These questions are particularly relevant for the operation of Article 45(7) of the Implementing Directive and Article 66 of the Level 1 Directive. Article 45(7) provides that Article 21 (not Article 45) applies to portfolio managers and order receivers and transmitters when they execute client orders.

The requirements under Article 45 are not as extensive as those under Article 21. Therefore, brokerage firms and portfolio managers have an incentive to characterise their business models as something other than execution of client orders.

If portfolio managers do execute client orders when they deal on quote driven markets or deal "direct" via regulated markets or MTFs, then there is a question about what Article 45(7) means for portfolio managers authorised under the UCITS Directive. This is because MiFID Article 66 only applies MiFID Articles 2(2), 12, 13 and 19 to UCITS portfolio managers but not Article 21. Does MiFID apply to transactions by UCITS portfolio managers when they execute client orders?

### Commission services' response

<sup>2</sup> We understand complex products as those that are composed of or represent the performance of more than one product.

16. Since the "execution of orders on behalf of clients" is a distinct investment service, it could be argued that only those entities licensed to provide this particular service can execute orders or decisions to deal on behalf of clients. This would mean that investment firms authorised to provide portfolio management services<sup>3</sup> may transact directly with execution venues (i.e. execute decisions to deal) only if they are authorised to provide the service of execution of orders on behalf of clients.
17. The consequence of this reading would be to prevent UCITS management companies from transacting directly with execution venues when providing the investment service of individual portfolio management under Article 5 of the UCITS directive.
18. In accordance with this reading, in such cases Article 45(7) of the implementing Directive will simply not apply because those entities cannot provide the service of execution of orders, and the question as to whether Article 21 applies to UCITS management entities providing the service of portfolio management would be irrelevant.
19. However, the MiFID implementing Directive supports a different interpretation of the relevant provisions which is more consistent with current business practices and also ensures the level of investor protection and gains in market efficiency which the best execution obligations are designed to secure. Under this interpretation, an authorisation to provide the service of portfolio management under Article 5(3) of the UCITS Directive is treated as entitling portfolio managers to execute their own decisions to deal. However, if, when executing the decisions to deal, those persons should be required to comply with the same obligations as those under Article 21 of the MiFID. Any other outcome would compromise investor protection.
20. Article 45(7) of the Level 2 Directive implies that persons who are authorised to carry out portfolio management are not considered to provide the MiFID service of executing orders on behalf of clients when executing decisions to deal in the course of the activity of portfolio management, because there may not necessarily be any client orders when the portfolio manager decides to initiate a transaction on behalf of a client's portfolio.
21. However, the Level Directive 2 recognises that the same policy concerns arise in situations when a portfolio manager executes a decision to deal as are present when an investment firm executes an order on behalf of a client. Indeed, in both cases, transactions are executed on behalf of clients, be they clients under management or clients placing orders. In fact, there seems to be little or no difference, in so far as the interests of the client are at stake, between a situation where a client receives advice from an investment firm and acts on this advice by issuing an order to an investment firm for execution and a situation where a portfolio manager executes a decision to deal directly with an execution venue. In both cases the client needs to be able to rely on the firm's expertise to deliver the best possible result for the transaction.
22. This is why Article 45(7) of the Level 2 Directive provides that when an investment firm that provides the service of portfolio management transacts or deals directly with an execution venue (i.e. executes a decision to deal), it should comply with the obligations under Article 21 of MiFID.

<sup>3</sup> Thus bringing them within the scope of MiFID. Collective investment undertakings that do not carry on individual portfolio management (or any other investment service of activity regulated under MiFID) are excluded from the scope of MiFID (Article 2(1)(h)).

23. This means that UCITS asset managers and investment firms, when executing orders directly (rather than transmitting them to an intermediary who would execute them on their behalf) in the course of providing the service of individual portfolio management, will have to comply with the obligations under Article 21. This is necessary in order to ensure adequate investor protection.

**Reception and transmission**

24. There should be a clear regulatory distinction between a firm that is authorised both to receive and transmit orders and to execute them and a firm that may only receive and transmit client orders for execution to another investment firm. The latter firm may not in any way alter client instructions as it transmits them to another firm for execution or further transmission.

25. Execution of a client order or a decision to deal is always carried out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue. Clearly, an investment firm may be the first and the last link in the chain: for example, when a client order is executed by an investment firm in its capacity as systematic internaliser.

26. A firm which is authorised both to receive and transmit orders and to execute orders on behalf of clients will need to comply either with Article 21 of MiFID or with the requirements under Article 45 of the MiFID implementing Directive, depending on whether the investment firm transacts directly with the execution venue or transmits the order to another firm for execution. In cases where the investment firm transacts directly with the execution venue, Article 21 of MiFID always applies.

27. Sometimes an investment firm that is authorised to execute orders but acting in its capacity as a receiver and transmitter of orders, issues instructions to another executing firm which are not client instructions and which may affect the quality of execution of the order. In such cases, the instructing firm must comply with Article 45 of the implementing Directive. Execution of the order is carried out by the last firm in the chain.

28. The firm which receives instructions (which are not client instructions) from another investment firm should comply with any instructions passed on to it, treating them as if they were client instructions for the purposes of Article 21(1). However, it must deliver best execution in respect of any part of the order which is not covered by an instruction.