

Good, Better, "Best"

Does your Execution
stand up to MiFID II?

Introduction

The fog is finally beginning to lift on the best execution aspects of MiFID II, so meaningful work can now be done while the FCA finalises the updating of its Conduct of Business Sourcebook (draft language was published in [FSA]). The aim of this particular regulation is to solve a difficult problem of conflicting interests and information asymmetry between client and broker. Such a problem does not have an easy solution, and ESMA has decided to build on the approach taken in MiFID by introducing even more comprehensive reporting requirements. The aim is to further improve transparency to clients and in the process, to enhance broker accountability. There are at least three key components, namely:



- Ensure protection of investors (by making them better informed).
- Ensuring integrity of the price formation process.
- Promote competition between trading venues by increasing transparency.

Practical Problems

It can be overwhelming trying to make sense of the MiFID II regulation which is extremely complex and abstract. For the best execution obligation we feel it is beneficial to decompose the requirements into 5 sub challenges and address each somewhat separately:

Adequacy of Systems and Controls	Having adequate processes and methodologies in place to monitor compliance with best execution obligations across the organisation with an effective escalation process for material problems ensuring that senior management receives all the necessary information to proactively address them.
Data Challenges	The transparency requirement on execution quality introduces a significant data set which will be challenging for both 'execution venues', who will need to produce and make public all the statistics on execution activity, and for users of those venues, who need to get comfortable with all the new information and contemplate how it can be proactively used to improve execution decisions.
Demonstrability	The ability to effortlessly demonstrate consistent best execution 'on-demand' to clients, regulator(s) or an internal supervisory committee.
Client Documentation	Ensure that publically available policies including terms and conditions are transparent and sufficiently detailed leaving the client in no doubt what has been accepted and with a good understanding of the firm's approach to best execution.
Broker Selection and Monitoring	All the new execution quality data gives market participants a whole new quantitative framework to evaluate the robustness of counterparty selection policies and on-going monitoring of 3rd party market participants' ability to supply clients with a service consistent with best execution rules. It does, however, come with an obligation to actively and intelligently use the data.

Another significant problem is that different asset classes have reached different levels of transparency and general agreement on how to monitor best execution. In equities and FX, transaction cost analysis (TCA) is becoming an increasingly common tool in trying to optimise execution and understand market microstructure. It is, however, important to understand that having a TCA toolkit is not a regulatory requirement¹ per se. Rather, each investment firm should consider the complexity of its business model and the asset classes in which it invests. Table 1 contains a high level description of major asset classes and it seems natural to structure analysis in support of best execution around such high level observations.

Asset Class	Status and Challenges
Equities	High liquidity fragmentation, extensive dark markets, high level of competition, low costs of a seat at the table, low complexity, high volume.
FX	Arguably lacks credible benchmarks, medium liquidity fragmentation, OTC, high level of competition, medium costs of a seat at the table, low complexity, and high volume.
Fixed Income	Medium liquidity fragmentation, costs of a seat at the table is high, medium competition, medium complexity, and medium volume.
Credit	Less liquidity (and fragmentation), cost of a seat at the table is very high, low competition, high complexity, regulatory headwinds, low volume.
Listed Derivatives	Like Equities but less fragmentation, competition and volume.
OTC Derivatives	Low liquidity fragmentation, low level of competition, counterparty risk, costs of a seat at the table is high, high complexity, regulatory headwinds, low volume, and lack of standardisation.

Table 1

High level description of the market structure of different asset classes. Clearly there are fundamental differences between markets which means the same solution is unlikely to fit all. In particular, traditional TCA was developed to address liquidity fragmentation in a fairly efficient market with lots of competition and low complexity.

Current State of MiFID II Best Execution Regulation

The MiFID II Directive has been available for some time (see [MiFID_II]) and supplementary information has been made available via Delegated Regulation (see [DREG]).

1. There can, however, be plenty of commercial reasons for buying a TCA toolkit and outputs can for some asset classes clearly be used both to optimise an execution process and as quantitative input to MiFID II broker selection analysis.

MiFID II is currently scheduled to take effect on the 3rd of January 2018, and this deadline therefore applies in particular to the new best execution requirements.

From an implementation point of view, however, the publication of two technical standards, namely RTS 27, concerning the data to be published by execution venues on the quality of execution of transactions (see [RTS27] and [RTS27A]), and RTS 28, concerning publication by investment firms of information on the identity of execution venues and on the quality of execution (see [RTS28] and [RTS28A]), has shed light on what needs to be done.

In particular, RTS 27 is a major step forward in improving transparency as the market data reported under this requirement is essentially what clients will need for robust post-trade execution quality analysis, albeit delivered with a significant time lag. On an aggregate basis these RTS 27 reports should be used for asset manager’s periodic assessment of venue/broker selection along with other commercial aspects, see Figure 1 for a possible dynamic assessment process. Consolidated tapes will be another source of valuable input to the assessment process.

Dynamic Venue/Broker Assessment

Possible Post Trade Dynamic Process

Execution Quality Data (RTS 27):

- Intraday (table 3) and daily price summary statistics (table 4).
- Aggregated Costs and Rebates (table 5).
- Likelihood of Execution: daily descriptive (table 6) and intraday (table 7) statistics.
- Speed: daily statistics (table 8/9).
- General execution information (table 8).

Possible Other Evaluation Factors:

- Perceived Product Expertise and Coverage.
- Counterparty Risk.
- Commercial Aspects (credit limits, competitive leverage etc.).
- Access to liquidity
- Integrity and historical relationship
- History of leakage?
- Special situations (quality of quotes in volatile markets etc.).
- Information from consolidated tapes.

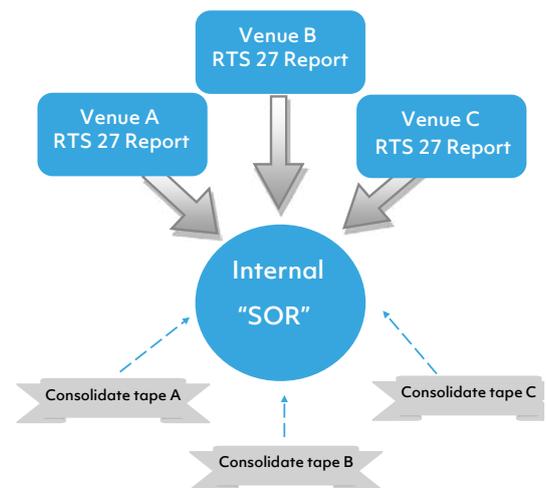


Figure 1

The execution quality data reported in RTS 27 is central to the best execution regulation, so asset managers really have little choice but to somehow include it in their broker assessment analysis. When consolidated tapes becomes available that will be another important input to the analysis along with commercial aspects and historical relationship.

Furthermore, the FCA's position was clarified in a recent Consultation Paper (see [FSA], particularly chapter 9). A lot of information is also available from a Thematic Review published in 2014 (see [FSA_TR]). The latter is interesting reading, as it gives insight into the FCA's view on the quality of execution at the time, and also highlights areas which, in the FCA's view, were in need of improvement.

It follows that financial firms who are currently compliant with MiFID will find the implementation of MiFID II a lot easier. In fact, 9.20 in [FCA] states that:

"To meet the new requirements firms will be expected to update existing execution arrangements, execution policies² and monitoring procedures."

while 9.21 further states that:

"the main impact ... will arise from the reporting requirements under RTS 27 and RTS 28"

However, reading the Thematic Review gives the impression that some financial firms operating under FCA's jurisdiction might have to do more than simply upgrade from MiFID to MiFID II.

The FCA does not necessarily appear to have a history of aggressive enforcement of best execution regulation, at least in the form of public fines where best execution violations are the main offense. This, in particular, compares well with the US, where numerous cases of financial fines can easily be found (see, for example, [US1], [US2], [US3], [US4] and [US5]).

A quick search revealed one case, the details of which can be found in [FSA_FINE], but other cases involving best execution do exist, such as [FX_FINE]. One reason could be that the regulatory approach taken in Europe is slightly different than in the US, in that an unambiguous definition of best execution is not offered under MiFID II. Rather, Article 27(1) [MiFID_II] states that firms must

"take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account:

- Price
- Costs (both implicit and explicit)
- Speed
- Likelihood of execution (and settlement)
- Size
- Other relevant factors"

'one has to question if "best" is really generally possible?'

Clearly, such a definition leaves room for interpretation, which naturally makes enforcement more challenging. Also, with a strict interpretation, one has to question if "best" is really generally possible? Fortunately, it seems that ESMA is recognising the problems, as a recent Q&A publication contains the following clarification on best execution (see [Q&A]):

"This overarching requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion."

2. Execution policies must be reviewed and updated to reflect potential changes (which could be changes in market practice, innovations, new market participants or most importantly insights gained from execution quality analysis) at least annually – particular addressing lessons learned from failures to secure clients the best possible execution result. Currently some companies have generic high level policies, and this is a clear violation of MiFID II which is very prescriptive on the required contents.

It therefore seems that the spirit of the regulation is to secure the best possible result for the client on a consistent basis, rather than on an individual basis. Slightly more guidance on how to weight the importance of these factors can be found in Article 64(1) in [DREG], which states that the characteristics of the client, the order, the financial instrument and the execution venue shall be taken into account.

Besides the new transparency requirement on execution quality introduced by RTS 27 and RTS 28, one of the biggest changes from MiFID to MiFID II is that all reasonable steps to secure best execution has been upgraded to all sufficient steps. As many companies' attitude to regulation is to use the minimal efforts to secure compliance, many people will undoubtedly spend lots of energy trying to interpret the exact meaning of "sufficient".

What is certain is that firms should expect to be held to a higher standard in their efforts to achieve and demonstrate best execution. In particular, it may seem natural to spend regulatory efforts on relatively high profit activities of the execution life cycle. While such profits might be perfectly legitimate from a regulatory point of view, the expectation of the regulators will likely be that competition and transparency, which are ultimately what this regulation seeks to promote, should lead to lower profits. High profits (if they can be easily identified) should therefore be expected to attract attention.

Best Execution for OTC products

OTC products are likely to be a particular challenging area when it comes to best execution, as the traditional lack of transparency means that standards and business practices in these markets are further away from where ESMA is trying to take financial markets. Also, as best execution might not be owed in these markets³, the regulation is instead focusing on "fairness" of prices.

Article 64(4) in [DREG] states that:

"When executing orders or taking decision to deal in OTC products including bespoke products, the investment firm shall check the fairness of the price proposed to the client, by gathering market data used in the estimation of the price of such products and, where possible, by comparing with similar or comparable products."

Further insights are given in Best Execution, Question 2 in [Q&A]:

"This is an ex-ante assessment by the firm that takes place prior to the execution of the order... The aim is for firms to be able to justify their pricing decisions, and have systems in place to ensure that any judgements or decisions are taken with the clients' best interests in mind and are not biased by conflicts of interest".

It therefore appears that ESMA is looking for independent internal verification for "fairness" of a trader's price before it is given to a client.

Interestingly, the fairness requirement also applies to investment firms carrying out portfolio management and reception and transmission of orders (without executing them) (see Article 65(3))

3. Trading parties are also likely both to be classified as Eligible Counterparties.

in [DEREG]), so expectations have been raised on the standards of business practice from all participants in the OTC market.

Finally, it is worth noting that some of the trading in this area will be initiated by clients sending out BWIC or OWIC lists to numerous brokers, so it is not inconceivable that a well-connected client with strong market access will, at times, find themselves better informed about best prices⁴ than participating brokers and therefore won't need particular protection.

New Reporting Requirements

RTS 27 (see [RTS27]), requires execution venues (defined as regulated markets, multilateral trading facility, organised trading facility, systematic internalisers, market makers and other liquidity providers) to make publically available, without any charges, daily data on price, costs and likelihood of execution for individual financial instruments. This information shall be published quarterly no later than 3 months following the end of each quarter.

RTS 28 (see [RTS28]), requires investment firms⁵ who execute client orders to annually publish information on the identity of the top 5 execution venues for each class of financial instrument and on the quality of execution. This information is descriptive, but Article 3(3) further requires investment firms to publish "a summary of the analysis and conclusions they draw from their detailed monitoring of the quality of execution obtained". Article 65(6) in [DREG] extends this requirement to investment firms carrying out portfolio management and reception and transmission of orders.

While most asset managers may currently have good reasons for their broker usage, they might not have the formal documentation and processes in place to permit later review of decisions. Also, the use of quantitative supporting statistics are no longer a "nice to have" but really a requirement which, as a minimum, should involve RTS 27 data. Many firms are not only concerned about the regulatory aspect of execution but also the commercial aspects. MiFID II can potentially be an excuse to upgrade both aspects, so it is interesting to think about how an execution model might be improved.

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4. This might not extend to other parameters relevant for best execution. Also this situation is unlikely to establish legitimate reliance so brokers might not owe best execution.

5. This is certainly all MiFID II firms but as FCA has expressed that the best execution framework should be extended to non-MiFID II firms.

In Figure 2, we have outlined a possible adoptive execution model.

Advance Dynamic Execution Model

Electronic Trading



Post Trade Evaluation

- Observe all the actual execution quality parameters.
- Compare to expected values established pre trade.
- Are realised values within an acceptable deviation from expected values.
- Yes: best execution accomplished.
- No: Look at recent execution statistics for assets with same classification and establish if outcome is one off (accept outcome) or systemic (investigate further and potentially change/update parameters).
- Save relevant data about the execution for documentation, future analysis and RTS 28 reporting.

Pre Trade Establish Plan

- Identify internal classification of asset and venues from OEP.
- Expected market impact, costs, timing, speed, fill rates etc.
- If the trade arise from external parties has special instructions been given?
- Classify market conditions.
- Plan "best" execution.
- Decide acceptable deviation from plan and a plan B (abort?).

During Trade Execution

- Observe how actual execution compares to plan.
- If deviation from plan becomes unacceptable effectuate plan B.

Figure 2

An asset manager's execution model should reflect and match the complexity of the business model and there will therefore be significant differences between firms. Historically, agency brokers have been experts in execution and arguably today they have been surpassed by HFT firms, at least for certain execution and markets. Regardless, it is interesting to speculate on how more advanced execution models might look.

Highlights from FCA's Thematic Review TR14/13

The FCA published its Thematic Review on best execution shortly after MiFID II had been published in the Official Journal, so firstly, the FCA had a good understanding of the contents of MiFID II and secondly, as arguably the most powerful national financial regulator in the EU, the FCA likely had plenty of inputs to the regulation. It would therefore seem ill-advised not to pay close attention to the concerns expressed in this document, which are somewhat more practical and explicit in nature than the regulatory texts. In particular, it is stated on page 9 in [FCA_TR]:

- Firms must establish and implement effective arrangements for complying with the best execution obligation, including an order execution policy that describes how these arrangements will operate.

- Firms must monitor the effectiveness of their arrangements and execution policy, as well as be able to demonstrate to clients that they have acted in accordance with that policy.
- Firms senior management also need to use the results of their robust monitoring and substantive review of their execution arrangements, including taking corrective action where required, to enable them to demonstrate to clients that they are delivering best execution on a consistent basis.

These points apply equally to MiFID and MiFID II, but arguably with higher severity under MiFID II, as the FCA, via this publication, has clearly made firms aware of what it considers non-compliance and poor business practice.

In chapter 2 of the Thematic Review important guidance on the interpretation of the cost factor in the best execution assessment can be found. It is clarified that three execution cost categories must be taken into account in the execution assessment for both retail and professional clients, namely:

1	Implicit cost (minimising the market impact of execution.)
2	Explicit external costs are those arising from intermediaries participating in the transaction (exchange, clearing or settlement fees etc.)
3	Explicit internal costs (commission and fees etc.)

It is also clarified that firms must make a distinction between retails and professional clients, if applicable to their business. For retail clients the best possible execution result must be determined in terms of the total consideration of the price of the financial instrument and all explicit costs incurred by the client⁶. For professional clients all best execution factors must be taken into consideration with appropriate weights.

Finally, the documents offers examples of poor business practice observed among participating firms in areas ranging from understanding the regulatory scope, monitoring of best execution, the use of Internalisation and connected parties to accountability for delivering best execution. We shall briefly summarise some of the findings in the following sections.

Understanding the Regulatory Scope

Generally, the investigation reported in the Thematic Review found that the scope of best execution was not well understood. Certain firms, for example, incorrectly excluded derivatives or fixed income from their best execution obligation. For avoidance of doubt, best execution applies to all instruments listed in Annex 1, Section C in [MiFID_II], which is a very comprehensive list. Noticeable instruments missing from this list include spot transactions (in, for example, FX and commodities), loan agreements, deposits, and Securities Financing Transactions (SFT), but it might be ill-advised not to extend the best execution framework to all assets classes. As an example, several banks received substantial fines from the FCA in high-profile litigation cases involving spot FX trading (see

6. As the typical size of a retail client order is unlikely to have any meaningful impact on the liquidity of an order book, execution is simplified.

[FX_FINE]). While the main reason for the fine was failing to control business practice, it was clear that one of the problems identified was that execution often had not led to the best possible result for clients.

Another source of confusion among financial firms related to which of their activities was caught by the best execution obligation. For retail clients, the situation is simple as the regulation states that they can always legitimately rely on investment firms to protect their interest, so the best execution obligation always applies to execution of trades on behalf of retail clients⁷. The situation becomes more complex for professional clients⁸, where best execution is owed by their broker in two cases, namely:

1. "The obligation to take all sufficient steps to obtain the best possible result for its clients (see COBS 11.2A.4R) should apply where a firm owes contractual or agency obligations to the client", 11.2A.13 in [FSA].
2. When dealing on a request for quote, RFQ, basis and circumstances demonstrates that the client is "legitimately relying" on the firm to protect their interest.

In determining whether 'legitimate reliance' applies, a Four-fold test⁹ published by the European Commission should be used.

Finally it is worth noticing that the FCA intends to extend MiFID II best execution rules to non-MiFID II businesses (see section 9.14 in [FCA]), so it is clearly an area they feel strongly about and financial firms should pay attention and act accordingly.

Monitoring of Best Execution

Arguably, monitoring of best execution is the most challenging part of the regulation, so it should come as no surprise that the Thematic Review generally labelled efforts as ineffective.

It was generally found that firms were poor at identifying best execution violations, and that violations were not subsequently analysed to extract lessons which could be used to improve policies and control processes. Further, where independent monitoring by a control function was in place, it tended to concentrate on equities, where price transparency is relatively higher anyway, and only involved pricing and not an assessment of all best execution factors. Monitoring by front office was more common, but it tended to be local and ad hoc, without the infrastructure to record problematic circumstances and there was generally an inability to demonstrate supervisory oversight. As such, firms were unable to demonstrate how management proactively took decisions to consistently deliver best execution.

Many firms did provide a Transaction Cost Analysis (TCA) upon request from clients, but the information was typically not readily available and such analysis was often performed separately from the execution/monitoring process, so information from client queries, potentially useful for improving the execution process, was lost or not utilised.

7. As a consequence many retail oriented brokers have limited the availability of complex products on their platform as the legal risks makes such business very unattractive.

8. Asset managers must ensure they are classified as Professional Client and not Eligible Counterparty by their broker to benefit from this

9. See [FCA_TR] page 44 for details.

Further, the choice of execution venue and counterparty selection was generally found to lack support from structured analysis. Another problem highlighted was a general lack of formal processes to evaluate if market conditions were changing, and if so, a robust decision framework for how execution should be modified.

Finally, some firms were found to be too uncritical about the execution quality of third party brokers, demonstrated by a lack of monitoring or review of the execution quality.

Using Internalisation and Connected Parties

Particular care should be taken when firms are internalising client orders or executing through connected parties, to address potential conflicts of interest. In particular, careful accounting for all costs is essential in this situation to demonstrate that such execution is, in fact, beneficial for the client compared to sending the orders to a public execution venue. Also, if a cost saving from using internalisation over using an external venue is not passed on to the client, it is deemed to discriminate unfairly between execution venues.

Some firms did not have clear processes to ensure that clients had given consent to internalisation, leaving them potentially unaware of the practice and therefore poorly equipped to assess associated risks and potential rewards.

This is potentially a violation of the best execution regulation as firms are required to secure prior express consent to the execution of client orders outside a regulated market or MTF.

Accountability

In many firms it was unclear who had responsibility and ultimate accountability for MiFID compliance of their execution. Particular the involvement of front office and senior management was often found to be inadequate.

'MiFID II is a complex regulation which will prove challenging for all financial firms'

Conclusion

MiFID II is a complex regulation which will prove challenging for all financial firms, both in implementation and in ensuring an adequate understanding across all business areas. The aim of the best execution regulation, in particular, is to improve transparency around order execution, such that clients either automatically receive the best possible result when orders are executed on their behalf, or as a minimum get access to information about the quality of the execution. The latter will obviously improve both the client's negotiation position against brokers and their understanding of the market microstructure.

The situation is most interesting in the case of asset managers, who as professional investors (and potentially even eligible counterparties) are less protected and potentially involved in more complex instruments.

'the understanding and quantification of implicit execution costs (and costs in general) is an area where firms are likely to have the biggest scope to improve, and in the process, gain a competitive advantage.'

As outlined in Article 65 [DREG], an asset management firm must act in the best interest of their clients, which includes securing best execution, even though they might not execute themselves. As best execution will not always be owed to asset managers by brokers, the burden of evidencing best execution sometimes will fall with the asset manager. Chances are that many firms are currently not in a position, where they can seamlessly deliver such support to their execution decision.

The best execution obligation under MiFID II will likely mean that all firms need to invest in both technology and infrastructure in order to deliver and/or analyse the required execution quality statistics. It also seems diligent to review current execution practice, governance structure and control processes to potential identify areas which might need to be upgraded from "reasonable" to "sufficient" (such reviews are required by the regulation anyway), particularly in light of the findings in the FCA's Thematic Review.

Finally, the regulation allows companies a lot of freedom in defining and implementing optimal execution policies, but in return it is expected that decisions are well documented, with processes and controls in place, and can be evidenced by solid facts and up-to-date analysis, which might require investment in execution surveillance software.

In particular, the understanding and quantification of implicit execution costs (and costs in general) is an area where firms are likely to have the biggest scope to improve, and in the process gain a competitive advantage. After all, investments in best execution solutions should not only be considered a regulatory cost, but an improved execution framework will lead to improved performance as well.

We are happy to answer any questions you may have such as:

- Is your execution practice adequately described in your Order Execution Policy with the level of detail and transparency now required across all instruments? Do you have a plan for how to utilise all the new execution quality data to improve your policy over time?
- Can you, with limited effort, clearly demonstrate to your clients or Board how Best Execution is consistently achieved?
- How your systems and business processes may be required to change in preparation for the best execution requirement?
- Do you have the data necessary to fulfil the requirement to disclose the top five executive venues per financial instrument including analysis supporting/justifying the use of these venues?
- Do you have industry best practice surveillance tools to identify instances where you are not getting best execution and, if so, a solid business process ensuring that such cases are documented, communicated to all relevant parties and potentially reflected in the Order Execution Policy?
- Do you have the data necessary to fulfil the requirement to disclose the top five executive venues per financial instrument including analysis supporting/justifying the use of these venues?
- Do you have industry best practice surveillance tools to identify instances where you are not getting best execution and, if so, a solid business process ensuring that such cases are documented, communicated to all relevant parties and potentially reflected in the Order Execution Policy?

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For more information about Axxsys Consulting's MiFID II services in general, or for more details about our best execution offering, please contact info@axxsysconsulting.com or +44 (0) 20 7526 4900.

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