

DATE OF MEMORANDUM: 28 OCTOBER 2007



**INFORMATION MEMORANDUM ON THE APPLICATION OF THE BEST EXECUTION
REQUIREMENTS UNDER THE FSA RULES IMPLEMENTING MiFID IN THE UK**

This Memorandum does not purport to be a definitive guide, but is instead a non-exhaustive statement of some of the measures that FOA and AFB member firms subject to MiFID may choose to adopt in complying with the requirements as to best execution under the FSA Rules implementing MiFID in the UK. It focuses on:

- *the scope of the best execution obligation, principally as it applies to OTC and other dealer markets - in particular whether an order is deemed to be executed "on behalf of a client" and reliance on or pursuant to "specific instructions" received from a client*
- *what is meant by the requirement on firms to take "all reasonable steps" to obtain the best possible result in respect of orders executed on behalf of clients;*
- *some of the various factors a firm may take into account in achieving best execution and how these may be applied in different circumstances; and*
- *elements that firms might consider in framing their order execution policy and required to be disclosed to clients.*

This Memorandum while taking account of MiFID and the EU Commission interpretive statements, is intended to address only the UK's implementation of those requirements as they relate to best execution.

This Memorandum is up to date as at the date of issue. It may be revised from time to time in the light of any relevant changes to the FSA Handbook. If you intend to place significant reliance on it, it would be sensible to check whether there have been any such changes to the FSA Handbook.

This Memorandum does not alter the meaning of any relevant FSA Rule, nor should it be interpreted as doing so. It has not been reviewed by the FSA and cannot be relied upon as official industry guidance.

Structure of this document:

Page:

Section 1 - Introduction to changes

3

Section 2 - Guidance to help firms understand the application of the best execution obligation.

5

<i>Section 3</i> -. Guidance to help firms understand the nature of the best execution obligation including how this will vary depending on the type of firm, its activities and the factors that may be taken into account in assessing the quality of execution.	9
<i>Section 4</i> - Guidance to help firms understand the requirements relating to the order execution policy including content and disclosure requirements.	14
<i>Appendix 1</i> - Possible elements for inclusion in an order execution policy disclosure statement.	22
<i>Appendix 2</i> -Checklist to aid member firms in the process of preparing for MiFID.	26

SECTION ONE

1. INTRODUCTION TO CHANGES

This section summarises the effect of the new FSA Rules implementing the best execution requirements of MiFID (the "**Implementing Rules**") and compares the positions post MiFID to the position pre-MiFID.

Under the pre-MiFID FSA Rules, a firm had to provide best execution when it executed a customer order in a designated investment. A firm could agree with an intermediate customer that it did not owe a duty of best execution to him, although such a carve-out did not exist in respect of private customers. Under the Implementing Rules, a firm must take all reasonable steps to obtain the best possible result when executing orders on behalf of clients (the "**Obligation**"). Firms cannot opt out of the Obligation, even when doing business with professional clients. However, orders executed on behalf of eligible counterparties are exempt from the Obligation. It should however be borne in mind that this exemption only applies to the extent that the firm is conducting "eligible counterparty business" with an entity that potentially qualifies as an eligible counterparty (broadly, dealing as principal or agent or receiving and transmitting orders and related ancillary activities). Where the firm is not conducting eligible counterparty business, for example, where it is advising an entity on a transaction before dealing, the firm will be required to treat the relevant entity as a professional client for the purposes of the advice and any resultant transaction. Since the client is treated as a professional client in these circumstances the Obligation will apply to the transaction. It is also open to fund and asset managers and other institutional customers to seek to be classed as professional clients, and thereby potentially have the Obligation applied to their business, even if that business would otherwise be classified as eligible counterparty business.

Under the pre-MiFID FSA Rules, while the obligation to provide best execution clearly applied to firms that executed orders in equities as agent on behalf of clients, the position was less clear when firms dealt in non-equities markets such as fixed income and over-the-counter instruments, particularly when acting as principal in doing so. Under the Implementing Rules, the Obligation applies to all product types including non-equities markets such as OTC trading in securities and derivatives. However, a firm is not necessarily expected to meet the Obligation in the same way for each type of product. For example, the way in which the Obligation is met in respect of derivatives products may well differ from the way it is met for equities products. There is greater flexibility in how a firm meets the Obligation when dealing with professional clients than when dealing with retail clients.

Under the old FSA Rules, the FSA's best execution requirement was framed with equities markets in mind - and was a requirement that was principally based on price. In contrast, the Obligation requires firms to obtain the best possible result (rather than the best price) and firms can take a number of other factors into account when providing best execution to their clients. (Although when dealing with retail clients, price and cost remain the key considerations.)

A firm satisfies the Obligation to the extent it executes an order or a specific aspect of an order in response to and in compliance with specific instructions received from a client.

Under the Implementing Rules, firms are required to establish and implement an order execution policy (the "**Policy**") and to obtain client consent to the Policy prior to executing orders. Firms must provide appropriate information about their Policy to their clients. Retail clients must be provided with more detailed information about the Policy. A firm must monitor and review its Policy and order execution arrangements.

The Implementing Rules also require firms to obtain prior express consent from clients before executing their orders other than through a regulated market or an MTF. This consent can either be obtained for specific transactions or generally. The FSA has recently addressed the question of how a firm might respond to a situation where it receives an order from an existing client that has not provided its express consent to execution of orders outside a regulated market or MTF, where the firm determines that the best possible result is most likely obtained by execution outside a regulated market. Should the firm:

- (i) execute the order on a regulated market in order to comply with the requirement for prior express consent;
- (ii) execute the order outside a regulated market in order to comply with the Obligation; or
- (iii) refrain from acting at all?

The FSA acknowledged the potential conflict of obligations raised in this situation and responded that a firm must decide whether it is appropriate in the circumstances to continue executing orders for the client while it is seeking the client's consent. In order to make this decision, the firm will need to assess the legal and regulatory implications and make its own judgements about how to manage the associated risks. There seems therefore to be an indication from the FSA that under certain circumstances firms *may* be able to execute orders outside a regulated market or MTF without prior express consent, but a firm must not embark on such action without addressing the legal and regulatory implications of doing so; firms should be comfortable that they will be able to justify their actions from a legal and regulatory standpoint. Also it should be borne in mind that the FSA's response does not have the status of official Guidance.

Firms that act as portfolio managers or receivers and transmitters of orders are required to take all reasonable steps to obtain the best possible result for their clients when placing an order with, or transmitting an order to, another entity for execution. These firms are also required to establish, implement and monitor an order execution policy, but do not have to demonstrate that orders have been executed in accordance with the policy.

SECTION TWO

2. APPLICATION

2.1 *Introduction*

The application of best execution in the context of order driven, dealer and OTC markets has been extensively discussed. The FSA, CESR and the Commission have each published views on this matter. In March 2007 the Commission responded to questions of scope raised by CESR (Working Document ESC-07 -2007), and the FSA has confirmed that it will proceed on the basis of the Commission's response.

We summarise below the Commission's opinion on the circumstances in which the Obligation would and would not apply and then discuss the potential implications of these conclusions for the dealer markets.

2.2 *Is the order executed "on behalf of clients"?*

2.2.1 *Does the firm owe contractual or agency obligations to the client?*

COBS 11.2.2G

The obligation to take all reasonable steps to obtain the best possible result for its clients (see COBS 11.2.1R) should apply to a firm which owes contractual or agency obligations to the client.

[Note: recital 33 of *MiFID*]

The key question when determining whether or not the Obligation will apply is whether the firm is executing an order *on behalf of a client*. COBS 11.2.2G indicates that the Obligation will typically apply where "contractual or agency obligations" are owed to the client.

The Commission has provided indicative examples of cases where a firm executes an order on behalf of a client (and so the Obligation applies) and where the firm generally does not execute an order on behalf of a client (and therefore the Obligation does not apply). These are summarised below.

2.2.2 *Indications of cases where the Obligation would apply*

Transactions based on a client's request to a firm to buy or sell a financial instrument for him will always fall within the Obligation. This will include the following cases:

- (a) executing a client order by dealing as agent for a client;
- (b) executing an order against the firm's own proprietary position (including as a systematic internaliser), where the firm has discretion as to how the order is executed (for example where it is "working the order" on the client's behalf); or
- (c) executing an 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 firm will typically deal as principal with its client at the same time and on the same terms as it enters in to an opposing transaction as principal with a counterparty. Dealing as riskless principal should however be distinguished from where the firm

enters into a separate transaction simply to hedge its own exposure; in these circumstances the Obligation will not necessarily apply.

2.2.3 *Indications of cases where the Obligation would not apply*

Transactions based on a specific request by the client to buy or sell a particular financial instrument, or on the acceptance by the client of an offer made by the firm to sell or buy a financial instrument, will typically not fall within the Obligation unless in all the circumstances the firm should properly be regarded as acting on behalf of the client by reference to the factors outlined below. On this basis a proprietary trade entered into pursuant to a client "request for quote" would not typically be subject to best execution.

However, in some cases firms will have to meet the Obligation when engaging in proprietary trades. This 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 Commission has suggested the following considerations, taken together, will help to answer this question.

- (a) Did the firm initiate the transaction with the client or the client instigate the transaction by making an approach to the firm? In cases where the firm approaches a retail client and suggests that he enters into a specific transaction it is more likely that the client will be relying on the firm to protect his or her interests in relation to pricing or other elements of the transaction.
- (b) Market practice will help decide whether it is legitimate for clients to rely on the firm. For example, in 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.
- (c) The relative levels of transparency within a market will also be relevant. For markets where clients do not have ready access to prices while firms do, the conclusion will be much more readily reached that they rely on the firm for the pricing of the transaction.
- (d) The information provided by the firm about its services and the terms of any agreement between the client and the investment firms will also be relevant, but not determinative of the question. The Commission warns that use of standard term agreements to characterise commercial relationships otherwise than in accordance with economic reality should be avoided.

The Commission believes that 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. Consequently, it is legitimate in dealer markets for firms to, in effect, disapply the Obligation by only dealing with clients on a request for quote basis. Likewise, it would also be legitimate in such markets for firms to agree with their clients that, as the firm is not acting on behalf of clients in entering into transactions and clients are not relying on the firm, that the Obligation will not apply.

However, this must reflect the reality of the situation and the firm must be satisfied that indeed its clients are not relying on the expertise of the firm to obtain the best available terms in the market.

2.3 *Specific instructions*

COBS 11.2.19R

(1) Whenever there is a specific instruction from the client, the firm must execute the order following the specific instruction

[Note: article 21(1) of *MiFID*]

(2) A firm satisfies its obligation under this section to take all reasonable steps to obtain the best possible result for a client to the extent that it executes an order, or a specific aspect of the order, following specific instructions from the client relating to the order or the specific aspect of the order.

[Note: article 44(2) of the *MiFID implementing Directive*]

2.3.1 *Exclusion is limited to the extent of the instructions*

Firms are deemed to have fulfilled the Obligation if they have acted under specific instructions from the client, but only in relation to those aspects of an order which are specifically addressed in the instructions. However, in the case of certain types of specific instructions, other execution aspects will be dictated by following that specific instruction. Firms should not however "suggest" instructions from their clients when they ought to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for the client.

2.3.2 *Application to customised OTC products*

The question has been raised whether, in respect of customised OTC products where the client indicates the particular characteristics of the product, this specification could be considered "specific instructions". The Commission has responded to this by stating that the Obligation applies to OTC customised instruments when the firm is considered to be acting on behalf of the client. This will depend on the considerations set out in paragraph 2.2 above. The fact that the client specifies what he needs in terms of exposure and protection does not necessarily exclude the application of best execution; a more precise description of the nature of the transaction and close client engagement in agreeing its terms is needed to give rise to a "specific instruction". However, it may be argued that where a firm designs and enters into a bespoke OTC derivative transaction with a client, the client can not legitimately expect the firm to protect its interests in relation to pricing and other elements of an OTC derivative since it would not be legitimate to expect the firm to share its proprietary knowledge in developing the product with competitors by obtaining another quote.

2.3.3 *Investment advice*

The Commission also pointed out that at the start of the relationship where a firm suggests to a client the elements of an OTC derivatives contract that would meet the client's needs, it is more appropriate to ask whether investment advice is being provided, rather than whether

best execution applies. For example, a client may ask a firm to design an instrument that will protect him against a fall in gas prices and a spike in the price of electricity. The firm may propose a number of different mechanisms and advise the client to select one particular design. This would prima facie be investment advice, meaning the suitability obligations would apply. Best execution could also apply when the client decides to deal, depending on the considerations set out in paragraph 2.2.

2.4 *Complex products*

It is worth mentioning the Commission's response to a question whether firms should consider that the Obligation applies to each single component of the product, or to the transaction as a whole. The term "complex product" in this context is taken to mean a product that is composed of or represents the performance of one or more product. The Commission has confirmed that the Obligation applies to the product as a whole. Best execution of the product as a whole may conceivably be obtained even if best execution for each component, when considered in isolation, is not obtained.

2.5 *Vanilla products*

Where a firm enters into a vanilla derivative transaction with a client, the presumption will generally be that the Obligation will apply. This presumption may however be rebutted where it is clear that the client is not relying on the firm to act in its interests. This will generally be easier to demonstrate in respect of larger institutions than the retail sector. In addition, firms who represent the interests of underlying clients, such as fund managers, may wish to make it explicit that it relies on the firm for best execution. However, vanilla products offered on a request for quote basis would not fall within the Obligation, provided that there are not additional circumstances to indicate that the client is relying on the firm to act on its behalf.

SECTION THREE

3. **NOTION OF REASONABLENESS**

COBS 11.2.1R

A *firm* must take all reasonable steps to obtain, when executing orders, the best possible result for its *clients*, taking into account the *execution factors*.

[Note: article 21(1) of *MiFID*]

COBS 11.2.2.G

The obligation to take all reasonable steps to obtain the best possible result for its *clients* (see *COBS 11.2.1R*) should apply to a *firm* which owes contractual or agency obligations to the *client*.

[Note: recital 33 to *MiFID*]

COBS 11.2.30 R

A *firm* must, when providing the service of *portfolio management*, comply with the obligation to act in accordance with the best interests of its *clients* when placing orders with other entities for execution that result from decisions by the *firm* to deal in *financial instruments* on behalf of its *client*.

[Note: article 45(1) of *MiFID implementing Directive*]

COBS 11.2.31 R

A *firm* must, when providing the service of reception and transmission of orders, comply with the obligation to act in accordance with the best interests of its *clients* when transmitting *client* orders to other entities for execution.

[Note: article 45(2) of the *MiFID implementing Directive*]

The test of reasonableness means that a firm is not expected to expend disproportionate amounts of funds or resources (leading, for example, to an overall substantial increase in fees) on achieving best execution.

In other words, the standard is set at the best possible result that a firm can reasonably be expected to achieve for its clients, rather than as an absolute standard that must be achieved by the firm irrespective of the resources available to it.

As noted later in this Memorandum, a firm demonstrates best execution by following its order execution policy - a policy that the firm needs to be satisfied is capable on a consistent basis of delivering best execution and which will vary depending on the nature and scale of a firm's business. The firm is not required to satisfy itself that best execution has been achieved for each order as they occur.

The way in which the Obligation can be met will vary depending on a number of factors including the type of firm, the nature of the client, the type of product and the state of the market at the time of execution. Each of these factors is considered below, in each case including a number of practical examples.

3.1.1 *Different client types*

COBS 11.2.6R

When executing a *client order*, a *firm* must take into account the following criteria for determining the relative importance of the *execution factors*:

- (1) the characteristics of the *client* including the categorisation of the *client* as retail or professional;
- (2) the characteristics of the *client order*;
- (3) the characteristics of *financial instruments* that are the subject of that order;
- (4) the characteristics of the *execution venues* to which that order can be directed.

[Note: article 44(1) of the *MiFID implementing Directive*]

A firm has significant latitude as to factors it may take into account in its Policy, at least when dealing with professional clients. Priorities will vary from transaction to transaction, market to market and client to client. A large institutional client - who will often have larger scale orders - may consider that speed of execution of a large volume trade is important. For smaller clients, costs may be a more important factor (which may in the context of smaller orders, form a larger element of the overall price). (For the purposes of the best execution requirement, costs only include charges passed directly to the client and not any commission or similar payments. They will include exchange fees and clearing and settlement fees) Indeed, for retail clients, COBS 11.2.7R makes clear that the best possible result will generally be determined in terms of total consideration - being price and all costs relating to execution. Consequently, the latitude to apply different factors is greater for professional clients. However, even in the case of retail clients, firms should note that this latitude is not totally eliminated. COBS 11.2.19R states that specific client instructions - for example to execute through a particular venue or within a specific time period - will override total consideration as the prevailing factor. Other factors, including implicit transaction costs, may also prevail for retail customers where and to the extent that they would be instrumental in delivering best possible result in terms of total consideration. Therefore, for example, if one venue has lower overall transaction costs, or can deliver execution of a large trade immediately rather than in several lots, in either case leading to overall lower total consideration compared to other venues, this will be considered as achieving best execution.

3.1.2 *Different firm types*

A firm may meet the Obligation differently depending on its size and the capacity in which it acts. As discussed earlier in this Section, the resources and funds committed to meet the Obligation should be reasonable in proportion to the firm's resources, but all firms should nonetheless aim to follow a process that produces the best result for the client that the firm is able to obtain.

The Obligation does not require two firms in the chain of execution to take exactly the same measures to provide best execution. Therefore it is not intended that between: (i) a firm ("A") that provides the services of reception and transmission of orders or portfolio management; and (ii) any other firm ("B") to which firm A transmits its orders for execution, A and B take exactly the same measures to achieve best execution. Firm A will need to take all reasonable steps to select entities that are most likely to deliver the best possible result in the execution of those orders when choosing firm B. Firm A will need to periodically monitor the execution quality delivered by firm B, and take the necessary steps to correct any deficiencies when they arise. This monitoring process need not require a transaction-by-transaction analysis, but can be expected to occur on the basis of a general overview, with regular review as part of the firm's review of its own order execution arrangements. Provided it does these things, firm A would be entitled to rely on the ability of firm B to deliver best execution and could include firm B as an execution venue. However this would need to be reviewed by firm A annually. In these circumstances Firm B would effectively have the obligation to deliver best execution to Firm A..

3.1.3 *Different product types*

COBS 11.2.5 G

The obligation to deliver the best possible result when executing *client* orders applies in relation to all types of *financial instruments*. However, given the differences in market structures or the structure of *financial instruments*, it may be difficult to identify and apply a uniform standard of and procedure for best execution that would be valid and effective for all classes of instrument. Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of *financial instruments*. For example, transactions involving a customised OTC *financial instrument* that involve a unique contractual relationship tailored to the circumstances of the *client* and the *firm* may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues.

[Note: recital 70 to the *MiFID implementing Directive*]

See COBS 11.2.6R above.

A firm may meet the Obligation differently depending on the relevant product type and the available market for the product. For certain customised transactions (such as OTC derivatives contracts) it may not be possible for a firm to obtain a better result by going to the market-place in search of an equivalent product in the way that a firm may be able to do when executing orders on behalf of clients in relation to shares. This is because the contract involves a unique relationship between the firm and the client that is based on a series of judgements including those relating to the counterparty risk associated with the particular client. Indeed, in these circumstances, the Obligation may not apply at all (see Section 2 above).

However, for products (even OTC products) which are not bespoke to the client's specific needs and requirements, where the client is relying on the firm in some way and where the relevant product is relatively comparable to or an equivalent of other products provided by other firms and/or traded on market (e.g. vanilla FX and interest rate derivatives) firms will

be expected to provide best execution. However, in doing so, where they are offering an OTC product, it is perfectly legitimate that they take account of their own internal credit scoring of the client or risk rating of the transaction in calculating the overall price at which they are willing to contract. Additionally, firms may use their own internal models for pricing OTC contracts and may do so without the requirement to publish their models to the client (see OTC example below).

When considering what is an equivalent product for this purpose, it will be possible to consider whether, from a contractual point of view, the terms of the product would be the same. In respect of contracts traded on more than one exchange, the actual contract terms will be dictated by the exchange and therefore may be subject to different terms (e.g. with respect to settlement and margin). Therefore, the fact that the underlying is the same does not necessarily mean that the product is equivalent. For example, this would be the case for single stock futures traded on a number of futures exchanges due to the differences in the underlying contracts with the exchange.

The criteria for assessing best execution needs to be tailored to the particular characteristics of each market while not going beyond what is reasonable in the circumstances. For example, some wholesale markets are highly international, liquid and largely institutional in nature, where prices are fast moving and volumes are often large. A venue or dealing arrangement that facilitates fast matching of client orders, may be considered by a firm to achieve best execution even though the costs involved may not be the lowest that are potentially achievable, where for example a cheaper arrangement would not necessarily achieve execution as quickly. When a firm acts on specific client instructions, which is particularly relevant to the OTC market, see the comments on the application of the Obligation in paragraph 2.3 above.

The inability of a firm to apply the Obligation in a way that is appropriate to a particular market or product (or the lack of a precise or reliable benchmark) does not relieve a firm from having to comply with the Obligation.

OTC products example:

Where a firm executes a client order in relation to an OTC transaction, it may, in determining whether it has met the best execution requirement, take into account any of the factors outlined above (i.e. price, costs, likelihood of execution and settlement, size) and any other consideration that is relevant to the execution of the order, e.g.:

- the creditworthiness of the client/any other relevant contractual counterparts and the overall price charged to the client for carrying the risk and cost of capital;
- any costs to the firm which are relevant to executing the transaction, including:
 - the cost to the firm of ongoing maintenance of the contracts, e.g. resets on a swap transaction and the provision of valuations;
 - the firm's operational costs in entering into the OTC contracts and, particularly, in the markets for bilateral OTC derivative contracts, its ability to enter into arrangements speedily and with contracts that are tailored to meet the relevant client's needs;
 - the cost of sharing the execution of a client order with another firm or firms (which may be necessary in the case of particularly large or complex transactions or because of the size of that other firm's balance sheet and/or the sophistication of its systems);

- to the extent relevant, any additional costs for structuring the transaction and tailoring customer documentation and any other costs over and above the price that is achieved by applying the firm's model;
- its longevity and liquidity;
- any costs generated by the assumption of transactional risk of the firm.

Obligations to ensure best execution apply as much where a firm is internalising flow, and thereby executes orders from its own book, as where it is executing through any other venue - i.e. where a firm may use its own models, it must be satisfied that execution from its own book is capable of delivering, on a consistent basis, the best possible result.

When acting as a portfolio manager or when transmitting an order to another firm, a firm still owes a duty to its client in relation to best execution. This means that such firms are obliged to take all reasonable steps to achieve the best possible result for their clients, taking into account the factors discussed above and by complying with an order execution policy.

However, such firms may rely on information provided by firms to which they submit client orders for execution to assist them to become comfortable that they are achieving best execution. This might mean, for example, taking information supplied by those brokers that portfolio managers or intermediaries use as their venues to demonstrate that the brokers are capable of achieving best execution. Firms should have reasonable grounds for being satisfied that such information is accurate and reliable.

SECTION FOUR

4. THE POLICY

4.1 *Structure and Content (See Appendix 1)*

4.2 A firm satisfies the Obligation by establishing and following an execution policy, and need not assess execution quality on a transaction-by-transaction basis. The Policy may be structured as one single policy with separate parts or as individual policies for each type of product or client. It should be clear which Policy, or section of the Policy applies to each type of product or client.

4.2.1 *Execution venues*

COBS 11.2.10R

For the purposes of delivering best execution for a *retail client* where there is more than one competing venue to execute an order for a *financial instrument*, in order to assess and compare the results for the *client* that would be achieved by executing the order on each of the *execution venues* listed in the *firm's* order execution policy that is capable of executing that order, the *firm's* own commissions and costs for executing the order on each of the eligible *execution venues* must be taken into account in that assessment.

[Note: article 44(3) of paragraph 2 of the *MiFID implementing Directive*]

COBS 11.2.11G

The obligation to deliver best execution for a *retail client* where there are competing *execution venues* is not intended to require a *firm* to compare the results that would be achieved for its *client* on the basis of its own execution policy and its own commissions and fees, with results that might be achieved for the same *client* by any other *firm* on the basis of a different execution policy or a different structure of commissions or fees. Nor is it intended to require a *firm* to compare the differences in its own commissions which are attributable to differences in the nature of the services that the *firm* provides to *clients*.

[Note: recital 71 to the *MiFID implementing Directive*]

COBS 11.2.12R

A *firm* must not structure or charge its commissions in such a way as to discriminate unfairly between *execution venues*.

[Note: article 44(4) of the *MiFID implementing Directive*]

COBS 11.2.13G

A *firm* would be considered to structure or charge its commissions in a way which discriminates unfairly between *execution venues* if it charges a different commission or spread to *clients* for execution on different *execution venues* and that difference does not reflect actual differences in the cost to the *firm* of executing on those venues.

[Note: recital 73 to the *MiFID implementing Directive*]

COBS 11.2.14R

A *firm* must establish and implement effective arrangements for complying with the obligation to take all reasonable steps to obtain the best possible result for its *clients*. In particular, the *firm* must establish and implement an order execution policy to allow it to obtain, for its *client* orders, the best possible result in accordance with that obligation.

[Note: article 21(2) of *MiFID*]

COBS 11.2.15R

The order execution policy must include, in respect of each class of *financial instruments*, information on the different *execution venues* where the *firm* executes its *client orders* and the factors affecting the choice of *execution venue*. It must at least include those *execution venues* that enable the *firm* to obtain on a consistent basis the best possible result for the execution of *client orders*.

[Note: paragraph 1 of article 21(3) of *MiFID*]

COBS 11.2.17G

The provisions of this section which provide that costs of execution include a *firm's* own commissions or fees charged to the *client* for the provision of an *investment service* should not apply for the purpose of determining what *execution venues* must be included in the *firm's* execution policy.

[Note: recital 72 to the *MiFID implementing Directive*]

The venues to be contained in the Policy will vary depending on the type of product and client and the firm's rights to access a venue.

The list of execution venues provided in the Policy need not be exhaustive and execution may occur on alternative venues from time to time provided those venues are consistent with the Policy.

The requirement to list execution venues in a firm's Policy is separate from - and may not be the same as - the list of venues on which a firm places significant reliance to achieve best execution - a list which needs to be disclosed to retail clients.

"Execution venue" is defined in the FSA Rules as a "regulated market, an MTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing". The definition does not address the case where there are different trading platforms or mechanisms within a single execution venue (for example, the LME offers an electronic trading platform in addition to the opportunity to trade by telephone or open outcry). In these circumstances it would not seem to be necessary or appropriate to treat each trading platform

or mechanism within a regulated market as a separate execution venue for the purposes of best execution.

4.2.2 *Consistent basis*

COBS 11.2.16G

(1) When establishing its execution policy, a *firm* should determine the relative importance of the *execution factors*, or at least establish the process by which it determines the relative importance of these factors, so that it can deliver the best possible result to its *clients*.

(2) In order to give effect to that policy, a *firm* should select the *execution venues* that enable it to obtain on a consistent basis the best possible result for the execution of *client* orders.

(3) A *firm* should apply its execution policy to each *client* order that it executes with a view to obtaining the best possible result for the *client* in accordance with that policy.

(4) The obligation to take all reasonable steps to obtain the best possible result for the *client* should not be treated as requiring a *firm* to include in its execution policy all available *execution venues*.

[Note: recital 66 of *MiFID implementing Directive*]

COBS 11.2.18G

The provisions of this section as to execution policy are without prejudice to the general obligation of a *firm* to monitor the effectiveness of its order execution arrangements and policy and assess the *execution venues* in its execution policy on a regular basis.

[Note: recital 74 of the *MiFID implementing Directive*]

Firms should select venues with a view to obtaining the best possible result on behalf of clients on a consistent basis. This will need to be kept under review. However, the review period may vary depending on the product type (e.g. the venues for instruments traded on numerous venues may need to be reviewed more frequently than instruments traded on a single execution venue) and may be done on a sampling basis. The obligation is to follow the Policy on a consistent basis.

It is possible for the Policy to include only one execution venue in respect of a particular product provided the firm has taken all reasonable steps to identify those venues which enable it to obtain the best possible result on a consistent basis in respect of that product. (For example, there may be limited venues available when dealing with illiquid products.) In some cases, where a firm deals only in OTC products, the requirement to select execution venues will not be relevant at all. In its May 2007 Paper (Best Execution under MiFID - Questions and Answers), CESR confirms that MiFID does not prohibit the use of only one execution venue provided that the firm can show by doing this it can provide best execution on a consistent basis. CESR acknowledge that, for example, there may be circumstances where a particular execution venue will deliver the best possible result for a given sub-set of

the execution policy, or where the costs of including more than one execution venue in the policy (to the extent those costs are passed on to the client) would outweigh any price improvements to be gained by doing so.

4.2.3 *Factors affecting choice*

COBS 11.2.7R

Where a *firm* executes an order on behalf of a *retail client*, the best possible result must be determined in terms of the total consideration, representing the price of the *financial instrument* and the costs related to execution, which must include all expenses incurred by the *client* which are directly related to the execution of the order, including *execution venue* fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

[Note: paragraph 1 of article 44(3) of the *MiFID implementing Directive*]

COBS 11.2.8G

For the purposes of ensuring that a *firm* obtains the best possible result for the *client* when executing a *retail client* order in the absence of specific *client* instructions, the *firm* should take into consideration all factors that will allow it to deliver the best possible result in terms of the total consideration, representing the price of the *financial instrument* and the costs related to execution. Speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs may be given precedence over the immediate price and cost consideration only insofar as they are instrumental in delivering the best possible result in terms of the total consideration to the *retail client*.

[Note: recital 67 to the *MiFID implementing Directive*]

COBS 11.2.9G

A *firm's* execution policy should determine the relative importance of each of the *execution factors* or establish a process by which the *firm* will determine the relative importance of the *execution factors*. The relative importance that the *firm* gives to those *execution factors* must be designed to obtain the best possible result for the execution of its *client* orders. Ordinarily, we would expect that price will merit a high relative importance in obtaining the best possible result for *professional clients*. However, in some circumstances for some *clients*, orders, *financial instruments* or markets, the policy may appropriately determine that other *execution factors* are more important than price in obtaining the best possible execution result.

The nature of the execution services and the way in which a firm provides them may affect the importance a firm places on the "execution factors", namely: price, costs, speed, likelihood of execution and settlement, size and nature of the order. Firms may take account of the following criteria in determining the relative importance of these factors:

- **Clients** - whether they are retail clients (noting the primacy of total consideration for retail clients) or professional clients, the nature of the execution services required by them and any other "characteristics" or factors relevant to the relationship including, for example, frequency of trading and the provision of any added services that are linked to the execution of the transaction. See also, paragraph 3.1.1 above.

- **Orders** – the size of client order, the types of instruments being traded, the settlement mechanics and any other order characteristics relevant to determining how orders should be executed on behalf of clients.
- **Instruments** – the degree of liquidity and the fact that different factors will be relevant to different instruments depending on their nature, characteristics and how they are traded (which may be of particular relevance in the context of orders executed in over-the-counter markets on behalf of clients). See also paragraph 3.1.3 above.
- **Market impact** - the Obligation can take into account any impact that the client order may have on the relevant market(s).
- **Circumstances of execution** - aspects such as time of trade or the state of the market.
- **Quality of execution** - which includes aspects such as the speed and likelihood of execution and the availability and incidence of price improvement, may be an important factor in the delivery of best execution.
- **Venue** - the price offered by the venue, the amount of any charges and any other charges that are passed through to the client, the ability of the venue to manage complex orders, including the sophistication of its systems, the speed of execution, the creditworthiness of the venue, whether it has reliable settlement and clearing facilities, the quality of applicable regulation and any other venue characteristics relevant to the execution of the order. The fact that a firm may be able to trade on a venue within a UK or European time zone may prove a significant contributing factor (for example, in the context of dual listed securities the speed of execution may be a factor more important than the price).
- **Client instructions** – following client instructions may modify the Obligation in relation to the factors affected by the instruction, and may affect the choice of venue.
- **Additional factors** - any other factor which is relevant to the execution in question (such as quality of the clearing guarantee and basis risk).

In considering the above factors, firms should have regard to product type. For example, see the list of specific factors to be taken into account for OTC derivatives listed in Section 3.1.3.

By way of example, where a client order requires a firm to execute on a market which is neither a regulated market nor an MTF based in the EEA, local regulation and/or market practice in the place of execution may colour the firm's ability to provide and demonstrate execution in the same manner as it would if trading within the EEA. If the selection of venue was made by the client or the selection of product made by the client allowed only for execution on such a venue, the Obligation would be reduced to the extent that the firm was acting on specific client instructions.) Local regulation applicable to a broker chosen by the firm to execute the order might dictate a different set of priorities to be allocated to factors affecting execution, such as an emphasis solely on best price. Furthermore, a firm might naturally use its affiliated entities to execute or transmit these orders. In each of these circumstances, it may be difficult for a firm to establish the same procedures for ensuring that executing brokers (whether or not affiliated to the firm) provide the level of information about execution policy or for monitoring the quality of execution by those brokers as would be the case when transacting within the EEA. The Policy should describe any such limitations and the information provided to clients should reflect this appropriately.

It should also be borne in mind that these criteria will be taken into account subject to the reasonableness considerations discussed in Section 3 above.

4.3 *Monitoring and Review*

See COBS 11.2.18G above.

COBS 11.2.27 R

A *firm* must monitor the effectiveness of its order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, it must assess, on a regular basis, whether the *execution venues* included in the order execution policy provide for the best possible result for the *client* or whether it needs to make changes to its execution arrangements. The *firm* must notify *clients* of any material changes to their order execution arrangements or execution policy.

[Note: article 21(4) of *MiFID*]

COBS 11.2.28 R

(1) A *firm* must review annually its execution policy, as well as its order execution arrangements.

(2) This review must also be carried out whenever a material change occurs that affects the *firm's* ability to continue to obtain the best possible result for the execution of its *client* orders on a consistent basis using the venues included in its execution policy.

[Note: article 46(1) of the *MiFID implementing Directive*]

In fulfilling their obligation to monitor the effectiveness of their order execution arrangements and policy so as to identify, and thereafter correct, any deficiencies, firms have significant flexibility. The requirement to assess, on a regular basis, whether the execution venues in their order execution policy are capable of achieving the best possible result for the client can be achieved in whatever way the firm sees fit. This may vary depending on the nature of the relevant market, e.g. what level of competition there is in different markets. The regularity of appropriate monitoring may also depend on factors such as the level of information available. Other elements may also become relevant such as the occurrence of new developments, innovations and participants in a given market. However, in broad terms, a firm may utilise whatever methods it deems appropriate to monitor the effectiveness of its arrangements to achieve best execution.

A firm may decide how frequently it will review its Policy provided such review is carried at least annually and whenever it is made aware that a material change has occurred that affects its ability to continue to meet the Obligation using the venues included in the Policy. A material change may relate to a change to one of the factors affecting execution or an execution venue itself. For example, where it is no longer possible (due to closure or other reason beyond the control of the firm) for a firm to execute orders through a venue on which it places significant reliance and there is no alternative venue available on which the execution of orders may be effected a review should take place.

When reviewing its Policy, a firm may need to take into account any changes to the factors affecting execution that have occurred since the last review and conduct an analysis of the venues to ensure that those venues identified in the Policy continue to meet the Obligation. If following a review, a firm identifies that the venues included in the Policy do not provide for the best possible result, it must take steps to amend its Policy.

Any material changes to the Policy must be notified to the client.

4.4 ***Disclosure of the Policy***

COBS 11.2.22 R

A *firm* must provide appropriate information to its *clients* on its order execution policy.

[Note: paragraph 2 of article 21(3) of *MiFID*]

COBS 11.2.23 R

(1) A *firm* must provide a *retail client* with the following details on its execution policy in good time prior to the provision of the service:

(a) an account of the relative importance the *firm* assigns, in accordance with the *execution criteria*, to the *execution factors*, or the process by which the *firm* determines the relative importance of those factors;

(b) a list of the *execution venues* on which the *firm* places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of *client* orders;

(c) a clear and prominent warning that any specific instructions from a *client* may prevent the *firm* from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions.

(2) That information must be provided in a *durable medium*, or by means of a website (where that does not constitute a *durable medium*) provided that the *website conditions* are satisfied.

[Note: article 46(2) of the *MiFID implementing Directive*]

COBS 11.2.24R

Where the order execution policy provides for the possibility that *client* orders may be executed outside a *regulated market* or an *MTF*, the *firm* must, in particular, inform its *clients* about this possibility.

[Note: paragraph 3 of article 21(3) of *MiFID*]

The level and type of information that a firm must provide to a client about its Policy may vary depending on the firm, product and client type. The way in which this requirement is met is at the discretion of the firm and firms may therefore choose to include the additional information required for retail clients in their Policies.

In order to indicate venues that the firm places significant reliance on, a firm may need to identify its most used venues. The information to be provided to clients can take the form of generic information on the venues used.

A firm will not need to publish its model for pricing contracts or any commercially confidential or sensitive data relevant to that model or to the dealing volume or methodology of the firm as part of its disclosure or to obtain the detail of equivalent models from other competitor firms as part of its exercise to satisfy itself that its model is competitive, but it should consider disclosing the factors and criteria that are used by it in order to determine how it satisfies itself that any model used by it, is assessed for the purposes of obtaining best execution for clients.

For some possible elements for inclusion in an order execution policy disclosure statement, see Appendix 1.

4.5 ***Record Keeping***

The obligation to maintain records in respect of best execution only requires a firm to maintain records that enable the firm to demonstrate that it has followed its order execution policy.

Consequently, if the firm's order execution policy contemplates spot checks of data to assist it in assessing the reliability of a given venue achieving best execution, relevant records would need to be kept of the data from those spot checks, but not in respect of all other trades effected through that venue.

Appendix 1

POSSIBLE ELEMENTS FOR INCLUSION IN AN ORDER EXECUTION POLICY DISCLOSURE STATEMENT

The following are some elements that firms may wish to include in their order execution policy disclosure statement, a disclosure statement that is required by COBS 11.2.22R and 11.2.23R (see paragraph 4.4 above).

The elements set out below do not purport to include all elements that firms may wish to include in their order execution policy disclosure statement. These will vary in respect of each firm, depending on the firm's business, the products it offers and its client base. Equally, the suggested language included below does not purport to be the only way in which relevant concepts may be expressed; it is merely intended to be illustrative.

Firms should note that this Memorandum has not been approved by the FSA, nor has such approval been sought for it. It is, rather, merely suggested text produced by the FOA and AFB as advised by Clifford Chance LLP.

A statement of the circumstances in which the firm will provide best execution

When executing orders on your behalf in relation to financial instruments, we will take all reasonable steps to achieve "best execution" of your orders. This means taking all reasonable steps to achieve the best possible result for you when executing your orders by following our order execution policy and complying with any specific instructions received from you. We will do this by following procedures which are designed to obtain the best possible execution result, subject to and taking into account the nature of your orders, the priorities you have identified to us in relation to filling of those orders and the practices relating to the market in question with the aim of producing a result which provides, in our view, the best balance across a range of sometimes conflicting factors.

We will regard ourselves to be typically executing orders on your behalf where in each case the relevant activities relate to "financial instruments" as defined in MiFID and you legitimately rely on us to protect your interests in relation to the pricing or other elements of the transaction which may be affected by us when executing your order. This would include:

- where we act as agent on your behalf in executing a transaction;
- where we "work an order" on your behalf; or
- where we execute your order by dealing as riskless principal or as principal against our own account.

Where we transmit an order to a third party for execution (including in circumstances where we are acting on as a discretionary manager) we will also have obligations to ensure that best execution is obtained for your orders.

We will not be executing orders for you, and best execution obligation will therefore not apply:

- where we provide you, either on request or on a continuous quoting basis, with a quote for the purchase or sale of a financial instrument;
- where we agree to deal with you as principal for your account, i.e. as a counterparty **and** we have a client relationship with you as a result of which you can not legitimately rely on us to protect your interests; or
- under any other circumstances where we can reasonably assume that you are not relying on us to protect your interests.

Where you give us specific instructions, including specifying the characteristics of a bespoke product, either relating to an order or a particular aspect of an order, we will execute the order in accordance with those instructions. This will mean that, in the context of this order or aspect we will not follow our best execution policy.

A statement of the factors that may be taken into consideration in seeking to deliver best execution.

When executing orders on your behalf, we will, at our discretion, take into consideration a range of different factors which include not just price, but such other factors as the cost of the transaction, the need for timely execution, the liquidity of the relevant market (which may make it difficult to even execute an order), the size of the order and the nature of the financial transaction including whether it is executed on a regulated market or over-the-counter, and how we price the risk to us of that transaction.

Where we are, in effect, ourselves the execution venue, i.e., where we deal directly with you on a principal-to-principal basis, we will review the quality of our own execution as if we were an execution venue and disclose the criteria used by us to judge the quality of the execution offered by us to you (and of any model used by us for this purpose). However, you should note that, as a regulated market will charge exchange fees which will include the cost attributable to the provision of its execution facilities, we have to price the cost of our own business model and the utilisation of our capital to support our dealings with you (including carrying the risk of those dealings, for example, credit risk) as part of our assessment of the quality of execution offered to you.

You should note that the diversity in the markets and financial instruments on which we execute your orders and the kind of orders that you may place with us mean that different factors will have to be taken into account when we assess the nature of our execution policy in the context of different instruments and different markets. For example, there is no formalised market or settlement infrastructure for over-the-counter transactions. In some markets, price volatility may mean that the timeliness of execution is a priority, whereas, in other markets that have low liquidity, the fact of execution may itself constitute best execution. In other cases, our choice of venue may be limited (even to the fact that there may only be one platform / market upon which we can execute your orders) because of the nature of your order or of your requirements.

We will also take into account your understanding and experience of the market in question, your dealing profile, the nature of the dealing service you require of us and the specific and general instructions given to us by you which may determine how we prioritise effecting your orders.

In the absence of express instructions from you, we will exercise our own discretion in determining the factors that we need to take into account for the purpose of providing you with “best execution”.

In the case of executing orders for retail clients, total consideration is the most important factor and therefore this language will need to be changed accordingly. Sample language might read:

Where we execute an order on behalf of a retail client, the best possible result must be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, which must include all expenses incurred by the retail client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order. Speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs will only be given precedence over the immediate price and cost consideration if they are key in delivering the best possible result in terms of total consideration to the retail client.

A statement that regulatory best execution requirements do not give rise to any form of fiduciary responsibility

Our commitment to provide you with “best execution” does not mean that we owe you any fiduciary responsibilities over and above the specific regulatory obligations placed upon us or as may be otherwise contracted between us.

A statement of basis for deciding on execution venues

Our order execution policy includes, for each financial instrument in which we execute orders on your behalf, those venues that we consider enable us to obtain on a consistent basis best execution for your orders.

Those possible execution venues include, as appropriate for each product: regulated markets, multilateral trading facilities, or since we may execute orders on your behalf outside regulated markets, systematic internalisers, our own propriety trading desks and third party investment firms and/or affiliates acting as a market maker.

Although this disclosure discharges the firm's duty under COBS 11.2.24R to inform a client that orders may be executed outside a regulated market or MTF, firms will still need to obtain express client consent to this matter under COBS 11.2.25R.

In relation to some financial instruments, there may be only one possible execution venue. In executing an order on your behalf in such circumstances it will be assumed that we have achieved best execution.

A statement as to monitoring of order execution policy and its regular review

We will monitor the effectiveness of our order execution arrangements and order execution policy by:

- (a) assessing on a regular basis whether the execution venues included in our order execution policy, and the brokers and dealers to whom we transmit orders, allow us to achieve best execution on a consistent basis or whether we need to make changes to our execution arrangements; and
- (b) reviewing our order execution arrangements and order execution policy regularly whenever a material change occurs either in respect of one of our chosen execution venues or otherwise that affects our ability to continue to achieve best execution.

Should there be any material changes to our order execution arrangements or order execution policy, we will notify you.

Where executing orders for retail clients, additional details on the Order Execution Policy must be disclosed to the client in good time prior to the provision of the service. These can be included in the Disclosure Document or in other communications with the client and are as follows:

- (a) an account of the relative importance that the firm assigns, in accordance with the execution criteria, to the execution factors, or the process by which it determines the relative importance of those factors;
- (b) a list of the execution venues on which the firm places significant reliance in meeting its obligation to obtain best execution of client orders on a consistent basis;

a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain best execution in respect of the elements covered by those instructions.

Appendix 2

CHECKLIST

Below is an initial possible checklist for firms to consider when preparing themselves for the implementation of the best execution requirement and preparing their execution policy.

[Question for MiFID Connect - should we retain this checklist?]

- Have you confirmed that the best execution obligation applies to the transactions under consideration?
- Have you established a best execution policy addressing the elements discussed in this guidance?
- If you are executing orders outside of a regulated market or multi-lateral trading facility, have you obtained your client's express written consent?
- Have you ensured that the policy enables you to take into account all relevant considerations when assessing which factors should be given priority for clients?
- Have you analysed the available execution venues in order to identify those venues that will enable you to obtain the best possible result?
- Have you ensured that there is a process in place for routing client orders to the appropriate venues?
- Have you ensured (in the execution policy and elsewhere) that you do not structure or charge your commissions in such a way as to discriminate unfairly between execution venues?
- Do you have a process in place for reviewing the execution policy (at least annually) or in the event of a material change?
- Do you have a process in place for disclosing your execution policy to clients?
- Do you have a process in place for ensuring that any other information discussed in this guidance is sent to clients (bearing in mind additional requirements for Retail Clients)?
- Have you included a clear and prominent warning in your policy that any specific instructions from a client may prevent you from taking steps you have designed and implemented in your execution policy to obtain the best possible result?
- Do you have systems in place for recording details of the policy and any relevant correspondence with clients (bearing in mind the 5-year minimum retention period)?