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 **NORTON ROSE FULBRIGHT**

MiFID II Academy – Best execution

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28 October 2015

WFC 60.66

Introduction

MiFID II: The big themes

MiFID I was not serious enough

- Belief that the letter of MiFID I was not fully implemented in areas such as best execution and conflicts so that a new, much thicker layer of regulation is needed
- Level playing field is the other side of this

Suspicion of the industry

- Regulation as a solution to the ills of the principal / agent problem, asymmetric information and too many regulatory loopholes

Classification of structural entities / players

- The OTF category is being introduced into an already complex environment, featuring trading venues spanning all asset classes across the EU
- It remains to be seen whether re-classification – of single dealer platforms, broker crossing networks, MTFs and third country platforms such as SEFs – will represent greater opportunity for flow, or impact the executable liquidity in non-equity markets
- One thing is for certain – the complexity of quote-driven markets is about to increase

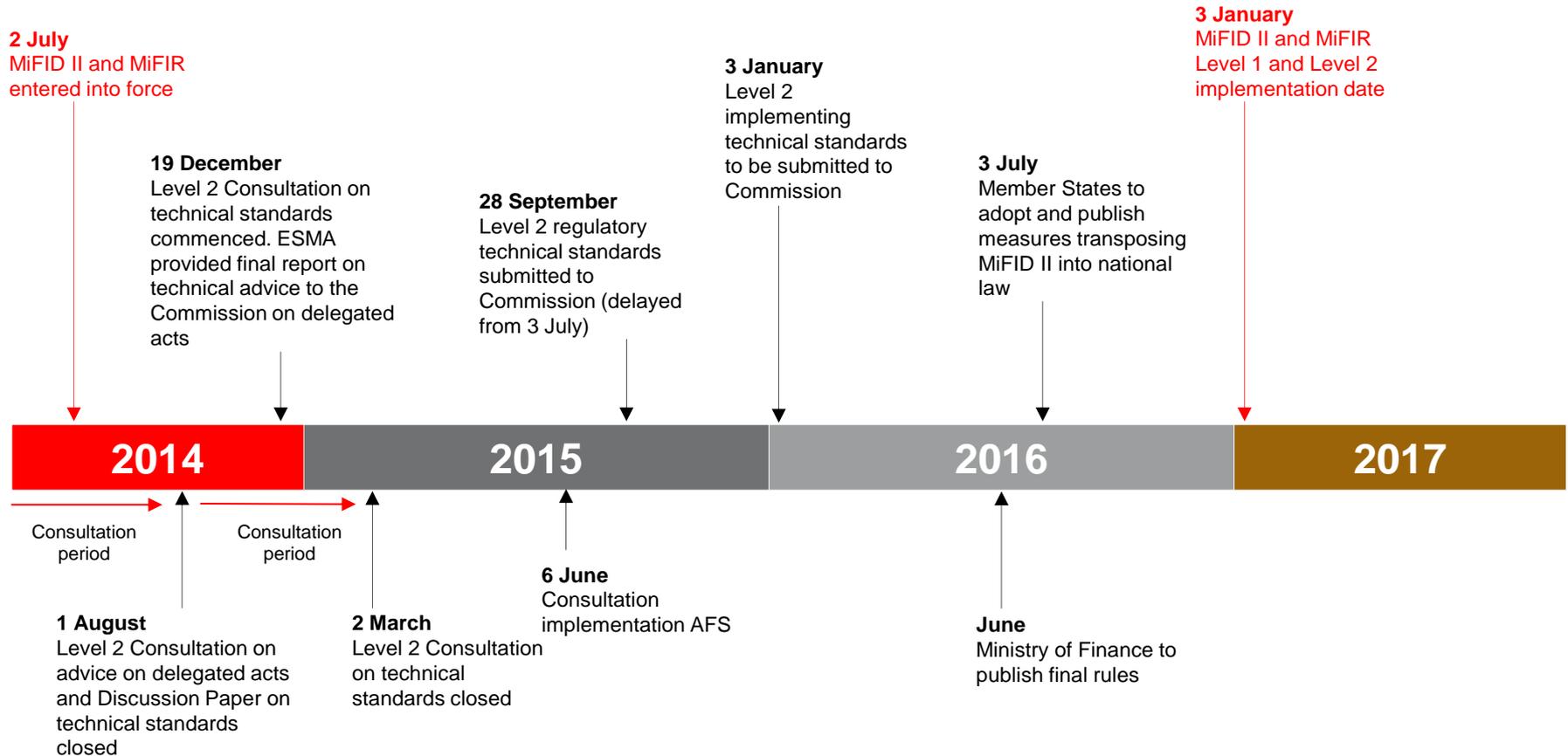
End of the OTC, bilateral world?

- The implementation of MiFID II will introduce, e.g., auction systems competing with dealer pricing, as products formerly traded OTC follow equities towards trading on venues

The regulation of retail

- Recognition that at the end of the chain stands the retail customer

MiFID II / MiFIR Level 2 Timeline



EU implementation

A brief history in time

- MiFID II and MiFIR were published in the OJ on 12 June 2014 and entered into force on the twentieth day following publication – i.e. 2 July 2014
- On 3 January 2017: MiFID II and MiFIR apply
- MiFID II and MiFIR supplemented by implementing measures (Level 2 legislation) consisting of delegated acts and technical standards: ESMA has a key role in producing these

Delegated acts

- The Commission will prepare the delegated acts on the basis of ESMA's technical advice – although it may elect to depart from it
- The power to adopt a delegated act is conferred on the Commission for an indeterminate period of time although it may be revoked at any time by the EP or Council
- As soon as it adopts a delegated act the Commission will notify the EP and Council
- EP and Council will consider the delegated acts adopted by the Commission and have the power to object, provided they do so within 3 months (which can be extended by a further 3 months)
- Once a delegated act is adopted it is published as a Commission delegated Regulation in the OJ. Delegated acts should be adopted by the Commission so that they enter into application by 3 January 2017

Technical standards

- Deadlines which ESMA is working to:
 - Must submit draft RTS to the Commission for adoption by 3 July 2015 (published 28 September 2015)
 - Must submit draft ITS to the Commission for adoption by 3 January 2016
- Key difference between RTS and ITS: EP and Council have no power of objection over ITS once adopted by Commission
- On receiving the ITS the Commission has three months to determine adoption (can be extended by one month)
- Within three months of receiving the RTS the Commission must determine adoption:
 - If the Commission adopts the RTS without amendment the EP and Council may object within one month (extended by another month)
 - If the Commission adopts the RTS with amendment the EP and Council may object within three months (which can be extended by another three months)
- Once adopted the RTS and ITS are published in the OJ as an implementing Regulation or implementing Decision

Dutch transposition

MiFID II implementation

- Article 93 MiFID II: Member States shall adopt and publish, by 3 July 2016, the laws, regulations and administrative provisions necessary to implement this Directive
- Consultation Ministry of Finance July 2015
 - closed on 6 July 2015
 - Lot of the detail will be implemented into the Besluit Gedragstoezicht financiële ondernemingen Wft
 - All RTS/ITS will be regulations which will have direct effect into Dutch law
- How to keep informed:
 - AFM MiFID review page - <https://www.afm.nl/nl-nl/professionals/onderwerpen/mifid-ii>
 - <http://www.regulationtomorrow.com/the-netherlands/>
 - <http://www.nortonrosefulbright.com/knowledge/technical-resources/pegasus/norton-rose-fulbright-briefings-slides-and-webex-recordings/>
 - http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm
 - <http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II>

EU developments

Key themes in wholesale conduct regulation





UK asset management industry may be leaving as much as £4.2bn of client returns on the table by failing to monitor how effectively its brokers are managing trades.

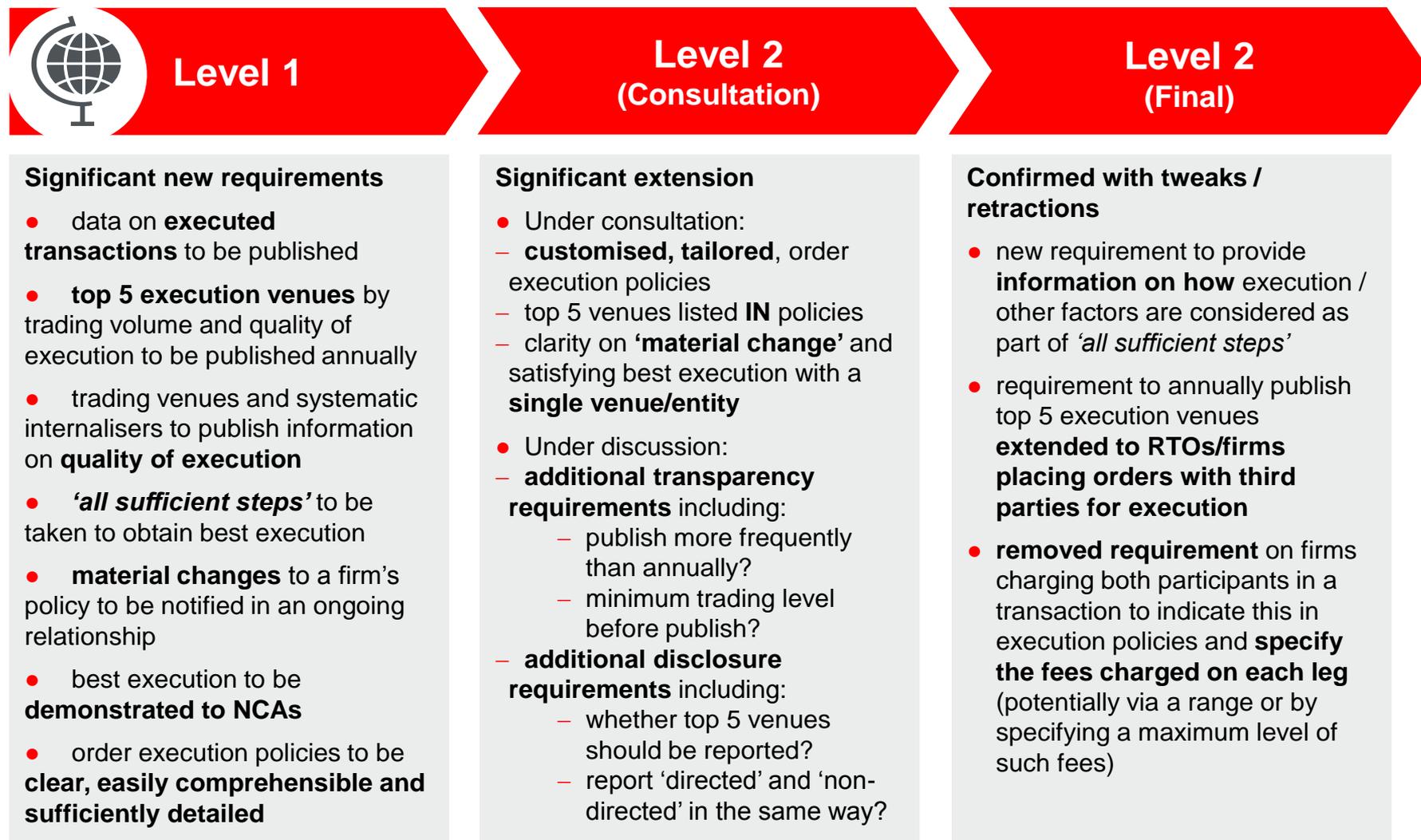
Source: FT.com 31/8/14

[MiFID II] will also present an implementation challenge for firms. Firms need to ensure now that they have fully embedded our existing regulatory requirements in preparation for the implementation of MiFID II to ensure they can continue to act in their clients' best interests.

Source: FCA, TR14/13, p8.



Best execution: EU developments



Best Execution

Best execution - applicability

- The obligation applies to executing orders in any type of financial instrument, including OTC derivatives.
- It applies when a firm executes orders, provides portfolio management and when receiving and transmitting orders. Not applicable if client gives specific instruction: if so, firm to provide a warning to retail client.
- This is true for both retail and professional clients. Best execution continues not to be owed to eligible counterparties.
- It applies to different trading models, including RFQ. CESR Q&A of May 2007 in relation to RFQ still relevant. Four factors to take into account:
 - Who initiates the transaction: if a firm suggests that a retail client enters into a specific transaction, the client is more likely to rely on the firm
 - Market practice: in markets where it is common to shop around for a quote, there is less expectation that the chosen party will provide best execution
 - Relative transparency of the market: clients rely more on the firm to price the transaction where they have less access to prices than the firms
 - The way the firm may have described the relationship is relevant but not determinative.

Best execution - applicability

- It applies on activities carried out by an investment firm in the EU, save where services are carried out from a non-EU branch to non-EU persons.
- If a non-EU firm operates through a branch in the EU, if the member state has opted into the branch regime in MiFID II, it will be required to comply with MiFID II rules; if it has not, it will depend on the member state's local regime but firms should assume that best execution will apply, especially if it is dealing with retail clients.
- If the non-EU firm only deals with per se professional clients and eligible counterparties from outside the EU, once it becomes registered with ESMA, we assume that the equivalence process will replace the need to comply with EU best execution obligations – however, if a non-EU country does not have an equivalent of the best execution requirements, firms may be required to “top up” by complying with EU rules. Until the equivalence assessments have been completed for a country and for a further three years thereafter, member states will be able to continue to operate its local regimes, so whether best execution applies will depend on this.

Best execution

MiFID I on best execution

Firms must take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order

MiFID II on best execution

Firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order

Execution policy – factors

- Explain what constitutes 'all sufficient steps' taking into account client classification, services to be provided, execution factors, execution venues and specific instruction. Explain how the execution factors of price costs, speed, likelihood of execution and any other relevant factors are considered as part of 'all sufficient steps'
- Execution factors to be considered: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.
New obligation: for retail clients, best execution in terms of total consideration:
 - price of the financial instrument
 - costs relating to execution
 - all expenses incurred by the client which are directly relating to the execution of the order (including execution venue fees, clearing and settlement fees);
 - any other fees paid to third parties involved in the execution of the order
- Include criteria for determining the relative importance of best execution factors:
 - characteristics of the client (retail or professional)
 - characteristics of the client order
 - characteristics of financial instruments that are the subject of that order
 - characteristics of the execution venues to which that order can be directed
 - Please note that the definition of execution venue now also includes OTFs

Execution policy - venue

- Information on the different execution venues where the investment firms executes client orders and the factors affecting the choice of execution venue.
 - New obligation: where there is more than one competing venue to execute an order for a financial instrument, investment firms to consider their own commissions and the costs for executing the order on each of the eligible execution venues.
 - Factors used to select execution venue should be consistent with controls used to demonstrate best execution and should be consistent across execution venues
 - list the factors selection of venue, including qualitative factors like clearing schemes, circuit breakers, schedule auctions and other relevant considerations
 - summarise the following information:
 - how venue selection occurs
 - how specific execution strategies are employed
 - the procedures and processes used to analyse the quality of execution obtained
 - how the firm monitors and verifies that the best possible results were obtained for their clients;
 - Summary of policy sufficient information on why fees are different:
 - - advantages of venue;
 - - disadvantages of venue.

Execution policy - venue

- Can still include only one execution venue or single entity used for execution
 - Policy needs to include detail of how the venue or entity will still achieve best execution:
 - by comparing best execution that could be received from using an alternative venue/entity
 - supported by data and information gathered from the market
 - following internal analysis
 - statement - fair execution prices on bespoke products

Firm needs procedures to gather market data to demonstrate the fairness of the proposed price for OTC products and bespoke products including:

 - data used in the estimation of the price
 - comparing that with similar or comparable products
 - Fairness: no guidance. Not necessarily give the best price on each transaction provided each price is reasonable and transparent and not discriminatory to the client. However, probably fairness test must be applied more strictly for retail clients. For all clients the firm would need to be able to show that its pricing provides the best possible result over time even if not on every transaction.
- Investment firms will not structure or charge commissions to discriminate unfairly between execution venues. The execution policy has to include clear information about the inducements that may be received. Fees charged by the investment firm to all parties to the transaction will need to be specified, and if the fees vary depending on the client – indication of maximum fees or range of the fees

Execution policy - summary

- Firms need to provide provide retail clients with a summary of the policy
- Summary to be tailored for retail clients
- Summary should focus on price
- Summary to include link to most recent execution quality data published.
- Inform clients of material changes: limited to an obligation to inform clients with whom the firm has an 'on-going relationship'. Material change is significant event of internal or external nature that could impact the best execution factors (cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order)

Best execution – after execution

- Following the execution of an order, a firm must inform its client **where that order was executed**
- A firm must summarise and make public on an annual basis, for each class of financial instruments, the **top five execution venues** in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained
- In complying with its existing obligation to monitor the effectiveness of its order execution arrangements and to, where appropriate, correct any deficiencies, a firm will also be required to take into account the information it is required to publish relating to the quality of **execution** of transactions and the summary of its **top five execution venues** for each class of financial instruments
- Upon request, firms will not only be required to **demonstrate to the regulator** that they have executed their orders in accordance with their execution policy but also their general compliance with the best execution obligation

Difference obligation placing orders

It does not have to:

- Obtain clients prior consent to policy
- Prescribed form of disclosure on policy to retail client
- Comply detailed rules on execution venues
- Obtain prior express consent for off-venue trading
- Notify clients of material changes policy
- On request client, demonstrate clients' order was executed in accordance with the policy.

Publication trading information

Investment firms shall publish for each class of financial instruments , the top five execution venues in terms of trading volumes for all executed client orders for retail clients the following information:

- (a) class of financial instruments;
- (b) venue name and identifier;
- (c) volume of client orders executed on that execution venue expressed as a percentage of total executed volume;
- (d) number of client orders executed on that execution venue expressed as a percentage of total executed orders;
- (e) percentage of the executed orders referred to in point (d) that were passive and aggressive orders;
- (f) percentage of orders referred to in point (d) that were directed orders;
- (g) notification of whether it has executed an average of less than one trade per business day in the previous year in that class of financial instruments.

Securities Financing Transactions do not need to be published. This will be mandatory but on the basis of different regulation.

Publication obligation execution venues

- Obligation for execution venue (trading venue, SI, market maker, liquidity provider) to publish certain information for each financial instrument subject to the trading obligation for each market segment it operates.
- Requirements different per execution venue, both on content as on timing.
 - For instance SI is required to publish certain information for: (i) each market segment it operates; and (ii) each financial instrument subject to the trading obligation.
 - For instance another execution venue is required to publish certain information for: (i) each market segment it operates; and (ii) for each other financial instrument.
- Requirements different continuous auction order book/ continuous quote trading system and request for quote trading system.

The logo consists of a stylized, upward-pointing chevron shape in a gold color, positioned above the first letter of the text.

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