MiFID II—Best Execution

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MiFID I

According to Article 21(1) of Directive 2004/39/EC on markets in financial instruments ("**MiFID I**"):

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

  Article 21

  Obligation to execute orders on terms most favourable to the client

  1. *Member States shall require that investment firms 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. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.*

Directive 2014/65/EU (commonly referred to as "**MiFID II**") is due to become applicable on 3 January 2018 (by virtue of a Commission delegated act delaying application) and, together with Regulation (EU) No 600/2014 ("**MiFIR**"), replace MiFID I.

*The best execution obligation does not apply to eligible counterparties.

MiFID II

There will be significant regulatory continuity under MiFID II…

Article 27

Obligation to execute orders on terms most favourable to the client

1. *Member States shall require that investment 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. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.*

   […].

   For the purposes of delivering best possible result in accordance with the first subparagraph 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 investment firm's order execution policy that is capable of executing that order, the investment firm's own commissions and the costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

Changes introduced by MiFID II—Information for clients

Firms will continue to be subject to an obligation to establish an order execution policy but they will be required to provide clients with more specific information about the policy:

Article 27

4. *Member States shall require investment firms to establish and implement effective arrangements for complying with paragraph 1. In particular, Member States shall require investment firms to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result in accordance with paragraph 1.*

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

   Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. That information shall explain clearly, in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by the investment firm for the client. Member States shall require that investment firms obtain the prior consent of their clients to the order execution policy.

Changes introduced by MiFID II—Mandatory publication

Publication of data relating to execution quality provided by execution venues is now mandatory and there is a new obligation for investment firms to summarise data on their use of execution venues**:**

Article 27

3. *Member States shall require that for financial instruments subject to the trading obligation in Articles 23 and 28 Regulation (EU) No 600/2014 each trading venue and systematic internaliser and for other financial instruments each execution venue makes available to the public, without any charges, data relating to the quality of execution of transactions on that venue on at least an annual basis and that following execution of a transaction on behalf of a client the investment firm shall inform the client where the order was executed. Periodic reports shall include details about price, costs, speed and likelihood of execution for individual financial instruments.*

4. *[…]*

5. *[…]*

6. *Member States shall require investment firms who execute client orders to 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.*

Changes introduced by MiFID II—Scope of obligations

There have also been changes to the scope of the best execution rules in respect of the financial instruments covered.

MiFID I set out a table of financial instruments at **Annex 1, Section C**. It includes

> *4. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash*;

It does not include spot forex contracts.

The definition of 'Execution of orders on behalf of clients' in **Article 4 MiFID I** is "acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients". This entails that execution of spot forex is not an investment service within the meaning of the directive and that the activity of executing spot forex contracts for clients is not, therefore, within scope of the best execution obligation.

Annex 1, Section C MiFID II has a similar, if expanded, list of financial instruments.

The Commission has now, however, introduced a definition of spot forex (through a delegated act) which may have the indirect effect of altering the scope of the best execution obligation in some Member States.

Changes introduced by MiFID II—Scope of obligations (cont.)

A new **Commission Delegated Act of 25.4.2016** defines a spot contract in **Article 10(2)** as:

> *a contract for the exchange of one currency against another currency, under the terms of which delivery is scheduled to be made within the longer of the following periods:*
>
> *a. 2 trading days in respect of any pair of the major currencies set out in paragraph 3;*
>
> *b. for any pair of currencies where at least one currency is not a major currency, the longer of 2 trading days or the period generally accepted in the market for that currency pair as the standard delivery period*
>
> *c. where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking as the standard delivery period or 5 trading days, whichever is shorter.*

And goes on to specify…

> *A contract shall not be considered a spot contract where, irrespective of its explicit terms, there is an understanding between the parties to the contract that delivery of the currency is to be postponed and not to be performed within the period set out in the first subparagraph.*

Recital 12 provides that non deliverable forwards, options and swaps on currencies are not spot contracts.

Changes introduced by MiFID II—Scope of obligations (cont.)

Article 10(1) also exempts any "derivative contracts relating to a currency" that are a means of commercial payment, in the following terms:

> *For the purposes of Section C (4) of Annex I to Directive 2014/65/EC, other derivative contracts relating to a currency shall not be a financial instrument where the contract is one of the following:*
>
> *(a) a spot contract within the meaning of paragraph 2 of this Article,*
>
> *(b) a means of payment that:*
>
> i. *must be settled physically otherwise than by reason of a default or other termination event;*
>
> ii. *is entered into by at least a person which is not a financial counterparty within the meaning of Article 2(8) of Regulation (EU) No. 648/2012 of the European Parliament and of the Council 19;*
>
> iii. *is entered into in order to facilitate payment for identifiable goods, services or direct investment; and*
>
> iv. *is not traded on a trading venue.*

Changes introduced by MiFID II—Scope of obligations (cont.)

Recital 10 of the Commission Delegated Act of 25.4.2016 offers further explanation:

> *Foreign exchange contracts may also be used for the purpose of effecting payment and those contracts should not be considered financial instruments provided they are not traded on a trading venue. Therefore it is appropriate to consider as spot contracts those foreign exchange contracts that are used to effect payment for financial instruments where the settlement period for those contracts is more than 2 trading days and less than 5 trading days. It is also appropriate to consider as means of payments those foreign exchange contracts that are entered into for the purpose of achieving certainty about the level of payments for goods, services and real investment. This will result in excluding from the definition of financial instruments foreign exchange contracts entered into by non-financial firms receiving payments in foreign currency for exports of identifiable goods and services and non-financial firms making payments in foreign currency to import specific goods and services.*

In the UK the test for whether a foreign exchange contract is a spot or forward contract has been whether the contract is made for investment purposes or commercial purposes. The carve-out for "means of payments" contracts is largely intended to reflect the "commercial purposes" test but it may allow some contracts to fall within scope which were previously excluded. Other Member States may see greater changes to the scope of their investment service obligations since the definition of "spot" had not been harmonised.

NB. The "means of payment" exemption is only available for transactions with non-financial clients.

Changes introduced by MiFID II—“Execution on behalf of clients”

Some instances of dealing on own account have been reclassified under MiFID II and now fall within scope of the best execution obligation to clients.

MiFID II, Article 4 definitions

5. *“Execution of orders on behalf of clients” means acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients and includes the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance;*

Thus the sale to an investor of shares in a firm’s own capital is now the execution of a client order. Does a firm which enters into an interest rate swap as contractual counterparty thereby “conclude an agreement for the sale, at time of issuance, of a financial instrument issued by an investment firm? Probably.

MiFID II, Recital 24

24. *Dealing on own account when executing client orders should include firms executing orders from different clients by matching them on a matched principal basis (back-to-back trading), which should be regarded as acting as principal and should be subject to the provisions of this Directive covering both the execution of orders on behalf of clients and dealing on own account.*

Thus, facilitating simultaneous matched trades as intermediary is now covered by the best execution rules (as well as by the rules for dealing on own account).

Changes introduced by MiFID II—Transaction reporting by broker

Under **MiFID I Article 25**, the transaction reporting obligation applies only to firms trading in investments on Regulated Markets. Under **Article 25(5)** the obligations of firms may be waived where reports are provided by the venue, by third parties or by an approved "reporting system". Thus, in the UK, under the current FCA rules, a "portfolio manager" is exempt where it has reasonable grounds to believe that the executing broker or other third party will report the transaction.

Under **Article 26 MiFIR**, the reporting obligation will be extended to instruments traded on a Multilateral Trading Facility ("MTF") or Organised Trading Facility ("OTF"). ESMA has proposed that the number of reporting fields should be increased from 23 to 65.

The reporting obligation will also extend to all investment firms, subject to a narrower exemption in for transmitting orders in **Article 26(4)**. This may apply to a fund manager transmitting an order on behalf of a fund, say. ESMA has proposed that the transmitting firm should be relieved from the reporting obligation only if certain conditions are met: (i) the information must have been sent to the receiving firm by the transmitting firm, (ii) the receiving firm must agree to make the report pursuant to written agreement with the transmitting firm, and (iii) the transmitting firm must have the systems and controls to ensure accurate and complete reports.

Firms have expressed concern about the scope of clients that **Article 26(6)** of MIFIR requires them to identify with a Legal Entity Identifier.

Changes introduced by MiFID II—Transaction reporting by broker (cont)

Submission of reports

Under **MiFID I Article 25(5)**, the transaction reporting obligation may be waived where reports are provided by the venue, by third parties or a trade repository. As we have seen, equivalent exemptions in MiFIR are much narrower.

Article 26(7) MiFIR permits a broker or other firm to rely on an Approved Reporting Mechanism ("ARM") or the trading venue where the transaction was executed to submit a transaction report. This is not equivalent to an exemption or safe-harbour—the broker or firm retains responsibility for the completeness, accuracy and timely submission of the reports.

Location—branches

Where an EU firm operates in another EEA member state through a branch, the branch will be required to make transaction reports under **Article 26 MiFIR** and the responsibility for supervising this responsibility—and, one infers, receiving the reports—lies with the host state competent authority under **MiFID II Article 38(5)**.

For third-country firms carrying out business in a particular Member State through a branch, host state authorisation is dependent (under **Article 41 MiFID II**) on compliance with the transaction reporting obligation in **Article 26 MiFIR** and monitoring and supervision of the obligation is the responsibility of the host state competent authority.

Changes introduced by MiFID II—Client order handling

In addition to rules on best execution, **MiFID I** also sets out rules, in **Article 22**, on client order handling, which are designed to guarantee the treatment received by the client's order within the firm.

These remain largely unchanged in **MiFID II**…

Article 28

Client order handling rules

1. *Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm. Those procedures or arrangements shall allow for the execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm.*
2. *[Provisions on client limit orders]*

…but the scope of the obligation has been extended under **Article 1(4)(b)** so as to apply to firms selling or advising clients in relation to structured deposits.

Conclusion

- Conclusions

Appendix—Market structure

Four types of organised trading under **MiFID II** (see **Article 4** definitions):

> *"regulated market" means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with Title III of [MiFID II];*

> *"multilateral trading facility" or "MTF" means a multilateral system, operated by an investment firm or a market operator, which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of [MiFID II];*

> *"organised trading facility" or "OTF" means a multilateral system which is not a regulated market or an MTF and in which multiple third-party buying and selling interests in bonds, structured finance products, emission allowances or derivatives are able to interact in the system in a way that results in a contract in accordance with Title II of [MiFID II];*

Unlike regulated markets and MTFs, operators of OTFs will a) have discretion as to how to execute orders, subject to pre-trade transparency and best execution obligations and b) be permitted to undertake matched principal trading with client consent.

> *"systematic internaliser" means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system;*

Unlike trading venues, a systematic internaliser can execute client transactions against its own proprietary capital.