Financial Conduct Authority

Market Watch

Newsletter on market conduct and transaction reporting Issues

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You can also find issues on our website at: www.fca.org.uk/firms/markets/market-abuse

Best Execution: A reminder to firms of their duties under the FCA's Rules

We are currently undertaking a thematic review of best execution in different markets and have also recently concluded analysis of firms offering transition management services. We aim to publish the findings of the thematic review later this year.

In the interim, we want to update the industry on some areas where firms may have mis-understood the requirements. This note is to remind firms of some of the provisions in the FCA Handbook and CESR (now ESMA) guidance on best execution.

'Best execution' is the term given to the obligation on firms to take all reasonable steps to obtain the best possible results for retail and professional clients on a consistent basis when executing orders on their behalf.[1]

Brokers in certain markets, including regulated CFD and spread-bet firms and those offering Rolling Spot Forex contracts for difference, may be failing to recognise that their activities fall within the scope of the best execution rules.

Investment firms are required to take into account the characteristics of their clients and the following factors: price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to order execution.[2]

Firms that execute orders and decisions to deal should establish an order execution policy and monitor the effectiveness of its order execution arrangements to identify and, where appropriate, correct any deficiencies.[3] Firms that receive and transmit orders for execution need to have a policy governing how they select executing brokers.[4]

1 COBS 11.2.1R
2 COBS 11.2.1R
3 COBS 11.2.14R and COBS 11.2.27R
4 COBS 11.2.32R(2)

Scope

The current best execution obligation was revised in 2007 through the introduction of MiFID[5], and has been transposed largely in COBS 11.2. We consulted extensively on best execution before issuing PS07/15[6] in 2007 and followed this in 2009 with a report of our supervisory experiences.[7]

CESR (now ESMA) and the European Commission have also issued guidance on the scope of the MiFID best execution obligation.[8] We recommend that firms should use this guidance when reviewing their systems and controls to consider how they are discharging their best execution obligations.

Our thematic work indicates that there are some aspects of this guidance and the COBS rules that are not currently embedded in firms' assessment of best execution. We expect firms to consider and embed the following:

- Best execution applies to execution of orders relating to OTC financial instruments as well as shares traded on centralised execution venues.[9]

- The application of the best execution obligations is determined by 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 based on whether a client legitimately relies on a firm to protect his or her interests in relation to particular elements of the transaction that may be affected by the choices the firm makes when it executes the order.[10]

- Specific instructions from a client partially satisfy the duty of best execution, but only in relation to the parameters of the trade that those instructions cover. A firm cannot induce a client to give instructions in order to circumvent the best execution duty.[11]

As previously set out in the Commission's guidance on whether a client legitimately relies on a firm to protect his or her interests, firms should note 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

- the non-fungible nature of some instruments results in 'captive trades' where the client relies entirely on the firm for pricing

Reliance and price transparency:

In obtaining best execution for the client, firms should consider a number of factors, including whether:

- The categorisation of their clients is relevant to the extent of their reliance on the firm or to their informational needs.

- Positive price movements between the submission of an order and its execution are passed on to the client, and that firms are not seeking to retain any slippage in the clients' favour.

5 Directive 2004/39/EC
6 www.fsa.gov.uk/pubs/policy/ps07_15.pdf
7 www.fsa.gov.uk/pubs/international/mifid_sup_priorities.pdf
8 http://www.esma.europa.eu/system/files/07_320.pdf
9 COBS 11.2.5G
10 PS07/15 Annex 1 p 22 www.fsa.gov.uk/pubs/policy/ps07_15.pdf
11 COBS 11.2.21G

- Limit orders are offered to clients on the basis of the MiFID definition (execution at a specified price limit or better), and that firms are not seeking to retain any slippage in clients' favour above or below the limit price.

- Best execution where price transparency to clients may be poor (for example, when trading as principal) can best be achieved by using public reference prices and disclosing a methodology for calculating fees and charges (or a 'mark-up' or 'mark-down').

This statement is intended to remind firms of their existing duties, and does not constitute new guidance. Firms should already be aware of their responsibilities under our rules and have adequate systems and controls in place to ensure they are complying with them.

If a firm is in breach of our rules, we will seek to take further regulatory action.

Update on suspicious transaction reports

In Market Watch 44, we described our increased focus on the Suspicious Transaction Reporting (STR) regime. There has been a positive, proactive response from the industry to our visits, which are predominantly educational, and we look forward to continuing our engagement with firms in this area.

We frequently receive requests for detailed statistics on the number of STR submissions we receive. We have therefore set out details of the 2013 numbers below.

STRs received by reported behaviour 2013

Month	Insider Dealing and Misuse of Information	False or Misleading Statements	Distortion and Manipulation	Total
January	86	0	15	101
February	88	0	9	97
March	88	0	15	103
April	79	0	9	88
May	106	1	13	120
June	79	1	5	85
July	111	0	13	124
August	97	0	14	111
September	84	1	10	95
October	120	1	11	132
November	122	1	11	134
December	104	1	13	118
Total	1164	6	138	1308

As well as an increased number of individual reports, we have also seen an increase in the number of individual firms reporting at least one suspicious transaction per year.

Number of individual firms submitting at least one STR

Year	Number of Firms
2009	123
2010	124
2011	129
2012	186
2013	210

As our supervisory programme progresses, we aim to draw on our experiences to provide enhanced best practice notes in future Market Watch publications.