Financial Conduct Authority

Thematic Review TR14/13

Best execution and payment for order flow

July 2014

Contents

1. Executive summary

Overview

This paper presents our findings from the review of best execution and Payment for Order Flow ('PFOF'). Delivering best execution is fundamental to market integrity and to the delivery of good outcomes for clients who rely on agents to act in their best interests. These outcomes are also underpinned by a range of relevant rules and guidance which set the parameters within which firms must operate.

Our regime requires that firms take all reasonable steps to obtain the best possible result when executing client orders or placing orders with (or transmitting orders to) other entities to execute. Firms must take into account a range of execution factors in order to deliver best execution and determine their relative importance based on the characteristics of their clients, the orders they receive and the markets in which they operate. The factors they need to consider when delivering best execution are price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order.

We have also incorporated into this review the practice of PFOF to assess how market participants have responded to our 2012 Finalised Guidance ('FG12/13').[1] PFOF can damage the transparency of the price formation process, thus undermining best execution and limiting effective competition in the interests of consumers.

Our review found that many firms do not understand key elements of our requirements and are not embedding them into their business practices. This paper therefore reiterates our policy position alongside our findings where appropriate.

There are two main messages from our work:

- Our review identifies a significant risk that best execution is not being delivered to all clients on a consistent basis.
  - Most firms are not doing enough to deliver best execution through adequate management focus, front-office business practices or supporting controls.
  - Firms need to improve their understanding of the scope of their best execution obligations, the capability of their monitoring and the degree of management engagement in execution strategy, if they are to meet our current requirements.

1 Guidance on the practice of 'Payment for Order Flow' (May 2012) FSA FG12/13 http://www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg1213

   - All firms also need to prepare for the challenges of MiFID II implementation in this area.

- A small number of firms continued to receive PFOF in contravention of the position we stated in FG12/13. We are keeping this area under active review and will take action against any firms which continue to evade our rules and requirements on PFOF. We will consider all available tools, including enforcement action.

One of the core principles of our wholesale conduct strategy is to ensure that firms put their clients' best interests at the heart of their businesses when acting as agents on behalf of their clients. Senior management is responsible for ensuring that robust business practices are operating in all their trading activities to deliver best execution on a consistent basis and for promoting a culture that proactively identifies and manages conflicts of interest.

This report is a key part of our wholesale conduct strategy. Our findings on the need for firms to control client execution costs in order to deliver best execution are closely linked to our ongoing thematic and policy work to ensure that firms scrutinise and control their use of client dealing commissions to purchase services. It reflects the importance of best execution and the integrity of agency remuneration practices to all of our operational objectives.

What we did

The review included 36 firms across five different business models: investment banks, contract for difference ('CfD') providers, wealth managers, brokers/interdealer brokers and retail banks. All the firms were sent information requests, after which we conducted a desk-based review and visited a subset of firms. Our review focused on firms that were active in one or more of cash equities, exchange traded derivatives and CfDs. We did not look at all asset classes which are within the scope of the best execution obligation (collectively 'relevant asset classes').[2] Other instruments with lower price transparency, such as fixed income, may present different challenges for delivering and evidencing best execution than those we observed during this work, but firms nevertheless need to embed our requirements into their activities in these other asset classes as well.

Findings

Best execution

Overall, many firms we visited appeared to rely on the assumption that clients would switch to a competitor if they were not satisfied that best execution was being consistently delivered to them. Firms should instead be focused on meeting our requirements and exercising their own judgement in their clients' best interests.

In this paper we set out our findings on best execution in four areas, each of which we develop in a separate section of Chapter 3, 'Supervisory findings and conclusions'. Our findings are supported by examples of good and poor practice, where appropriate. These findings should be read in conjunction with a summary of our requirements in the introduction and a more developed policy narrative on two key areas of risk (the scope of best execution and PFOF)

2 Best execution applies to all instruments listed within Annex 1 Section C of the MiFID framework directive (2004/39/EC) including equities, derivatives, contracts for difference and fixed income.

which we set out in Chapter 4. Each section of Chapter 3, on supervisory findings, addresses a specific risk to the consistent delivery of best execution which we summarise below:

1. **Scope:** There was a poor level of understanding of which activities are covered by the obligation to provide best execution. Frequent attempts were made by firms to limit the scope of the obligation in their dealings with clients, often through the use of general 'carve-outs' which are not permissible or through continued reliance on out-dated market conventions.

2. **Monitoring:** Most firms lacked effective monitoring capability to identify best execution failures or poor client outcomes. Monitoring often did not cover all relevant asset classes, reflect all of the execution factors which firms are required to assess or include adequate samples of transactions. In addition, it was often unclear how monitoring was captured in management information and used to inform action to correct any deficiencies observed by firms.

3. **Internalisation and connected parties:** Firms which relied heavily on internalisation or on executing orders through connected parties were often unable to evidence whether this delivered best execution and how they were managing potential conflicts of interest. Firms were also unable to show how they separated explicit external costs incurred on behalf of clients from internal costs or how their commission structures for internalisation avoided discriminating against other venues.

4. **Accountability:** It was often unclear who had responsibility and ultimate accountability for ensuring that execution arrangements and policies met our requirements. Despite the significant volume of change in European markets since 2007, firms were still conducting only cursory reviews of policy documents which did not address the full scope of their best execution obligations. Moreover, these were largely focused on process rather than delivering client outcomes and often lacked front-office engagement.

PFOF

We set out our detailed supervisory findings on PFOF in the final section of Chapter 3. In addition, we set out a summary of our engagement with market participants and more detail of our policy analysis in Chapter 4. Our key findings were that:

1. As set out in FG12/13, we consider, on the basis of all examples seen by us, that PFOF arrangements create a clear conflict of interest between the firm and its clients, are unlikely to be compatible with our inducements rule and risk compromising compliance with best execution rules. Following publication of FG12/13 we undertook a pilot review of PFOF in 2012, as a result of which some firms ceased to receive commission from market makers in respect of their London International Financial Futures and Options Exchange (LIFFE) business. After our thematic review information request in October 2013 several other firms confirmed to us that they had stopped receiving PFOF.

2. However, despite the publication of FG12/13, a small number of market participants in our thematic sample still continued to receive PFOF by changing the description of the service they provided to clients during the course of our thematic work. This recast PFOF arrangement sought to describe their commercial relationships in terms that are not consistent with the economic realities of their activities. This still constitutes a PFOF arrangement and is not compatible with our rules. We are also aware that some other market participants who were not involved in this thematic work were considering adopting this recast PFOF

arrangement. We contacted the four firms within our sample that were relying on this argument and they have ceased receiving PFOF. All firms in our thematic sample have now confirmed to us that they are no longer receiving PFOF.

3. We are keeping this area under active review and will take action against any remaining firms which continue to evade our rules and requirements on PFOF. We will consider all available tools, including enforcement action.

Who does this document affect?

This document is relevant to all firms which execute, receive and transmit or place orders for execution, including portfolio managers. Although this review did not involve questioning or visiting buy-side firms, many of its conclusions will also be of interest to these firms given their need to act in the best interests of their underlying clients.

Next steps

What will we do?

We will shortly be writing to all the firms in our thematic sample to provide individual feedback on our findings and will require firms to take immediate action to address all areas of our findings that are relevant to them. In addition to requiring confirmation that they are no longer receiving PFOF, we will require confirmation that firms fully understand the scope of their best execution obligations to clients and the steps that they are taking to reflect these obligations in their execution arrangements.

What do you need to do next?

Given the nature and broad relevance of the findings, all investment firms should review their arrangements for delivering best execution and ensure that they are not receiving PFOF. Firms need to ensure that business practices are fit for purpose and that these are supported by appropriate second line of defence controls.

Our findings not only highlight that a failure to obtain best execution on a consistent basis presents a risk of detriment to individual clients, but that it also presents risks to trust and confidence in the integrity of our markets as well as potentially undermining competition between trading venues.

All firms also need to assess the risks and issues identified in this report in the context of future regulatory developments. Additional obligations in the recast Markets in Financial Instruments Directive (MiFID II) are intended to address some of the specific weaknesses observed in this work, in particular regarding the adequacy of monitoring. Therefore firms need to improve their current systems and controls and be ready for the implementation of future policy change. These improvements will need to be broadly applied, since the new obligations under MiFID will enhance reporting requirements across all relevant asset classes.

2. Introduction

Our regulatory objectives

This report sets out the findings and conclusions from our thematic work on best execution and PFOF. It meets several commitments made in our latest business plan, not least that we would take steps to ensure that transactions between more sophisticated market participants do not have a harmful impact on market integrity or lead to consumer detriment. It is one of several steps towards fulfilling the goal set out in the FCA's approach to advancing its objectives, which stated that improving standards of wholesale conduct was central to our work.

Why best execution matters

Best execution is a core component in the regulation of financial services. Its aims are threefold:

- to ensure protection for investors;
- to sustain the integrity of the price formation process, which itself underpins all trading activity; and
- to promote competition among trading venues in increasingly fragmented markets.

Best execution is essential to ensuring a high standard of wholesale conduct by delivering good client outcomes and is not a tick-box process. The soundness, stability and resilience of financial markets and the transparency of the pricing process relies on participants behaving appropriately and taking the necessary steps to ensure that they are acting in the best interests of their clients.

There is a connection between wholesale and retail markets which may lead to risks, including additional transaction costs, being transferred from one to another. There is an even more direct link to the retail market and our review assessed several firms which executed retail client orders, particularly in the cash equity market.

Different participants in wholesale markets have different degrees of expertise. Some therefore need more protection than others and our rules reflect this. Our work on best execution also addressed these differences in sophistication and the way in which client categorisation affected the protection that clients were offered, the information they were provided with and ultimately the execution outcome they received.

A clear focus of our work in wholesale markets is to scrutinise the way in which agents control their clients' costs. There is a clear link between the conclusions of this report on the control of client execution costs and our ongoing work on the use of dealing commissions. Both workstreams concern the way in which firms exercise effective oversight over client costs in order to act as good agents on behalf of their clients.

Given the scale of assets under management in the UK, how firms perform on best execution could have a significant impact on investor returns. The Investment Management Association estimates that its members manage some £2.2 trillion[3] in equities. To illustrate the importance of effective trade implementation and proper monitoring of best execution by all market participants, every basis point of cost saving could translate into £264mn in additional client returns each year[4]. Over a thirty year period, a 1 basis point improvement in trading costs could represent an additional £37.5 billion in client returns[5]. Some public sources estimate that more than 1 basis point of cost savings is achievable by firms[6].

Looking ahead, this year has already seen the agreement of Level 1 of MiFID II and the beginning of ESMA's consultation on regulatory technical standards at Level 2. These will enhance the transparency of execution quality and some of the payment mechanisms that we encountered during this work. They will also represent 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 and to ensure that they can continue to act in their clients' best interests.

Implications of this report for firms

Many firms in our review explained to us that best execution is simple – a commercial imperative expected by clients and automatically delivered to them. However, our findings suggest that not enough is being done by firms to ensure best execution is being consistently delivered to clients, including taking into account the impact of changing market structure and the emergence of new products.

In addition, the way that execution services are paid for, particularly when the payment comes from third-parties, must be in clients' best interests and be sufficiently transparent that it upholds the integrity of our markets. In particular, we do not believe that PFOF is compatible with transparent and efficient markets or is in clients' best interests.

3 Investment Management Association (IMA), Annual Report (2013), http://www.investmentfunds.org.uk/research/ima-annual-industry-survey/

4 Based on 1 basis point applied to UK AUM and using estimated UK trading equity portfolio turnover of 60% (for a round-trip trading value of 120%). Sources: Fitz Partners (March 2014), http://www.investmenteurope.net/investment-europe/news/2336669/fitz-partners-identifies-turnover-costs-in-uk-domiciled-portfolios and long run US data from ICI (1980-2012), http://www.ici.org/pdf/2013_factbook.pdf

5 Returns estimated at 5.5% based on Barclays Capital Equity Gilt Study (2014) as an indicative return, recognising that past performance is not a guarantee of future returns.

6 Public sources include: Russell Investments, http://www.russell.com/documents/institutional-investors/research/the-managed-implementation-advantage.pdf and Instinet http://www.ftseglobalmarkets.com/issues/issue-40-the-2010-global-trading-handbook/competition-delivers-benefits-but-to-whom.html.

Our findings have also led us to include best execution and PFOF as two of the potential competition issues which we may study in more detail, following our recent call for inputs[7], as part of a competition review of the wholesale sector announced in our Business Plan for 2014/15.

This work builds on other failures to provide best execution that we have investigated in the last year, including two examples of enforcement action and a thematic report on transitions management, which highlight the continuing importance of this issue and its broad relevance. Given our previous experience of the way in which CfD providers understand and deliver best execution, we have specifically addressed our experience of this sector in Section (i) of Chapter 3 of our findings.

Our regulatory requirements

The meaning of best execution

The overarching best execution obligation requires firms to take all reasonable steps to obtain the best possible result, taking into account a range of execution factors, when executing client orders or placing orders with (or transmitting orders to) other entities to execute. Since the introduction of MiFID, our rules have required firms to assess best execution by taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. In doing this:

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

- Firms must monitor the effectiveness of their arrangements and execution policy, as well as be able to demonstrate to clients that they have acted in accordance with that policy.

- Firms' senior management also need to use the results of their robust monitoring and substantive review of their execution arrangements, including taking corrective action where required, to enable them to demonstrate to clients that they are delivering best execution on a consistent basis.

The rules on the application of best execution are not prescriptive in many areas. This means that firms need to exercise their judgement in the best interests of their clients, given their differing needs and requirements. The regime recognises that the best execution obligation requires firms to 'take reasonable steps' to achieve the best possible result on a consistent basis rather than in every case. In addition, except where specified by the relevant regulatory provisions, firms have a degree of discretion in how to apply the different execution factors and this may result in a range of different permissible approaches to executing client orders[8]. Firms are responsible for:

- Whether best execution is owed in a particular situation: we address our findings on the scope of best execution in Section (i) of Chapter 3.

7 Wholesale sector competition review – Call for inputs (July 2014)
8 For example, on the role of Price in COBS 11.2.7R –COBS 11.2.9G

- How to gain assurance and demonstrate to clients that 'reasonable steps' have been taken to achieve the best possible result on a consistent basis: we address our findings on monitoring in Section (ii) of Chapter 3.

- How and where to execute a client order: our findings on internalisation and intra-group reliance in Section (iii) of Chapter 3 address this point.

- How to identify any deficiencies and whether changes to execution arrangements and policies need to be made in future: we assess the levels of accountability for the execution of client orders in Section (iv) of Chapter 3.

Consequently, where we have identified failings, they are in relation to the steps that firms have taken to obtain best execution on a consistent basis, rather than for individual transactions. Overall, very few firms could provide evidence that the steps they were taking were sufficiently rigorous to consistently obtain the best possible result for their clients.

Assessing the different execution factors

Best execution is broader than 'best price' and this is a major difference between European markets and those in other jurisdictions such as the United States. Most obviously, the best price may not offer the best result for a client if it comes with high costs and we discuss this further below. Our rules do not specify a weighting for the factors (except in relation to retail clients) and all factors are therefore important to firms' ability to assess best execution. Firms are required to take into account several criteria to determine the relative importance of the execution factors:

- the characteristics of the client, including the categorisation of the client as retail or professional;

- the characteristics of the client order;

- the characteristics of the financial instruments that are the subject of that order; and

- the characteristics of the execution venues to which that order can be directed.

Firms therefore need to equip themselves to apply the execution factors in light of these criteria. In addition, our rules have a broad scope and do not allow firms to exempt particular products or activities from best execution requirements or permit clients to waive the application of best execution.

Minimising client costs

Cost is one of the execution factors and the duty of agents to control the costs incurred on behalf of their clients is integral to best execution for both retail and professional clients.

For professional clients cost is simply one of the execution factors. However, for retail clients it is, along with price, part of the assessment of 'total consideration', which takes precedence over all other factors.

There are three broad categories of cost, all of which are relevant to both professional and retail clients:

- implicit cost control, meaning minimising the market impact of order execution;

- explicit external costs (e.g. exchange or clearing fees); and

- explicit internal costs, which represent the firm's own remuneration through its commission or spread.

The relevance of implicit costs for all clients

Implicit costs arise from the execution of all client orders. Firms should measure implicit costs as part of their arrangements to monitor execution performance and review the execution quality of entities or execution venues.

Implicit costs result from how a trade is executed (for example, immediately or worked over a period of time, in a block, aggregated with other trades, or as child orders sent to multiple different execution venues). A trade may appear more expensive in terms of explicit costs but may be less expensive when implicit costs are considered. For example, a firm that works a large order over time, preserving the client's confidentiality and minimising market impact, may achieve the lowest total costs (and the best net price). Unlike explicit costs, the impact of implicit costs can only be precisely assessed after a trade is completed and even then, implicit costs are difficult to quantify. As a result, ahead of a trade, a judgement needs to be made by firms about the likely implicit costs of an execution strategy and firms are required to take all reasonable steps to manage them.

In addition to the requirement to control execution costs for all clients, our rules also require that firms do not discriminate unfairly between execution venues in the way in which they structure or charge their commissions. This means that a firm cannot charge a different commission or spread to clients for execution on different execution venues which is not related identifiable differences in the explicit costs incurred on behalf of clients.

Explicit cost control for retail clients

The three categories of cost identified above are relevant to both professional and retail clients. However, cost control for retail clients involves additional requirements. Specifically, best execution for retail client orders is assessed on the basis of 'total consideration' which is the sum of the price and the costs incurred by clients. For this purpose, the best execution regime separately identifies the explicit external and internal costs of execution for retail client orders. This is to enable firms, and their retail clients, to differentiate between different sources of cost. These are:

- **Explicit external costs** which include commissions, fees, taxes, exchange fees, clearing and settlement costs, or any other costs passed on to the client by intermediaries participating in the transaction. Explicit external costs are clearly subject to the best execution obligation.

- **Explicit internal costs** represent an investment firm's own remuneration (including a commission or spread) for completing a transaction. These internal commissions and costs for executing an order must be taken into account in assessing where to execute the order, where there is more than one competing venue available. Thereafter, when judging whether best execution has been given on an individual transaction, firms can omit their own fees and charges from the assessment.

The best execution obligation is not intended to require a firm to compare the results that would be achieved for its clients on the basis of its own commissions and fees with those of another firm's retail commissions or fees, which may be structured differently or which may relate to differences in the nature of the services provided to clients. This means that a firm need not reduce its commission to the lowest level in the market in order to deliver best execution when dealing with retail clients.

There are particular implications for explicit cost control in certain markets. For example, when looking at OTC markets, where firms make their profits through the difference in price between the bid and offer (the spread), these spreads can be treated as internal costs (rather than price) because one firm is not obliged by the rules to offer a fee or commission to a retail client which is as competitive as another. However, in order for a spread to be considered an internal cost, it needs to be known and agreed in advance with the client and clearly differentiated from price. This could be achieved by agreeing a spread limit for each financial instrument. This differentiation will ensure that the retail client is clear which aspects of their order are subject to best execution and which relate to a firm's own costs and charges. We further discuss the related issue of price benchmarking methodologies below.

In summary, firms executing professional and retail client orders need to monitor and control both their implicit and explicit costs.

The use of benchmarks to facilitate explicit cost control

In order to minimise explicit costs incurred on behalf of clients it is necessary to differentiate them from the price of an instrument. This gives rise to two separate but linked issues related to the use of price benchmarks:

- MiFID removed an explicit minimum price standard for best execution. This was because the market was increasingly characterised by competition between execution venues and a single-venue benchmark (for example the LSE Stock Exchange Electronic Trading Service or 'SETS' benchmark or 'yellow strip price') provided insufficient incentive to obtain best execution to clients by seeking better prices or lower trading costs which improved performance beyond the level of the benchmark.

- Nevertheless, while the best execution regime does not include a 'safe harbour' or minimum price benchmark to define best execution, price benchmarks can be useful in monitoring best execution and importantly in dealer markets they can be crucial to demonstrating transparent control of explicit internal costs (the firm's own commission or spread).

As an example of how to meet our requirements on cost control, we have previously described a benchmark execution model for use in quote-driven markets.[9] This model allows firms to demonstrate that they are taking reasonable steps to get the best possible price for a client based on publically verifiable pricing data or assumptions. Firms can then add a transparent mark-up of their own internal costs and commissions to that price in order to clearly demonstrate to the client the difference between the instrument price (and any external costs incurred) and the internal cost resulting from the firm's own fees and charges.

Implementation and supervisory engagement

Best execution is a key element of MiFID. The FSA considered the MiFID best execution regime in three principal publications and the majority of the requirements were transposed into UK domestic law in Chapter 11.2 of COBS. Alongside a final Policy Statement on best execution, the FSA included guidance published by the Committee of European Securities Regulators ('CESR,' now European Securities and Markets Authority or 'ESMA') and an opinion by the European Commission on the scope of best execution.[10] These documents (collectively 'relevant

9 This model is discussed extensively in Chapter 3 of DP06/3 'Implementing MiFID's best execution requirements' and in a report on Options for Providing Best Execution commissioned by the FSA from IBM Global Business Services

10 CESR: Best Execution under MiFID Questions and Answers (May 2007) CESR/07-320, incorporating Commission Opinion on the scope of best execution ESC-07-2007; both incorporated by the FSA in PS 07/15 Best execution

materials') continue to provide crucial interpretative guidance on the FCA's approach to the supervision of best execution and are discussed in further detail in Chapter 4.

Moreover, in 2009, the FSA included best execution as a key issue and supervisory priority, as part of a post-implementation review of MiFID. Many of the issues the FSA identified in 2009 remain relevant to the findings of this thematic review and clearly point to firms having not sufficiently engaged with some key areas of MiFID implementation, despite the availability of wide–ranging and consistently articulated policy requirements. More recently, the FCA has published several communications which address best execution, including an issue of Market Watch,[11] which highlighted some of the initial findings of this thematic work.

11 Market Watch No. 45 (February 2014) http://www.fca.org.uk/static/documents/newsletters/market-watch-45.pdf

3.
Supervisory findings and conclusions

i. The scope of best execution

There was a poor level of understanding of which activities are covered by the obligation to provide best execution, particularly in quote-driven markets. Frequent attempts were made by firms to limit the scope of the obligation in their dealings with clients, often through the use of general 'carve-outs' which are not permissible or through continued reliance on out-dated market conventions.

- **Firms need to take action to ensure that they are correctly assessing whether their clients are relying on them to deliver best execution on a consistent basis. Firms must apply a four-fold cumulative test when making this determination and need to apply the full range of relevant materials in reaching their judgements.**
- **An accurate understanding of the scope of best execution underpins our requirements and is crucial to minimising the risk that clients will not consistently be given best execution.**

Introduction and summary findings on the scope of the best execution obligation

Our rules and other relevant material on the scope of the best execution dictate under which circumstances and market models, and to which categories of clients, best execution applies. It is central to best execution that firms appropriately interpret and apply the scope of their obligations to clients. Following this introduction we present our detailed findings on the following issues:

- firms' understanding of scope;
- broad and non-permissible carve-outs;
- specific sub-sector risks: CfD providers;
- market evolution: client specific instructions and algorithmic trading; and
- disclosure to clients.

General requirements on the scope of best execution

Best execution must be provided to retail and professional clients across all relevant asset classes. The exact scope of the obligation depends on a wide range of considerations which firms need to assess and we explore some of these in detail below. However, the starting position for all market models is that best execution should apply to all firms which owe contractual or agency obligations to their clients.[12]

Application to quote-driven markets

One of the key areas of risk we identified in firms' understanding of the scope of best execution was in its application to quote-driven (or dealer) markets. This is because we found that many firms are seeking to limit the application of best execution in all situations where a client has accepted a quote.

The key concept in quote-driven markets is whether the firm is acting 'on behalf of the client' when executing its order. This focuses on the economic reality of the relationship between the firm and the client and, specifically, whether the client 'legitimately relies' on the firm to protect their interests in relation to pricing and other important elements of the transaction. 'Legitimate reliance' is driven by reference to the categorisation of the client and to other characteristics of the transaction. The starting point for firms is that:

- **retail clients** do legitimately rely on the firm to protect their interests in relation to the pricing and other parameters of a transaction (with the intention that best execution is always provided to retail clients); but
- **for professional clients** this starting point is reversed. The assumption is that they do not rely on firms to achieve best execution. However, in order to reach this conclusion, we expect firms to apply a four-fold cumulative test, published by the European Commission,[13] (further details of which are set out in Chapter 4) which addresses:
  - which party initiates the transaction;
  - questions of market practice and the existence of a convention to 'shop around';
  - the relative levels of price transparency within a market; and
  - the information provided by the firm and any agreement reached.

Application to dealing on own account

A further key area of risk that we identified in firms' understanding of scope of best execution is when firms deal on their own account with clients. For most retail transactions, firms accept orders from their clients and execute them with third-parties (regulated markets, MTFs and other counterparties) and are accordingly 'acting on behalf of clients'. However, where firms act as the counterparty to client orders, they may still be 'acting on behalf of their clients'. For example, best execution would not be owed by a market maker which displayed quotes that were then accepted by a client, provided that the client was not legitimately relying on the firm to protect his or her interests in relation to the pricing and other elements of the transaction, (bearing in mind the starting point that retail clients would be legitimately relying on the firm). In other situations, executing a client order against a firm's proprietary position (including a systematic internaliser), where the firm is making decisions on how the order is executed (ie. is working the order on the client's behalf) or executing a client order by dealing as a riskless

12 COBS 11.2.2G

13 PS07/15: Best execution – Financial Services Authority

principal on behalf of the client, including cases where the client is charged a spread on the transaction, will always be cases where best execution applies.

There is a wide range of relevant materials which collectively provide interpretative guidance on our rules and requirements on best execution. Many of the key points in the relevant materials address in detail the scope of the best execution obligation. However, we found that the majority of firms are still not taking account of these relevant materials; are doing so selectively or are including them in disclosures but not clearly implementing appropriate business practices which give them effect. It is essential that firms understand our rules on the scope of best execution and are using all the relevant materials which can help them to assess which of their activities are caught by the best execution obligation. We set out a summary of the guidance, with our findings on its current usage and its relevance, in Chapter 4.

Relevance of client categorisation

Given the relevance of client categorisation to determining whether clients are relying on a firm to give them best execution, it is important that firms' processes accurately reflect client categorisation requirements on an ongoing basis. We saw some firms that operated robust processes for regularly reviewing client categorisation and which could provide examples of clients that had been re-categorised at the firm's own initiative. However, even these firms with robust processes did not consistently demonstrate that the client's category actually drove an assessment of whether the client was relying on the firm to deliver best execution.

Our detailed findings on firms' understanding of scope

Overall, we found that firms had a limited awareness of the scope of best execution and could not demonstrate how their assessment of clients' reliance on them as agents was embedded within their business practices or influenced their judgements. Moreover, the failings that we identified when we reported the findings of thematic work undertaken in 2009 have not been addressed to any significant degree.

Understanding of scope

Poor practice	All firms were unable to demonstrate to us that their front-office staff had a consistent understanding of the scope of best execution in relation to different categories of client, market models or instruments and that staff were supported by robust controls which could demonstrate when clients were relying on their agents to deliver best execution. One firm was not clear on the scope of the instruments to which best execution applied and its annual review had concluded that fixed income was generally out of scope of the best execution rule. Another firm had limited its monitoring arrangements in the belief that its futures and options business was outside the scope of best execution.

These examples showed a poor understanding of the scope of best execution, which applies to all relevant asset classes, including fixed income.

Use of client categorisation

Poor practice	Some firms did not adequately differentiate between different categories of clients when executing orders.

This overlooks the fact that the rules require a different standard of best execution (i.e. based on 'total consideration' or the sum of instrument price and costs as discussed in Chapter 2) for retail versus professional clients but it also undermines the crucial differences in the extent of reliance placed on an agent to deliver best execution.

Dealing on quotes

Poor practice	Some firms maintained order execution policies which described their approach to clients dealing on quotes so inconsistently that it was impossible to determine how the firm behaved in practice. Several firms described within their order execution policies a total exclusion from best execution for clients who chose to deal on a quote.

These blanket exclusions often ignored client categorisation or other relevant aspects of the transaction which were crucial to determining whether a client was legitimately relying on a firm and therefore whether best execution applied.

Poor practice	One firm stated that when it provided quotes or negotiated a price with a client on request they would not be deemed to be executing a client order subject to best execution irrespective of which party initiated the transaction.

This does not reflect the four-fold cumulative test for determining the scope of best execution, set out in Chapter 4.

Poor practice	Similarly, another firm described its obligations when acting on behalf of a client, including when it dealt directly with the client as principal, in line with relevant rules and guidance. However these firms still wrongly excluded best execution from all dealing on quotes without taking account of the four-fold cumulative test for determining legitimate reliance.

Understanding and expression of 'legitimate reliance'

Poor practice	Some firms included a brief explanation of 'legitimate reliance' in their execution policies but it was unclear how, if at all, this four-fold cumulative test informed their business practices. One firm clearly understood the four-fold cumulative test for legitimate reliance for retail and professional clients. However, this firm chose not to apply it by including a blanket exclusion to best execution in its arrangements which stipulated that no request for quote could result in a client order to which best execution would apply. Another firm said that no client order would arise if it did not have a reason to believe that the client was placing reliance on the firm (including where it acted as principal or was providing a quote) in which case the onus was on the client to be comfortable with the dealing terms offered.

This approach did not explain how the firm assessed legitimate reliance and wrongly suggested that the client, rather than the firm itself, was responsible for the assessment.

The impact of market convention

Poor practice	Some firms relied on the existence of market conventions that clients will 'shop around' before dealing on quotes.

Whilst this is a relevant consideration reflected in guidance, firms did not always adequately assess the other relevant factors, such as the client categorisation or the specific characteristics of an instrument or order. Considerations by the firm of all of the relevant factors should form the starting point for determining whether professional clients are in fact relying on the firm to deliver best execution.

Inter-dealer brokers

Poor practice	The inter-dealer brokers in our sample often correctly noted that most of their activities lay outside the scope of best execution because the regulated activity that they undertook in the majority of cases was 'arranging deals in investments' rather than 'executing client orders'. However, these firms did not have robust business practices and supporting controls in place to deliver and monitor best execution in relation to those areas of their activities where best execution was owed because they were executing client orders.

Our detailed finding on broad and non-permissible carve-outs

Given the importance of best execution to consumer protection and market integrity, we expect firms to undertake an assessment of whether it applies to all their activities. The scope of best execution is not straightforward because of the number of characteristics of the instrument, client and market that firms need to assess. However, the assessments that firms had carried out were generally poor, with frequent reliance on general carve-outs.

Use of general carve-outs

Poor practice	We found several examples of firms that used a general carve-out from giving best execution to clients when executing client orders against their own books.

Executing a client order against a firm's own account is within scope of the best execution obligation and firms which acted in this way were not meeting our requirements.[14]

As discussed in Chapter 2, (see 'The use of benchmarks to facilitate cost control') the FSA had previously set out its requirements in relation to executions which result from firms taking proprietary positions, which we have described as the benchmark execution model. Although prevalent throughout our sample, this was a particular issue for CfD providers:

Specific sub-sector risks: CfD providers

Prior to the introduction of MiFID, CfD providers were not within the scope of the UK best execution regime. Our current rules are clear that CfDs are MiFID instruments and that clients are owed best execution on the same basis as when trading in the underlying instrument. However, CfDs do present additional risks in relation to best execution, which we explore below.

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Clients' ability to 'shop around' for quotes may be limited if they cannot maintain multiple accounts with different CfD providers. Even where quotes are visible, it is difficult to compare them in markets where prices move rapidly and quote information is not consolidated. This means high levels of sophistication are necessary if a client is to look after its own interests by monitoring a firm's pricing and indicates a market where price transparency is low. Even where price transparency is available, clients must close out contracts with the firm that sold them even if there is a better price elsewhere. Therefore at least half of all trades are effectively 'captive' due to the lack of client choice over where to execute when closing their positions.

One way in which firms are able to deliver on the best execution requirement is by obtaining best execution for the instrument underlying the CfD and by disclosing how they calculate their internal fees and charges.

Dealing with price slippage

Good practice	We saw two examples of firms meeting our requirements by not seeking to benefit from price slippage against a client (i.e. where there is a movement in price to a client's disadvantage between receipt of a client order and its execution). One firm specifically addressed the situation where there is a slippage in prices by acknowledging that there were several factors which may lead to price slippage (for example market data latency, the speed of a client's internet connection or high market volatility). The firm acknowledged that such movements could be in the client's favour or to their disadvantage. The other firm described its practice for working large CfD positions by executing a hedge in the market for the underlying instrument before filling the client at the average price of the full volume of the hedge, but noted that any price improvement during this process would be passed back to the client.

In both cases, the firms were not seeking to benefit from a practice which has been described to us as 'asymmetric price slippage' where a firm passes on adverse price movements to the client while retaining for itself any movement in the client's favour.

Information on reference prices and spreads

Good practice	One firm made available to clients additional information relevant to underlying market infrastructure or liquidity providers used to construct reference prices. Where this data was not available, the firm instead applied a transparent spread to the last actual trade in the underlying financial instrument or sought prices from a market maker with a history of providing two-way prices on a consistent basis in order to manufacture a price. Two firms published maximum spreads for each class of instrument underlying its contracts for difference.

This approach is in line with our requirements that firms should apply a transparent mark-up to an instrument where it has manufactured the price using external benchmarks or similar approaches.

Adequacy of order execution policies

Poor practice	Several firms had inadequate execution policies and one did not provide us with its execution policy at all in response to our information request.

Application of the execution factors

Poor practice	Some firms said that the relative importance of each execution factor was 'high' leaving it impossible to understand how they weighted each factor in practice.

Use of carve-outs

Poor practice	Several firms explained ways in which their best execution obligations were limited. These firms argued that they were responding to requests for quotes or that they dealt with clients as principal and were therefore the clients' only 'execution venue'. However, some of these firms also acknowledged that any trades were non-transferable and had to be closed with the same firm with which they were opened.

These firms sought to rely on the actual execution automatically constituting best execution because they were the 'only execution venue' for bespoke OTC transactions. This ignored our requirements on how to price transactions in OTC markets transparently (based on benchmarks or other publically available pricing data to which a mark-up could then be applied) in order to demonstrate that best execution had been given. In addition, where the firm hedged the client's position in the market for the underlying financial instrument it was not acting as the single execution venue since it could choose a venue or counterparty to execute the hedge. In addition, these firms did not consider the implications of the very high degree of reliance that clients had to place on them (particularly on the pricing of any transaction) as a result of the fact that at least half of all client trades were 'captive'.

Poor practice	Two firms indicated that they could not guarantee that the prices they offered to clients were better than those available elsewhere.

This was potentially misleading because it did not explain what steps a firm was taking to price its instruments (for example by using an external benchmark) and implied that best execution was not being offered to clients.

Our detailed findings on market evolution: client specific instructions and algorithmic trading

Client specific instructions continue to be a significant feature of the way firms execute client orders. The evolution of market structure and products, including the proliferation of venues as well as the growing prevalence of algorithmic trading, means that many orders contain some element of specific instruction. However, we found that firms' procedures frequently did not coherently explain which aspects of an order were subject to specific instruction and which relied on their own discretion as agents. Establishing responsibility for instructions in increasingly complex trading environments requires firms to implement clear and robust controls to ensure that firms remain accountable for exercising their judgement. Firms should not induce clients to instruct them to execute an order in a particular way, by expressly indicating or implicitly suggesting the content of the instruction to the client, when the firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client. This covers situations such as the selection of an algorithm or individual parameters of an algorithm.

Specific instructions

Good practice	Some firms were able to point to clear processes which recorded the scope of their clients' instructions or embedded them into execution arrangements. These included systems that recorded clients' venue preferences for all their orders and/or processes which left a clear audit trail of a client's wishes when they requested that the parameters of an algorithm should be customised by the firm. Although several firms quoted from the rule requiring that they would apply their judgement (and take reasonable steps to obtain best execution) outside the scope of any client instructions, one firm clarified that it would always seek to use its judgement to obtain the best possible result rather than seeking to rely on the protection of client instructions. One firm said that it considered any client order that it executed (or which it transmitted to another entity for execution) to contain an implicit instruction that the client legitimately relied on the firm when it exercised its judgement over how to handle the order.

Accordingly, it was clear to clients where they were relying on the firm to deliver best execution.

Good practice	Another clarified in its disclosure the circumstances in which it believed best execution would not apply to client orders but said that there were circumstances in which it might agree to extend best execution beyond the scope of the regulatory requirement, subject to agreement with a client before the transaction took place.

Poor practice	In contrast, some firms carved-out best execution altogether from any order which contained an element of specific instruction.

This resulted in those aspects of the order not covered by that instruction also being incorrectly disregarded for the purposes of best execution.

Poor practice	One firm said that client orders resulting from the client's choice of algorithm (and any individual parameters of that algorithm specified by the client) would be viewed as having met the firm's best execution obligation.

This meant that the firm was wrongly excluding all algorithmic execution from best execution, despite the firm exercising its own judgement as part of its order routing logic, where the best execution rules clearly apply.

Poor practice	One firm admitted that most orders it received contained an element of client specific instruction but was unable to explain how it handled those aspects of an order which were not covered by instructions. One firm wrongly believed it could contract out of offering best execution altogether.

Our detailed findings on disclosure to clients

Firms are under an obligation to provide appropriate information on their order execution policy to clients so that clients can be informed how firms intend to achieve best execution. We found that client disclosures were often high-level and formulaic documents which do not provide appropriate information to clients or allow them to make informed decisions.

Adequacy of order execution policies

Good practice	One firm had fully considered the level of information required by its retail clients and had developed a clear 'question and answer' format to make its execution policy easier to understand. This document had been developed following consumer testing to ensure that it was meeting client needs. One firm clearly disclosed how its order routing system executed orders on the basis of a ranking of the execution factors.

The ranking of factors is an important part of the best execution obligation and the clear disclosure set out in the firm's execution policy helped clients understand how their orders would be executed.

Poor practice	Several firms simply copied out the relevant rules, particularly on the application of the execution factors, without indicating how they would be applied in practice.

Degree of differentiation

Poor practice	Most firms failed to adequately differentiate their execution policies at the level of different asset classes. Where there was adequate differentiation between asset classes, we sometimes found policy inconsistencies between different desks which were not justified by the different asset classes involved, (for instance there were blanket exemptions from the scope of best execution applied by some desks but not by others, leaving the firm's overall approach unclear. We also observed inconsistencies between the approaches described in desk policies and the way that staff put policies into practice.

Conclusions

A significant number of firms had a poor understanding of the scope of the best execution requirements and how that applied to their activities.

All firms should therefore take immediate action to fully review their arrangements and policies to ensure scope is comprehensively understood and embedded within their business practices and supporting controls. This review needs to consider all relevant materials to ensure firms' arrangements are consistent with our requirements regarding the application of their best execution obligations, including when dealing on quotes, dealing on own account and acting on client specific instructions. In particular, we expect firms to apply the four-fold cumulative test set out by the European Commission to determine whether best execution applies in any particular circumstance. We expect the assessments that firms are making regarding the scope of best execution to be clearly and consistently communicated to clients.

ii. Monitoring of best execution

Most firms lacked effective monitoring capability to identify best execution failures or poor client outcomes. Monitoring often did not cover all relevant asset classes, reflect all of the execution factors which firms are required to assess or include adequate samples of transactions. In addition, it was often unclear how monitoring was captured in management information and used to inform action to correct any deficiencies observed by firms. Many firms were too reliant on clients monitoring their own execution quality.

- **Firms must take action to ensure that their monitoring is helping to deliver best execution for clients on a consistent basis and that it equips them to improve their performance where the results of monitoring show this is necessary.**
- **Adequate monitoring and prompt corrective action where required underpins our requirements and is crucial to minimising the risk that clients will not consistently be given best execution.**

Introduction and summary findings on monitoring of best execution

The obligation on firms to monitor best execution has several different components and needs to address all the execution factors. For example, pre-trade monitoring helps firms to select the right execution venues and post-trade monitoring enables them to evaluate the performance actually achieved for clients. Monitoring enables firms to demonstrate to themselves, to clients and to us that best execution has consistently been achieved. It also enables firms to take corrective action where necessary. Following this introduction we present our detailed findings on the following issues:

- front-office monitoring;
- the use of transaction cost analysis to communicate with clients;
- venue or third-party broker selection;
- challenge provided by the second line of defence;
- the scope and scale of monitoring; and
- the use of price benchmarks and setting tolerances for exception reporting.

Overall, we found most firms lacked effective monitoring and were unable to demonstrate that their monitoring arrangements were capable of, or indeed ever had, identified best execution failures or poor client outcomes. Moreover, firms could rarely point to changes being made to their execution arrangements to address issues identified through their monitoring. We also found that monitoring activities were often undertaken in silos, with firms not being able to effectively explain how different checks and processes related to one another or supported management oversight and governance to help drive consistent delivery of best execution. In addition, most firms lacked effective independent challenge to the front-office, or had implemented only a formalised 'tick-box' process, which added little value to delivering best execution. The second line of defence generally played a limited or non-existent role in challenging the conclusions reached by front-office monitoring. Monitoring was largely confined to the cash equities markets, where price transparency is higher, and focused on price to the exclusion of other execution factors.

Our detailed findings on front-office monitoring

Front-office monitoring generally comprised real-time, end-of-day and periodic reporting. Real-time monitoring was widely used by firms at front-office desk level, often based on alerts, limits or specific rules (for example, a price register) to identify and remediate situations where firms were not meeting client requirements and delivering best execution.

Many firms were clearly monitoring their client executions as they were being worked. However, this monitoring (and any remedial action required on a real-time basis) was in the hands of executing brokers and their immediate line management. We observed little in the way of supervisory oversight which resulted in the escalation of issues through the use of appropriate management information. This limited the ability of firms to take broader corrective action where comparable issues that required client remediation were identified. Firms could not therefore demonstrate to us that they applied the lessons learned in individual cases to the full scope of their activities. End-of-day and periodic reporting was also not generally well developed across the firms we visited, particularly in terms of quality and frequency.

Real-time monitoring

Good practice	In a limited number of firms we saw evidence of highly sophisticated real-time monitoring and intervention in the operation of algorithmic trading by altering order execution parameters to achieve best execution.
Poor practice	In most firms, the impact of real-time monitoring was not well evidenced through management information and it was difficult to see how this effectively supported the delivery of best execution. Even where management information did exist, firms were also generally unable to demonstrate the escalation of best execution issues arising from real-time monitoring or how these may have improved execution quality for clients. This was true of firms that we visited as well as those that we reviewed via desk-based analysis.

End-of-day and periodic monitoring

Good practice	In a few firms, there was evidence of sophisticated technology being deployed to support the firm's end-of-day and periodic monitoring programme, particularly on the electronic/low touch equities businesses. These solutions were developed in-house, as well as by independent third-parties, and could be scaled to meet the needs of different business models. Firms also generally recognised that front-office monitoring is an area where additional investment is required and we found that in the majority of cases this additional investment was necessary.

Our detailed findings on Transaction Cost Analysis ('TCA') to communicate with clients

Most firms generally provided some form of TCA to clients but this was usually only provided to clients upon request rather than as a matter of course and such requests were infrequent. The content of the analysis also varied widely across firms.

The provision of TCA was often separate from the firm's internal monitoring processes, with the result that individual client queries did not serve to inform or improve overall execution quality at firms. It was often confined to verifying whether the firm's own processes had been applied to an order, regardless of whether those processes were adequate for demonstrating whether or not best execution had actually been achieved.

From our discussions with some firms, it also appeared that they were relying on their buy-side clients to conduct sophisticated TCA in order to detect issues with execution quality, as well as operating on the basis of clients switching to a competitor if they were not satisfied best execution was being consistently delivered to them.

This reliance on client scrutiny was underpinned by the frequent assertion by firms that best execution was a commercial imperative, without which clients would switch their business to competitors. We observed a consistent reliance on the assumption that some clients were undertaking their own monitoring. Firms believed that these clients were sufficiently informed and expert to enable them to hold their agents to account as well as to discharge their agency duties to their own underlying clients.

These assumptions about client scrutiny was supported by evidence that sophisticated clients sometimes detected issues before the firm executing their order and that firms rectified these issues on an ad-hoc basis when they were challenged to do so. We found that potential detriment from best execution failures was therefore likely to fall disproportionately on less sophisticated clients most in need of protection because these clients would be the least likely to identify cases in which best execution had not been delivered.

In addition, firms used the low numbers of complaints to support the assumption that best execution was being delivered on a consistent basis. However, we were unable to determine whether the relative scarcity of client complaints arose as a result of the fundamental information asymmetry and the complexity of judging best execution or because firms were meeting their obligations on a consistent basis. In addition, where executing brokers were able to correct issues identified by sophisticated clients on an intra-day basis these issues were never escalated to become complaints. For both these reasons we determined that firms cannot conclude that low levels of complaints mean that best execution is being consistently provided.

Our detailed findings on execution venue and third-party broker selection

Execution venue and counterparty selection

Given the critical role that firms' choice of execution venues plays in the delivery of best execution, it is essential that firms put in place monitoring which permits them to assess whether venues are continuing to enable them to consistently meet their best execution obligations. We found that some firms were undertaking monitoring and analysis to support their selection of particular execution venues. However, many others continued to rely on single execution venues or on their current venue selection without any evidence to justify the decision or to evaluate whether market conditions were changing. This was also true of firms which executed their client orders with a panel of liquidity providers. While most firms did not meet our requirements, a minority did show what was possible.

Venue monitoring

Good practice	We found some good examples of firms developing well thought-out venue monitoring, which was linked to client needs and requirements. Some firms' monitoring included liquidity, toxicity and reversion analysis and those firms were able to demonstrate how this material was used to set execution venue strategy. Another firm had a scoring system for monitoring their liquidity providers and had a thorough on-boarding process for potential counterparties based on assessment against objective criteria e.g. market share, tenure and breadth of market coverage.

Third-party broker selection

Our findings were less positive in relation to third-party broker monitoring, where some firms were unable to show a consistent scrutiny of their brokers which would enable them to assess whether these third-parties consistently obtained best execution. In particular, firms were not routinely able to evidence a high level of execution quality for orders placed with or transmitted to a third-party. We do not expect firms to duplicate the monitoring efforts made by the third-parties that they use to execute client orders. However, a firm cannot continue to rely on a third-party to obtain best execution if its monitoring or review indicates that the entity is not, in fact, enabling it to obtain the best possible result for the execution of its client orders.

Poor practice	One firm transmitted orders in certain instruments to a third-party for execution and for one such order the firm's client missed best execution because the full volume was executed at market open, significantly affecting the price that the client received, without the client having given any instruction to execute at that time.

On investigation, the firm was unable to articulate who, through the multiple parties within the execution chain, was responsible for the quality of the execution. This brought into question the overall effectiveness of the firm's third-party broker monitoring.

Poor practice	One firm had selected a Direct Market Access ('DMA') provider without following any formal tender process or evaluating the ability of this provider to obtain best execution. Another firm had not been monitoring the performance of its DMA provider. One firm could not provide us (or indeed its clients) with a list of the third-party brokers that it used for execution.

Our detailed findings on challenge provided by the second line of defence

We found that most firms relied too much on front-office monitoring and were not able to demonstrate robust challenge or appropriate capability to assess the data in the second line of defence. Staff in the second line of defence often admitted to a limited understanding of best execution.

Responsibility for best execution monitoring

We expect ownership of best execution monitoring to reside with the front-office. However, the second line of defence should be adequately equipped to challenge the conclusions reached by execution desks in order to mitigate the potential for conflicts of interest that may result from front-office staff providing the sole scrutiny of their own performance. Effective second line of defence monitoring and challenge therefore helps support firms' delivery of best execution and the second line of defence can contribute to the overall responsibility of management to consistently deliver best execution.

Poor practice	One firm did not feel that compliance had any role to play as they lacked the relevant expertise and therefore no second line of defence monitoring, challenge or validation was taking place.

Effective challenge

Where monitoring did take place in the second line, challenge around possible best execution failures was weak. It was often limited to confirming compliance with the appropriate internal process, rather than challenging whether best execution had been achieved. It also relied heavily on explanations of performance by the front-office which were often taken at face value. In addition, some compliance monitoring was ineffective due to its sign-off not being independent of front-office. Overall, we found that the second line of defence was not currently providing effective support in ensuring that business practices delivered best execution. Firms need to ensure that the second line of defence can provide effective challenge.

Poor practice	Some firms' second line of defence had never found an instance where the firm had failed to meet best execution.

Our detailed findings on the scope and scale of monitoring

We set out above the common components of firms' monitoring programmes. However, regardless of how monitoring is delivered (and by whom within a firm) it is only of use in assessing whether best execution is being delivered to clients if it covers the whole scope of a firm's activities, has sufficient depth to account for the scale of those activities and does so in a way which supports the delivery of best execution by detecting issues and facilitating corrective action.

Monitoring the full scope of a firm's activities

Monitoring needs to cover all relevant asset classes and needs to reflect differences in market model as well as the characteristics that firms must take into account when considering the application of the best execution factors.

Poor practice	One firm did not conduct any monitoring of execution quality in its futures and options business because it believed that this business was outside the scope of best execution due to the prevalence of client specific instructions.

As we set out in Section 1 of this chapter, this was a significant over-generalisation of the scope of best execution.

Consideration of other execution factors

As we set out in the introduction, best execution is measured by taking account of a broad range of factors which need to be considered in monitoring. However, almost all monitoring that we observed related to the execution price achieved. Overall, we saw limited evidence of monitoring of cost and timeliness of execution, which are integral to any assessment of whether best execution is being delivered.

Liquidity analysis

Good practice	Some firms did conduct liquidity analysis to assist in the selection of venues and assess the likelihood of execution. Others looked at the characteristics of the order flow attracted by different venues to assess whether this flow posed a risk to their clients' best interests (so called 'toxic flow').

Assessing market impact

Good practice	One firm conducted reversion analysis to measure the implicit costs of its order executions and the extent to which the market impact of its order flow moved the price on venues to which it routed its orders.

Appropriate methodologies for monitoring the scale of a firm's activities

We found several firms that were using a very small or inadequate sample size for monitoring in comparison to the scale of the firm's activities. We found that monitoring was not sufficient to indicate that best execution was being provided on a consistent basis where firms relied on small samples. Moreover, the lessons learned from the detection of individual issues from small samples were not consistently applied to the full scope of firms' trading activities.

Poor practice	One firm monitored ten transactions a month (and only two on a particularly high risk platform) despite using electronic systems which could have supported the monitoring of all orders. This firm had even scaled back its monitoring because it had not identified any issues. Another monitored a two week sample per quarter of all its direct electronic executions. Most firms had an entirely disproportionate sample size in comparison to the volume of activity undertaken by their trading operations.

The relevant materials which assist firms to understand our requirements are clear that where monitoring every transaction would be disproportionate then other approaches, such as appropriate methodologies for sampling, may suffice. Because the test of whether to sample every order is one of proportionality it may remain appropriate for all orders which are executed by straight through processing (STP) to be monitored. However, when monitoring of all transactions is not employed because it would be disproportionate to do so then firms cannot not rely on sample sizes which are so small that they could not reasonably be considered 'appropriate methodologies'. Firms should also note that ESMA is currently consulting[15] on a requirement under the recast MiFID directive for firms to publish a summary of their monitoring and that this should be 'based on a representative sample of client orders'. Firms therefore need to ensure that where they use sampling on the grounds of proportionality, their methodologies are appropriate to support the consistent delivery of best execution.

Our detailed findings on the use of price benchmarks and setting tolerances for exception reporting

The output of firms' monitoring was commonly based on the existence of alerts, limits or rules which were often triggered when an execution fell outside a given tolerance from a pre-determined benchmark. We frequently found instances of firms comparing their order execution against inadequate or simplistic benchmarks and data, or using unsuitably wide tolerances, rules and alerts.

Choice of benchmarks

Poor practice	Several firms were unable to explain why they were using particular benchmark in their monitoring programme, why they were thought to be adequate, how they had been developed or when they had last been reviewed. One firm carried out daily monitoring only where there was a fixed nominal price differential of £500 from a benchmark, irrespective of the size of the execution.

This meant that smaller orders could miss the benchmark by a larger margin than large orders before triggering the £500 threshold and being detected.

Monitoring only with reference to the 'yellow strip price' as a benchmark

As we set out in Chapter 2, the best execution regime does not recognise a single price benchmark which provides a 'safe harbour' to firms if their executions meet that benchmark.

When choosing the venues which they use to execute client orders, firms need to assess whether other sources of liquidity may offer clients improved prices and reduced explicit external costs. Firms are then entitled to restrict their use of particular execution venues and are not required, at a transactional level, to review all possible execution venues in search of the best possible result. However, the majority of retail cash equity orders (and a significant percentage of all orders) are able to be executed inside the main market spread. Indeed, the Retail Service Provider ('RSP') market model is predicated on the ability of most retail client orders to do this. Since such clients rely on firms to act in their best interests and would reasonably expect an execution inside the yellow strip, this is not a sufficient benchmark to use. The FSA made this clear even before the introduction of MiFID when it consulted on the removal of the SETS benchmark because it found that a fixed benchmark provides no real incentive for a firm to seek out the best deals for its clients. Reliance on the yellow strip price as a performance benchmark implies that firms still incorrectly view it as a safe harbour that they

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have achieved best execution. Monitoring should equip firms to look at additional potential sources of liquidity and to assess the amount of price improvement that they are able to achieve for clients beyond the yellow strip benchmark.

Poor practice	One firm simply used the main market touch price, or 'yellow strip', to assess their execution quality rather than assessing whole-of-market data or using broader benchmarks to measure best execution.

Choosing the right benchmark and setting tolerances for compliance

The measurement of best execution is a complex and continually evolving subject. Firms, third-party specialist consultants and academic literature all reveal a range of views on the appropriate way to measure best execution. Because of the diversity of potential approaches we have deliberately avoided prescribing specific benchmarks or tolerances and this approach has also been adopted by ESMA in its recent Discussion Paper on MiFID, which includes best execution.[16] However, firms need to ensure that they are reaching informed conclusions regarding how they benchmark their order execution and that whichever approach they adopt is effective in demonstrating whether or not best execution is consistently achieved.

Poor practice	One firm had daily exception reporting on trades missing a benchmark by 300 basis points or more and another assumed that best execution was achieved with tolerance levels for alerts set at ±5 – 7.5% from the volume weighted average price ('VWAP').

The above examples are illustrative of the importance of benchmark selection and tolerance setting. VWAP is not always an appropriate benchmark to use, depending on the characteristics of the order. Where a firm is 'working' a large order over the course of a day VWAP can be an appropriate benchmark and, indeed, some clients specifically request that it be used to measure execution performance. However, it has several inherent limitations and there are other measures available. For example, a firm which is trading heavily in an illiquid instrument can impact the VWAP, resulting in it not be being a valid performance measure because the firm would effectively be setting its own benchmark. Likewise, because VWAP is determined on the basis of trading activity throughout the day, it is possible for a firm to estimate the final VWAP. As a result it can choose to delay a trading decision which is made late in the day, that would be executed outside of the VWAP, until the following day when it has a higher probability of achieving VWAP. In this case the execution price might remain the same but its performance against the benchmark would be improved, with no benefit to the client. Similarly, because it is a measure of performance over a day, it is difficult to achieve either very good or very poor performance against VWAP. As a result, whether clients achieve the VWAP may not be able to determine whether they were given best execution.

Where firms elect to use benchmarks for monitoring, these need to support their ability to give best execution on a consistent basis. Having chosen a benchmark, firms also need to set appropriate tolerances. If wide tolerances are set then even an appropriate benchmark will not be useful in determining whether best execution is being obtained. Nevertheless, we frequently found a lack of understanding and supporting documentation, derived from a current risk assessment, demonstrating why particular benchmarks and sensitivities were thought to be adequate, or whether alternative approaches would yield better results for clients by detecting potential improvements.

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Conclusions

Most firms lacked effective monitoring which was capable of, or indeed ever had, identified best execution failures or poor client outcomes. Moreover, firms could rarely point to changes being made to their execution arrangements to address issues identified through their monitoring. Monitoring should extend to all relevant instruments in which they execute and should be capable of addressing the specific challenges of those instruments with lower price transparency or where electronic trading is less prevalent. Benchmarks, where used, need to be appropriate for the characteristics of the client order and have thresholds that are properly defined. Sample sizes must be adequate to facilitate systematic corrective action if issues are detected. Monitoring must cover all of the execution factors to reflect the full breadth of the best execution obligation, including (but not limited to) the explicit and implicit costs incurred on behalf of clients. Firms cannot simply rely on their clients to monitor the quality of execution.

All firms should therefore take immediate action to fully review their monitoring arrangements to ensure that they have an adequate, effective and embedded monitoring framework with a clear governance structure for escalation and resolution of issues, which underpins the delivery of best execution on a consistent basis. It must be clear how the different components of monitoring contribute to relevant management information and inform the action taken by management to correct any deficiencies observed. The outcomes generated by monitoring should be subject to independent challenge which is adequately resourced with the relevant skills and data needed to deliver best execution. The adequacy of monitoring should be reviewed and assessed as part of the annual review of execution arrangements and policies.

iii. Executing internally or through connected parties

Firms which relied heavily on internalisation or on executing orders through connected parties were often unable to evidence whether this delivered best execution and how they were managing potential conflicts of interest. Firms were also unable to show how they separated explicit external costs incurred on behalf of clients from internal costs or how their commission structures for internalisation avoided discriminating against other venues.

- **The onus is on firms to demonstrate how they are acting in clients' best interests, ensuring that their arrangements comply with our best execution requirements and that they are managing the potential conflicts of interest if they choose to internalise or rely on connected parties.**

- **Effective cost control and transparent venue or counterparty selection underpins our requirements and is crucial to minimising the risk that clients will not consistently be given best execution.**

Introduction and summary findings on firms' internalisation of client orders

When internalising, a firm is accessing only a part of the overall market and may be missing better execution available elsewhere. A firm may also enjoy lower costs, an opportunity to manage its own risk or inventory and other potential benefits which accrue to itself but which may not have a corresponding benefit for clients. These features could result in potential conflicts of interest, as could relying on a connected party for execution. Following this introduction we present our detailed findings on the following issues:

- cost control when internalising client orders; and

- execution through connected parties.

We found that some firms executed significant levels of their equities volume through their own internal matching facilities, without evidencing whether this had delivered best execution. It is therefore important for firms' business practices and supporting controls to adequately consider the risks of internalisation as part of their arrangements and policies for delivering best execution and their conflicts management processes.

Poor practice	One firm excluded its internal matching facility from its monitoring of other third-party execution venues.

This suggested that it did not apply the same standards to itself as it did to other execution venues and that it did not assess whether clients were benefited or disadvantaged by internalisation compared to other execution options. This firm could not therefore demonstrate that it was taking reasonable steps to achieve best execution.

Our detailed findings on cost control when internalising client orders

We found that while some firms said they had mechanisms in place to determine whether the execution price available was the best in the market at the time of execution, they did not have similar controls over the explicit costs faced by clients (for example, exchange fees or clearing and settlement costs).

As we set out in Chapter 2, firms are required to assess and minimise the costs incurred by their clients in executing orders. Internalisation offers three main areas of potential benefit to clients:

- price improvement through spread-capture by executing at (or nearer to) the mid-price than on an external venue;
- cost control through the reduction of explicit external costs (e.g. exchange or clearing fees); and
- implicit cost control by minimising market impact through a reduction in information leakage.

We found that it could not be shown that the benefit of explicit external cost reduction was realised by clients in practice. When executing retail client orders, firms are required to take into account their own commissions and costs in respect of each of the eligible execution venues when assessing which venues to use when executing client orders.[17] This ensures that firms' execution decisions are based on the total costs incurred by clients. However, when assessing whether best execution has been given in relation to individual transactions firms can exclude their own commissions and fees. This is why firms must be able to separate an assessment of external costs related to venue selection from their own internal commissions and fees. When internalising, firms cannot therefore claim that the explicit external costs saved by internalisation (and not passed back to clients) are internal costs which are not subject to the best execution regime.

Non-discrimination when selecting venues and internalising all client orders

Our requirements also require that a firm must not structure or charge its commissions in such a way as to discriminate unfairly between execution venues[18]. For example, if a firm has included a regulated market and a systematic internaliser in its execution policy (or is itself a systematic internaliser) because both those venues enable the firm to obtain on a consistent basis the best possible result for the execution of its client orders, the firm will need to take into account not only the prices displayed by those two venues, but also any difference in fees or commission it charges the client for executing on one venue rather than the other (as well as any other explicit costs or relevant factors).

The implications of this rule and relevant materials for our findings is that where firms directly benefit from reduced execution costs resulting from internalisation (because they charge their clients flat commission rates and do not rebate any costs saved from internalising) then they will be discriminating against other venues.

17 COBS 11.2.10R

18 COBS 11.2.12R

Ignoring the impact of explicit costs

Poor practice	Some firms applied an all-in flat commission structure to all orders, inclusive of agency commissions, as well as ancillary third-party costs. These structures did not pass on to the client any benefit resulting from the reduced explicit costs (for example, exchange fees) from internally executed orders.

In contrast, we did see some firms adopt commission charging structures which could have helped control explicit execution costs incurred by clients, although there was little evidence of their consistent use in practice.

Accounting for explicit costs

Good practice	Some firms applied a cost-plus commission structure which more accurately reflected the explicit execution costs incurred (i.e. itemised exchange, clearing and settlement costs). Another firm went further and applied a separate commission structure for internalised orders which recognised a reduction in explicit external costs such as exchange and clearing fees.

Our detailed findings on execution through connected parties

We found that some firms relied on connected parties for execution of certain order flow but did not manage these relationships in the same way as similar third-party execution relationships they held. Typically, firms did not support their choice of a connected party with the same data and analysis that was applied to third-parties operating at arms' length. There was therefore a risk that use of connected parties to execute client orders was not delivering best execution.

Poor practice	Some firms' operating models were set up so that all client orders received in certain overseas securities were routed to the firm's overseas connected party for execution, without an assessment (either at the time of the relationship was established or on an ongoing basis) as to whether that affiliate was consistently providing the best possible result for clients.

Best execution applies to third-parties operating at arms' length and to connected parties alike. Firms should not place their affiliates in a privileged position by omitting them from best execution monitoring processes or competitive tender. All firms which transmit or place orders with a single entity for execution (whether a connected party or third-party operating at arms' length) need to be sure that their choice is able to deliver best execution at least as well as any alternative.

Client consent to execution outside of a regulated market or MTF

We found that several firms did not have clear processes for confirming that clients had consented to internalisation. Firms were often unclear about our requirements regarding when and in what form consent was required. This gave rise to the risk that clients are not always in a position to evaluate the risks of internalisation or to scrutinise the results achieved, including whether they were benefitting from potential cost savings.

Conclusions

Firms are required to secure express prior consent to the execution of client orders outside a regulated market or Multilateral Trading Facility ('MTF') and must ensure that this is obtained before client orders are internalised. Firms should also give consideration to the management of potential conflicts of interests and ensure that the governance and oversight of these arrangements is adequate. Where a firm's own execution arrangements give rise to the risk of conflicts of interest because of the many potential benefits to the firm of internal crossing of transactions, the firm must be clear how the outcome delivers best execution on a consistent basis and is in clients' best interests. Firms must ensure that when internalising orders they are not structuring their commissions in such a way as to discriminate against external execution venues because firms are retaining the benefit of any reduction in explicit costs (such as venue or clearing fees) which should be returned to the client.

Firms should take action to ensure that where their arrangements include reliance on internalisation or connected parties, these do not undermine the delivery of best execution and that their business practices and management oversight, supported by adequate second line of defence controls, properly address these risks on an ongoing basis.

iv. Accountability for delivering best execution

It was often unclear who had responsibility and ultimate accountability for ensuring that execution arrangements and policies met our requirements. Despite the significant volume of change in European markets since 2007, firms were still conducting only cursory reviews of policy documents which did not address the full scope of their best execution obligations. Moreover, these were largely focused on process rather than delivering client outcomes and often lacked front-office engagement.

- **All firms need to conduct substantive reviews of their arrangements and policies at least annually to ensure that they are capable of delivering best execution on a consistent basis. Reviews need to take account of the results of monitoring and any changes in the market. We expect senior management with responsibility for trading activities to take greater responsibility for ensuring that policies and arrangements remain fit for purpose.**

- **Regular substantive reviews of execution arrangements and polices, with appropriately broad business engagement, underpins our requirements and is crucial to minimising the risk that clients will not consistently be given best execution.**

Introduction and summary findings on accountability

Our findings on accountability for the delivery of best execution are based on two key themes: how clear firms were about the ownership of the responsibility for delivering best execution and what is actually done in practice to review the adequacy of the firm's arrangements in delivering best execution. Following this introduction we present our detailed findings on the following issues:

- ownership of responsibility for delivering best execution; and

- how firms review the adequacy of their arrangements.

Our detailed findings on the ownership of responsibility for delivering best execution

In many cases ownership of the execution arrangements and policies within firms was unclear, with little evidence of substantive review and limited front-office or management involvement. Written documents and staff understanding often conflicted and review of policies was often cursory and process oriented rather than intended to improve the firm's ability to obtain best execution.

A consistent lack of front-office involvement

Contrary to our experience with monitoring, which was delivered primarily in the front-office, these reviews were largely conducted and assessed by the second line of defence and were often disconnected from those responsible for execution of client orders.

The result was that monitoring and review processes which should have been mutually reinforcing were seldom delivered by the same staff or with a common goal. This undermined the ability of these review processes to deliver improvements to execution performance in support of good client outcomes.

Good practice	One firm established clear ownership of the execution policy with business management and a senior manager was responsible for monitoring processes as well as for the annual review of whether policies and arrangements remained adequate.
Poor practice	The ownership of the review process at one firm resided entirely with the compliance function and did not involve the front-office. Several firms were unclear about the ownership of their best execution policies or we saw evidence of ownership which was directly contradictory.

Our detailed findings on how firms review the adequacy of their arrangements

We found some firms that had a well defined and formal review process which drew on relevant expertise from multiple front-office, operations, second line of defence and management roles and resulted in formal actions being taken. Such firms were also able to demonstrate not only a clear audit trail of revisions to arrangements, including documentation and their subsequent approval, but could also highlight actual changes to business practice that had resulted from the review of execution arrangements. However, many more firms were unable to demonstrate that their review of execution arrangements and policies had been undertaken at all or had involved a substantive review.

Firms' arrangements and policies need to support consistent delivery of best execution. Policies must be able to accurately reflect relevant changes to market structure, the entry or exit of market participants or significant changes in technology. All firms are required to review their order execution arrangements and policies at least annually.

Timeliness of review

Poor practice	One firm had no formal record of an annual review having taken place. Another sent us its published best execution policy dated October 2007, which suggested that it had been written as part of MiFID implementation and never subsequently reviewed or updated. Several firms had recently drafted execution policies which appeared to have been prompted by our thematic review and information request. The best execution governance committee of one firm had not met since August 2012 at the time of our information request in October 2013.

Effectiveness of review

Poor practice	One firm's execution policy contained wording clearly written before the introduction of MiFID which did not reflect the current best execution obligation as set out in our rules. One firm had last substantively reviewed its policy in May 2012 and there was little change from the policy's inception in 2007. Some firms also had out of date policies that no longer described actual business practice and could not be explained by relevant staff.

Reviews of performance triggered by a 'material change'

Firms need to review their order execution arrangements and policies when they identify a 'material change' that affects their ability to deliver best execution on a consistent basis. This could include, for example, the merger of two execution venues or a change in the identity of a DMA provider. We asked all firms to indicate to us when a 'material change' had triggered a review of their execution policy or arrangements outside of the regular cycle of required annual reviews. Only one could readily provide examples of when they considered a material change to have occurred. Since it is a regulatory obligation to review policies when a material change has occurred, this implied that most firms did not consider there to have been a material change in European markets or in their execution arrangements since 2007. Because this issue remains important, firms should be aware that ESMA is currently consulting on a range of indicative criteria which constitute a 'material change' as part of implementation of the recast MiFID directive.

Poor practice	Almost all firms indicated that they had not observed such a material change since the introduction of MiFID. In addition, some firms could not articulate what they would consider to constitute a 'material change'.

Conclusions

We found that firms were often unclear about the ownership of responsibility for best execution and the way in which it linked to other conduct risks. Firms were not generally undertaking substantive reviews of their execution arrangements and the policies which described them.

Firms need to establish clear ownership and accountability for delivery of best execution. Furthermore, firms need to ensure that order execution arrangements and policies reflect the diversity of execution arrangements for all relevant asset classes, as well as covering all the execution factors and enabling them to assess these factors in light of the execution criteria. They must also review their arrangements and policies at least annually and when required to reflect relevant changes to their own operations or the external environment.

All firms should therefore take immediate action to ensure that scrutiny involves contributions from front-office as well as second line of defence and should be subject to senior management oversight.

v. Payment for order flow

- **Following publication of FG12/13 we undertook a pilot review of PFOF in 2012, as a result of which some firms ceased to receive commission from market makers in respect of their London International Financial Futures and Options Exchange (LIFFE) business. Following our thematic review information request in October 2013 several other firms confirmed to us that they had stopped receiving PFOF.**
- **However, despite the publication of FG12/13, a small number of market participants in our thematic sample still continued to receive PFOF by changing the description of the service they provided to clients during the course of our thematic work. This recast PFOF arrangement sought to describe their commercial relationships in terms that are not consistent with the economic realities of their activities. This still constitutes a PFOF arrangement and is not compatible with our rules. We are also aware that some other market participants who were not involved in this thematic work were considering adopting this recast PFOF arrangement. We contacted the four firms within our sample that were relying on this argument and they have ceased receiving PFOF. All firms in our thematic sample have now confirmed to us that they are no longer receiving PFOF.**
- **We are keeping this area under active review and will take action against any remaining firms which continue to evade our rules and requirements on PFOF. We will consider all available tools, including enforcement action.**

Introduction and our summary findings on PFOF

PFOF is the practice of an investment firm which executes client orders (the broker) receiving commission both from the client originating the order and also from the counterparty with whom the trade is then executed (the market maker[19]). This practice has historically been common on the LIFFE market, where brokers call around to market makers in order to get quotes that are not displayed on the electronic order book.

The risk of PFOF is that it undermines the transparency and efficiency of the price formation process, which in turn damages market integrity, inhibits competition and causes detriment to consumers. We said in our finalised guidance on PFOF (FG12/13) that these arrangements create a clear conflict of interest between the firm and its clients, are unlikely to be compatible with our inducements rule and risk compromising compliance with best execution rules. Following this introduction we present our detailed findings on the adoption of a recast PFOF arrangement by firms and further details on our policy analysis are set out in Chapter 4.

19 By market maker we mean a person who holds himself out on the financial markets on a continuous basis as being willing to deal on own account by buying and selling financial instruments against his proprietary capital at prices defined by him.

All firms in our sample have confirmed that they are now complying with the relevant Rules, as informed by FG12/13. More widely, previous market soundings highlighted that several other significant participants outside of our thematic sample have ceased charging market makers commission in respect of their LIFFE business. Many did so between November 2012, when we first undertook discovery work on this issue, and October 2013 when we contacted a broader sample of firms with an information request at the beginning of this thematic work. However in answering our information request, some firms stated to us that they had merely instituted 'payment holidays' for commissions received from market makers while they reviewed their terms of business. We therefore found that market practice continued to change in response to both the issuance of industry guidance and also to our ongoing scrutiny during this thematic work. A small number of market participants still continued to receive PFOF by changing the description of the service they provided to clients. All four firms in out sample who admitted to using this 'recast' PFOF arrangement have now stopped accepting PFOF. We describe this recast arrangement below.

Our detailed findings on the adoption of a recast PFOF arrangement by market participants

We encountered one recast PFOF arrangement, in limited use. From our wider market soundings and external regulatory seminars, it appears that other market participants have adopted, or may be preparing to adopt this approach. Conversely, we encountered firms which had considered using the recast arrangement but had declined to do so. The recast arrangement is summarised below:

The recast PFOF arrangement was predicated on an argument that:

- **using the 'call around market' results in the provision of an 'arranging service' and not the execution of client orders.**
- **consequently no 'third-party' payment arises because the broker acts to arrange a transaction between two parties who then contract on terms that they individually agree between themselves. This allowed each party to remunerate the broker independently.**
- **best execution did not apply because there was no 'execution' by the broker. However, the 'arranging service' was offered alongside an 'execution service' which was either provided free of charge or invoiced separately to the originating client.**
- **relevant conflicts of interest were managed by harmonising commission rates paid by all market makers which provide quotes.**

This recast arrangement is not consistent with our requirements under the relevant rules and guidance and a full explanation of this is set out in Chapter 4. We describe our supervisory findings in relation to best execution and legitimate reliance on an agent below:

Poor practice	We found firms' terms of business which stated that when arranging a transaction on LIFFE they were not acting on behalf of any one client.

This contrasted with front-office staff who indicated to us that they acted solely on behalf of the client initiating the order and intended to give that client best execution. This finding supports our conclusion that firms were describing their commercial relationships in terms that are not consistent with the economic realities of their activities.

Poor practice	We found that those market makers which were unwilling to be designated as clients and pay a commission were not approached for quotes by brokers.

As we stated in FG12/13, this risks compromising compliance with best execution rules, as firms are not taking reasonable steps to access sufficient available liquidity to meet their obligation to take reasonable steps to achieve the best possible result on a consistent basis. It is also likely that market makers that pay commissions to brokers will build that cost into the spread they offer, which will negatively impact the original investor. If third-party fees like this are retained by the broker when the benefit could instead accrue to the client in terms of reduced commission, this will also represent a sub-optimal outcome for clients.

Conclusions

As set out in our Guidance, we consider, on the basis of all examples seen by us, that PFOF arrangements create a clear conflict of interest between the clients of the firm, are unlikely to be compatible with our inducements rule and risk compromising compliance with the best execution rules. Our findings indicate that some firms have implemented, or are considering implementing what they describe as an 'arranging service' for both the brokerage clients and the market makers as a 'recast' PFOF arrangement. Consistent with the position expressed in FG12/13, this arrangement still constitutes a PFOF arrangement and is not compatible with our rules. In addition, we observed that there was no change in the economic substance of the service offered by these firms or in staff understanding of that service, notwithstanding the change in the way it was described. We are keeping this area under active review and will take action against any remaining firms which continue to evade our rules and requirements on PFOF. We will consider all available tools including enforcement action.

4.
Policy context

Background and preparing for change

We include this Chapter on the policy context because our review found that many firms do not understand key elements of our requirements and are not embedding them into their business practices. Where appropriate we have restated our key requirements and annexed many of the rules and relevant materials to this paper.

Best execution

The overarching best execution obligation requires firms to take all reasonable steps to obtain the best possible result, taking into account a range of execution factors, when executing client orders or placing orders with (or transmitting orders to) other entities to execute. These factors are price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order. The rules on the application of the best execution are not prescriptive and the open-ended nature of the list indicates the importance of firms being able to exercise their judgement in the best interests of their clients given their differing needs and requirements.

Firms must also comply with more detailed rules relating to arrangements and policies, disclosure, consent, demonstrating compliance and monitoring and review. These rules exist to mitigate many of the risks identified in this paper and to enable firms to prove that they are taking reasonable steps to obtain the best possible result on a consistent basis.

Relevant materials on the scope of best execution

In section (i) of the last chapter we discussed our findings on the scope of best execution and, in particular how firms determined whether they acted on behalf of their clients for the purpose of obtaining best execution. This concept of 'legitimate reliance' was explored in correspondence between the European Commission and CESR in 2007. We agreed with CESR about the relevance of the Commission analysis, which we referred to extensively during MiFID implementation and which we continue to include in our Handbook through a note and link to the full text.

We set out key extracts of this opinion below but firms should consider the implications of the entire document:

Extract from Commission Opinion on the scope of best execution under MiFID and the implementing directive: Working Document ESC-07-2007

4. 'In our view, the key concept to focus on in interpreting Article 21 is the execution of orders *on behalf of clients*. This is consistent with the definition in Article 4(1)(5) of MiFID, which refers specifically to a firm acting to conclude agreements to buy or sell financial instruments *on behalf of clients*, and the description of the relevant investment service in Annex I to MiFID as the 'execution of orders on behalf of clients'. Both provisions support the idea that the requirement that an order is being executed on behalf of a client is integral to the concept of best execution.

…

8. The application or otherwise of best execution 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 and 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**.'

Determining 'legitimate reliance' – applying the Commission's test

The Commission Opinion sets out a list of the four-fold cumulative test to help determine whether a client is legitimately relying on the firm. These are set out in the box below together with our findings on how firms have responded to them:

i. Which party initiates the transaction

We found that firms focused on this consideration. They tended to argue, without assessing any of the other considerations, that best execution did not apply to clients who were dealing on quotes, so were carved-out because the client had initiated the transaction. This approach failed to take into account the Commission's view that the four considerations should be 'taken together'.

ii. Questions of market practice and the existence of a convention to 'shop around'

We found that several firms asserted the existence of a market practice or a convention to 'shop around' but gave little or no weight to circumstances that may prevent clients from doing so. These included investment firms dealing with professional clients in OTC markets but also CfD providers who were entering into 'captive trades' with clients which prevented them from shopping around in order to close their open positions.

iii. The relative levels of price transparency within a market

We saw no evidence of firms considering where price transparency impacted the client's legitimate reliance, despite our review covering OTC instruments and markets where it was common practice to source additional liquidity and tighter pricing away from the electronic order book.

iv. The information provided by the firm and any agreement reached

We found significant emphasis by some firms on attempting to limit or carve-out the provision of best execution through information to clients or terms of business.

One firm indicated clearly in its execution policy and disclosures to clients that it presumed that any retail client would be legitimately relying on the firm to deliver best execution for all transactions, regardless of how they arose. This approach was fully in line with the Commission's conclusion 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.'

In addition to this four-fold cumulative test, the Commission Opinion also provides a number of non-exhaustive considerations that help to determine whether or not a client is legitimately relying on a firm to protect their interests in relation to the transaction and thus, whether or not a firm is acting on behalf of the client. All firms should consider these tests and the examples provided by the Commission when reviewing their own activities.

Other relevant conduct of business rules

Several other conduct of business rules and organisational requirements have a bearing on our thematic work and complement the rules and guidance set out above. For example, there are rules in place to ensure that firms act in clients' best interests, identify and manage conflicts of interest, use dealing commissions only to pay for goods or services directly related to the execution of trades or for substantive research, and do not exclude, restrict or rely on any exclusion or restriction of any duty or liability they may have to a client. This last rule is relevant, for example, to the attempts that we observed by firms to establish by contract limitations to the application of regulatory provisions such as best execution.

Future policy developments

Looking forward, the FCA has been closely engaged in the negotiation and development of future rules on best execution under the recast MiFID directive. Many of these developments will also explicitly address shortcomings identified in this report, including the adequacy of disclosure, monitoring and reviews undertaken by firms. We set out the principal proposed changes below.

Best execution: key execution: key changes under MiFID II, Level 1, Article 27:

- **Firms will be required to take all sufficient steps to achieve the best possible results Article 27(1), rather than all 'reasonable' steps as currently required.**
- **An explicit prohibition of remuneration for executing client orders which is contrary to the rules on inducements or conflicts of interest, addressing some our findings on intra-group reliance and payment for order flow. Article 27(2)**
- **A requirement for all venues to publish data on the execution quality obtained which will assist firms in delivering their monitoring requirements. Article 27(3)**
- **A requirement on all investment firms to publish data on the top five venues where they executed client orders, and information on the quality of execution obtained. This will increase transparency to clients about firms' execution arrangements and increase the quality of monitoring and review that firms undertake. Article 27(6)**
- **New requirements for firms to provide information to clients on the execution of different classes of financial instrument and detail on how they have applied the execution factors which will help clients to scrutinise firms' activities. Article 27(5)**

ESMA is currently consulting on implementing measures for the recast MiFiD Directive and firms should consider the implications of this consultation in light of the findings set out in this report:

- The ESMA Discussion Paper of 22 May 2014 (ESMA/2014/548) sets out new data requirements on trading and execution venues at 2.3 and new order flow and execution quality reporting requirements on investment firms at 2.4 (Q8-44).
- The ESMA Consultation Paper of 22 May 2014 (ESMA/2014/549) addresses a broader range of issues related to monitoring, accountability, disclosure and consent at 2.21 (Question 101-102).

Conclusions

Firms will need to consider the potential challenges of implementing additional requirements which build upon the current rules. Some of these challenges are detailed within ESMA's Consultation on proposals for the implementation of MiFID II. The consultation also outlines several proposals concerning inducements, and firms will also need to carefully consider these.

All firms need to view the risks and issues identified in this report in the context of future regulatory developments. Additional obligations under MiFID II are intended to address some of the specific weaknesses observed during the course of this work, in particular on the adequacy of monitoring. Therefore, firms need to improve their current systems and controls, and position themselves for the implementation of future policy change.

Payment for order flow

In this section, we set out the policy background regarding PFOF, together with our detailed requirements on recent developments. The rule on inducements, in particular, governs the circumstances under which it is permissible for a firm to make or receive payments in connection with the provision of a service. CESR has also provided a range of guidance on the application of the rule on Inducements.

FSA Guidance consultation FG12/13

The FSA investigated PFOF over a period of several years and the findings of this report are supported by the conclusions of that investigation. In 2011 we consulted on whether this practice was compatible with our rules and issued Finalised Guidance in May 2012 (FG12/13).

An activity-based approach to the scope of PFOF

In FG12/13 we adopted an approach to PFOF that was based on the economic substance of the activities undertaken by different market participants. We said that 'It is worth clarifying that where a broker acts as an intermediary to bring together two principals then the broker charges both principals a commission. This is the practice of inter-dealer brokers. These commission payments would not be classified as 'payments for order flow'. Such commission would be a legitimate payment for an investment service provided by the broker and would not therefore be considered to be an inducement. Under these circumstances, neither party relies on the broker or has the expectation that the broker will be acting in their 'best interest'. The broker is merely providing the investment service of bringing two counterparties together.'

Subsequent FSA and FCA engagement with market participants:

Following the publication of FG12/13 we continued to engage informally with market participants, particularly in relation to proposed industry guidance by two trade associations, the Futures and Options Association ('FOA') and the Wholesale Markets Brokers' Association ('WMBA'). These publications were not approved by the FSA or FCA but we addressed two arguments that were presented to us:

- firstly, that when the broker executes its client's order, the broker is simultaneously providing a service to the market maker and the market marker is a client of the broker in respect of that service ('the service argument'); and
- secondly, that the payment by the market maker to the broker is a third-party payment that complies with the FSA rule on inducements and in particular, that it 'is designed to enhance the quality of the service to the client' ('the designed benefit argument').

We rejected both arguments in turn. The service argument was rejected because the list of putative services offered to 'the market maker client' of the broker did not constitute the provision of a designated investment service in respect of which the market maker is a client. Specifically:

- submission of blocks and crosses and allocation related only to the reporting of transactions to the exchange and not the provision of a separate 'service';
- the broker's assumption of counterparty risks which we concluded should be managed by means of counterparty credit limits and the use of a clearing arrangement with a clearing member rather than a fee; and
- research and market commentary which we concluded was valid only insofar as it was a service provided to a genuine client originating an order and not to a counterparty.

We acknowledged that in the context of trade execution there was one situation in which a market maker was a client of a broker – where a market maker instructs a broker to execute on its behalf (the market maker contacts the broker with an order). In such a situation, the broker's task is to find suitable counterparties (i.e. other market makers) in order to execute the client's order and the original market maker is indeed an end user client of a service for which it is legitimate to charge a fee.

The designed benefit argument was rejected because we had made clear in the finalised guidance that no argument had been put forward that explains how the inducement arrangement meets the 'designed to enhance the quality of the service' requirement. A final version of FOA industry guidance was issued in July 2013. Some market participants responded to this final industry guidance by adopting a recast arrangement to PFOF which we describe in our supervisory findings.

Why the recast arrangement does not work

As set out in the previous section, some participants have continued receipt of PFOF by describing their commercial relationships in new terms, while admitting that the substance of those activities remains unchanged.

The Industry guidance issued by the FOA in 2013 and referenced above, included the statement that when considering the nature of any putative relationship or service in terms of business 'it is important that such terms do not characterise a commercial relationship otherwise than in accordance with economic reality.' We believe this is a fundamental principle which underpins our rules, our guidance and the integrity of the markets themselves.

Importantly, the recast arrangement relies on a presumption that a broker is providing a service to a market maker, rather than the reverse. But market makers report that firms do not allow market makers to originate orders themselves. We have previously refuted similar arguments founded on the purported existence of client relationships and the provision of services.

The recast arrangement seeks to establish parallels between brokers executing client orders on a regulated market and the activities of inter-dealer brokers which we described in FG12/13, on the basis that we had indicated that the guidance did not apply to those activities. However, these parallels cannot be sustained or applied to participants acting on a regulated market. Here the broker does not provide an 'arranging service' because the exchange itself (and not the broker) fulfils the role of bringing together market participants. Trades are not executed on terms which are individually agreed by the participants without the involvement of the broker, they are executed under the rules of the exchange.

We do not agree with the view that an execution service can be offered alongside an arranging service in respect of the same transaction. Execution requires 'acting to conclude' a transaction and 'arranging' requires the arranger to step away from a bilateral transaction on terms agreed by the parties. The two services are therefore mutually exclusive and cannot both be offered in respect of the same transaction. The transfer of an economic interest when a service is 'arranged' takes place after the broker is no longer involved in the transaction. But in a transaction on a Regulated Market the broker, and the exchange, both remain a participant in the transaction when transfer of the economic interest occurs.

Conclusions

Firms need to understand the implications of FG12/13, the recast MiFID directive and this report for their businesses and remuneration practices in order to ensure that they are properly identifying and categorising third-party payments which contravene the rule on inducements and our other requirements.

5. Next steps

Given the nature and broad relevance of the findings, all investment firms should review their arrangements for delivering best execution and ensure that they are not receiving PFOF. Firms need to ensure that business practices are fit for purpose and that these are supported by appropriate second line of defence controls.

Our findings not only highlight that a failure to obtain best execution on a consistent basis presents a risk of detriment to individual clients, but that it also presents risks to trust and confidence in the integrity of our markets, as well as potentially undermining competition between trading venues.

All firms also need to assess the risks and issues identified in this report in the context of future regulatory developments. Additional obligations in the recast Markets in Financial Instruments Directive (MiFID II) are intended to address some of the specific weaknesses observed in this work, in particular regarding the adequacy of monitoring. Therefore firms need to improve their current systems and controls and be ready for the implementation of future policy change. These improvements will need to be broadly applied, since the new obligations under MiFID will enhance reporting requirements across relevant asset classes.

Appendix 1
Relevant rules and guidance

Overarching rules and relevant publications		
Best Execution	Overarching obligation	COBS 11.2.1R CESR Q&A 2 and 3
Inducements	Third-party payment rule	COBS 2.3.1R(2)
Clients' best interests	Clients' best interests	COBS 2.1.1R
Clients' best interests	Contractual exclusions of liability	COBS 2.1.2R
Conflicts of interest	Identifying, managing, recording and disclosing	SYSC 10.1
Client Categorisation	Calibrates application; standards and disclosure requirements	COBS 3 PS07/15 at 2.7
Scope		
Application of best execution obligation:	Best execution criteria Role of Price Retail total consideration Relative importance of factors	COBS 11.2.6R COBS 11.2.7R COBS 11.2.8G; CESR Q&A 11 COBS 11.2.9G; CESR Q&A 10
Following specific instructions from a client:	Specific instructions	COBS 11.2.19R; 11.2.20G; 11.2.21G
Information about the Order Execution Policy:	Appropriate Disclosure Retail disclosure	COBS 11.2.22R; CESR Q&A 14, 16 and 17 COBS 11.2.23R; CESR Q&A 15 and 19
Commission Opinion CESR/07-320: Best execution under MiFID: Questions and Answers (May 2007)	Dealing on Quotes Specific instructions Portfolio managers and receivers and transmitters	Commission Opinion (1) Commission Opinion (2) Commission Opinion (3)
Monitoring		
Monitoring the effectiveness of execution arrangements and policy	Monitoring requirements Reception and transmission Cost monitoring (explicit and implicit)	COBS 11.2.27R; CESR Q&A 24 and 25 COBS 11.2.32R(4) COBS 11.2.33G; CESR Q&A 22 PS07/15 at 2.9

Internalisation and third-parties		
Information about the Order Execution Policy:	Information on execution outside RM / MTF	COBS 11.2.24R
Client consent to execution policy and execution of orders outside a regulated market or MTF	Consent Process	COBS 11.2.26R; CESR Q&A 20 and 21
Duty of portfolio managers, receivers and transmitters and management companies to act in clients' best interests	Best interests	COBS 11.2.31R
	Factors	COBS 11.2.32R(1)
	Policy	COBS 11.2.32R(2) CESR Q&A 6 and 7
	Disclosure	COBS 11.2.32R(3); CESR Q&A 14-17
	Single venue	CESR Q&A 9
Delivering best execution where there are competing execution venues	Retail client fees and charges	COBS 11.2.10R; COBS 11.2.11G; Q&A 12 and 13
	Non-discrimination	COBS 11.2.12R; COBS 11.2.13G
Conflicts of interest	Identify and manage	SYSC 10.1
Accountability		
Requirement for order execution arrangements including an order execution policy	Arrangements and policy	COBS 11.2.14R; PS07/15 2.10 COBS 11.2.15R
	By class of financial instrument Factors, venues and clients	COBS 11.2.16G CESR Q&A 4, 5 and 7
	Single venue	CESR Q&A 8
Review of the order execution policy	Regular review	COBS 11.2.18G; CESR Q&A 23
	Annual and material change review Reception and transmitter review	COBS 11.2.28R COBS 11.2.32R(5)
Demonstration of execution of orders in accordance with execution policy	Demonstration Consent to changes to policy	COBS 11.2.29R PS07/15 at 2.6
Payment for order flow		
General guidance on inducements	Inducements: Report on good and poor practices Date: 19 April 2010 Ref.: CESR/10-295	
FSA guidance on payment for order flow	FG 12/13 Guidance on the practice of 'Payment for Order Flow' (May 2012)	

Financial Conduct Authority

PUB REF: 004900

25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk