

**AMF consultation
on enforcing the best-execution principles
in MiFID and its implementing directive**

A key element of the Markets in Financial Instruments Directive (MiFID) is the requirement for investment firms to execute orders in the best interests of their clients. This requirement has been introduced to address the greater diversity of order execution venues.

The French securities regulator, Autorité des Marchés Financiers (AMF), has made "better regulation" a central goal of its rule-making policy for the years ahead. Accordingly, when it transposes MiFID into its General Regulation, the AMF must ensure that the European rules are incorporated as faithfully as possible into the French regulatory corpus. That said, the new directives' provisions on the best-execution principle have raised many questions from the industry.

For this reason, the AMF decided to produce a guidance document explaining the tenor of the best execution framework and its plans for implementation in order to accompany the transposition of the directive in its General Regulation, a process that is now under way.

The purpose of this guidance document, released for consultation today, is to seek the views of stakeholders, be they intermediaries, investors, on the consistency and relevance of the document and on any points that could be added to it.

**Responses to this consultation should be sent to the AMF at the following address by
31 October 2006: mif@amf-france.org**

Contents

1. Introduction	page 3
2. The best-execution obligation in outline	page 8
3. The best-execution rule: an overall framework	page 10
3.1. Definition	page 10
3.2. Best-execution arrangements and execution policy	page 11
3.3. Factors and criteria	page 12
3.4. Seeking the best possible result through effective procedures	page 17
3.5. Circumstances and conditions in which an ISP can include only one execution venue in its execution policy	page 18
4. Informing clients	page 20
5. Special applications of the best-execution principle for certain markets or instruments	page 22
6. Responsibilities of the various entities that may participate in order execution	page 27
6.1. ISPs that receive and transmit orders	page 27
6.2. ISPs that manage portfolios	page 32
6.3. Institutions that perform order reception and transmission, portfolio management and order execution on an integrated basis	page 35
7. Data retention	page 36
Annex: Excerpts from MiFID and the draft implementing directive concerning the best-execution rule	page 37

1. Introduction

The best-execution principle: evolution, not revolution

1. The rule imposed by the Markets in Financial Instruments Directive (MiFID) and its implementing directive¹ that orders must be executed in the best interests of clients is essential to the new regulatory framework stemming from MiFID.
2. The principle is not new. Although it does not appear as such in the 1993 Investment Services Directive (ISD)², which MiFID replaces, it is found in the transposition regulations adopted by Member States. Article 11 of the ISD requires Member States to establish rules of conduct under which an investment services provider (ISP)³ must act "honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market" and "with due skill, care and diligence, in the best interests of its clients and the integrity of the market". Accordingly, the rules of conduct laid down by the AMF General Regulation include order execution rules that apply both to ISPs handling clients' trades and to asset management companies:
 - ISPs executing orders for clients must make every effort to provide the best possible execution, taking into account the instructions they receive, the state of the relevant market(s) and the financial instruments involved. Furthermore, if an ISP makes a trade at a price other than a market price available at the time, it must be able to explain to the AMF its reasons for doing so.⁴
 - Asset management companies must obtain the best possible execution of orders. To this end, they must adopt procedures for selecting intermediaries and counterparties as well as an appropriate internal organisational structure and procedures for the placing of orders.⁵

A core principle of efficient price formation and investor protection

3. The main objective behind reform of the ISD is to increase competition among the various trading venues -- regulated markets, multilateral trading facilities (MTFs) and internalising intermediaries -- by laying the necessary "foundations for a coherent regulatory framework for integrated financial markets".⁶ The ultimate purpose of this new regulatory regime is primarily to benefit investors, since competition between execution venues should improve the quality and lower the cost of order execution.

¹ See Directive 2004/39/EC on markets in financial instruments (21 April 2004) and draft Commission Directive implementing this directive (30 June 2006).

² Directive 93/22/EEC on investment services in the securities field (10 May 1993).

³ The term "investment services provider" (ISP) is used here because in French law it covers not only investment firms in the strict sense of the term but also credit institutions authorised to provide investment services.

⁴ See AMF General Regulation, Articles 321-42 and 321-77

⁵ See AMF General Regulation, Articles 322-49 to 322-52

⁶ See Memorandum explaining the Commission's reasons for proposing a revised directive on investment services and regulated markets (2002/0269 (COD), 19 November 2002).

4. Aiming for increased competition is not without risk, however. This is especially true for equity markets, where it could fragment liquidity across multiple execution venues, with adverse consequences for efficient price formation. To offset the potential effects of fragmentation, the directive establishes a number of safeguards. The most prominent of these are the best-execution rule and the rules for transparency when trading equity instruments.
5. The best-execution rule is key to ensuring effective price formation and efficient markets. As the Commission said in its explanatory memorandum for the draft directive, "The operation of an integrated financial market requires that orders to buy and sell financial instruments interact effectively, freely and instantaneously with each other on a cross-border basis. Requiring investment firms to consider trading conditions on a reasonable range of execution venues, and to route orders to the venues offering the best prices, will ensure that liquidity responds quickly to price differentials. In this way, an effective 'best execution' policy helps to ensure that liquidity flows to the most efficient and competitive trade-execution venues and serves as a guarantor of overall market efficiency." Investors stand to benefit from the fragmentation of liquidity since "investment firms [will have to] consider trading conditions on a range of trading venues, and make use of 'smart' order-routing techniques in order to seek out the best bargains for their clients. In doing so, [the best-execution rule] will allow competition between brokers to drive improvements in execution quality to the benefit of the investor."
6. The best-execution rule is also crucial for investor protection. With trading dispersed across multiple venues, each offering its own prices and conditions, and with the possible weakening of the bellwether role now played by regulated markets' prices, investors may well find it harder to obtain the information they need to make investment decisions and assess the quality of execution of their orders. The best-execution rule should therefore help to make investors more confident that their ISPs will do everything necessary to execute their orders for the best possible result, in particular by choosing the execution venue that appears most likely to provide that best result. Given the increased risk of conflicts of interest within entities that prefer to execute clients' orders internally, the rule also serves to limit this practice to situations where it can be done on terms as good as, if not better than, those available on an organised market (regulated market or multilateral trading facility).

A framework that raises questions about the changes needed in ISPs' organisational practices

7. The framework stemming from the new directive is similar to the general principles embodied in the AMF General Regulation. MiFID, however, aims to facilitate cross-border provision of services by seeking uniform implementation of the new regulatory regime across Europe. It therefore sets rules that are far more detailed than those in the ISD and relies on the comitology process to clarify the scope of practice established by the Level 1 directive. For these reasons, the MiFID best-execution requirement is far more precise than the existing provisions of the AMF General Regulation on the same subject.

8. Questions have arisen as to how the new framework will be applied in practice. That uncertainty is evident both from the dialogue with the industry during the adoption of the directive and its implementing texts and from the exchanges that continue to take place as the AMF works to transpose these texts. In the French environment, these questions are further accentuated by the elimination of the order concentration rule, which affirmed the pre-eminence of the regulated market. Accordingly, orders executed on a regulated market were traditionally considered to enjoy a "safe harbour".⁷
9. Furthermore, the Commission's key objective of countering the adverse effects of fragmentation has led to the adoption of principles that seek chiefly to maintain orderly equity markets. However, the way in which these principles are worded raises questions about how they will apply to financial instruments with characteristics and modes of trading unlike those of equities. The comitology measures that recently clarified the implementation of Article 21 shed valuable light on a number of points. However, they have not resolved all the questions about interpretation and concrete application of the rule, as shown by the many debates that have taken place since the first draft of the proposed implementing directive was published.

The need to spell out precisely how the AMF intends to implement the new requirement

10. The AMF has made the "better regulation" approach recommended by the European Commission a central goal of its rule-making policy for the years ahead. Accordingly, when it transposes MiFID into its General Regulation, the AMF must ensure that the European rules are incorporated as faithfully as possible into the French regulatory corpus.⁸ As regards the transposition of the best-execution requirement, the AMF wanted to produce an accompanying guidance document explaining the tenor of the framework and the way in which the AMF expects it to be implemented. The purpose of this document, released for consultation today, is to outline the main thrusts of the AMF's proposed interpretation and to seek the views of stakeholders, be they intermediaries investors, on the consistency and relevance of the document and on any points that could be added to it.
11. **Encourage ISPs to assume more responsibility : simplicity and adaptability of the principles to their strategy**

In view of the great number of different situations that may arise, this document is not intended to offer predetermined solutions for every case, as is appropriate in a regulatory environment where intermediaries are given greater leeway to assess the measures they should take to comply with laws and regulations. The objective of the guidelines proposed in this document is threefold:

⁷ The central market in France operates in a way that contributes to investor protection. It provides most of the liquidity for trades in equity instruments by running a central order book and also by permitting large-volume orders to be executed outside the book but at prices correlated with the book's prices.

⁸ Transposition in the AMF General Regulation is part of the larger task of transposing the directive into French law, which will also have to contain provisions concerning the best-execution rule.

- provide the protection that investors have a right to expect from these principles ;
 - put forward simple, practical principles that will allow ISPs to take the measures most appropriate to their strategy, business and clients;
 - provide clear guidelines on how the AMF intends to enforce the best-execution rule.
12. **Convergence and consistency of regulatory principles across national regulators.** The analyses offered in this document draw on work carried out at the European level. In particular, they take into account the joint efforts of the AMF and other European regulators in preparing the technical advice given to the Commission by the Committee of European Securities Regulators (CESR), which incorporated the responses to public consultations from stakeholders in the various Member States. These analyses also draw on the exchanges that took place during the drafting of the proposed implementing directive by the Commission as well as the regular dialogue between the AMF and its main counterparts on the progress of their implementation efforts.⁹
13. The AMF is especially aware that its interpretation must be consistent with that being prepared by its counterparts in Europe, for two reasons. It has no desire to distort competition to the detriment of French institutions; and it does not wish to interfere needlessly with efforts by financial groups operating in several European countries to implement overarching policies. This need for consistency is present regardless of the legal form under which a group does business in a country, i.e. whether it has subsidiaries or branch offices subject to the rules of the host country (see below, § 18).
14. This consultation is being initiated with due regard for the timetable that sets 31 January 2007 as the deadline for transposition of MiFID. However, the Level 3 work being conducted by CESR is due to be spread over the second and third quarters of 2007. These efforts are intended to ensure convergent implementation of the provisions of MiFID and its implementing directive and regulation. This document will of course be modified to reflect the results of this consultation, and the CESR working groups will be informed of any changes. Besides these modifications, it is also possible that the interpretation put forward here may evolve over time. The AMF hopes, however, that by starting this exercise now, it will help to limit the uncertainties faced by ISPs, which must begin at once to put in place the resources they will need to meet their new obligations by November 2007.

⁹ In particular the UK's Financial Services Authority, which published a consultation document, "Implementing MiFID's best execution requirements", in May 2006.

2. The best-execution obligation in summary

15. The principle of best execution is established by Article 21 of MiFID, titled "Obligation to execute orders on terms most favourable to the client", and supplemented by Articles 44 and 46 of the implementing directive. In addition, ISPs that perform portfolio management or reception and transmission of orders (RTO) have a similar obligation because of their duty to act in the best interests of their clients (Article 19.1 MiFID) whenever they place orders resulting from their investment decisions or transmit clients' orders for execution by other entities. These requirements are set forth in Article 45 of the proposed implementing directive.
16. Principle: when orders are executed, take all reasonable steps to obtain the best possible result for the client with regard to the following factors:
 - price
 - cost
 - speed, likelihood of execution and settlement
 - order size, order characteristics
 - or any other consideration relating to the execution of the order

Notwithstanding this principle , whenever there is a specific instruction from the client, the ISP must execute the order in accordance with that instruction.

17. Nature of the obligation: "best efforts", meaning the obligation is met by having a policy and effective arrangements for executing orders. The order execution policy must include at least those venues that consistently enable the investment firm to obtain the best possible result when executing client orders. The order execution policy must also include, for each class of instrument, information on the different venues where the ISP executes its client orders and on the factors affecting the choice of execution venue.
18. Scope of the obligation:
 - applies to ISPs when they execute orders of their clients.
 - does not apply when ISPs enter into transactions with eligible counterparties¹⁰ or arrange transactions between such counterparties.
 - covers all financial instruments.

¹⁰ Eligible counterparties include investment firms, asset management companies, credit institutions, insurance companies, collective investment schemes and their management companies, pension funds and their management companies, other financial institutions authorised or regulated under Community legislation or the national law of a Member State, "locals" and proprietary traders in commodities and commodity derivatives, national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations. Large enterprises meeting certain quantitative thresholds may also be recognised as eligible counterparties, if the Member State in which the enterprise is established permits it and provided the enterprise itself agrees to be so treated (Article 24 MiFID).

- requires ISPs to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any shortcomings.
- includes an obligation to disclose to clients the ISP's order execution policy and inform them of any material change in that policy or in the ISP's order execution arrangements.
- includes an obligation to obtain clients' prior consent to the execution policy as well as an obligation to obtain clients' express prior consent before execution of their orders outside a regulated market or an MTF, either in the form of a general agreement or in respect of individual transactions.
- also requires ISPs to be able to demonstrate to clients, at their request, that their orders have been executed in accordance with the firm's execution policy.
- applies to branches of ISPs in respect of the services they provide in the territory of the host country. Under Article 32.7 MiFID, both Article 21 and Article 19.1, which lay down the obligations of ISPs when they place or transmit orders to third parties for execution, are part of the rules of conduct that fall under the jurisdiction of the host-country authorities. Branches of a parent company in another Member State must therefore comply with local rules as transposed by the country in which they operate. Since transposition necessarily entails a certain amount of latitude, groups with branches in several Member States will probably have to comply with provisions that vary slightly from one Member State to another. It should be borne in mind that the ability of Member States and their regulators to maintain or impose requirements additional to those in the implementing directive is limited. Article 4 of the directive allows such requirements only in cases where they are needed to prevent a risk to investor protection or market integrity that is not adequately addressed by the implementing directive, and only on condition that the specific risks addressed by the requirements are of particular importance, having regard to the market structure of the Member State. Furthermore, Member States must notify and justify any such requirements to the Commission. These provisions will help Member States to implement MiFID rules in the most uniform possible way.

3. The best-execution rule: an overall framework

3.1. Definition

19. The best-execution requirement is a best-efforts obligation under which ISPs must take "all reasonable steps" to obtain the best possible result when executing orders for their clients (MiFID Article 21). Accordingly, the directive does not require that ISPs actually obtain the best execution of each and every order. Rather, it requires
 - that they do everything necessary to obtain best execution, and
 - that all client orders benefit from the arrangements the ISP has put in place to obtain the best possible execution (Recital 66 of the proposed implementing directive).
20. The ISP complies with the best-execution rule by implementing arrangements and procedures aimed at obtaining the best possible execution of orders. In particular, it establishes an order execution policy, informs the client of this policy and obtains the client's prior consent thereto. The policy applies for all order execution venues that the ISP has chosen to use, but that choice must include at least those venues that appear most likely to provide the best possible result. However, the obligation to take all reasonable steps to obtain the best possible result does not mean that the ISP's policy must include all execution venues (Recital 66 of the proposed implementing directive).
21. The execution venues are regulated markets, MTFs, systematic internalisers, market-makers or other liquidity providers, and entities in a third country that perform similar functions (Article 44.1(2) of the proposed implementing directive).
22. Compliance with the best-execution rule also requires the ISP to monitor the effectiveness of its order execution arrangements and policy so that it can remedy any shortcomings. Monitoring entails regular verification and, if need be, a revised choice of execution venues. When supervising compliance with the best-execution requirement, the competent authorities do not verify every execution; rather, they check that the ISP has put the necessary procedures in place. The ISP must also be able to demonstrate to its clients, upon request, that it has obtained the best possible result for them under the terms of its execution policy.

3.2. Best-execution arrangements and execution policy

23. The execution policy is part of a set of best-execution procedures that the ISP must put in place to meet the criteria listed in MiFID and its implementing directive.
24. In practice, these procedures correspond to the organisational structure that the ISP must implement to obtain the best possible execution of client orders. The procedures will vary from one ISP to another but will include:
 - the process by which the ISP determines the relative importance of the factors listed in Article 21, taking into consideration the assessment criteria given in the implementing directive. Depending on the types of clients that the ISP serves, the instruments concerned and the types of order handled, the ISP must identify the factor(s) that should be given the most weight in obtaining the best possible result;
 - the process by which the ISP selects execution venues;
 - the useful and necessary information that the ISP provides clients to enable them to judge how it is executing their orders.
25. It is this useful and necessary information provided to the client that will constitute the ISP's execution policy, and the ISP must obtain the client's consent to this policy before executing any of his orders. Not all the ISP's order execution arrangements must necessarily be described in the execution policy, provided the policy covers everything clients need to know in order to give informed consent to the terms and conditions on which their orders will be executed. The ISP is not required to disclose all aspects of its execution arrangements in the policy, not only because doing so could unnecessarily complicate the information provided to clients, but also for reasons of confidentiality regarding the ISP's expertise vis-à-vis its competitors (cf. § 59).

Question 1: Are there any additional factors that need to be considered here to complete the description of the arrangements that ISPs must implement?

3.3. Factors and criteria

26. For the ISP, the requirement to execute clients' orders on the terms most favourable to them consists in taking all reasonable steps to obtain the best possible result, having regard to the following factors:
- price
 - cost
 - speed, likelihood of execution and settlement
 - size of the order
 - characteristics of the order
 - or any other consideration relating to execution of the order

Whenever there is a specific instruction from the client, however, the ISP must execute the order in accordance with that instruction.

27. Under the Level 2 text, the "total consideration" criterion – that is, the price at which the instrument is traded plus execution-related costs – is the main priority when executing retail orders without specific instructions from the client.
28. To determine the relative importance of these different factors, the ISP must take into account the following criteria:
- the characteristics of the client, including whether it is categorised as a retail or professional investor;
 - the characteristics of the client order;
 - the characteristics of the financial instruments;
 - the characteristics of the execution venues to which that order can be directed.
29. **Responsibility for assessment lies with ISPs.** It is up to each ISP to determine how it will weight the different criteria that it takes into account in making its arrangements and establishing its policy for order execution. Its weighting could therefore reflect various factors such as its business strategy, its clients, its technical capabilities, or the financial instruments in question.

<p>Question 2: Does the leeway allowed ISPs in assessing the best-execution criteria appear to be warranted?</p>

30. **Price: a key criterion of best execution.** Although the directive allows various factors – including, but not only, the price – to be taken into account, most investors would probably attach greatest importance to the execution price. Indeed, for retail clients, the implementing directive establishes "total consideration" as the predominant factor (cf. Paragraph 33 and following).

31. When preparing its technical advice, CESR conducted research on methods of identifying the most relevant market in terms of liquidity for purposes of transaction reporting. This work showed that, at least for equities, the most liquid market was in 95 per cent of the cases five or more times the size of the second most relevant market (in terms of volume and value of securities traded). In 90 per cent of the cases, it was even eleven times greater than the second-largest market (cf. CESR/04-261b., page 107).
32. It is unlikely that this situation will change overnight when the directive is first transposed. In this context, the AMF would consider that the price of execution of an equity order would benefit from a "safe harbour" as regards best execution if the order is executed at the price quoted on the organised market that commands the greatest liquidity in the stock in question, whether the trade is made through the order book or by automatic referral to the order book price.

Question 3: Do you agree that the price in the most liquid market can be presumed to be the best price?

33. **Cost**
Cost is an element to be considered in evaluating how to obtain the best possible result when several methods of executing an order are possible. The gain that might be realised by using one execution system with a better posted price than another system could disappear, if the first system's costs were to exceed the price differential (for example, access costs or higher settlement costs).
34. **"Total consideration": determining factor in the execution of retail client orders.** The proposed implementing directive makes "total consideration" the criterion for determining best execution of retail client orders (cf. Article 44.3), barring a specific instruction from the client and provided that other assessment criteria do not have an overriding influence on obtaining the best possible result in terms of total amount paid (cf. Recital 67).
35. Total consideration is defined as "the price of the financial instrument and the costs related to execution, [including] all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order" (cf. Article 44.3).
36. In practice, clients will have been informed beforehand of the ISP's execution policy and its fee schedule, which will show the cost of service to the client associated with each venue or execution method. In any event, given the different ways in which ISPs charge for their services, it is important that order execution costs be clearly indicated. Clients should know what costs they can expect to pay. After the fact, the client can compare the quality/price ratios offered by different firms by comparing the price at which the order was executed as well as the costs charged by the intermediary.

37. **Inclusion of the ISP's costs and commissions in deciding between two or more execution venues.** When the ISP's execution policy includes several trading systems capable of executing a given order, the ISP must evaluate and compare the results it would obtain, if it executed the order on each one. To perform this evaluation, the ISP must take into account the commissions and costs that it would charge for executing the order in each of the eligible venues (cf. Article 44.3(2) of the implementing directive).
38. This approach has the advantage of allowing the ISP itself to assess what the net result will be for the client. The ISP may have to compare an order execution on which it bills a commission to one where it covers its costs through a price spread, as is usually the practice when filling an order from its own inventory.
39. This approach has two drawbacks, however:
- firstly, it means that the ISP's remuneration comes within the scope of the best-execution rule, and this could be construed as an obligation for ISPs to direct clients towards a competitor who offers a more attractive commission schedule;
 - secondly, it allows a lack of transparency that the ISP could use to conceal discriminatory pricing against an execution venue it does not wish to use because of the additional costs it would incur.
40. A number of provisions of the implementing directive, including some of the recitals, serve to resolve these difficulties.
41. **The purpose of including the ISP's costs and commissions in deciding between two or more venues that might provide best execution is not to require the ISP to compare its fee schedule to those of its competitors.** Recital 71 makes it clear that an ISP is not required to "compare the results that would be achieved for its client on the basis of its own execution policy and its own commissions and fees, with results that might be achieved for the same client . . . on the basis of a different execution policy or a different structure of commissions or fees. Nor is [an ISP required] to compare the differences in its own commissions which are attributable to differences in the nature of the services that [it] provides to clients."
42. **Inclusion of the ISP's costs and commissions in deciding between two or more execution venues that might provide best execution cannot justify an execution policy that the ISP can change in a discretionary manner.** Article 44.4 of the implementing directive prohibits ISPs from structuring or charging their commissions in such a way as to discriminate unfairly between execution venues. This provision must be understood in the context of Recital 73 of the same directive, under which an ISP is considered to structure or charge its commissions "in a way which discriminates unfairly between execution venues if it charges a different commission or spread to clients for

execution on different execution venues and that difference does not reflect actual differences in the cost to the firm of executing on those venues".

Furthermore, Recital 72 of the implementing directive reflects the Commission's concern to prevent ISPs from using the full-cost approach as an excuse not to include other systems in their execution policy, citing heavy investment outlays as a reason for rejecting a system even if it has already proved effective for order execution. This recital clearly states that the approach under which ISPs include their own costs and commissions for the purpose of determining which trading venue is likely to provide the best possible result is not applicable in the context of selecting executing venues for inclusion in the execution policy.

43. The purpose of these provisions is to prevent ISPs from doing the following:
- neglecting to verify the relevance of their execution policy once they have chosen one or two execution venues and failing to consider other trading platforms because of the expenditures that would be needed to use them;
 - charging commissions that artificially favour one execution venue over another because, for example, the ISP might derive a benefit that would not be shared with the client.
44. The ISP must therefore be able to justify its execution policy to the regulator, showing not only how it evaluated and chose among the various execution venues, but also that it has met its obligation to reconsider and revise those choices where appropriate (cf. Article 21.3 and 4 MiFID and Article 46 of the proposed implementing directive). In addition, the ISP has an obligation to the regulator, and probably also to the client, to make full disclosure of the components of execution cost on the different systems. It should be able to show that its choice of systems has been made for the benefit of clients and that costs have not been structured to favour any particular system.

<p>Question 4: Do you agree with the above analysis? Are there other elements that should be taken into consideration?</p>

45. **Common factors in assessing order execution costs for all types of client**

Although each ISP is responsible for determining how it weights the various factors it considers in making its execution arrangements and establishing its execution policy, price and cost are important aspects of best execution for all types of client order. The proposed implementing directive refers to "total consideration" only for assessing the best possible result for retail clients. For other clients, the assessment is made with regard to price, cost, speed, likelihood of execution and settlement, and so on. The concept of net cost seems

25 July 2006

relevant for the assessment of execution costs on professional clients' orders as well, although not with the same primacy as for individual clients.

46. Under the heading of execution costs, the ISP should take into account the following:

- Explicit costs directly related to execution.
- Implicit costs (market impact and opportunity cost) : Recital 67 mentions only the possibility of taking into account "market impact and any other implicit transaction costs" among the several criteria that may be considered in certain circumstances, as regards execution of retail client orders. For professional clients, however, these costs appear to be important.

From the standpoint of French ISPs, the tax treatment of execution is the same regardless of the execution venue. Taxation is therefore a constant and must not be taken into account when assessing which venue will provide the best possible result for the ISP's clients.

Question 5: Have the practical implications of the provisions on execution cost assessment been accurately described above?

47. **Specific instructions from clients**

If an ISP complies with specific instructions from a client concerning an order, the ISP fulfils its best-execution obligation (Article 21.1 MiFID, Article 44.2 of the implementing directive). If the client's instructions cover one particular aspect of an order and the ISP complies with them, it satisfies its best-execution obligation in respect of that aspect, but not necessarily in respect of other aspects (Recital 68 of the implementing directive). Furthermore, the ISP must caution its clients, via a warning in its execution policy, that specific instructions of this kind may prevent the firm from taking the steps it has designed and implemented in its policy to obtain best execution (cf. Article 46.2(c) of the implementing directive).

48. To prevent abuse of this automatic presumption of best execution, Recital 68 of the implementing directive provides that an ISP must not induce a client to instruct it to execute an order in a particular way, by expressly indicating or implicitly suggesting the content of the instruction to the client, when it 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 proscription does not bar the ISP from asking the client to choose between two or more of the execution venues in its policy.

**Question 6: Is the analysis of assessment criteria presented here adequate?
Are there any useful clarifications that could be added?**

3.4. Seeking the best possible result through effective arrangements

49. To fulfil its best-execution obligation, the ISP must implement "effective arrangements ", including an execution policy that:
- enables the ISP to obtain the best possible result on executing client orders;
 - includes information on the various systems used by the ISP for each class of instrument and the factors affecting the choice of systems;
 - includes at least those venues that enable the investment firm to obtain on a consistent basis the best possible result on executing client orders.
50. The proposed implementing directive confirms that every order must enjoy the benefit of the ISP's arrangements for best execution (cf. Recital 66). The ISP must therefore apply its execution policy to every order it executes, so as to obtain the best possible result in accordance with that policy.
51. The way in which the best possible result is obtained may be determined periodically. Depending on the nature of the orders, which is closely linked to the nature of the client, as well as on the size of the orders relative to the volume usually traded and the type of instrument concerned, the ISP may need to:
- decide on a case-by-case basis, before executing the order, which execution venue is likely to provide the best possible result, or
 - assess periodically which execution strategy or execution venue is most appropriate, rather than at the time of each order. For example, periodic assessment may be appropriate for orders with standard characteristics that allow automated execution, such as most orders of individual clients.
52. Depending on their characteristics, especially size, orders may qualify for varying degrees of "automated" execution. For example, the execution procedures for orders placed by individuals through retail bank networks ought not to require systematic assessment of the relevance of venue selection criteria, including price and cost, before each order is executed. This assessment will have been done beforehand, in the context of selecting the most appropriate mode of execution to obtain the best possible result. In addition, after the fact, the ISP will check whether the system selected for a given type of order was indeed the one that generally provided the best possible result. On the other hand, an order representing, say, 5 per cent of daily trading volume in a given security would be expected to receive special treatment, including a check on which venue offers the best price.
53. For orders to be executed in an automated system, the execution policy is inseparable from the posted commission schedule, which must be determined in advance and provided to the client. Thus, an ISP may choose to execute retail client orders in liquid stocks on the most

liquid regulated market if, by doing so, it can generally obtain the best possible result in terms of total cost for its clients.

Question 7: How do you think ISPs will be able to differentiate their execution procedures and policies: by type of client? by instruments traded? by other criteria? What degree of segmentation do you think is appropriate?

3.5. Circumstances and conditions in which an ISP can include only one execution venue in its execution policy

54. There may be circumstances in which an ISP that executes orders directly is a member of only one execution system. For example, depending on the nature of the instruments traded, there may be only one execution venue that offers the best possible result "on a consistent basis". Or, depending on the volume of orders to be executed or the nature of the ISP's client base, there may be several possible execution venues, but the upfront costs required to use them, in particular the cost of system membership, would negate the benefits of having direct access to each of them. The cost and effectiveness of the clearing and settlement systems associated with a particular execution venue is likewise a determining factor.
55. The directive does not require an execution policy to include several order execution modes or venues in order to obtain the best possible result. Nevertheless, the ISP that uses a single order execution system still has to demonstrate that by, doing so, it meets its obligation to take all reasonable steps to obtain the best possible result for its clients in terms of the various factors, especially cost.
56. Furthermore, it is conceivable that an ISP will have several execution policies, depending on the nature of its clients and of the instruments traded. In any event, the directive requires an execution policy to provide information on the systems used "in respect of each class of instrument". An ISP might therefore include only one execution venue in a given policy which applies exclusively to execution of orders in a specified class of instrument.
57. The directive also does not require direct access to an execution venue. An ISP may use execution venues indirectly, by transmitting orders it has received to brokers that are members of the systems it wishes to use. The ISP's execution policy should therefore identify not only the systems to which it has direct access as a member but also those to which it has indirect access through another intermediary.
58. Regarding instruments such as fixed-income products traded over the counter (OTC) and available from liquidity providers or market-makers, or OTC derivatives, or customised structured products tailored to a particular client, the concept of an execution "venue" or "system" to be included in an execution policy corresponds to a reality which, in this case, is altogether different from what is generally understood to be the case for instruments

traded on organised markets. The ISP itself is the "execution venue".¹¹ This will be reflected in the ISP's execution policy, which will also be tailored to the circumstances (see below, § 67 and following).

Question 8: Are the circumstances and conditions described above (when an ISP can have just one execution venue in its execution policy) relevant? Are there other aspects that should be considered?

¹¹ See Article 44.1(2) of the proposed implementing directive.

4. Informing clients

59. ISPs must "provide appropriate information to their clients on their execution policy" and "obtain their prior consent to the execution policy". This means ISPs will have to describe in their policy what the client needs to know in order to be able to choose a service provider on the basis of the nature and quality of its order execution arrangements. The information must be suited to the client. However complex the arrangements, they must be described in a way that makes them understandable to the clients receiving the information.
60. The Level 2 directive gives details of the minimum information to be provided on the execution policy:
- the relative importance assigned by the ISP to the factors listed in Article 21.1 of MiFID (price, cost, speed and likelihood of execution, etc.) on the basis of the criteria listed in the implementing directive (characteristics of the client, the order, and the financial instruments concerned; characteristics of the execution venues to which the order can be routed);
 - a list of the execution venues on which the ISP places significant reliance in meeting its obligation to take all reasonable steps to obtain, on a consistent basis, the best possible result for the execution of client orders;
 - a clear warning that any specific instructions from a client may prevent the ISP from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions.
61. The information must be provided to the client on a durable medium, or by means of a website if certain conditions are met, and the client's consent must be obtained before any order execution service is rendered.
62. The execution policy is consequently part of the contract between the client and the ISP. On the basis of this policy, the ISP must be able to demonstrate to the client, upon request, that the client's order has indeed been executed in accordance with the policy.
63. The ISP must obtain the client's consent, but the text does not require it to obtain consent in writing. Consent may be obtained by using a durable medium as defined in the implementing directive, but it may also be obtained by tacit acceptance (for example, by the client placing an order after having been informed of the execution policy).
64. The ISP must also obtain express prior consent from the client for orders to be executed outside an organised market (i.e. outside a regulated market or an MTF). This consent can be obtained either as a general authorisation or for specified transactions.

65. Lastly, the ISP must make clients aware of any material change in its execution arrangements or policy.
66. The content of the execution policy can be expected to vary according to the nature of the ISP's business and the clients it serves. There are unlikely to be many elements in common in the execution policies of a credit institution that receives and transmits retail client orders, an ISP acting as a liquidity provider in the fixed-income market, and an ISP that produces customised structured products.

Question 9: Is this description of execution policy content and client acceptance procedures relevant? What procedures should ISPs use to obtain clients' express prior consent to orders being executed outside a regulated market or MTF?

5. Methods of application of the best-execution principle for certain markets or instruments

67. Questions raised by the wording of Article 21 of the framework directive

Article 21 of MiFID sets forth the measures that ISPs must implement when executing client orders. It is applicable to all financial instruments. It is suited to the processing of orders placed by clients in markets where the ISP acts as an intermediary between its clients and an exchange or another service provider. The intermediary's duty is then to execute each client order in the best interests of the client, by choosing the best mode of execution for the client. One of the modes that may qualify as best could consist in filling the order internally from the ISP's own inventory.

68. There are, however, markets and transactions in specific instruments that are structured in other ways and do not depend on the execution of client orders as described above. This is the case for transactions in some relatively standardised financial instruments, customarily traded over the counter, to which the intermediary is a party on its own account. Although there is no doubt that ISPs can deal on own account without necessarily executing a client order, it is also true that an ISP that deals on its own account to execute a client order is bound by Article 21.

69. For these reasons, a number of recitals have been inserted in the implementing directive to spell out special ways of applying the best-execution principle to client transactions carried out by ISPs dealing on own account in OTC financial instruments and customised financial products.

70. The purpose of these recitals is:

- to close a potential loophole and prevent ISPs that execute client orders by dealing on own account from shirking any obligation to meet the best-execution rules when filling those orders (cf. Recital 69),
- to recognise at the same time that the best-execution principle should be tailored to the particular circumstances resulting from the structure of certain markets and financial instruments (cf. Recital 70).

71. **Solutions offered in the directives**

The eligible counterparty regime. Implementation of the ISD highlighted the difficulty of applying client protection rules to entities that trade with an ISP on an equal footing. Because of this difficulty, the category of "eligible counterparty" was introduced into MiFID. ISPs are not required to meet the best-execution rule when they trade with eligible counterparties or arrange transactions between two such counterparties. This regime is intended to clarify the situations described above in which, strictly speaking, there is no execution of client orders. Eligible counterparties may, however, opt to be treated as professional clients and thus to benefit from the best-execution rule.

72. **Transactions made by an ISP dealing on own account and complying with specific client instructions.** When an ISP makes a trade at a price that it has quoted and its client has accepted, it is considered to meet its best-execution obligation in respect of the price, in this context treated as a specific client instruction, so long as the quoted price satisfies the requirements of Article 21.1 of MiFID. This clarification is supplied by Recital 70 of the implementing directive.

Recital 70 further establishes the conditions on which the ISP continues to meet its best-execution obligation without having to update the quoted price, so long as market conditions have not changed to the point of invalidating it: "However, if an investment firm provides a quote to a client and that quote would meet the investment firm's obligations under Article 21(1) of Directive 2004/39/EC if the firm executed that quote at the time the quote was provided, then the firm will meet those same obligations if it executes its quote after the client accepts it, provided that, taking into account the changing market conditions and the time elapsed between the offer and acceptance of the quote, the quote is not manifestly out of date."

73. **A question that remains: complying with the requirement to provide a quote that satisfies the ISP's obligations under Article 21**

The situations that Recital 70 seeks to cover are not those in which the ISP must choose between several order execution venues, but situations where the venue is the ISP itself. The ISP can then find itself in a conflict of interests vis-à-vis its clients when it determines the price at which it proposes to make the transaction. An ISP that proposes the prices at

which it is prepared to trade is inevitably in a situation where its interest – i.e. to manage its positions so as to maximise its gains – is clearly and inherently in conflict with its clients' interests.

74. Recital 70 does not relieve the ISP of the obligation to provide a quote that satisfies its obligations under Article 21.1, leaving the question of how the ISP can meet those obligations given the particular circumstances. In this situation, the ISP is itself the execution venue and, depending on the instrument concerned, there may be no points of reference that would enable it to assess the relevance of the price it plans to offer.
75. One solution to this dilemma, depending on the instrument concerned and the availability of a reference price for it, is to recommend that the ISP use prices of transactions on regulated markets or MTFs, or prices published by data vendors, or any other internal procedure for creating suitable reference prices for external use in respect of markets where such prices are lacking.

This solution is close to the one now covered by Article 321-77¹² of the AMF General Regulation. In their exchanges with industry professionals, AMF staff have understood that this provision could be a point of departure for a MiFID-compatible rule. In accordance with this article, ISPs have implemented procedures to set price spreads that traders generally should not exceed. The spread can be exceeded with the authorisation of the compliance officer, as, for example, when a higher margin is justified on a deal that is particularly intricate. To verify the claimed justification, the compliance officer can refer to evidence such as the recordings of telephone conversations with clients and the prices available from wire services. On the basis of this article and current practice at ISPs, the guiding principles of the special arrangements for executing transactions of this kind (external reference prices, internal procedures, etc.) could be made part of the ISP's order execution policy. The principle set forth in Article 321-77 would then cease to be considered merely a means of *ex post* proof and would become an integral part of the ISP's execution policy.

76. **Execution of orders by systematic internalisers.** The issue for systematic internalisers is somewhat different. As the intermediary to which clients have entrusted execution of their orders, the ISP must, before it executes those orders in its internalisation system (i.e. against its own account), make sure that its system is the one that will indeed obtain the best result for its clients, in comparison with any other execution venues in its execution policy. If the client, at his own initiative, has requested that his order be executed on an ISP's internalisation system at a price posted by that ISP, the situation is clearly one in which the posted price has guided the client's choice and the client has given a specific instruction as to the execution venue. The intermediary is therefore presumed to have fulfilled its best-execution obligation as regards price and execution venue.

¹² This article provides that "If a member of an authorised provider's staff makes a trade at a price other than a market price available at the time, the provider must be able to explain the reasons there for upon request of the AMF."

77. **Application of the best-execution principle to customised products** The implementing directive also provides details for satisfying the best-execution rule on customised products. Recital 70 cites customised structured products as an example: "Transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues."
78. The context in which this particular situation arises needs to be borne in mind:
- The best-execution rule is a best endeavours obligation. Not all the factors listed in Article 21.1 can be relevant to a complex transaction or a structured product. In particular, "price" is just one aspect of the best possible result, which may be determined with regard to "any other consideration relating to order execution". Cost should be assessed according to the analysis proposed above (cf. § 75).

The ISP is considered to meet its best-execution obligation in respect of specific client instructions for an order or an aspect of an order. If, for a customised OTC product, the client indicates the particular characteristics of the product that he wants, specifying the characteristics can be considered equivalent to giving specific instructions.

- The best-execution obligation rests on an execution policy, and the content of that policy must be appropriate to the particular situation. In practice, one may question the relevance, or, at least, the content of an execution policy for customised products. Logic demands that the content of any such policy should be different for each instrument.

79. **A general principle to be applied in a differentiated manner**

It would thus appear that the general principle set forth in the directive will have to be applied in a differentiated manner suitable to each situation. The aim would be to take account of differences in the maturity of the markets concerned, in market structure (dealer market only, or market with both dealers and brokers), in the degree of competition, in the instruments traded (customised vs. standardised, even if traded over the counter) or in the degree of liquidity. The AMF will take these special characteristics and this diversity of contexts into account in its oversight of ISPs' implementation of the best-execution concept.

Question 10: Are the above guidelines relevant? What difficulties might they raise?
--

6. Responsibilities of the various entities that may participate in order execution

80. Besides the obligations that apply to ISPs charged with executing orders, there are obligations applicable to ISPs that, instead of executing orders themselves, route them to a third party for execution. There are likewise obligations that apply to ISPs which manage

portfolios and engage a third party to execute the orders stemming from their investment decisions.

81. These ISPs are subject to specific obligations under their duty to act in the best interests of clients whenever they entrust the execution of orders received from clients or orders stemming from investment decisions to a third party.
82. As Recital 75 of the implementing directive confirms, there is no question of requiring a duplication of effort as to best execution between an ISP providing order reception and transmission (RTO) or portfolio management services and another ISP that provides order execution.

6.1. ISPs that receive and transmit orders

83. There are situations where an ISP is unable to execute an order itself, for example, because it is not a member of the trading platform that handles the instrument concerned (a platform may be located outside the EU).
84. In other situations, ISPs have organised themselves to obtain the best possible result by entrusting execution of client orders to one or more third parties. This is the case for order collectors, the term generally used in France to designate credit institution ISPs that transmit retail client orders to a third party for execution. The third party is often a broker affiliated with the same group.
85. There are also less frequent situations in which clients, typically institutional clients,
 - have entrusted execution of their orders to an intermediary with which they have a relationship that may also cover custody account-keeping,
 - and also receive advice from an ISP acting solely to facilitate transmission of their orders and thus acting as an RTO.
86. These RTOs lack the capacity to execute client orders themselves. Rather, they have special expertise in particular market sectors, geographic areas or asset classes; their value added lies in their knowledge of the products or instruments concerned. They bring the client ideas in terms of analysis or arbitrage between securities or markets, and the client gains the benefit of their specialised knowledge of the markets where these instruments are traded. Because they know how orders are placed in these markets, the special care they provide can contribute to best execution.
87. **Principles**

Whenever they transmit client orders to a third party for execution, ISPs are bound by the following obligations arising from their duty to act in the best interests of their clients (cf. Article 45 of the implementing directive):

- They must take all reasonable steps to obtain the best possible result for their clients, taking into account the factors referred to in Article 21(1) of MiFID (price, cost, speed and likelihood of execution, etc.) and the criteria listed in the proposed implementing directive (characteristics of the client, the order, the financial instruments concerned and the intermediaries to which the order can be directed).
 - For retail clients, the factor that takes precedence is "total consideration", reflecting the traded price plus execution-related costs. In addition, the RTO is presumed to have met a "best transmission" obligation in respect of any specific instructions the client may have given.
 - To satisfy their obligation, RTOs must establish a policy that specifies the entities to which orders for each class of instrument may be transmitted. These entities must have an execution policy that enables the RTO to meet its own obligations on transmission of orders to the entity charged with executing them.
 - Clients must receive appropriate information on this policy, including information on the trading firms chosen to perform execution and the factors influencing the choice of those trading firms.
 - RTOs must monitor the effectiveness of this policy on a regular basis. In particular, they must review the quality of execution by the trading firms they have selected and, if need be, correct any shortcomings. They must also review their execution policy annually and whenever a material change affects their ability to continue obtaining the best possible result for their clients.
88. Depending on whether the RTO is an eligible counterparty vis-à-vis the trading firm, the relationship between the RTO and the trading firm may come under the best-execution provisions of Article 21. If it does not, the parties should agree by contract on mechanisms by which the trading firm ensures the best possible result on client order execution.
89. When the trading firm has no direct knowledge of the client, it will rely on the information provided by the RTO to ensure best execution (cf. Article 20 MiFID). In particular, orders from the RTO's clients must not be executed outside an organised market (regulated market or MTF) unless the RTO has obtained clients' consent to such execution. On this aspect, the RTO will have to decide upon this with the trading firm to ensure compliance.
90. ISPs that provide an RTO service and execute these orders themselves are subject to the same obligations as those applicable to ISPs executing orders from their clients (cf. Article 45.7 of the proposed implementing directive).
91. **Analysis**

ISPs that entrust the execution of their clients' orders to another entity may exercise a degree of discretion as to how the orders are executed. They can determine all or some of the allowable modes of execution, for example, by specifying how or where orders are to be executed or by giving instructions for special treatment. Alternately, they can delegate the entire task of specifying and performing execution to the trading firm. Any specific instructions given by the ISP are requirements that the trading firm must meet, and by meeting them the trading firm satisfies its best-execution obligation.

92. The provisions of the implementing directive (cf. Article 45) address the different situations that arise depending on the roles played by the RTO and the trading firm in the chain that runs from the client's decision to place an order to the trading firm's execution of that order. The RTO must:
- implement a policy that enables it to satisfy its obligations to act in the best interests of the client when it transmits orders to a third party for execution; thus, it must take all reasonable steps to obtain the best possible result on those orders, taking into account the factors listed in Article 21.1 of the directive (price, cost, speed and likelihood of execution, etc.) and the criteria listed in the implementing directive (characteristics of the client, the order, the financial instruments concerned, the trading firms to which the order can be directed);
 - ensure that the entities it selects to perform order execution have mechanisms in place that enable it to meet its own obligations.
93. **Order collector RTOs.** An order collector RTO has a direct relation with the clients who have given it orders to execute, but its clients are unacquainted with the trading firm to which their orders will be sent for execution. The RTO is in fact providing a comprehensive service that includes order execution and will take responsibility for handling client complaints about order execution, having recourse against the trading firm if need be. In practice, order collectors make it their business to handle every aspect of the processing of their clients' orders, but generally entrust execution to a third-party trading firm. Since the RTO is the only party in a direct relation with the client, the duty of ensuring best execution falls to the RTO. This is consistent with Recital 33 of MiFID, according to which the best-execution obligation should apply to the entity that "owes contractual or agency obligations to the client", and with Article 21.1 of the same directive, which requires that ISPs take reasonable steps to obtain, "when executing orders", the best possible result.
94. The RTO must therefore select the trading firm or trading firms likely to provide the best possible result on execution of its clients' orders based on the characteristics of its clientele, its business and the orders it receives (in particular the type of instruments to be traded: equities, bonds, other). It is also the RTO's responsibility to "monitor" the trading firms to which it sends client orders for execution.
95. The trading firms selected by the RTO must each have an execution policy that enables the RTO to meet its obligations as to order transmission. Because the RTO owes its clients the

best possible result on execution of their orders, the RTO will frame its execution policy under its own responsibility, but in collaboration with the trading firms, whose execution policy will be incorporated to a greater or lesser degree in the RTO's own:

- either the RTO will send the trading firm a set of detailed requirements ("If you want to receive orders from me, you must agree to the following conditions: . . ."), where the conditions are designed to enable the RTO to meet its "best transmission" obligations (cf. 6.1.1(1) above),
 - or the trading firm will impose its own terms on the RTO ("I can execute the orders you send me only on the following conditions: . . ."), the question for the RTO then being whether, given the characteristics of the orders that the RTO receives, those conditions allow it to select that trading firm.
 - or, in all likelihood, a solution somewhere between the two above.
96. In practice, there are several different ways of organising this relationship, including arrangements where the RTO itself makes choices that are tantamount to instructions to the trading firm:
- segmentation of the client base and choice of mode of execution (for example, the market where orders will be sent for execution) based on characteristics of client orders, or
 - transmission of the entire order flow to the trading firm, without segmentation by type of instrument or order characteristics, with the trading firm then having to put into place the execution arrangements that will enable the RTO to meet its obligations.
97. It can be expected that the information the RTO owes its clients regarding execution policy, and to which it must obtain their consent, will largely reflect the execution policy of the trading firm.
98. **Adviser RTOs.** In a situation where the client has direct relations with both the RTO and the trading firm, the RTO is only receiving and transmitting the order, which will have been specified in detail by the client (quantity, instrument, price or other type of conditional order). The RTO has an obligation to transmit orders in such a way that it acts in the best interests of the client, in accordance with the principles indicated above which includes providing any specific instructions intended to facilitate order execution. Since the trading firm will have been chosen by the client, barring exceptions, the RTO is not responsible for having made that selection.
99. The trading firm has a duty of best execution to the client directly, except as regards any specific instructions from the RTO.
100. **Circumstances and conditions in which an RTO can include only one intermediary in its execution policy and still satisfy its best-execution obligation.** As indicated above,

when the client has direct relations with both the RTO and the trading firm, the trading firm will generally have been chosen by the client, and the RTO has no responsibility for that choice.

101. As regards order collectors, the usual situation is one where the execution of orders collected by the branch network is performed by another entity of the same group.
102. The obligation of the order collector is to take all reasonable steps to ensure the best possible result on execution of client orders, giving precedence to total cost where retail clients are concerned. Groups that have orders executed by an "in-house" trading firm generally have a special commission schedule for orders originating from group entities. An order collector must be able to show that it obtains the best possible result by transmitting its clients' orders to its affiliated trading firm.
103. Given the nature of orders handled by an order collector, the selection of a trading firm is decided periodically rather than at the time of each transmission, having regard to the previously mentioned assessment factors. The order collector must monitor the quality of execution by the trading firm on a regular basis. In any case, it must verify, at least once a year, the effectiveness of the arrangements it has made to ensure the best possible result on execution of its clients' orders.

104. As noted above, to meet its obligation to inform clients properly, the order collector will probably include information in its execution policy that draws heavily on the trading firm's execution policy.

Question 11: Does the foregoing analysis cover the different situations relating to reception and transmission of orders? Are there typologies or contractual relations that are missing from the schematic descriptions identified above?

6.2. ISPs that manage portfolios

105. Principles

As part of their duty to act in the best interests of their discretionary clients, ISPs that manage portfolios must select trading firms whose execution policy enables them to obtain the best possible result on execution of orders resulting from their investment decisions for the portfolios they manage.

106. Their specific obligations are the following:

- Portfolio manager ISPs (hereinafter "managers") must take all reasonable steps to obtain the best possible result, taking into account the factors listed in Article 21.1 of the directive (price, cost, speed and likelihood of execution, etc.) and the criteria listed in the implementing directive (characteristics of the client, the order, the financial instruments concerned, the trading firms to which the order can be directed).
- For retail clients, the factor that takes precedence is "total consideration", reflecting the traded price plus execution-related costs. In addition, the manager is presumed to have met his best-transmission obligation with respect to any specific instructions the client may have given. In the context of discretionary management, specific instructions from the client raise questions of interpretation. A client request to execute a particular order would seem to contradict the very purpose of a management mandate (although occasional specific instructions would seem to be acceptable).
- To meet the aforementioned obligation, managers must establish a policy that selects the entities to which orders for each class of instrument are to be directed. The execution policies of these entities must enable the manager to satisfy his own obligations on orders transmitted for execution.
- Clients must receive appropriate information on the policies of portfolio manager ISPs, in particular information on the trading firms chosen and the factors influencing the choice of those trading firms.

- The managers must monitor the effectiveness of their policy on a regular basis, reviewing the quality of execution by the trading firms they have selected and, if need be, correcting any shortcomings. They must also review their execution policy annually and whenever a material change affects their ability to continue obtaining the best possible result for their clients.

107. ISPs that provide both portfolio management and order execution are subject to the same obligations that apply to ISPs executing orders from their clients (cf. Article 45.7 of the proposed implementing directive).

108. **Analysis**

ISPs that manage portfolios under mandate from their clients are responsible for ensuring that the orders resulting from their investment decisions are executed in the clients' best interests. This responsibility is an integral part of the manager's professional role, which consists in taking all reasonable care and giving the instructions necessary to obtain the best possible result on execution of the orders that he sends to a third party. In the relationship between the manager and the third-party intermediary, the warranty of best execution is "owed" by the intermediary to the manager acting as agent under the mandate. The principals, i.e. the clients of the portfolio manager ISP, should not have to concern themselves with the quality of execution provided by the trading firm, nor should they need to monitor it.

109. Note that the trading firm will have an Article 21 best-execution obligation to the manager only if the manager has asked to be treated as a client and the trading firm has accepted that request. Otherwise, the manager will be considered to be an eligible counterparty. Either way, it is likely that the parties will agree by contract on how the manager's orders are to be executed.

110. **Price and cost factors: meaning of "total consideration" for the retail client.** Under the Level 2 text, the "total consideration" criterion – that is, the price at which the instrument is traded plus execution-related costs – is the main priority when executing retail orders without specific instructions from the client.

111. In applying this text to portfolio manager ISPs, and by analogy with the provisions applicable to trading firms, logic demands that the total amount billed for execution should be taken into account when selecting trading firms. The trading firm with the "lowest total cost" of execution is the one that should be selected.

112. Because it must be based on quality of execution in the strict sense of the term, the selection of trading firms can no longer include research as a factor. However, managers are free to choose among trading firms with equal quality of execution and direct their orders based on the quality of the trading firm's research.

113. **Circumstances and conditions in which a portfolio manager ISP can include only one intermediary in its execution policy and still satisfy its best-execution obligation.** This question arises often in the context of orders placed by management companies with relatively modest order volume that lead them to work with a single intermediary. Generally, that intermediary also provides custody account-keeping for the management company's clients. The answer to the question must turn on the obligation to take all reasonable steps to obtain the best possible result on execution of orders stemming from investment decisions on behalf of client portfolios. Dividing the order flow of such a company between two or more intermediaries for the purpose of inciting competition between them could result in higher fees to the company, since trading firms' commission rates are generally tied to volume. Any cost saving that might be achieved by bargaining with competing trading firms could then be vitiated by the impossibility of maintaining sufficient volume to obtain a lower rate.
114. This question also comes up in the context of groups where a management company seeks to entrust execution of orders resulting from its investment decisions to an affiliated trading firm.
115. As noted above, the directive does not require an execution policy to include several order execution modes or venues in order to obtain the best possible result. The management company must be able to demonstrate that going through its affiliated trading firm is the way in which it satisfies its obligation to take all reasonable steps to achieve the best possible result.
116. **Treatment of management companies covered by MiFID and management companies covered by the UCITS directive.** Under the UCITS directive, the best-execution obligations of UCITS management companies are established by that directive in general terms equivalent to those of the current ISD, meaning less detailed than those of MiFID.¹³ However, when such companies also provide advisory services or individual portfolio management services on an ancillary basis, they must obey the rules of conduct applicable to individual asset management companies, including Article 19. Management companies of coordinated UCITS are consequently subject to the best-transmission rules of MiFID in respect of their individual management business.
117. In view of the architecture of French law, which has established a unique status for asset management companies, the impact of MiFID and related comitology measures on UCITS management companies is examined in the context of a general analysis of this subject. As regards the best-execution requirement, non-uniform treatment of management companies subject to MiFID in respect of all or part of their business and management companies not

¹³ Each Member State establishes rules of conduct that management companies authorised in that Member State are required to observe at all times. These rules must implement at least the principles set forth in the points below. The management company is required to:

- a) act honestly and fairly in conducting its business activities in the best interests of the investment scheme it manages and for the integrity of the market;
 - b.) act with due skill, care and diligence in the best interests of the UCITS that it manages and market integrity;
- [...] Article 5(9)

subject to MiFID (those that manage only non-UCITS or only UCITS, for example) seems hard to justify, unless the rules introduced by MiFID and its implementing texts pose difficulties for UCITS management companies that those in the AMF's current General Regulation do not pose.

Question 12: Is the analysis of the directive's provisions concerning portfolio manager ISPs relevant? What elements, if any, are missing from this analysis? Are there special characteristics of UCITS management that would prevent making it subject to the same rules as individual management?

6.3. Institutions that perform order reception and transmission, portfolio management and order execution on an integrated basis

118. Regardless of the organisational structure chosen by an integrated institution offering at least two of the services mentioned, it is important that the overall best-execution requirement be assured for the benefit of the institution's clients. Under MiFID (cf. Recital 33), the entity that has a direct contractual relation with the client owes a duty of best execution to that client. In the case of a retail client, the entity has an obligation to obtain the best possible result in terms of net cost.
119. It is important that each group entity meet its due-care obligations. These include monitoring the effectiveness of the procedures and policies that other service providers within the group have implemented to meet their obligations. Thus, the RTO or management company will have to see to it that the group entity in charge of executing orders provides the best service possible. The group entity with the direct relation with the client (the RTO or the management company) is responsible for ensuring that it receives the best possible service in terms of order transmission and execution, notwithstanding the closed architecture of the group and the absence of systematic competition for the entity that performs order execution.

Question 13: In the context of section 6 as a whole, do you agree with the foregoing analysis?

7. Data retention

120. Article 21.5 of MiFID requires an ISP to be able to demonstrate to its clients, at their request, that it has executed their orders in accordance with its execution policy. This implies that the ISP will have to be able to provide the evidence needed to reconstruct the conditions in which an order was executed, by retaining the necessary data (directly or by

using a sub-contractor such as a data provider). Note that the standard duration of data retention required by the directive is five years.

Question 14: What particular difficulties does this solution raise? What solutions are there that would enable ISPs to meet their obligation?

Annex

Excerpts from MiFID and the proposed implementing directive concerning the best-execution rule

MiFID

(33) It is necessary to impose an effective 'best execution' obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. This obligation should apply to the firm which owes contractual or agency obligations to the client.

Article 19

Conduct of business obligations when providing investment services to clients

1. Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients and comply, in particular, with the principles set out in paragraphs 2 to 8.

[...]

Article 21

Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

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

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

Member States shall require that investment firms provide appropriate information to their clients on their order execution policy. Member States shall require that investment firms obtain the prior consent of their clients to the execution policy.

Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the investment firm shall, in particular, inform its clients about this possibility. Member States shall require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a

regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement or in respect of individual transactions.

4. Member States shall require investment firms to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements. Member States shall require investment firms to notify clients of any material changes to their order execution arrangements or execution policy.

5. Member States shall require investment firms to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm's execution policy.

6. In order to ensure the protection necessary for investors, the fair and orderly functioning of markets, and to ensure the uniform application of paragraphs 1, 3 and 4, the Commission shall, in accordance with the procedure referred to in Article 64(2), adopt implementing measures concerning:

(a) the criteria for determining the relative importance of the different factors that, pursuant to paragraph 1, may be taken into account for determining the best possible result taking into account the size and type of order and the retail or professional nature of the client;

(b) factors that may be taken into account by an investment firm when reviewing its execution arrangements and the circumstances under which changes to such arrangements may be appropriate. In particular, the factors for determining which venues enable investment firms to obtain on a consistent basis the best possible result for executing the client orders;

(c) the nature and extent of the information to be provided to clients on their execution policies, pursuant to paragraph 3.

Proposed implementing directive
--

Whereas

(66) When establishing its execution policy in accordance with Article 21(2) of Directive 2004/39/EC, an investment firm should determine the relative importance of the factors mentioned in Article 21(1) of that Directive, or at least establish the process by which it determines the relative importance of these factors, so that it can deliver the best possible result to its clients. In order to give effect to that policy, an investment firm should select the execution venues that enable it to obtain on a consistent basis the best possible result for the execution of client orders. An investment firm should apply its execution policy to each client order that it executes with a view to obtaining the best possible result for the client in accordance with that policy. The obligation under Directive 2004/39/EC to take all reasonable steps to obtain the best possible result for the client should not be treated as requiring an investment firm to include in its execution policy all available execution venues.

(67) For the purposes of ensuring that an investment firm obtains the best possible result for the client when executing a retail client order in the absence of specific client instructions, the firm

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

- (68) When an investment firm executes an order following specific instructions from the client, it should be treated as having satisfied its best execution obligations only in respect of the part or aspect of the order to which the client instructions relate. The fact that the client has given specific instructions which cover one part or aspect of the order should not be treated as releasing the investment firm from its best execution obligations in respect of any other parts or aspects of the client order that are not covered by such instructions. An investment firm should not induce a client to instruct it 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. However, this should not prevent a firm inviting a client to choose between two or more specified trading venues, provided that those venues are consistent with the execution policy of the firm.
- (69) Dealing on own account with clients by an investment firm should be considered as the execution of client orders, and therefore subject to the requirements under Directive 2004/39/EC and this Directive and, in particular, those obligations in relation to best execution. However, if an investment firm provides a quote to a client and that quote would meet the investment firm's obligations under Article 21(1) of Directive 2004/39/EC if the firm executed that quote at the time the quote was provided, then the firm will meet those same obligations if it executes its quote after the client accepts it, provided that, taking into account the changing market conditions and the time elapsed between the offer and acceptance of the quote, the quote is not manifestly out of date.
- (70) The obligation to deliver the best possible result when executing client orders applies in relation to all types of financial instruments. However, given the differences in market structures or the structure of financial instruments, it may be difficult to identify and apply a uniform standard of and procedure for best execution that would be valid and effective for all classes of instrument. Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments. For example, transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues.
- (71) For the purposes of determining best execution when executing retail client orders, the costs related to execution should include an investment firm's own commissions or fees charged to the client for limited purposes, in cases where more than one venue listed in the firm's execution policy is capable of executing a particular order. In such cases, the firm's own

commissions and costs for executing the order on each of the eligible execution venues should be taken into account in order to assess and compare the results for the client that would be achieved by executing the order on each such venue. However, it is not intended to require a firm to compare the results that would be achieved for its client on the basis of its own execution policy and its own commissions and fees, with results that might be achieved for the same client by any other investment firm on the basis of a different execution policy or a different structure of commissions or fees. Nor is it intended to require a firm to compare the differences in its own commissions which are attributable to differences in the nature of the services that the firm provides to clients.

- (72) The provisions of this Directive that provide that costs of execution should include an investment firm's own commissions or fees charged to the client for the provision of an investment service should not apply for the purpose of determining what execution venues must be included in the firm's execution policy for the purposes of Article 21(3) of Directive 2004/39/EC.
- (73) It should be considered that an investment firm structures or charges its commissions in a way which discriminates unfairly between execution venues if it charges a different commission or spread to clients for execution on different execution venues and that difference does not reflect actual differences in the cost to the firm of executing on those venues.
- (74) The provisions of this Directive as to execution policy are without prejudice to the general obligation of an investment firm under Article 21(4) of Directive 2004/39/EC to monitor the effectiveness of its order execution arrangements and policy and assess the venues in its execution policy on a regular basis.
- (75) This Directive is not intended to require a duplication of effort as to best execution between an investment firm which provides the service of reception and transmission of order or portfolio management and any investment firm to which that investment firm transmits its orders for execution.
- (76) The best execution obligation under Directive 2004/39/EC requires investment firms to take all reasonable steps to obtain the best possible result for their clients. The quality of execution, which includes aspects such as the speed and likelihood of execution (fill rate) and the availability and incidence of price improvement, is an important factor in the delivery of best execution. Availability, comparability and consolidation of data related to execution quality provided by the various execution venues is crucial in enabling investment firms and investors to identify those execution venues that deliver the highest quality of execution for their clients. This Directive does not mandate the publication by execution venues of their execution quality data, as execution venues and data providers should be permitted to develop solutions concerning the provision of execution quality data. The Commission should submit a report by 1 November 2008 on the market-led developments in this area with a view to assessing availability, comparability and consolidation at a European level of information concerning execution quality.

SECTION 5

BEST EXECUTION

Article 44

(Articles 21(1) and 19(1) of Directive 2004/39/EC)

Best execution criteria

1. Member States shall ensure that, when executing client orders, investment firms take into account the following criteria for determining the relative importance of the factors referred to in Article 21(1) of Directive 2004/39/EC:

(a) the characteristics of the client including the categorisation of the client as retail or professional;

(b) the characteristics of the client order;

(c) the characteristics of financial instruments that are the subject of that order;

(d) the characteristics of the execution venues to which that order can be directed.

For the purposes of this Article and Article 46, 'execution venue' means a regulated market, an MTF, a systematic internaliser, or a market maker or other liquidity provider or an entity that performs a similar function in a third country to the functions performed by any of the foregoing.

2. An investment firm satisfies its obligation under Article 21(1) of Directive 2004/39/EC to take all reasonable steps to obtain the best possible result for a client to the extent that it executes an order or a specific aspect of an order following specific instructions from the client relating to the order or the specific aspect of the order.
3. Where an investment firm executes an order on behalf of a retail client, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution, which shall include all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

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

commissions and costs for executing the order on each of the eligible execution venues shall be taken into account in that assessment.

4. Member States shall require that investment firms do not structure or charge their commissions in such a way as to discriminate unfairly between execution venues.
5. Before 1 November 2008 the Commission shall present a report to the European Parliament and to the Council on the availability, comparability and consolidation of information concerning the quality of execution of various execution venues.

Article 45

(Article 19(1) of Directive 2004/39/EC)

Duty of investment firms carrying out portfolio management and reception and transmission

of orders to act in the best interests of the client

1. Member States shall require investment firms, when providing the service of portfolio management, to comply with the obligation under Article 19(1) of Directive 2004/39/EC to act in accordance with the best interests of their clients when placing orders with other entities for execution that result from decisions by the investment firm to deal in financial instruments on behalf of its client.
2. Member States shall require investment firms, when providing the service of reception and transmission of orders, to comply with the obligation under Article 19(1) of Directive 2004/39/EC to act in accordance with the best interests of their clients when transmitting client orders to other entities for execution.
3. Member States shall ensure that, in order to comply with paragraphs 1 or 2, investment firms take the actions mentioned in paragraphs 4 to 6.
4. Investment firms shall take all reasonable steps to obtain the best possible result for their clients taking into account the factors referred to in Article 21(1) of Directive 2004/39/EC. The relative importance of these factors shall be determined by reference to the criteria set out in Article 44(1) and, for retail clients, to the requirement under Article 44(3).

An investment firm satisfies its obligations under paragraph 1 or 2, and is not required to take the steps mentioned in this paragraph, to the extent that it follows specific instructions from its client when placing an order with, or transmitting an order to, another entity for execution.

5. Investment firms shall establish and implement a policy to enable them to comply with the obligation in paragraph 4. The policy shall identify, in respect of each class of instruments, the entities with which the orders are placed or to which the investment firm transmits orders for execution. The entities identified must have execution arrangements that enable the

investment firm to comply with its obligations under this Article when it places or transmits orders to that entity for execution.

Investment firms shall provide appropriate information to their clients on the policy established in accordance with this paragraph.

6. Investment firms shall monitor on a regular basis the effectiveness of the policy established in accordance with paragraph 5 and, in particular, the execution quality of the entities identified in that policy and, where appropriate, correct any deficiencies.

In addition, investment firms shall review the policy annually. Such a review shall also be carried out whenever a material change occurs that affects the firm's ability to continue to obtain the best possible result for their clients.

7. This Article shall not apply when the investment firm that provides the service of portfolio management and/or reception and transmission of orders also executes the orders received or the decisions to deal on behalf of its client's portfolio. In those cases Article 21 of Directive 2004/39/EC applies.

Article 46

(Article 21(3) and (4) of Directive 2004/39/EC)

Execution policy

1. Member States shall ensure that investment firms review annually the execution policy established pursuant to Article 21(2) of Directive 2004/39/EC, as well as their order execution arrangements.

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

2. Investment firms shall provide retail clients with the following details on their execution policy in good time prior to the provision of the service:

(a) an account of the relative importance the investment firm assigns, in accordance with the criteria specified in Article 44(1), to the factors referred to in Article 21(1) of Directive 2004/39/EC, or the process by which the firm determines the relative importance of those factors;

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

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

That information shall be provided in a durable medium, or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Article 3(2) are satisfied.