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MiFID II: What is new for buy side? Best Execution

Topic 3

In our document on Topic 1 of this series looking at MiFID II, we examined the new trade and transaction reporting obligations, and in our document on Topic 2 we focused on systematic internalization, the trading obligation and matched principal trading. In this document, we discuss the best execution obligation and examine new requirements that have arisen in MiFID II. Broadly speaking, the new rules cast positive obligations on execution venues, which include trading venues, systematic internalisers, market makers and other liquidity providers, and investment firms to publish aggregated best execution data periodically; marking a significant departure from the current rules which do not require such information to be published and which require investment firms to be able to demonstrate compliance with the firms' execution policy in respect of the execution of a client order only at the request of a client.

Proving adherence to the best execution obligation now poses greater challenges to investment firms and execution venues as they need to implement more processes, increase controls and monitoring, such as due diligence on execution venues and brokers, and make arrangements for the collection and publication of execution data.

In this note we shall discuss the new obligations arising under the MiFID II framework.

Where is the regulation?

The rules regarding the best execution obligations are contained in Article 27[1] of MiFID II, which is supplemented by RTS 27 and 28 and section 5 of the Delegated Regulation[2].

What is new?

Simply put, the best execution obligation requires investment firms to achieve the best possible result for their clients taking into account price, cost, speed, likelihood of settlement and execution, size, nature and *"other relevant considerations"*[3]. Hitherto, investment firms were obliged to obtain best execution for their clients; however they were not required to evidence it publicly, but did need to evidence compliance with the best execution policy when requested to

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[1] **Article 27(1) MiFID II:** *Member States shall require that investment firms take all sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.*

2 *Commission Delegated Regulation (EU) .../... of 25.4.2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that directive.*

[3] *Ibid, note 1.*

do so by individual clients. This left the investors and regulators with very little public information about a particular firm's performance regarding compliance with the best execution requirements.

Therefore, regulators sought greater transparency into the execution arrangements of investment firms. This is a common theme in MiFID II, and the regulators are also seeking greater transparency in relation to the use of investor funds towards expenses such as research and venue costs and fees. We will consider the changes to payments for research in a separate report, but for the purposes of this document we wanted to highlight that unbundling payments for research from those relating to execution will assist firms in their management of conflicts of interests and will help to ensure that orders are routed to the broker or venue which provides the best execution. Investors and regulators will be able to see the different components of costs associated with a transaction and see if there is an objective justification for the decisions made by firms relating to the selection of execution venues.

Consequently, MiFID II introduced requirements for the mandatory publication of execution data by execution venues and investment firms to afford the regulators and investors better insight into the execution quality of execution venues and the top five venues used by investment firms. In introducing this requirement, new obligations have created a framework where execution venues and investment firms will have to implement systems for the collection and publication of execution data in order to assist with their monitoring and review procedures, to evidence their compliance with their best execution obligations, and to enable investors and regulators to review the execution quality of execution venues used by investment firms. By revamping the best execution requirements, MiFID II seeks to make the execution arrangements for the buying and selling of financial instruments more transparent.

What is new for clients?

More often than not, the fees charged to an investment firm differs from venue to venue and the regulators were concerned about the firms' motivations to pick one venue over the other. MiFID II precludes investment firms from structuring or charging their commissions in such a way as to discriminate unfairly between execution venues, and the new provisions require that in deciding the preferred venue of execution, investment firms will be required to take into account their own commission and costs when assessing and comparing the results for the client that would be achieved by executing the order at each of the competing venues. Generally speaking, MiFID II provisions aim to give more visibility to clients into the firms' processes of venue selection and monitoring; and the reports give clients more visibility into the costs associated with the execution venues that the firm uses.

After the execution of the transaction, the investment firms will also have to inform their clients at which venue their order was executed.

What is new for execution venues?

Under Article 27(3) of MiFID II, trading venues, systematic internalisers, market makers and other liquidity providers will be obligated to publish on a quarterly basis execution quality data for each financial instrument without any charges.

Execution venues are required to publish separate reports for each financial instrument per market segment, which means that separate reports will need to be submitted for segments that operate different order books, or which are regulated differently, or where different market segment identifiers have been assigned, in order to provide proper context for the quality of execution and to ensure the relevance of the collected data. In addition to details about price, likelihood of execution and trading mode; these reports will also have to provide information about all costs associated with a particular venue including execution fees, market access fees, fees for using terminals, order and quote submission/ cancellation/ modification fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

Specific details about the format and content of these reports are provided in RTS 27 and repeated in the appendix.

What is new for investment firms?

To enable the public to evaluate the order execution quality of investment firms, firms will have to identify and publish the top 5 execution venues in terms of volume in each of 22 asset classes (refer to appendix) where they (i) executed client orders; and (ii) transmitted orders for execution, on an annual basis. Additionally, firms will also need to provide analysis of their findings in the top 5 reports, including an explanation of the relative importance placed on various execution factors such as costs, price and speed, information about impact of client categorization on execution arrangements, description of close links, conflicts of interest and common ownerships with respect to execution venues and description of any specific arrangements with venues such as payments made/ received, discounts, rebates or other non monetary benefits received[4].

In ascertaining their top 5 execution venues, firms should consider volume executed on trading venues, systematic internalisers, market makers and other liquidity providers both within the EU and in third countries. Specific details about the format and content of these reports are provided in RTS 28 (refer to appendix for further information).

Do investment firms have to make changes to their documentation?

MiFID II requires investment firms to establish and implement an order execution policy to allow them to obtain best possible results for their clients. Article 66 of the Delegated Regulation sets out detailed requirements regarding what should be included in the execution policy. These requirements are more prescriptive than those which existed under MiFID I, and accordingly certain amendments will need to be made. Thus firms need to revisit their order execution policy to incorporate these additional requirements and firms should also take the opportunity to generally review their policy and arrangements to ensure that all information therein is "*clear, sufficient and documented in a manner that is easily understood by clients*"[5].

Further, investment firms will have to notify their ongoing clients of any 'material change' to their order execution policy or other execution arrangements. Article 65(7) of the Delegated Regulation gives guidance on what could be considered as a material change: "*a significant event that could impact parameters of best execution such as cost, price, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order*". Therefore, it would be safe to assume that any change that affects cost, price, speed, likelihood of execution and settlement, size, nature or any other parameter considered relevant to the execution of the order should amount to a 'material change'. Increased monitoring coupled with a broad interpretation of "material change" means that clients will need to be notified of changes more frequently.

How does MiFID II affect systems and controls for firms?

MiFID II strengthens the overall framework by mandating that investment firms to take "all sufficient steps" to obtain best execution as opposed to "all reasonable steps" under the existing MiFID provisions. This change of phrasing imposes greater responsibility and accountability for investment firms, due to the higher standard of compliance required.

In its latest Q&A's on Investor Protection topics, ESMA explains what this change of phrasing entails. ESMA requires firms to ensure that their execution policies and arrangements are designed to consistently achieve intended outcomes. In practice, this may involve increasing front office accountability and improving detection capabilities of systems to identify any deficiencies. It further requires that firms should not only consider the quality of execution obtained, but should also take into account the quality and appropriateness of their execution policies and arrangements to identify deficiencies and ascertain the need to change their processes where needed.

Are firms allowed to receive payments for order flow?

In contrast to the existing regime there is an explicit ban on payment for order flow. Payment for

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[4] **Article 3(3), RTS 28.**
[5] **Article 27(5), MiFID II.**

order flows is believed to hinder the price formation process, damage market integrity and create a clear conflict of interest between the investment firm and its client. In introducing this ban, MiFID II mirrors the 2012 decision of FSA which prohibits investment firms from receiving payments from market makers for routing client orders to them.

Global Market Structure- EMEA

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Appendix

Table 1- Classes of Financial Instruments (RTS 28)

(a) Equities – Shares & Depositary Receipts
(i) Tick size liquidity bands 5 and 6 (from 2000 trades per day)
(ii) Tick size liquidity bands 3 and 4 (from 80 to 1999 trades per day)
(iii) Tick size liquidity band 1 and 2 (from 0 to 79 trades per day)

(b) Debt instruments
(i) Bonds
(ii) Money markets instruments

(c) Interest rates derivatives
(i) Futures and options admitted to trading on a trading venue
(ii) Swaps, forwards, and other interest rates derivatives

(d) Credit derivatives
(i) Futures and options admitted to trading on a trading venue
(ii) Other credit derivatives

(e) Currency derivatives
(i) Futures and options admitted to trading on a trading venue
(ii) Swaps, forwards, and other currency derivatives

(f) Structured finance instruments

(g) Equity Derivatives
(i) Options and Futures admitted to trading on a trading venue
(ii) Swaps and other equity derivatives

(h) Securitized Derivatives
(i) Warrants and Certificate Derivatives
(ii) Other securitized derivatives

(i) Commodities derivatives and emission allowances Derivatives
(i) Options and Futures admitted to trading on a trading venue
(ii) Other commodities derivatives and emission allowances derivatives

(j) Contracts for difference

(k) Exchange traded products (Exchange traded funds, exchange traded notes and exchange traded commodities)

(l) Emission allowances

(m) Other instruments

Table 2 - Top 5 Execution Venues Report (RTS 28)

Class of Instrument					
Notification if <1 average trade per business day in the previous year	Y / N				
Top five execution venues ranked in terms of trading volumes (descending order)	Proportion of volume traded as a percentage of total in that class	Proportion of orders executed as percentage of total in that class	Percentage of passive orders	Percentage of aggressive orders	Percentage of directed orders
Name and Venue Identifier (MIC or LEI)					
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Name and venue identifier (MIC or LEI)					
Name and venue identifier (MIC or LEI)					

Table 3 - Top 5 Execution Venues Report (RTS 28)

Class of Instrument		
Notification if <1 average trade per business day in the previous year	Yes / No	
Top 5 Venues ranked in terms of volume (descending order)	Proportion of volume executed as a percentage of total in that class	Proportion of orders executed as percentage of total in that class
Name and Venue Identifier(MIC or LEI)		
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Name and venue identifier(MIC or LEI)		
Name and venue identifier(MIC or LEI)		
Name and venue identifier(MIC or LEI)		

Information to be published by Trading and Execution Venues (RTS 27)

Table 1 - Identification Information Type of Execution Venue

Venue	Name	Identifier (ISO 10383 Market Identifier Code (MIC) or the Legal Entity Identifier (LEI)	
Country of Competent Authority	Name		
Market Segment	Name	Identifier (ISO 10383 market segment MIC)	
Date of the trading day	ISO 8601		
Outages	Nature	Number	Average duration
Scheduled Auction	Nature	Number	Average duration
Failed Transactions		Number	Value (as % of total value of transactions executed on that day)

Table 2- Identification Information – Type of Financial Instrument

Financial Instrument	Name	Identifier(ISO 6166)
Written description of financial instrument, if no identifier available (including the currency of the underlying instrument, price multiplier, price notation, quantity notation and delivery type)		
Instrument classification	(ISO 10962 CFI code)	
Currency	(ISO 4217)	

Table 3 - Price Information

Time (T)	Size Range	All trades executed within first two minutes after time T		First transaction after time T (if no transactions within first two minutes after time T)						
		Simple average executed price (excluding commissions and accrued interest)	Total value executed	Price	Time of execution	Transaction size	Trading System	Trading Mode	Trading platform	best bid and offer or suitable reference price at time of execution
09.30.00	1									
	2									
	3									
11.30.00	1									
	2									
	3									
13.30.00	1									
	2									
	3									
15.30.00	1									
	2									
	3									

Table 4 - Price Information

simple average transaction price	
volume-weighted transaction price	
highest executed price	
lowest executed price	

Table 5 – Cost Information

Information required under Article 5(a) to (d)	(Description)
Link to a website or other source where further information on costs is available	
Total value of all rebates, discounts, or other payments offered (as % of total traded value during the reporting period)	%
Total value of all costs (as a % of total traded value during the reporting period volume)	%

Table 6 – Likelihood of Execution Information

Number of orders or request for quotes received	
Number of transactions executed	
Total value of transactions executed	
Number of orders or request for quotes received cancelled or withdrawn	
Number of orders or request for quotes received modified	
Median transaction size	
Median size of all orders or requests for quote	
Number of designated market makers	

Table 7 - Likelihood of Execution Information

Time	Best Bid Price	Best Offer Price	Bid Size	Offer Size	Book depth within 3 price increments
9.30.00					
11.30.00					
13.30.00					
15.30.00					

Table 8 – Information to be published by Execution Venues operating a continuous auction order book or continuous quote driven execution venue

Average effective spread	
Average volume at best bid and offer	
Average spread at best bid and offer	
Number of cancellations at best bid and offer	
Number of modifications at best bid and offer	
Average book depth at 3 price increments	
Mean time elapsed (to the mili-second) between an aggressive order or quote acceptance being received by the execution venue and the subsequent total or partial execution	
Median time elapsed (to the mili-second) between a market order being received by the execution venue and the subsequent total or partial execution	
Average speed of execution for unmodified passive orders at best bid and offer	
Number of Fill or Kill orders that failed	
Number of Immediate or Cancel orders that got zero fill	
Number of transactions executed on the trading venue that are Large in Scale pursuant to Article 4 or 9 of Regulation (EU) No 600/2014	
Value of transactions executed on the trading venue that are Large in Scale pursuant to Article 4 or 9 of Regulation (EU) No 600/2014	
Number of transactions that were executed on the trading venue pursuant to Article 4 or 9 of MiFIR, except for orders that are held in an order management facility of the trading venue pending disclosure and not Large in Scale	
Value of transactions that were executed on the trading venue pursuant to Article 4 or 9 of MiFIR, except for orders that are held in an order management facility of the trading venue pending disclosure and not Large in Scale	
Number of trading interruptions	

Average duration of trading interruptions	
Number of suspensions	
Nature of suspensions	
Average duration of suspensions	

For continuous quote venues, number of periods during which no quotes were provided	
For continuous quote venues, average duration of periods during which no quotes were provided	
Average quote presence	

Table 9: Information to be published for request for quote execution venues

Mean time elapsed between acceptance and execution	
Median time elapsed between acceptance and execution	
Mean time elapsed between request and provision of any corresponding quotes	
Median time elapsed between request and provision of any corresponding quotes	

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