

MiFID II

Best execution and client order handling

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Key Points

- The definition of trading venue will include the new MiFID II concept of an organised trading facility.
- A firm's obligation to take steps to obtain best execution for clients will be strengthened.
- Firms will be required to take into account and publish information on the quality of execution obtained.
- Additional information requirements will be introduced to ensure that firms' execution policies contain clear and appropriate information to allow clients to understand the execution process.
- Certain types of commissions, benefits and remuneration will be limited and those which are permitted must be disclosed to clients.
- No changes will be made to the MiFID I rules on client order handling.

Background

The MiFID I Directive currently contains high-level obligations requiring firms to obtain best execution for clients¹ and to handle client orders appropriately.²

Further detailed provisions are contained in Articles 44-46 (in respect of best execution) and Articles 47-49 (in respect of client order handling) of the MiFID Implementing Directive. This includes the clarification that the best execution requirements apply where:

- firms offering portfolio management services are making their own decisions to place execution orders with other entities on their client's behalf; and

- firms are transmitting client orders to other entities for execution.³

MiFID II will change the current high-level obligations in relation to best execution. In addition, the detailed requirements of the MiFID Implementing Directive will be replaced and amended by the MiFID II Delegated Regulation, which is based on Technical Advice published by ESMA in December 2014.⁴

The European Commission has adopted regulatory technical standards which set out detailed requirements for execution quality metrics across all venues.⁵

MiFID II will not change the existing high-level obligations in relation to client order handling.⁶

Best execution

The main changes being introduced to best execution under MiFID II are as set out below.

"Trading venue" to include OTFs

The definitions of "trading venue" and "execution venue" will include the new MiFID II concept of an "organised trading facility" or "OTF". The broader

³ Article 45, MiFID Implementing Directive. This will continue to apply under MiFID II: see Article 65, MiFID II Delegated Regulation.

⁴ The European Commission has adopted Delegated Regulation of 25 April 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 (the "**MiFID II Delegated Regulation**"). For ESMA's advice to the Commission, see ESMA, Final Report: Technical Advice to the Commission on MiFID II and MiFIR, 19 December 2014 (ESMA/2014/1569) (the "**Technical Advice**"), Chapter 2.21.

⁵ See Delegated Regulation of 8 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards concerning the data to be published by execution venues on the quality of execution of transactions ("**RTS 27**"); and Delegated Regulation of 8 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the annual publication by investment firms of information on the identity of execution venues and on the quality of execution ("**RTS 28**"). For earlier commentary on the RTS, see ESMA, Final Report: Draft Regulatory and Implementing Technical Standards (the "**Final Report**"), 28 September 2015, Chapter 9.

⁶ Article 28, MiFID II Directive.

¹ Articles 19(1) and 21(1)-(4), MiFID I Directive.

² Articles 19(1) and 22(1), MiFID I Directive.

scope of these definitions is intended to ensure that more trading is regulated by MiFID II.

"Sufficient" steps

Firms are currently required to "take all reasonable steps" to obtain the best possible result for clients when executing a client order.⁷ Under MiFID II, this requirement will be strengthened so that firms must take "all sufficient steps" to obtain the best result.⁸

Article 27(1) of the MiFID II Directive lists factors for firms to take into account in order to show that "sufficient steps" have been taken. Specific criteria to decide the relative importance of each of these factors include:

- whether the order is for a retail or professional client;
- order characteristics, for example if a securities financing transaction is involved;
- characteristics of the financial instruments involved; and
- characteristics of the execution venues being considered.⁹

Following specific instructions from a client relating to the order is enough to demonstrate that "sufficient steps" have been taken.¹⁰

It will be possible for a firm to rely on one execution venue only, provided that it is able to meet the best execution requirements. This involves the firm being able to expect that the execution venue will enable it to obtain results for clients that are at least as good as the results that could be obtained from other execution venues, as supported by relevant data or information.

Best possible result in terms of total consideration

Firms are currently under an obligation to obtain the best possible result for clients. Article 27(1) of

the MiFID II Directive will make clear that, in relation to executing orders on behalf of retail clients, the best possible result shall be determined in terms of the total consideration, representing the price of the financial instrument and the costs relating to the execution. This will include all directly related expenses such as execution venue fees and clearing and settlement fees. Retail clients in this scenario should be provided with a summary of the relevant execution policy which is focused on the total costs incurred (including recent execution quality data for the execution venues listed in the policy).¹¹

The MiFID II Directive also clarifies that, where there is more than one competing venue for execution, the firm must take into account both (i) its own commissions and (ii) the costs for executing the order on each of the venues.¹²

Where there is a fee differential between competing execution venues, a firm will be required to provide detailed information to allow clients to understand both the advantages and disadvantages of one execution venue over another. Where the firm invites the client to select the execution venue, this information must be clear, fair and not misleading and must allow the client to make an informed decision rather than simply relying on the firm's pricing policy.¹³

Prohibition on commission

Firms will be prohibited from receiving any remuneration, discount or non-monetary benefit for routing an order to a particular venue where that remuneration, etc. would be contrary to its obligation to act in the client's best interest or the inducements rules contained in MiFID II (which are discussed in our separate briefing note on Inducements).¹⁴

Where a firm receives permitted payments from third parties, it must (i) provide clear information about the inducements that may be received,

⁷ Article 21(1), MiFID I Directive.

⁸ Article 27(1), MiFID II Delegated Regulation.

⁹ Article 64(1), MiFID II Delegated Regulation.

¹⁰ Article 64(2), MiFID II Delegated Regulation.

¹¹ Article 66(9), MiFID II Delegated Regulation.

¹² Article 27(1), MiFID II Directive.

¹³ Article 66(4) and (5), MiFID II Delegated Regulation.

¹⁴ Article 27(2), MiFID II Directive.

specifying the fees charged and, (ii) where the fees vary according to the client, the maximum fees or range of fees that may be payable. A firm shall make the client aware of the value of any monetary or non-monetary benefit received by the firm where it can charge more than one participant in the transaction.¹⁵

Non-discrimination

Firms should not structure or charge commission in a way which would discriminate unfairly between execution venues.¹⁶

Provision of execution data

Trading venues and systematic internalisers will be obliged to provide to the public, free of charge, data relating to the quality of the execution of transactions on that venue on at least an annual basis, including details of price, costs, speed and likelihood of execution for individual financial instruments.

Only trading venues and systematic internalisers will be required to make public information on execution quality.¹⁷ During consultation by ESMA, it was suggested that the scope should be extended to market makers and other liquidity providers. However, ESMA subsequently confirmed that the scope will not be extended in this way.¹⁸

The content and format of the data to be made public is specified by Articles 3 to 10 of RTS 27, covering the following areas:

- the price for each trading day an order was executed;
- the costs applied by the venue;
- the likelihood of execution for each trading day;
- for those operating continuous auction order books or quote driven trading systems, specific information

at specified reference points for each trading day (for example best bid and offer price, average effective spread, and period lasting more than 15 minutes during which no bid or offers were provided);

- for those operating under a request for quote trading system, specific information for each trading day (for example mean and median amount of time elapsed between the acceptance of a quote and execution); and
- reporting executed transactions within set ranges, dependent upon the financial instrument.

Firms will be obliged to inform clients of the execution venue used in relation to each order.

Requirement to state "top 5" execution venues

Firms will also be required to summarise and make public on their website annually, for each class of financial instrument, the top five execution venues used in terms of (i) trading volumes (in a machine-readable format) and (ii) the provision of information on the quality of execution obtained (in an electronic format).¹⁹ A firm must also publish this information on the top five investment firms used in the preceding year where it selects other firms to provide order execution services.²⁰

The nature of the trading volume information to be published will vary depending on whether the order is for a professional or retail client.²¹

ESMA clarified in its final draft RTS in September 2015,²² that, in order to protect commercially sensitive information, the number and volume of client orders executed on each of the five execution

¹⁵ Article 66(6) and (7), MiFID II Delegated Regulation.

¹⁶ Article 64(3), MiFID II Delegated Regulation.

¹⁷ For the content and format of the information to be provided, see Article 3 of RTS 27.

¹⁸ ESMA, Final Report, Chapter 9.

¹⁹ Article 27(6), MiFID II Directive.

²⁰ Article 65(6), MiFID II Delegated Regulation.

²¹ The format of information to be published on orders relating to retail client orders is specified at Table 1 of Annex II to RTS 28; for professional clients, at Table 2 of Annex II to RTS 28; for all clients, Table 3 of Annex II to RTS 28.

²² See ESMA, Final Report, Chapter 9.

venues should be provided as a percentage of the firm's total for that class of financial instruments.

According to RTS 28, for orders other than securities financing transactions the information to be published includes:

- the class of financial instruments and venue name;
- percentage volume and number of client orders executed at that venue;
- percentage of the client orders that were passive and aggressive orders and directed orders; and
- confirmation of whether the firm has executed an average of less than one trade per business day in the previous year in that class of financial instruments.

For securities financing transactions, the information to be published includes:

- volume and number of client orders executed at that execution venue; and
- confirmation of whether the firm has executed an average of less than one trade per business day in the previous year in that class of financial instruments.

Firms will also need to provide a summary analysis for each class of financial instruments drawn from monitoring execution of client orders in the previous year. The analysis should cover such topics as the relative importance given by the firm to execution factors, a description of specific arrangements with execution venues, and any close links or conflicts with those venues.

Guidance is given on the full required content at Article 3(3) of RTS 28.

ESMA commentary on execution data

ESMA noted during its consultation on the RTS that respondents to its consultation had expressed concern regarding the large quantity of execution data to be published. Accordingly, ESMA reduced the number of metrics in the data and the quantity of data required for some of those metrics.

ESMA also noted that respondents had raised issues about being required to publish data on illiquid instruments that are rarely traded. ESMA clarified that where no transactions occurred in a particular financial instrument on a particular day (i.e. illiquid instruments), execution venues are not required to publish the reports dealing with price information.

In its final draft RTS, ESMA made further changes and clarifications compared with its previous proposals in the December 2014 Consultation Paper, including the following statements:

- Information on factors such as price, speed and likelihood of execution will have to be captured for each instrument for each trading day.
- Execution venues that operate a number of different markets will be required to provide the information for each segment they operate.
- Information on costs should only capture data relating to costs that arise for the user of the venue or the client who has given the order (i.e. the investor) when orders are executed on that venue and when the venue has sight of them. This will include, for example, settlement fees or taxes.
- Information must be published on quality of execution obtained on all execution venues for each class of financial instruments where the investment firm executed client orders during the year.
- In order to increase the readability of the information for retail clients, ESMA ensured that the requirement for information on the order flow to the top five venues are clearly separate to the requirement for information in relation to the quality of execution obtained.
- Client categorisation should be taken into account for order flow reporting on the top five venues.

Execution policy

Under MiFID II, firms will be obliged to ensure that their order execution policies explain clearly, and in sufficient detail and in a way that can be easily understood by clients, how orders will be executed by those firms for their clients.²³

The execution policy should include:

- information on the transmitting or placing of orders with other entities. This information will be in a customised form depending on the class of financial instrument and the type of service provided;
- the list of factors to be used to select an execution venue and the relative importance of each factor. This should be consistent with the controls used by the firm to demonstrate to clients that best execution has been achieved on a consistent basis and when reviewing the adequacy of its policy and arrangements;
- information on how the execution factors of costs, speed, likelihood of execution and other relevant factors are considered;²⁴
- a summary of how venue selection occurs;
- a summary of specific execution strategies employed;
- a summary of the procedures and processes used to analyse execution quality;
- a summary of how the firm monitors and verifies best execution; and
- when the firm does not execute orders itself, a list of the execution venues used for each class of financial instruments (in addition to confirming these venues have execution arrangements that enable the firm to comply with their obligation to act

in accordance with the best interests of their clients when placing orders)²⁵.

Retail clients shall be provided with a summary of the execution policy which is focussed on the total costs in order to give understandable information to the client, and must include a link to the most recent execution quality data.

Disclosure and consent

A firm will be required to answer clearly and within a reasonable time requests from clients for information about their policies or arrangements and how they are reviewed (provided that the request is reasonable and proportionate).²⁶

Clients should be provided with detail from the firm's execution policy in good time before providing them with the intended service.²⁷ This includes:

- a clear and prominent warning that following client instructions may prevent the firm from using their execution policy to achieve the best possible result;
- information on how the execution factors of costs, speed, likelihood of execution and other relevant factors are considered as sufficient steps to obtain the best possible result, including the relative importance of each in the firm's approach;
- a summary of how the firm selects execution venues, including the selection factors used, the firm's view of the relative importance of each, and how venues are monitored and verified;²⁸
- a list of execution venues on which the firm tends to rely;

²³ MiFID II Directive, Article 27(5).

²⁴ Article 64(1) of the MiFID II Delegated Regulation provides criteria to take into account when deciding the relative importance of these factors in obtaining the best possible result.

²⁵ Article 65(5), MiFID II Delegated Regulation.

²⁶ Article 66(8), MiFID II Delegated Regulation.

²⁷ According to Article 66(3) of the MiFID II Delegated Regulation, this information needs to be provided in a durable medium or through the firm's website.

²⁸ Article 66(3)(c) of the MiFID II Delegated Regulation is clear that the relative importance of each of these factors should be consistent with any review the firm makes of the adequacy of their execution policy and related arrangements.

- the execution venues used for each class of financial instrument, retail client orders, and professional client orders; and
- where the firm executes orders outside a trading venue and the consequences (where applicable).

Changes to execution policy

Firms will be required to monitor the effectiveness of their execution policies and their order execution arrangements regularly. They must carry out an annual review of the policy, together with a further review whenever there is a "material change" that affects their ability to obtain best execution.²⁹ A material change for these purposes will include any significant event of an internal or external nature that could impact on the firm's best execution factors, or any other consideration relating to execution of an order. Firms will be required to assess whether a material change has occurred which may require it to consider making changes to the relative importance of factors, or to the execution venues on which it places significant reliance.³⁰

When considering whether to make changes to its execution policy, a firm must take into account the public information published by other firms and trading venues.

OTC trades

Where a firm deals on an over-the-counter basis, it must be able to check the fairness of the price proposed to the client. It should do so by gathering market data used in the estimation of the price of such product and, where possible by comparing with similar or comparable products.³¹

Where a firm executes a trade outside a trading venue, this must be clearly indicated in the information to be provided to clients describing the firm's execution policy. This must include information on the consequences of counterparty risk to the client.

Firms will be required to provide appropriate information about trades carried out with third parties outside a trading venue, where a client requests that information.

Timescales for implementation

The MiFID II Directive and MiFIR came into force on 3 July 2014, and most of their provisions will come into effect in member states from 3 January 2018. Member states have until 3 July 2017 to transpose the MiFID II Directive into national law.

The changes to the MiFID Implementing Directive will be made by way of the MiFID II Delegated Regulation which will become effective by 3 January 2018. The MiFID II Delegated Regulation will have direct effect and the member states will not need to implement these changes into national law.

ESMA submitted draft technical standards to the Commission on 28 September 2015, 3 January 2016 and 8 June 2016. The current status of each varies – some are in force, some are proceeding to publication, some are subject to a scrutiny period, and others are awaiting adoption by the European Commission. The technical standards will become effective on 3 January 2018.

²⁹ Article 66(1), MiFID II Delegated Regulation.

³⁰ Article 65(7), MiFID II Delegated Regulation.

³¹ Article 64(4), MiFID II Delegated Regulation.

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