MiFID Cash Equity Best Execution: Key Requirements Explained

This White Paper is part of a series of Equiduct Trading sponsored research papers that aim to increase awareness of the impact of MiFID and to assist the financial community in the practical implementation of MiFID.

The opinions and views expressed in this White Paper are the personal opinions and views of the author and also draw upon on-going discussions taking place within the MiFID Joint Working Group Best Execution Subject Group (www.mifid.com <http://www.mifid.com/>). They do not necessarily represent those of Equiduct Trading.

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About Equiduct Trading

Equiduct Trading will offer a MiFID compliant, integrated pan-European single point of connectivity for trading services through the Regulated Market operated by Börse Berlin.

Equiduct Trading will offer a range of services to enable financial institutions to meet their statutory commitments to provide best execution and transparency to their clients for all equity instruments listed on the European Economic Area (EEA) regulated markets (RM), in a single point of contact and cost effective manner. Equiduct Trading will also eliminate the need for financial institutions to become 'Systematic Internalisers' (SI).

Equiduct Trading's "Best Execution" and trade reporting services drastically reduce the cost and time required for participant firms to achieve MiFID compliance in these areas, while simultaneously enabling MiFID related revenue streams and market penetration. Additionally, Equiduct Trading offers very low cost per transaction relative to other exchanges as well as unique settlement flexibility and guaranteed execution in a protected environment. Retail investors will benefit from Equiduct Trading's transparent environment and will receive the guaranteed best price and very low transaction cost.

Specific legal advice should be taken before acting on any of the topics covered.

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1. Introduction

This White Paper intends to provide guidance to financial institutions relating to the practical implementation of their Best Execution obligations under the Markets in Financial Instruments Directive (MiFID). The MiFID Best Execution framework explains when, how and to whom best execution must be provided. The sheer volume of MiFID documentation means that it is a complicated and time consuming task to interpret all of the paperwork to arrive at your own firm's underlying implementation requirements for the achievement of best execution.

This situation is not necessarily helped by the increasing abundance of independent MiFID analysis which does not always reach similar conclusions or explain what best execution means in practice.

So the reality of today's situation is this; many firms are still confused about the most fundamental aspects of best execution and yet they will have to implement systems, design business processes and comply with the new rules from November 1st 2007.

Of course, it must also be recognised that there are still important public consultations underway of which the outcome is as yet unknown. However, it should be possible to take the original MiFID level 1 and level 2 texts to determine with a sufficient degree of comfort your own firm's obligations for the achievement of best execution.

This white paper takes a slightly different approach to analysing and demystifying best execution. It considers the fundamental best execution requirements through direct reference to MiFID text. The main content of this paper avoids speculation or interpretation when discussing what best execution requirements will exist under MiFID. The relevant texts have been extracted directly from the original MiFID documents; they are then linked together to describe the fundamentals of MiFID best execution. All of the source documents are clearly referenced in the Appendix so that readers can identify further reading and review the original MiFID documentation as required.

Later in the document some interpretation is introduced and important best execution side issues are identified for firms to consider in the context of their actual trading practices and operational environments. Some example scenarios have also been included to explain how best execution is expected to work in real-life trading situations.

The analysis presented here has been limited to the most important issues and requirements that will affect the majority of firms with best execution responsibilities. The analysis intentionally simplifies many aspects of best execution and in doing so it does not attempt to consider every aspect of MiFID's extensive rules, or every waiver, exception or caveat available to investment firms. The analysis mostly considers markets where information is reasonably open and available, and of course this tends to be the equity trading markets.

2. Best Execution – What Are The MiFID Rules?

This is the high level MiFID best execution rule:

> ***Level 1, article 21***
> *"Obligation to execute orders on terms most favourable to the client*
> *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."*

In addition to achieving the best possible result, firms must document their process for best execution in the form of an order execution policy:

> ***Level 1, article 21***
> *"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."*

So accordingly, any firm with best execution obligations must have an order execution policy. This policy has to cover all instrument types covered by MiFID.

Finally, MiFID sets out a general framework in terms of how best execution can and should be achieved and monitored by firms, and this is described later in more detail.

Which orders are subject to best execution?

MiFID states that a firm's execution policy applies to each client order that is being executed on behalf of clients to whom best execution must be provided.

> ***Level 2 Directive, [Best execution]***
> *"(66) … 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."*[1]

Who has to provide best execution?

Firms trading for retail or professional clients must provide best execution, subject to certain available waivers and exemptions.

[1] For a discussion of how this requirement should be applied in practice, and with regard to the meaning of "each client order" please refer to the appendix.

Exemptions from best execution

Perhaps the most important exemption to best execution is related to trades executed between firms categorised as "eligible counterparties". Firms falling under this category will be the most experienced firms operating in the marketplace, such as professional trading firms and asset managers executing client orders. MiFID recognises that these firms do not require the same level of protection as less experienced clients.

MiFID addresses this exemption through the inclusion of a general waiver for trades carried out between eligible counterparties:

> ***Level 1, Article 24***
> "1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1) in respect of those transactions or in respect of any ancillary service directly related to those transactions."

Professional clients who trade on behalf of their clients

MiFID recognises that many professional clients (such as asset managers) will have responsibility for the execution of their clients' trades. However, these firms are likely to be very experienced traders in their own right and so MiFID assumes that these firms would not usually require best execution protection from their trading counterparties.

Instead of creating an additional waiver, MiFID instead deals with this through an "opting up" process within client categorisation as follows:

> ***Level 1, Article 24***
> *"2. Member States shall recognise as eligible counterparties for the purposes of this Article investment firms, credit institutions, insurance companies, UCITS 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, undertakings exempted from the application of this Directive under Article 2(1)(k) and (l), national governments and their corresponding offices including public bodies that deal with public debt, central banks and supranational organisations."*

Those firms recognised as eligible counterparties under the above article are referred to as "per se eligible counterparties".

This means that for the purposes of trading, professional clients such as asset managers are "opted up" to the status of eligible counterparty. This opting up process applies to Article 24, which in turn applies to the removal of obligations otherwise imposed in Articles 19, 21 and 22(1), and therefore includes best execution.

How does opting up happen?

MiFID documentation indicates that this opting up process is both automatic and compulsory. Furthermore an eligible counterparty does not necessarily have to inform a client that they are treating them as an eligible counterparty if they have reasons for doing so:

Level 2 Directive background note, 7.3.3. Eligible counterparties

"Entities that are explicitly mentioned in Article 24(2) of the level 1 Directive are automatically recognised as eligible counterparties."

This interpretation is supported by regulators such as the FSA:

CP 06/19

"However, provided the client meets the thresholds and the pre-MiFID business fell within the IPC, the client will be capable of being categorised as a per se ECP under MiFID and the broker will be able to decide to treat the client as an ECP without notification."

However, if a firm that has been automatically opted up through this process wishes to change their client category with respect to Article 24, they are permitted to do so:

Level 1, Article 24

"Classification as an eligible counterparty under the first subparagraph shall be without prejudice to the right of such entities to request, either on a general form or on a trade-by-trade basis, treatment as clients whose business with the investment firm is subject to Articles 19, 21 and 22."

This means that firms who subsequently opt down from per se eligible counterparty status are to be treated as clients who are owed best execution.

In a chain of executing firms, who is responsible?

Establishing whether a firm has a responsibility for best execution is largely assessed by reference to the firm's client's categorisation under MiFID (excluding waivers). This means that in a chain of execution, there may be a number of parties who bear a responsibility for best execution.

The following related text illustrates the principle of responsibility for best execution when multiple firms are involved in the execution chain:

Level 2 Directive background note, 7.7.2. Scope

"This is why firms providing the services of reception and transmission of orders and portfolio management are also required to comply with requirements analogous to the best execution requirements (Article 45). Such firms will often not execute client orders directly on execution venues, passing them instead to other intermediaries for execution. The possibility of such delegation of best execution should be allowed provided that there is no delegation of responsibility for best execution."

This is supported by the FSA:

CP 06/19

"9.13 To the extent they mitigate information asymmetries between clients and the firms they invest through, the MiFID best execution requirements may also stimulate competition further down the chain of execution. Consider an intermediary after the imposition of the MiFID best execution obligations. To comply with the execution policy, the intermediary may need to choose more carefully between the deals various dealers or trading venues offer than prior to the implementation of MiFID. This increases the pressure on dealers and execution venues to offer competitive deals."

Does a principal trader have a duty of best execution?

MiFID indicates that best execution obligations also apply to a principal trader or market maker trading against client orders:

> ### *Level 2 Directive, [Best execution]*
> *"(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."*

This would indicate that a principal trader or market maker must consider those prices available externally to it from its own set of execution venues when fulfilling best execution obligations for client orders.

What is an "execution venue"?

For the sake of clarity, "execution venue" covers the following types of business:

> ### *Level 2 Directive, Article 44*
> *"(Articles 21(1) and 19(1) of Directive 2004/39/EC) Best execution criteria*
> *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."*

It would appear from this definition that an intermediate trader such as an agency broker is not necessarily an execution venue.

The term "entity" appears to be used to describe more than one particular situation within the MiFID text and therefore may have multiple meanings depending upon the particular MiFID article. The text above considers an entity that is performing a similar function to that of an execution venue but in a third country. In this particular example an entity is linked to the activity of an execution venue.

However, there are also references contained within the MiFID level 1 text which refer to entities alongside execution venues, but performing different activities. In the example below "entity" refers to an organisation that appears to be an agent for the execution of an order, such as an intermediate broker. In this example a firm would have to ensure that the entity could comply with execution obligations that are analogous to those the firm would have if dealing directly with an execution venue:

> ### *Level 1, Article 45*
> *"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."*

It would therefore seem reasonable to assume that an intermediate trading partner such as an agency broker would be captured under the term "entity". Obligations relating to the management of execution via entities appear to be analogous to those relating to execution venues.

This terminology is also echoed in the CESR consultation document as follows:

> *CESR 07-050b, Article 51*
> *"As pointed out in paragraph 22, a firm's (execution) policy must describe and explain the firm's execution approach, setting out the execution venues or entities the firm uses and the impact of the Article 21(1) factors on the firm's execution approach."*

3. Assessing Best Execution

MiFID considers best execution in the context of client categorisation and in a tiered manner. This means that the achievement of best execution for retail and professional clients is assessed differently.

Professional clients

The achievement of best execution for a professional client has to consider a number of factors which contribute toward achieving the best possible result for the client:

> ### *Level 1, article 21*
> *"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."*

Retail clients

For retail clients there is a slightly different approach. Retail clients are said to have achieved best execution when they have received the best price net of expenses – this can be thought of as the "best economic value":

> ### *Level 2 Directive, Article 44*
> *"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."*

This does not contradict the best execution approach described above; it simply says that in this case the net price should usually be the most important determinant. The other factors can still play a role but in a limited manner:

> ### *Level 2 Directive, General provisions*
> *"(60)… 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 to the retail client."*

4. The Best Execution Framework for Firms' Compliance

Earlier MiFID documentation suggested a three step approach to managing best execution:

> ***Level 2 Directive background note, Section 7.7.1***
> *"Article 21 of the level 1 Directive provides that an investment firm should follow a basic three step approach in establishing and implementing its execution policy."*
>
> *"First, depending on the nature of the clients and their needs, an investment firm should decide which factors affecting the result of execution should be given priority for clients generally or particular groups of clients. As a minimum, it should establish a process by which it determines the relative importance of these factors…"*
>
> *"Secondly, in accordance with Article 21(3) of the level 1 Directive, the investment firm should analyse the available execution venues in order to identify those venues that will enable it to obtain the best possible result and take the necessary steps to make it possible to execute its client orders in those venues. Access may be direct or through an intermediary. This does not mean that every investment firm will have to connect at any cost to almost every execution venue… …the principle that firms must take all reasonable steps to deliver the best possible result."*
>
> *"Thirdly, client orders should be routed, on an order-by-order basis, to the appropriate venues, taking into account the relative importance of the factors as set out in its best execution policy."* [2]

[2] Formal references to "order by order" were later removed from the final directive. Please refer to the appendix for a discussion of this issue.

5. Applying MiFID Best Execution Requirements in Practice

The previous sections used direct references to MiFID text to attempt to explain the environment that firms will face for the management of their best execution processes. They try to avoid any interpretation of the MiFID text in order to achieve consensus agreement of the meaning of MiFID best execution.

The following sections now attempt to take the principles of MiFID best execution regulation and approach, and apply the intentions to real life trading and operational environments.

It is impossible to consider every available exception, waiver, or caveat contained within MiFID. However a small number of particularly pertinent trading scenarios have been described to attempt to explain practical issues for firms.

In interpreting MiFID regulation, it is helpful to understand in broad outline the objectives of the regulation. A model for achieving this is proposed in the following section.

6. Achieving Best Execution

The “frame of reference” approach to Best Execution

Perhaps the easiest way to think about how best execution should work is in terms of a “frame of reference” approach for each firm’s execution process.

Each firm will have its own unique viewpoint or frame of reference: a unique set of execution venues and trading entities. Each firm will manage best execution within this known set of relationships but the set will remain fluid as firms become aware of and review other external venues and seek out those that can provide better trading performance.

This reviewing process (as described in the previous section) is critical to a firm’s ability to fulfil its best execution obligations. MiFID requires that firms must regularly consider other execution venues such as regulated markets, multilateral trading facilities and systematic internalisers in order to provide the best overall result to their clients. When a suitable new execution venue is identified, MiFID best execution requires the firm to consider the inclusion of that venue within its execution policy. Unless the firm concludes that the cost or other practical aspects of inclusion would be unreasonable for the firm, then the firm has a duty to use the execution venue.

This requirement applies to all firms with a best execution responsibility to their clients, no matter where they are placed in the execution chain.

As has been described above, dealing on own account with a client is regarded as the execution of client orders and subject to best execution. This means that firms with access to a better price from a third party would be obliged to trade a client order with the third party, rather than against (for example) their own principal position.

Because a firm’s frame of reference is almost always going to be unique to it, opportunities to subcontract best execution will usually be extremely limited, if not impossible to achieve in practice. This is because if a firm has a responsibility of best execution to its client, it must consider all execution venues within its *own* frame of reference. When the firm passes an order to another intermediary or execution venue (“subcontracted firm”), that subcontracted firm is unlikely to have exactly the same frame of reference for the best available price as the firm that gave the order. Consequently it would be impossible for the subcontracted firm to achieve best execution from the viewpoint of the originating firm.

Because the firm giving the client order bears responsibility for best execution, that firm must therefore assess all execution venues available to it at the point of execution. As per the level 2 directive explained above, the execution policy must be applied to each client order (please refer to the Appendix for a discussion of the interpretation of ”each client order ”) with a view to achieving the best possible result to the client.

Achieving the best possible result for large client orders requires that the firm should follow its execution policy, but there are practical issues which reflect differences compared to achieving the best possible result for smaller client orders. A firm will rarely have access to multiple prices for large order sizes against which a simple comparison could be made.

In practice, the completion of large client orders is likely to comprise a number of executions. On these occasions the firm may be particularly interested in achieving executions that help it to reduce implicit costs of trading such as market impact and opportunity costs in the course of a larger execution strategy.

For these large orders it is likely that the firm's execution policy will apply different weightings to its best execution factors, such as adjusting the relative importance of speed or likelihood of completion. In these cases the firm should satisfy itself that its execution venues are providing the best overall result for the trades executed, according to those factors and the weightings applied. In demonstrating that the best overall result has been achieved, the firm is likely to employ the use of technical measurement techniques such as transaction cost analysis tools.

In the case of smaller orders such as small trades created by automated trading algorithms, direct market access strategies and retail orders, comparable prices are likely to be available to the firm. This is because there are likely to be a number of multilateral trading facilities and regulated markets providing live quotes in smaller trade sizes. In this instance the firm has a duty to compare all of the prices available to it in order to decide upon the execution venue that will give the best possible result. For these smaller orders the most important factor in achievement of best execution is likely to be the execution price.

Where a firm has access to multiple price sources for an order, its ability to consolidate those prices will be a major determinant of the firm's ability to achieve and manage best execution.

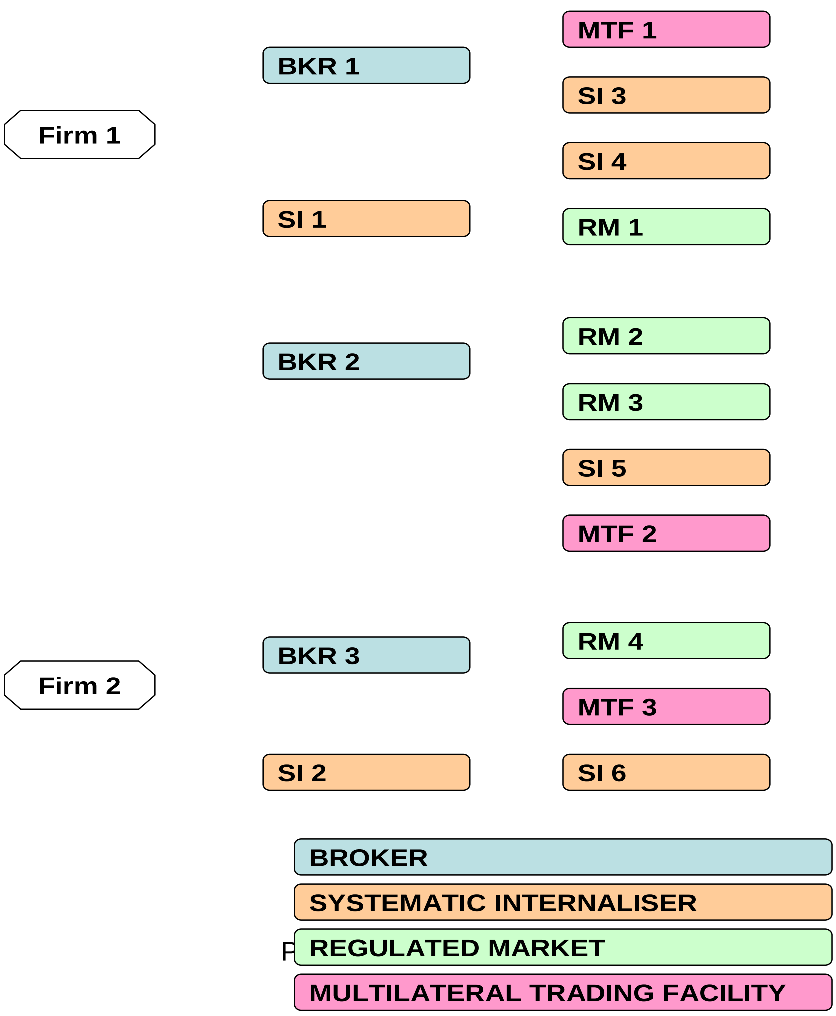
7. Best Execution

It can be difficult to understand how an execution policy would have to be applied in practice just from reading the MiFID text. The following pages take the MiFID text and try to show how the three stage process described in the level 2 background note would be applied, how this is explained through the frame of reference approach, and what this will mean to firms in practice. The example is then extended to try to understand some important practical and commercial issues.

Of course these examples take a highly simplified model, but even with the simplifications it is possible to understand many of the key concepts of the execution process and how the best possible result can be achieved for a client.

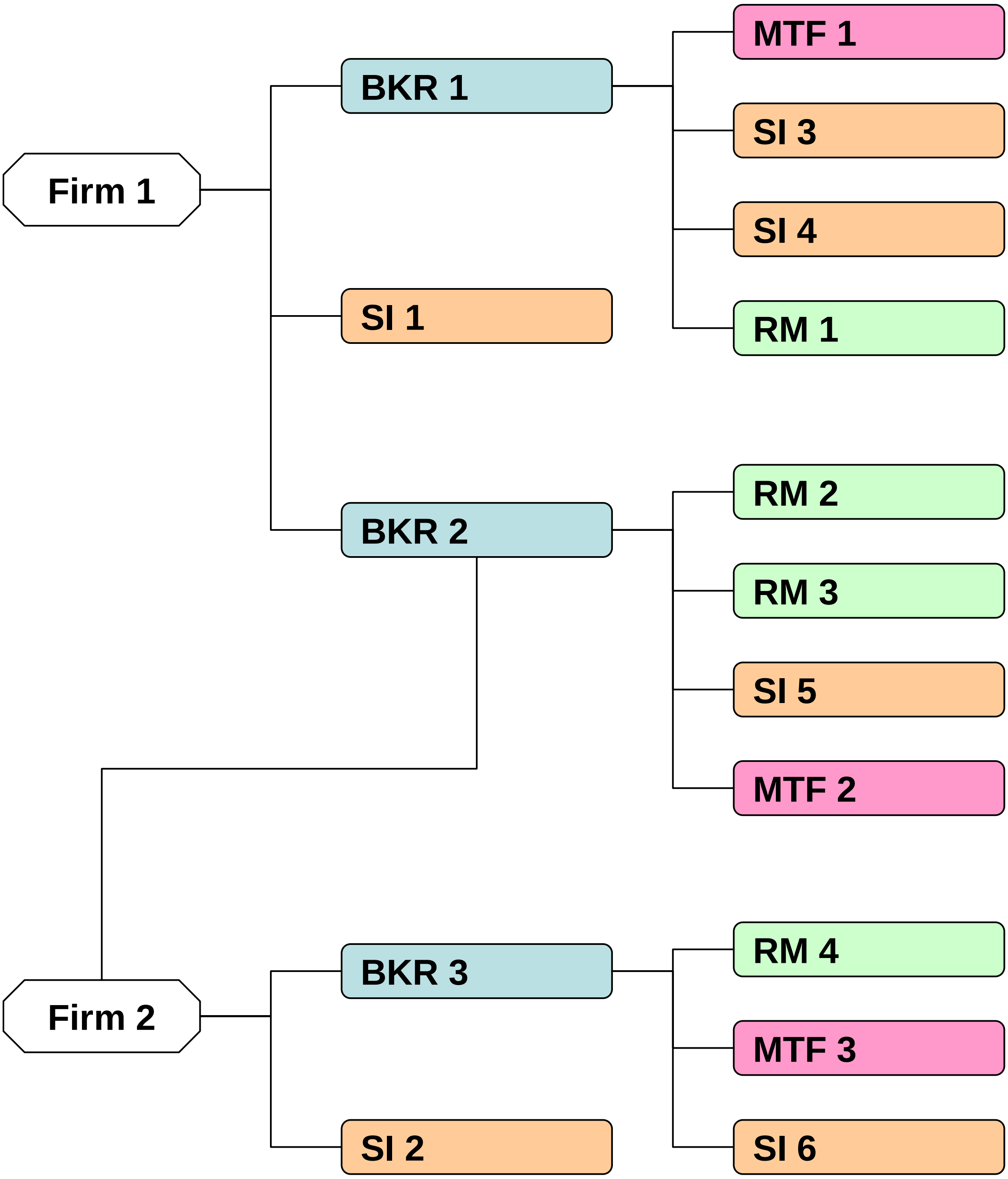
The example below considers two firms who have responsibility for achieving best execution on behalf of their clients. These firms potentially have access to a variety of execution venues or intermediaries in the forms of MTFs, systematic internalisers, trading firms such as brokers, and regulated markets. In line with our guidance above concerning the definition of "execution venues", we will use this term in the remainder of this document as covering both execution venues *per se* (i.e. venues where orders are matched) and intermediaries such as agency brokers. The execution venues that these firms choose to use are also likely to themselves have access to a unique selection of execution venues.

Our simple universe of 2 firms and all available execution venues could look something like this:



Venue selection

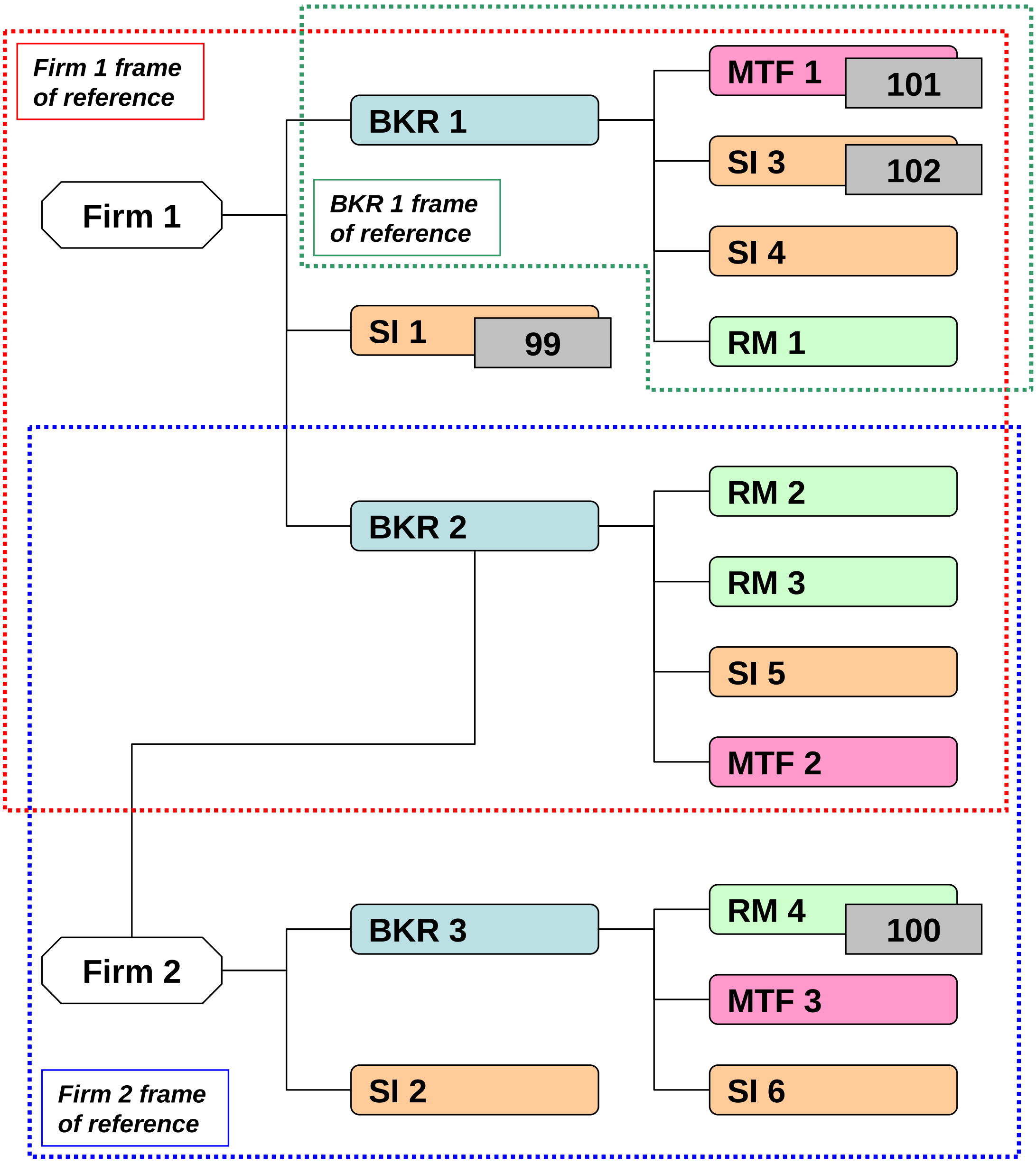
The two firms have to assess those execution venues available in the marketplace for suitability for the provision of execution services and then establish connections with them. Following this venue selection process our picture of trading relationships might then look like this:



Frames of reference and the best possible result

In this example a policy driven approach has therefore defined the suitable execution venues for our two firms. However as we can see, these firms have access to different price sources and therefore have a different frame of reference as to what the best possible result for a client execution could be. In fact, every firm within this structure may well have an entirely different frame of reference as to the best possible result for an execution.

Let's assume both of our firms are executing a retail client purchase order, and we populate our model with a small number of prices:



This is an example of where an understanding of the frame of reference approach becomes extremely important. This is because there are at least 3 viewpoints as to what the best possible execution result is, and from the point of view of each firm, all are valid. This small example makes it obvious that the best possible result is affected by the size and quality of the frame of reference. BKR1 knows the best possible result to be an offer price of 101. Firm 2 knows a best offer price of 100, whereas Firm 1 knows the best offer price to be 99.

Ultimately, the responsibility for achieving the best possible result rests with a firm who owes best execution to their professional or retail client. In this example, there may be responsibility for best execution at multiple firms in a chain of execution. If Firm 1 is a professional or retail client, then BKR 1 owes Firm 1 the best possible result. However, if Firm 1 is executing on behalf of their own professional or retail client, then Firm 1 owes their client the best possible result.

As has been described earlier, professional firms executing business or behalf of their clients are automatically opted up to "per se" eligible counterparties. However, it is within Firm 1's right to opt back down again and become a professional client for the purposes of best execution.

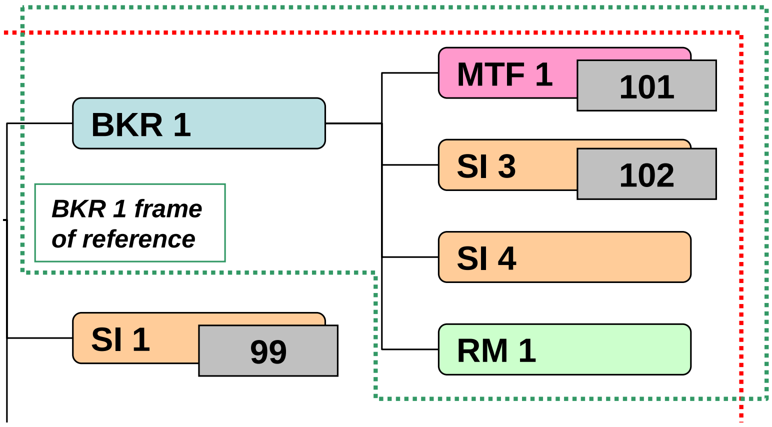
For simplicity we are assuming a retail order in this example. This is because we can consider the best possible result as the best price available (assuming equivalent costs, speed, likelihood of execution and so forth). However, we could equally apply the example to professional orders if we accounted for the other factors relevant to execution, such as likelihood of execution, speed etc.

This example highlights perhaps the biggest challenge in achieving the best possible result for firms, which we can illustrate if we consider the position of Firm 1. Irrespective of whether BKR 1 provides Firm 1 with the best possible result, there are two different frames of reference at work. Firm 1 has sufficient information to know that BKR 1's price does not in fact provide the best possible result within Firm 1's frame of reference.

This also illustrates a key point, which is that (in this example) Firm 1 would be wrong to rely upon BKR 1 to provide the best possible result when trading. BKR 1 is not at fault; it simply does not have access to the same execution venues. Many firms are likely to experience this situation in real life and have multiple sources of price information. The ability to aggregate all available prices within their frame of reference and have access to these prices will have a significant and material impact upon their ability to deliver the best possible result to their clients, and therefore truly comply with MiFID.

Brokers with internal systematic internalisers

Another interesting aspect of this example relates to BKR 1's frame of reference:



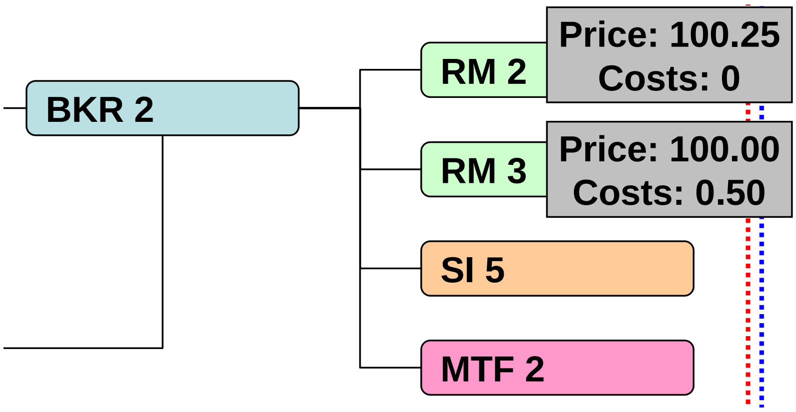
Just for a moment let's assume that BKR 1 is a dual capacity firm, insofar as it acts as an agent trader on behalf of its clients, but it also owns and operates a systematic internaliser, SI 3.

In this example it would not provide the best possible result to the client if BKR 1 bought stock on behalf of their client from its own systematic internaliser, SI 3. The best possible result would be achieved by trading with MTF 1, which may well be an external third-party system.

Other costs associated with execution

Another interesting example relates to costs that are associated with execution, other than price, which are passed on to the client. In the case of executions for retail clients, MiFID explicitly states that the best economic value of a trade represents the best possible result for a retail client. In the case of a professional client order the weighting of execution factors is likely to include these costs but perhaps to a different extent.

Let us consider the following example:



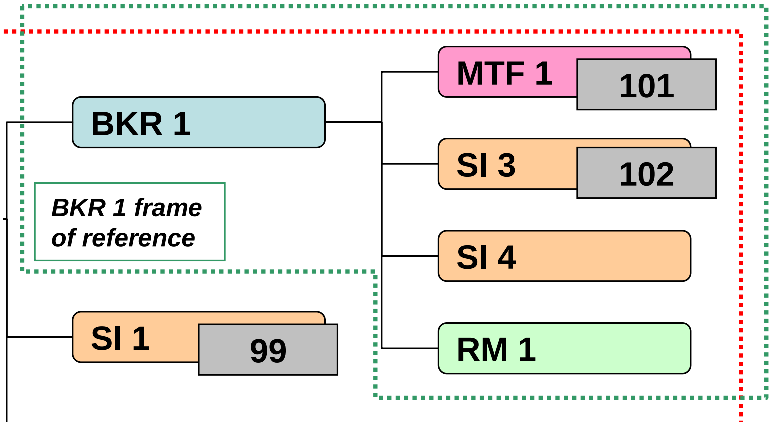
If we consider a retail purchase order in the context of BKR 2's frame of reference, we have to consider those costs that would be passed through to the retail client.

Superficially, purchasing the stock from RM3 would appear to be the correct course of action because the headline price would be better. However when we take account of additional pass-through costs which might include fees, ancillary charges or taxes then we would arrive at a different conclusion. The best economic value for a retail purchase order in this situation would be a purchase at the price of 100.25 with zero costs as opposed to a purchase of 100 with costs of 0.50.

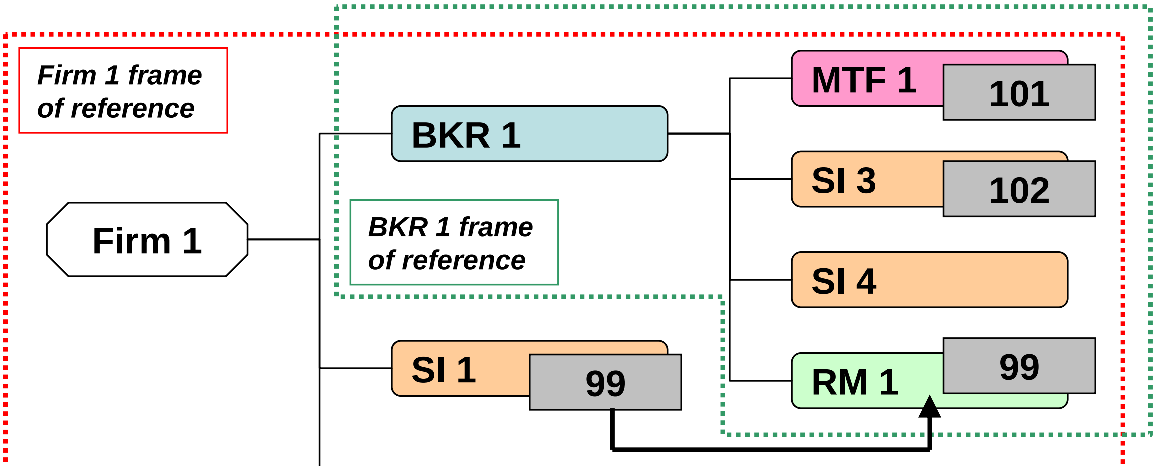
The importance of consolidated price information

There are various ways in which the consolidation of price information would be highly desirable to firms. Consolidation of price data simplifies the process of achieving the best possible result for the client through easy comparison of similar trading opportunities.

A simple example of the value of consolidated price information can be described with reference to an earlier situation. We considered the following trading situation for a retail purchase order:



However, if SI 1 were to incorporate their prices within RM 1, and therefore increase the consolidation of price data this creates additional value at various levels of the execution chain. This may look something like the following example:



In this particular example, it means that BKR 1's frame of reference becomes equivalent to that of Firm 1. This also means that Firm 1 can now depend upon BKR 1 to deliver the best possible result for the client.

However, this is an extremely limited example and certainly is not representative of all possible real life situations that a firm may encounter.

The fundamental point though is that consolidation of price data simplifies a firm's process of achieving the best possible result for the client.

8. Some Practical Issues for Firms

Complying with MiFID best execution rules requires a firm to establish its client execution requirements and create one or more execution approaches, or policies. This will lead to the definition of the firm's overall execution policy, containing those execution approaches. Firms must then ensure that the required systems and processes are in place so that execution venue selection and assessment can be carried out.

Thinking of MiFID requirements in simple terms can help firms to identify some obvious key areas for consideration when structuring their execution policy and processes. There are many operational side issues that can arise from the best execution requirements, of which just a few are identified here:

Consolidating execution venue price data

The ability to comply with MiFID rules will depend greatly upon a firm's ability to manage trading data. Perhaps one of the most important aspects of this data management will be the ability to consolidate prices from multiple, and very likely unconnected, systems.

Clearly those firms that have the ability to source the best prices and integrate them through a single system will be at a significant advantage to those who can not.

Under MiFID a Domestic Exchange can no longer be considered a de facto "safe harbour" for best execution and all execution venues must be considered when executing client business. This means that the electronic consolidation of prices will be a critical process for many firms.

Alignment of client and supplier execution policies

Because execution policies will be clearly documented, it will be important to consider not only your own firm's policy, but also those of your trading counterparties. When a firm is executing a client order via another firm, it will be important for the execution policies to be in agreement with the way in which those orders will be executed. It would not be appropriate for a firm to place a client's order with an intermediary who did not provide the execution capability appropriate to the client's order.

As has also been noted above, an understanding of an intermediary trader's frame of reference will greatly assist a firm in their achievement of the best possible result under MiFID requirements.

Internalisation versus trading with other execution venues

MiFID requires firms dealing on own account to treat client orders as subject to best execution. This means that these firms would not be permitted to trade against their own account if another execution venue had a better available price.

9. Conclusions and Key Issues

MiFID best execution constitutes an environment which is prescriptive at the highest level, but then provides a great deal of flexibility in terms of firms' ability to apply the rules in a way which is appropriate to their business model and client requirements. For example, firms have flexibility in their selection and management of execution venues but are required to monitor and adjust their execution venues when they themselves identify better performing suitable alternatives.

One of the key principles of understanding best execution is the relationship between best execution obligations and a client's MiFID categorisation. Firms will be subject to obligations that vary largely depending upon the status of the client they are executing trades for.

At very least, firms must recognise that different execution factors apply to retail and professional clients. Furthermore, firms are likely to create separate policy approaches for different professional client groups in order to apply the best execution factors in appropriate and different weightings. For example, a successful outcome for an index fund may not be the same as a successful outcome for an actively managed fund, and so the weightings of the execution factors would also be different. A sensible approach would be to recognise these multiple approaches via different execution factor weightings within the firm's overarching execution policy.

Subcontracting best execution is likely to be very difficult to achieve in practice for many firms. The permission within MiFID for per se eligible counterparties to opt back down to professional client status does not mean that the professional firm is providing their clients with best execution by default. While the professional firm's counterparty must provide best execution, the professional firm may itself be in possession of information that their counterparty is not. If this information included a better price, the counterparty may have achieved best execution; however the professional firm clearly did not.

The key to achieving best execution is understanding and managing the frame of reference concept.

10. Appendix A – Document References

Reference within this document	Official document title
"Level 1"	30.4.2004 EN Official Journal of the European Union L 145/1 DIRECTIVE 2004/39/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC http://eur-lex.europa.eu/LexUriServ/site/en/oj/2004/l_145/l_14520040430en00010044.pdf
"Level 2 Directive"	L 241/26 EN Official Journal of the European Union 2.9.2006 COMMISSION DIRECTIVE 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC 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 http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/l_241/l_24120060902en00260058.pdf
"Level 2 Directive background note"	Draft COMMISSION DIRECTIVE implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive BACKGROUND NOTE http://ec.europa.eu/internal_market/securities/docs/isd/dir-2004-39-implement/dir-backgroundnote_en.pdf
CP 06/19	FSA Consultation Paper 06/19 Reforming Conduct of Business Regulation http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf
CESR 07-050b	Committee of European Securities Regulators - Ref: CESR/07-050b Best execution under MIFID Public consultation February 2007 http://www.cesr-eu.org/popup2.php?id=4160

Additional Recommended Reading

AMF Consultation Paper on enforcing the best-execution principles in MiFID and its implementing directive (July 2006)

11. Appendix B – Applying Best Execution

Applying the best execution policy in practice

Level 2 Directive, [Best execution]
"(66) … 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."

Does this mean that best execution has to be provided for each client order?

Current explanation from the European Commission is that best execution does not have to be managed on an order by order basis. As specified above, the directive states that the execution policy must be applied to each client order with a view to obtaining the best possible result for the client.

In practice however, it would be prudent for firms to take advice in establishing the precise legal meaning of this particular article. This is because it is difficult to understand how the best possible result could be delivered to a client if, for example, an individual order received an inferior execution because it had not been considered separately and on its own merits. Such a situation shows that the poor individual execution detracted from the overall result for the client, which was neither the best, nor the only possible result available.

This is clearly a highly technical point of interpretation which this paper does not seek to resolve, and firms would be wise to seek legal clarification.

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