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Internal Market and Services DG

**FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS**  
Director

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Mr. Eddy Wymeersch  
Chairman  
CESR  
Avenue de Friedland 11-13  
75008 Paris  
FRANCE

**Subject : Best execution – scope issues under Mifid and the implementing directive**

Dear Eddy,

Following Arthur Philippe's request of 15 November 2006 please find the Commission services' opinion on the three issues related to best execution for which CESR asked for clarification.

Yours sincerely

David WRIGHT

## WORKING DOCUMENT ESC-07-2007

### Commission answers to CESR scope issues under MiFID and the implementing directive

#### Issue 1 – Dealing on quotes

*In what circumstances do the best execution requirements apply to firms who operate by providing quotes and then dealing?*

In many markets in financial instruments firms operate by providing 'quotes' (that is, prices at which they may be willing to buy or sell:

- continuously, such as for example, on a web-page or some limited access bulletin board; or
- to a particular person, such as, for example, in response to a 'request for quote' from that person, which is communicated electronically or over the phone, and then dealing with a person to whom they have made a quote.

In its consultation paper published on 31 October 2006, the UK FSA has suggested that best execution requirements do not necessarily apply to firms who operate in this way for either or both of the following reasons:

- (i) A firm operating in this way may not be providing an investment service, only performing an investment activity. That is, there is no client;
- (ii) A firm operating in this way does not receive a client order, because there can only be an order where the firm commits to do something on behalf of the client and the presumption is that there is no such commitment in this type of dealing. (An order would be, for example, where the firm commits to obtaining the best price.)

Other CESR members believe that the above-mentioned interpretation is not consistent with Art. 21 of MiFID and Art. 44 of the implementing directive because the "dealing on quotes" meets the criteria of dealing on own account. Dealing on own account with clients by investment firms should be considered as the execution of client orders and therefore is subject to the best execution requirements (Recital 69 of the implementing directive).

The interpretation according to which "dealing on quotes" does not amount to "dealing on own account" was expressly rejected in the negotiation of level 2 measures. The rationale behind was that such an interpretation runs against the approach adopted in the Level 1 regulatory framework.

According to MiFID, only eligible counterparties may be allowed to enter into transactions without benefiting of the best execution requirements. Apart from such an exception,

whenever an investment firm executes an order, it provides an investment service to a client, therefore best execution requirements apply.

Moreover, Art. 44(3) of the implementing directive expressly refers to the need of taking into account the client's nature (retail/professional) in order to achieve the best possible result.

The motive for not having exempted professional clients may be that the best execution rules not only serve the purpose of investor protection but also to foster the competition between execution venues and overall market efficiency. This is expressed in Art. 21(6) of MiFID ("fair and orderly functioning of markets") and Art. 44(4) of the implementing directive ("discriminate unfairly between execution venues").

#### Commission services' response

1. We do not consider it fruitful to distinguish between, on the one hand, cases where a service is being provided to a client and, on the other hand, those where an activity is simply being carried on *with* a person who is not a client. The Level 1 Directive provides no clear criterion for distinguishing between these two situations. It is clearly the case, for example, that carrying on the activity of dealing on own account can also involve the provision of a service to a client in some cases. This much is implicit in Recital 69 of the Level 2 Directive. Therefore, we do not believe this distinction should determine whether or not best execution is required in a particular case. Similarly, we do not believe it is useful to focus on the question of when an *order* arises. Again, this is consistent with Recital 69, which clarifies that whenever a firm deals on own account with a client there should be considered to be an order.
2. As a corollary, we believe that whenever a person or entity enters into a transaction with an investment firm, it will do so in the capacity either of an eligible counterparty, or as a retail or professional client.
3. As regards eligible counterparties, Article 24 of MiFID provides that best execution obligations under Article 21, together with conduct of business obligations under Article 19 and client order handling obligations under 22(1), do not apply. At the same time, as indicated by Recital 40 of MiFID, eligible counterparties should be considered to be acting as clients. One consequence of this is that the protections of Articles 13 and 18, relating *inter alia* to conflicts of interest and client assets, will continue to apply. As regards retail or professional clients, Articles 13, 18 and 19 of MiFID will always apply whilst the application of Article 21 will depend on what is said below.
4. In our view, the key concept to focus on in interpreting Article 21 is the execution of orders *on behalf of clients*. This is consistent with the definition in Article 4(1)(5) of MiFID, which refers specifically to a firm acting to conclude agreements to buy or sell financial instruments *on behalf of clients*, and the description of the relevant investment service in Annex I to MiFID as the "execution of orders on behalf of clients". Both provisions support the idea that the requirement that an order is being executed on behalf of a client is integral to the concept of best execution.
5. Recital 33 of MiFID provides some explanation of the concept of execution of orders *on behalf of clients*, by indicating that it will typically be present in a range of circumstances which are broadly referred to in that Recital as situations where 'contractual or agency

obligations' are owed by the firm to the client<sup>1</sup>. It is also important to note that Recital 33 of MiFID circumscribes the scope of Recital 69 of the level 2 Directive, so that the scope of best execution requirements in relation to dealing on own account is limited to circumstances covered by Recital 33 where the firm is acting on behalf of the client (and is thereby in a position to make decisions that will affect the interests of the client).

**Indicative examples of cases where a firm executes an order on behalf of a client and therefore best execution applies**

6. Applying the principles set out above, transactions based on a client's request to the investment firm to buy or sell a financial instrument for him will *always* fall within the concept of execution of an order on behalf of a client. This will include the following types:
- Executing a client order by dealing as agent for a client. In this situation, the intermediary takes a customer order and places the order, on behalf of the client, with an execution venue (such as an exchange, a systematic internaliser or another liquidity provider) for execution. For example, client A instructs investment firm B to buy 100 shares of X. The firm must then seek the execution venue that offers the best conditions for buying X shares at the time that the order is to be executed.
  - Executing a client order against the firm's own proprietary position (including as a systematic internaliser), where the firm is making decisions as to how the order is executed: e.g. where it is 'working the order' on the client's behalf. For example, client A gives the same instruction as in the preceding example, but investment firm B sells 100 shares in X to client A from its own portfolio. In this case, B puts itself in competition with other relevant execution venues and can execute the client instructions by selling the shares from its portfolio, provided that in doing so it obtains the best result for the client as compared with the other execution venues surveyed.
  - Executing a client order by dealing as a riskless principal on behalf of the client, including cases where the client is charged a spread on the transaction. In this type of transaction, the investment firm will typically deal as principal with its client at the same time, and on the same terms (as to instrument, time and price (allowing for any spread)), as it enters a transaction as principal with a counterparty.

**Indicative examples of transactions where a firm generally does not execute an order on behalf of a client and therefore does not owe an obligation of best execution to its client**

7. Transactions based on a specific request by the client to buy or sell a financial instrument from the investment firm, or on the acceptance by the client of an offer made by the firm to buy or sell a financial instrument from the firm, will typically not fall within the concept of execution of an order on behalf of a client unless in all the circumstances, taking into account the considerations set out in paragraph 8 below, the firm should properly be regarded as acting on behalf of the client. This class of transactions will include the following type:

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<sup>1</sup> However, the reference to 'agency' in Recital 33 is not intended to equate the application of best execution obligations with the existence of an agency relationship under the applicable national law.

- Executing a client order by entering a proprietary trade with the client in those cases not covered by paragraph 6 above. This includes the case where the firm engages in proprietary trading by quoting on a 'request for quote' basis. For example, client A requests a quote from investment firm B for 100 shares of X. The firm provides a quote which the client accepts and asks to buy 100 shares at the price quoted by B. By way of further example, B is a market maker that displays its quotes and Client A "hits" the quote displayed by B.
8. However, in some cases, proprietary trades will attract the best execution obligation. The application or otherwise of best execution will depend on whether the execution of the client's order can be seen as truly done *on behalf of* the client. This is a question of fact in each case which ultimately depends on **whether the client legitimately relies on the firm to protect his or her interests in relation to the pricing and other elements of the transaction - such as speed or likelihood of execution and settlement -that may be affected by the choices made by the firm when executing the order.** The following considerations, taken together, will help to determine the answer to this question:
- whether the firm approaches (initiates the transaction with) the client or the client instigates the transaction by making an approach to the firm. In those cases where the firm approaches a retail client and suggests him to enter into a specific transaction it is more probable that the client will be relying on the firm, to protect his or her interests in relation to the pricing and other elements of the transaction.
  - questions of market practice will help to determine whether it is legitimate for clients to rely on the firm. For example, in the wholesale OTC derivatives and bond markets buyers conventionally 'shop around' by approaching several dealers for a quote, and in these circumstances there is no expectation between the parties that the dealer chosen by the client will owe best execution.
  - the relative levels of transparency within a market will also be relevant. For markets where clients do not have ready access to prices while investment firms do, the conclusion will be much more readily reached that they rely on the firm in relation to the pricing of the transaction.
  - the information provided by the firm about its services and the terms of any agreement between the client and the investment firm will also be relevant, but not determinative of the question. The use of standard term agreements to characterise commercial relationships otherwise than in accordance with economic reality should be avoided.
9. These factors are likely to support the presumption that, in ordinary circumstances, a retail client legitimately relies on the firm to protect his or her interests in relation to the pricing and other parameters of the transaction. Similarly, *prima facie* application of these factors is likely to lead to the presumption that in the wholesale markets clients do not rely on the firm in the same way.

## Issue 2 - Use of Specific Instructions

*What scope may "specific instructions" from a client cover?*

Investment firms are considered to meet their best-execution obligation in respect of specific client instructions for an order or an aspect of an order.

Recital 68 clarifies that 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. This provision should not be used by firms to avoid their duty of best execution. In particular, firms should not "suggest" instructions from their clients and thus avoid complying with their obligation.

**Commission services' response**

10. Recital 68 of the Level 2 Directive must be read in its entirety. In particular, the clarification that a firm should not solicit a specific instruction by expressly indicating or implicitly suggesting the content of an instruction to a client is limited to those circumstances "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". So, a firm that 'suggests' instructions to a client should not be considered as avoiding best execution in all cases.
11. For example, a client chooses to use a Direct Market Access system, such that he himself selects parameters of the trade (such as the price, the counterparty, the venue, the timing and the size of trade). In such a case the dealer, while acting on the client's behalf in providing the DMA service, will be treated as having satisfied its duty of best execution to the extent that the client has given specific instructions by means of the DMA system.

The scope for specific instructions deserves legal clarifications as regards, at least, its application in customised products.

Regarding application of the best-execution to customised products (e.g. an Over-The-Counter product), where the client indicates the particular characteristics of the product that he/she wants, can this specification of the characteristics be considered "specific instructions"? Or, as recital 70 of the implementing directive already provides for a differentiated approach to best execution, should this be dealt with not as a scope issue but as an issue of the relevant standard of best execution? Or, in case of complex products, should we consider that the best execution requirement applies to each of the single components of the product?

**Commission services' response**

12. Best execution applies to OTC customised instruments in those cases when the firm is considered to be acting on behalf of the client. This will depend on the factors set out in our answer to issue 1. A customised instrument should be understood as that instrument which is tailored to specific needs of a client and for which there is practically no liquidity. On the contrary, an OTC plain vanilla option on a single liquid share with a maturity of one month should not be considered as a customised instrument.
13. The fact that the client specifies what he needs in terms of exposure and protection does not necessarily exclude the application of best execution. In the first stage where an investment firm proposes to a client the elements of an OTC derivatives contract that would respond the client's needs, it is more appropriate to speak of investment advice rather than best execution. For example, a client may ask an investment firm to design an instrument that will protect him against a collapse in gas prices and a spike in the price of

electricity. The investment firm may propose a number of alternatives with different pay-off structures and advise the client to select one particular design meaning the suitability obligations apply. Best execution obligations could apply depending on the considerations set out in our answer to issue 1. .

14. Ordinarily, in those circumstances where best execution applies, the identity of the instruments sought will be a matter of the information contained in the order rather than a question of specific instructions. Nevertheless there may be a level of discretion as to exactly which instruments to obtain on behalf of a client in the order.
15. In the case of complex products<sup>2</sup>, the best execution requirement (when applicable) applies to the product as a whole. Best execution for the product as a whole may conceivably be obtained even if best execution for each component, when considered in isolation, is not obtained.

### Issue 3 – Obligations on portfolio managers and order receivers and transmitters

*In what circumstances do portfolio managers and order receivers and transmitters "execute client orders"?*

Some take the view that portfolio managers execute client orders when they deal directly with execution venues, including direct access to regulated markets as well as use of MTFs, investment firms that deal on own account and other liquidity providers and counterparties.

Others take the view that portfolio managers never execute client orders, except possibly where they arrange transactions between their clients ("agency cross transactions"). For transactions in quote driven markets, some argue that portfolio managers are price takers, not makers, and that, for this reason, they are not 'executing client orders'. Rather, it is the dealer who executes.

In addition, some investment firms that provide retail brokerage services suggest that they themselves only receive client orders and transmit them to other investment firms, it is these other firms that take responsibility for executing these orders. Is there any clear line that can be drawn between reception and transmission of client orders for execution and execution of client orders? Is it possible for two firms in a chain of execution both to be viewed as executing those orders?

These questions are particularly relevant for the operation of Article 45(7) of the Implementing Directive and Article 66 of the Level 1 Directive. Article 45(7) provides that Article 21 (not Article 45) applies to portfolio managers and order receivers and transmitters when they execute client orders.

The requirements under Article 45 are not as extensive as those under Article 21. Therefore, brokerage firms and portfolio managers have an incentive to characterise their business models as something other than execution of client orders.

If portfolio managers do execute client orders when they deal on quote driven markets or deal "direct" via regulated markets or MTFs, then there is a question about what Article 45(7) means for portfolio managers authorised under the UCITS Directive. This is because MiFID Article 66 only applies MiFID Articles 2(2), 12, 13 and 19 to UCITS portfolio managers but not Article 21. Does MiFID apply to transactions by UCITS portfolio managers when they execute client orders?

### **Commission services' response**

<sup>2</sup> We understand complex products as those that are composed of or represent the performance of more than one product.

16. Since the "execution of orders on behalf of clients" is a distinct investment service, it could be argued that only those entities licensed to provide this particular service can execute orders or decisions to deal on behalf of clients. This would mean that investment firms authorised to provide portfolio management services<sup>3</sup> may transact directly with execution venues (i.e. execute decisions to deal) only if they are authorised to provide the service of execution of orders on behalf of clients.
17. The consequence of this reading would be to prevent UCITS management companies from transacting directly with execution venues when providing the investment service of individual portfolio management under Article 5 of the UCITS directive.
18. In accordance with this reading, in such cases Article 45(7) of the implementing Directive will simply not apply because those entities cannot provide the service of execution of orders, and the question as to whether Article 21 applies to UCITS management entities providing the service of portfolio management would be irrelevant.
19. However, the MiFID implementing Directive supports a different interpretation of the relevant provisions which is more consistent with current business practices and also ensures the level of investor protection and gains in market efficiency which the best execution obligations are designed to secure. Under this interpretation, an authorisation to provide the service of portfolio management under Article 5(3) of the UCITS Directive is treated as entitling portfolio managers to execute their own decisions to deal. However, if, when executing the decisions to deal, those persons should be required to comply with the same obligations as those under Article 21 of the MiFID. Any other outcome would compromise investor protection.
20. Article 45(7) of the Level 2 Directive implies that persons who are authorised to carry out portfolio management are not considered to provide the MiFID service of executing orders on behalf of clients when executing decisions to deal in the course of the activity of portfolio management, because there may not necessarily be any client orders when the portfolio manager decides to initiate a transaction on behalf of a client's portfolio.
21. However, the Level Directive 2 recognises that the same policy concerns arise in situations when a portfolio manager executes a decision to deal as are present when an investment firm executes an order on behalf of a client. Indeed, in both cases, transactions are executed on behalf of clients, be they clients under management or clients placing orders. In fact, there seems to be little or no difference, in so far as the interests of the client are at stake, between a situation where a client receives advice from an investment firm and acts on this advice by issuing an order to an investment firm for execution and a situation where a portfolio manager executes a decision to deal directly with an execution venue. In both cases the client needs to be able to rely on the firm's expertise to deliver the best possible result for the transaction.
22. This is why Article 45(7) of the Level 2 Directive provides that when an investment firm that provides the service of portfolio management transacts or deals directly with an execution venue (i.e. executes a decision to deal), it should comply with the obligations under Article 21 of MiFID.

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<sup>3</sup> Thus bringing them within the scope of MiFID. Collective investment undertakings that do not carry on individual portfolio management (or any other investment service of activity regulated under MiFID) are excluded from the scope of MiFID (Article 2(1)(h)).



23. This means that UCITS asset managers and investment firms, when executing orders directly (rather than transmitting them to an intermediary who would execute them on their behalf) in the course of providing the service of individual portfolio management, will have to comply with the obligations under Article 21. This is necessary in order to ensure adequate investor protection.

#### **Reception and transmission**

24. There should be a clear regulatory distinction between a firm that is authorised both to receive and transmit orders and to execute them and a firm that may only receive and transmit client orders for execution to another investment firm. The latter firm may not in any way alter client instructions as it transmits them to another firm for execution or further transmission.

25. Execution of a client order or a decision to deal is always carried out when an investment firm is the last link in the chain of intermediaries between the client order and an execution venue. Clearly, an investment firm may be the first and the last link in the chain: for example, when a client order is executed by an investment firm in its capacity as systematic internaliser.

26. A firm which is authorised both to receive and transmit orders and to execute orders on behalf of clients will need to comply either with Article 21 of MiFID or with the requirements under Article 45 of the MiFID implementing Directive, depending on whether the investment firm transacts directly with the execution venue or transmits the order to another firm for execution. In cases where the investment firm transacts directly with the execution venue, Article 21 of MiFID always applies.

27. Sometimes an investment firm that is authorised to execute orders but acting in its capacity as a receiver and transmitter of orders, issues instructions to another executing firm which are not client instructions and which may affect the quality of execution of the order. In such cases, the instructing firm must comply with Article 45 of the implementing Directive. Execution of the order is carried out by the last firm in the chain.

28. The firm which receives instructions (which are not client instructions) from another investment firm should comply with any instructions passed on to it, treating them as if they were client instructions for the purposes of Article 21(1). However, it must deliver best execution in respect of any part of the order which is not covered by an instruction.