Taking a look at the new regulatory requirements and which key challenges in implementation need to be overcome.

Rules pertaining to best execution are not entirely new to EU investment firms. Best Execution had already been introduced to the EU investment landscape by the first Markets in Financial Instruments Directive (MiFID) in 2007. Best execution rules are however yet another topic Brussels has put on the agenda of MiFID’s regulatory overhaul.

Best execution means achieving the best possible result for customers when executing their orders via execution venues or OTC.

The second Markets in Financial Instruments Directive (MiFID II) aims at achieving extensive transparency over investment firms’ order execution modalities. Moreover, investment firms are soon required to install thorough reporting and monitoring mechanisms in order to evaluate whether the execution quality achieved corresponds to the quality promised in their best execution policies. The realm of the existing MiFID regime is significantly broadened.

In the following, a brief regulatory overview of the best execution novelties due to MiFID II will be given. The focus will be on the key challenges that the updated regulatory framework confronts EU investment firms with. Furthermore, implications of financial products, processes and IT systems for the implementation of those new regulatory requirements will be addressed and how the aforementioned challenges can be remedied.
**Regulatory overview and key challenges**

Generally, client orders need to be executed in compliance with the applicable best execution policy. Best execution requirements apply especially to orders made by retail and professional clients. Eligible counterparties are in no need for protection by these rules.

When executing client orders, investment firms can direct these to multiple execution venues. Execution venues include:

- regulated markets (RMs)
- multilateral trading facilities (MTFs)
- organised trading facilities (OTFs)
- systematic internalisers (SIs)
- market makers
- other liquidity providers
- comparable third country entities.

Alternatively, investment firms can decide to select other firms (e.g. broker) to provide execution services for their clients.

MiFID II best execution augments the current best execution requirements. The main regulatory novelties however relate to the following three main key points:

- a quarterly own quality of execution report which has to be published by all execution venues.
- an annual top 5 execution venue report (applicable for all investment firm executing client orders).
- an annual report about the monitoring of the execution quality of all used execution venues (when executing client orders).

These topics will be elaborated in the following.

**Quarterly own quality of execution report**

MiFID II obligates every execution venue to publish – on a quarterly basis – a report on the execution quality achieved. EU investment firms are affected by this requirement either if classified as a SI, market maker or liquidity provider, or if they operate a RM, MTF or an OTF. Execution venues will have to publish their first quarterly report by June 30th, 2018 which will have to contain information from the first quarter of 2018 (Jan-Mar).

The publication should take place via the venue’s homepage and needs to be accessible for at least the following two years. The report should be published by investment firms irrespective of the category of clients to which the transactions relate – in their capacity as an execution venue.

The quality of execution report consists the following information.

**Information on the execution venue**

The quarterly report has to include information on the type of execution venue one constitutes. As mentioned before this can range from an RM to an SI or other liquidity provider. The regulatory technical standards (RTS) that constitute the concretisation of the requirements on Level II include a detailed list on the contents that need to be included.

**Information on the type of financial instrument**

Execution quality needs to be reported per financial instrument on an ISIN basis. The existence of an ISIN determines the basis data (e.g. currency) of a financial product. The EU regulator acknowledges, that an ISIN might not exist in every case – for which a narrative description of the financial instrument shall be provided in order to identify it.

Further, execution venues have to provide information on intraday price and trading day price information for each financial instrument.

The Level II RTS lists specifically which intraday price information e.g. the average market price for all trades is required to be considered at what time. The intraday price information has to include information on execution time, the trading systems and trading modes utilised as well as trading venues resorted to. Additionally, the best bid and ask price at execution needs to be provided.

The next chapter of the quarterly report concern information on costs. ESMA provides an elaborate a list on the specific contents to be published. A description of any fee or charge paid, (non-) monetary benefits offered and taxes invoked, needs to be provided. The total of the (non-) monetary benefits plus the costs needs to be calculated as a percentile of the overall trade value during the reporting period.

For each financial instrument the execution venue soon has to publish information on the likelihood of execution. This has to be done for every trading day.

Likelihood is calculated on the basis of different variables:

- number of orders received, number of executed orders,
- total value of executed orders, number of retracted/changed orders, median order and transaction size, and the number of identified market makers.

Finally, execution venues have to disclose additional information for requests for quote systems per financial instrument:

- median and actual time elapsed between acceptance of an offer and its execution, and
- median and actual time elapsed between the request for quote and an offer made.

**Key challenges**

Firms must continuously assess whether they constitute the definition of an execution venue and therefore have to publish quarterly reports on execution quality.

A currently unclear definition respectively classification and separation as a ‘market maker and, liquidity provider’ exists.

Extensive order and transaction data will have to be collected and consolidated per financial instrument.

An intensive interaction between internal IT systems and external vendors and platforms will need to be extended in order to facilitate the reporting duties.

A decision of the investment firms is required whether they are able and willing to administer execution data or will rather opt for an externally provided service.
**Annual Top 5 execution venue report**

Investment firms have to report their Top 5 execution venues in terms of trading volumes per class of financial instrument on an annual basis. A class of financial instrument is categorised in one of 13 different classes (22 subclasses) of financial instruments – for instance bonds.

An important distinction needs to be made when it comes to this annual Top 5 report. Investment firms have to make separation based on whether they execute the order directly or if they transmit the order for execution to another investment firm. If an investment firm provides both services, Mi-FID II requires investment firms to publish two separate Top 5 reports – one for order execution and one for order transmission e.g. to a broker.

Adding a further dimension to the Top 5 report on execution venues resorted to, separate reports have to be made, depending on whether the execution venues were used for:

- professional client orders
- retail client orders
- securities Financing Transactions (SFTs)

Content wise, all three of the above Top 5 reports need to encompass execution venue name and identifier, the information on the total volume and number in percentage of all client orders executed on that execution venue in that class of financial instrument as well as a confirmation of whether the investment firm has executed an average of less than one trade per business day in the previous year in that class of financial instruments.

For the reports regarding professional and retail client orders, additional content needs to be provided:

- class of financial instrument covered
- percentage of passive and aggressive orders
- percentage of directed orders

A passive order is characterised as an order that is entered into the order book of a trading venue and provides liquidity, whereas an aggressive order is defined as an order that is entered into the order book of a trading venue and takes liquidity. The conditions of a directed order are met, when a specific execution venue was specified by the client prior to the execution of the order.

**Key challenges**

For some investment firms it will be difficult to differentiate in their trading systems, whether an order has been directed or not.

Information on whether an order was aggressive or passive will be provided by the trading venues. This means firms will need to prepare to be able to process such information in their front office systems.

Investment firms will need to be able to identify whether their counterpart acts as an SI, market maker or other liquidity provider, i.e. an execution venue to determine, if they executed an order on an execution venue or transmitted it to another broker.

Additionally, if an investment firms executes an order in its role as an SI, market maker or liquidity provider, it should mention itself in the report as one of the execution venues for a client.

In order to determine the top 5 execution venues, firms will have to map their own financial instruments categories according to the 22 asset classes as defined by the EU regulator.

The reports need to distinguish between retail, professional clients and SFTs. Therefore transactions with eligible counterparts have to be entirely combed out.

Investment firms may decide whether they are able and willing to calculate the top 5 statistics by themselves or they will rather outsource the calculation to an external service provider.
Annual report about the monitoring of the execution quality of all used execution venues

Generally, investment firms already have to periodically monitor the execution quality of the execution venues they have resorted to under the current regulatory regime. Today, the best execution policy needs to be monitored at least annually. Content and the structure of the best execution policy is slightly amended by MiFID II.

One of the new obligations under MiFID II however is the requirement for every execution venue to publish – on a quarterly basis – a report on the execution quality achieved as explained before. These information must be considered in the investment firm’s quality assessment. The EU regulator has recategorised financial instruments in new categories of financial instruments (22 classes) in comparison to the current groups of financial instruments which most bank defined themselves dependent on its execution model. For each of these categories, investment firms will soon have to evaluate the execution quality achieved.

Investment firms have to sum up for the 22 categories of financial instruments the following data and information:

- how the price, costs, speed and likelihood of execution are factored in the overall assessment of execution quality achieved
- whether close connections to venues, conflicts of interest or shared ownership of venues has influenced execution quality
- whether (non-) monetary benefits have been received
- whether any changes occurred regarding the execution venues listed in the best execution policy, and
- whether execution quality differs if confronted with retail or professional clients

Investment firms have to provide their clients with information on the execution quality achieved with a report. The publication should take place via the investment firm’s homepage and needs to be accessible for at least the following two years.

Further, investment firms will have to establish a more granular selection process for execution venues.

Key challenges

Currently, it is still not clear, how detailed the report on execution quality needs to be.

Products which have in the past traditionally been traded OTC will soon be traded on MTFs and new information on OTC trades will become available due to MiFID II. Investment firms need to factor this new information in evaluating execution quality.

A detailed monitoring may requires a system-based implementation which is a question of build or buy?
**Impact on products, processes and systems for measuring the execution quality**

In comparison with its predecessor, MiFID II makes deciding shift by requiring investment firms to take all “sufficient” instead of all “reasonable steps” to obtain, when executing orders, the best possible result for their clients. In that process firms are still required to take into account several factors like:

- price and costs;
- speed
- likelihood of execution and settlement
- size, nature or any other consideration relevant to the execution of the order e.g. characteristics of the client, of the order, financial instrument, and execution venue.

Same as under MiFID I, where provided, an investment firm is required to execute the order in accordance with the specific instruction given by the client. For orders executed on behalf of the retail clients, the best possible result shall be determined in terms of the total consideration which shall represent the price of the instrument, execution related costs including fees charged by trading venue, clearing, settlement and any other fees paid to third parties involved in the execution of the client order.

In its most recent Q&A’s ESMA has provided an explanation what actually represents this change in wording from all reasonable to all sufficient steps, by explicitly stating that this change sets a higher bar for compliance for investment firms. They will become required to design their policies and establish internal arrangements in such manner to ensure that the intended outcomes can be successfully achieved on an ongoing basis. ESMA has specified that this will likely involve the strengthening of the front office accountability and systems and controls according to which firms are expected to ensure that their detection capabilities remain able to identify any potential difficulties. Furthermore, internal processes might involve combination of front office and compliance monitoring.

However, it has been made clear that the new requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion.

**Product related implications**

The implementation of the MiFID II Best execution requirements has certain implications that relate to products specifically. Generally it is expected that the need to ensure standardised market data on products will be one of the greatest challenges. Further, the MiFID II definition of classes of financial instruments is not entirely unambiguous. For instance, structured finance instruments or securitised derivatives have proven to be interpreted differently.

We would now like to point attention to the specific product groups from which each one poses its own challenges in the context of implementation of MiFID II best execution requirements.

**Fixed income products**

In the world of fixed income financial products, new requirements on best execution under MiFID II that cover these instruments now as well, are expected to have particularly specific dimension. This can be explained by the considerable difference between the equity markets where the process of best execution assessment, analysis financial instruments, their prices, costs and other relevant factors covers relatively small number of instruments that are typically very liquid. As such, exchange traded financial instruments are normally backed up with well established pricing sources that enable proper comparison of all relevant factors for the best execution assessment.

The challenges of an OTC market characterised by the lack of central record of prices or volumes, and in which large numbers of instruments might not be traded at all for weeks or months are considerable. Assessment of all available options intended to provide a clear picture that is to be used as the starting point for best execution is quite complicated.

However, this remains depended on liquidity of fixed income instruments and number of comparable options that are available as well as general market characteristics and other best execution factors.

Therefore in the case of fixed income products (as well as FX) manual comparison of competing quotes from a limited number of counterparties is commonly seen as suitable approach. In the process of price discovery mixing of voice and onscreen sources which involves traders checking a variety of sources including onscreen quotes, chat messages, axes/runs and discussing pricing with selected counterparties will still take place as appropriate solution.

**OTC derivatives**

Under MiFID II European regulator has come up with the new additional requirement which is to be applicable with respect to OTC transactions – assessment of the fairness of the price.

Namely MiFID II Delegated Regulation stipulates that where investment firm executes an order or takes decision to deal in OTC products, it shall check the fairness of the price proposed to the client, by gathering market data used in the estimation of the price of such product. Where possible investment firm is expected to compare the relevant OTC product with similar or comparable products.
Clarification of what is meant by this requirement provides ESMA in its most recent Q&A’s on investor protection topics. Namely ESMA has pointed that the aim behind this requirement is actually to make investment firms, which already now on a quite frequent basis are taking into account external market data and reference prices, to ensure that such checks are undertaken on a systematic basis, and that they are embedded in their internal policies and practices.

ESMA specifies that despite the fact that this is an ex-ante assessment, there is an expectation that any pre-trade checks or processes are to be included in the firm’s review and monitoring of its best execution arrangements. Therefore existence of the records documentation in place as the evidence is required.

However similar like in the case of fixed income instruments main problem for investment firms in the process of fulfillment of the best execution requirements remains gathering of market data. Aimed to demonstrate the fairness of price, the market data in the case of OTC transactions is not so easy to obtain.

The data needs required for such comparison vary from instrument to instrument but inputs required for price estimation and comparisons with prices of similar instruments are typically included.

**FX products**

Concept of the best execution is quite a novelty in the world of foreign exchange transactions, and at the first glance it seems that the immediate challenge would be the proper definition of what best execution in the context of FX transactions really means.

With regard to spot FX contracts, under MiFID II they will remain partly out of scope of the best execution requirements, where they are able to meet certain conditions. Namely spot FX contract will not be considered as a financial instrument, and by that not as subject of the best execution requirements, only where delivery is to be made within the period not longer than two trading days for major currencies or within the commonly accepted period in the market in the case of nonmajor currencies.

However it is clearly stated that the contract shall not be considered as spot contract that is subject to exemption, irrespective of its explicit terms where there is an understanding between the parties that delivery of the currency is to be postponed and not performed within the specified period that leads to exemption.

In the case of any other types of transactions related to FX contracts, requirements on best execution are to be fulfilled. When fulfilling best execution requirements with respect to FX products investment firms are expected to perform more intelligent transaction cost analysis in particular by estimating costs before trading and comparing them with the actual costs incurred.

Standard comparison of the three most competitive quotas, will likely still take place for spot contracts but existence of systematic processes for assessment of forwards or swaps is still rather exception than the standard by majority of market participants.

**Process and system implications**

Under MiFID II investment firms are going to be required in the first place to ensure that their internal reporting processes and controls are robust and fit for their purpose on an ongoing basis.

Training of the staff, establishment of the new governance arrangements as well as continuous monitoring and effective oversight are going to be some of the main requirements that investment firms will have to meet under the new regulatory framework. Data, analytics and technology will be the key elements for proving of best execution.

Therefore, in order to meet newly stipulated requirements under the new regime, investment firms will need to have sophisticated technology in place that can properly absorb, store and supply data well on time.

Furthermore MiFID II Delegated acts have made it clear that it is expected from firms to use new technology and data, including algorithmic analysis, so that they can optimise and assess execution performance as the part of the best execution obligation.
Conclusion

• Enhanced requirements (in particular in reporting obligations and execution quality benchmarking) under MiFID II, now affecting a wide range of newly covered instruments, are shaping the new market landscape and significant steps are expected to be taken by the investment firms on the road towards full compliance with the new rules.

• However, despite the fact that MiFID II coming into effect is just less than one year away, the state of readiness of a significant number of market participants that will be affected with the new rules is still questionable.

• With regards to fixed income, OTC and FX products new requirements on best execution represent even more considerable obstacle, bearing in mind that they will affect these types of instruments more extensive. In order to meet best execution requirements, it is likely that many firms will implement manual or partially automated processes that will enable comparison of dealer quotes by using daily or even intraday data. Comparison of the performance against a range of price sources (actual market quotes and trades) are expected to be applied by the more advanced market players.

• The main challenge, particularly with respect to fixed income and OTC products will remain accurate determination of the fair price. Whether is it possible that developments in market structure with particular emphasis on IT systems will finally allow the same level of accurate analysis like in the equities market, remains to be seen.

How we can help?

Are you ready for the new regime?

We already know that the way capital markets operate in Europe will change fundamentally. Learning both from the deficiencies of the original regime and from the financial crisis, the key goals are to radically strengthen both market integrity and investor protection, while ‘future-proofing’ the regime where possible.

Our MiFID II initiative has been established to support you in all aspects as the new regime comes into focus, providing insights and perspectives. As a network, we can mobilise multi-disciplinary teams bringing together skilled strategy, change management, operational efficiency, IT, tax, legal and regulatory specialists with extensive knowledge of global and European securities markets to help you address the challenges and realise the opportunities that MiFID II can bring.

To access our suite of tools, propositions, insights and thought leadership, as well as our multi territory network please visit our dedicated webpage:

http://www.pwc.com/MIFIDII

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Hot Topic  | Financial Services Risk and regulation
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