

The Compliance Officer

4 July 2012

Re: Best Execution under MiFID Themed Inspection of Investment and Stockbroking Firms

Dear Sir/Madam

The Central Bank of Ireland ('the Central Bank') recently completed a Best Execution themed inspection of investment and stockbroking firms with retail clients ('firms') authorised under the European Communities (Markets in Financial Instruments) Regulations, 2007 ('MiFID Regulations'). The purpose of this letter is to provide feedback in relation to the areas of concern identified by the Central Bank following the themed inspection.

For client protection purposes, best execution requires that firms must have arrangements in place to *'take all reasonable steps to obtain 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'*. Best execution requirements also set standards of due care and diligence that an investment firm should follow when dealing on behalf of its clients in financial instruments. Best execution requirements give clients confidence that firms will act in their best interests at all times.

The aim of the inspection was to assess and evaluate the best execution arrangements firms had in place. A number of issues were identified which are a cause for concern to the Central Bank.

The themed inspection was conducted in two parts. Part 1 consisted of a desk based review of the best execution policies and procedures of 32 firms with retail clients. Part 2 included detailed onsite visits of three firms to examine their policy in practice, to review trades recently executed by those firms, and to determine the extent to which firms were able to demonstrate to the Central Bank how their execution policy and arrangements enabled them to obtain the best possible result for their clients.

For the purposes of our review, firms were broken down into firms authorised to receive and transmit orders for clients, and firms authorised to execute orders for clients. However, it should be noted that some firms are authorised to carry out the activities of executing orders *and* receiving and transmitting orders. Firms may also, in the course of providing a portfolio management service to clients, carry out the service of executing and/or receiving and transmitting orders.

The Central Bank considered the following in conducting this review:

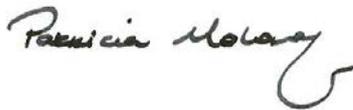
- the MiFID Regulations;
- the ‘CESR. Best Execution under MiFID. Questions & Answers’ document (Ref: CESR/07-320) which was published in May 2007 (the CESR Q&A); and
- the ‘MiFID Feedback on Discussions of Conduct of Business Industry Working Group’ document published by the Central Bank of Ireland and issued to MiFID firms in October 2007 (feedback document).

Please see the attached Schedule for the main areas of concern identified from both parts of the themed inspection. The Central Bank requires the firm to immediately consider the issues detailed in the Schedule, review its best execution arrangements in light of these issues and take any remedial action necessary. The Central Bank requires the Chief Executive Officer/Managing Director of your firm to confirm to the Central Bank in writing by 31 August 2012 that this review has been undertaken, and that any required changes to your firm’s best execution arrangements have been made. Other issues identified during this inspection are subject to separate engagement by the Central Bank with the individual firms concerned.

The Central Bank may choose to revisit this theme in the near future. Firms should also note that any issues raised during the course of this themed inspection will be considered during the conduct of any future inspections. Firms should note that the Central Bank will have regard to the guidance set out in this letter, or any other guidance issued by the Central Bank or applicable supervisory authority in relation to the application of the Best Execution requirements in the MiFID Regulations, in assessing firms' future compliance with the provisions of these regulations.

Should you have any queries in relation to the contents of this letter, please contact Ms Jennifer Bohan at jennifer.bohan@centralbank.ie or Ms Karen Cullen at karen.cullen@centralbank.ie

Yours sincerely

A handwritten signature in black ink that reads "Patricia Moloney". The signature is written in a cursive style with a large, sweeping flourish at the end.

Patricia Moloney
Head of Consumer Protection: Insurance, Investments & Intermediaries

Schedule 1

Part One - Review of Best Execution Policies and Procedures

A. Main Concerns Identified

1) Content of Policy

i) Generic in nature

Authorised Officers found that firms had very similar policies which were generic in nature and quoted MiFID without specific detail about the firm's strategy or key steps to achieve best execution. This is not sufficient to meet the requirements of MiFID. Guidance contained in Question 4 and 6 of the CESR Q&A state that the policy should set out the strategy of the firm, the key steps the firm is taking to comply with the overarching best execution requirement and how those steps enable the firm to obtain the best possible result. Question 7 of the CESR Q&A also states that '*the investment firm should differentiate its (execution) policy to the extent necessary to comply with the overarching best execution requirement*'.

ii) Policies did not set out the importance of the key factors, and did not set out the relative importance for retail clients, i.e. total consideration

Regulation 98(3) requires that an investment firm which provides services as set out in Regulation 98(1) and (2), shall take all reasonable steps to obtain the best possible result for the firm's clients. The firm shall take into account the factors referred to in Regulation 106(1). These factors include price, costs, speed, likelihood of execution and settlement, size, nature and any other consideration relevant to the execution of the order. It shall then determine the relative importance of those factors by reference to the criteria set out in Regulation 97(2) and where its clients are retail clients, also take account of those factors set out in Regulation 97(4) and (5).

Question 6.3 of the CESR Q&A states that '*The policy should also include an account of the relative importance, or the process for determining the relative importance, the firm places on the best execution factors when carrying out client orders, as well as information on how those factors affect the firm's choice of entities for inclusion in the policy*'.

31% of firms reviewed that are authorised to receive and transmit orders did not set out the importance of the key factors, or the process for determining the relative importance the firm places on the factors. In many cases, the firms only listed the factors as set out in MiFID or made reference to using the firm's discretion. This approach is not sufficient to meet the requirements of Regulation 98(3) of MiFID.

Where an investment firm executes an order on behalf of a retail client, Regulation 97(4) provides that *'the best possible result shall be determined in terms of the total consideration, representing (a) the price of the financial instrument, and (b) the costs related to execution, including (i) all expenses incurred by the client which are directly related to the execution of the order, (ii) execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order'*. 31% of the firms authorised to receive and transmit, and 38% of firms authorised to execute did not sufficiently address this factor in their policy as required by Regulation 97(4).

MiFID and the guidance set out in the CESR Q&A require firms' policies to identify the relative importance of the key execution factors, with total consideration of a transaction being a primary factor in determining the best possible result for retail clients.

iii) Failure to list the venues/entities used for execution

Regulation 98(3)(c)(i) requires that an investment firm's policy *'identifies for each class of instruments, the entities with which the orders are placed or to which the investment firm transmits orders for execution'*. Question 6.4 of the CESR Q&A states that *'The policy should also set out the entities the firm uses.'*

Only 16% of firms that are authorised to receive and transmit orders listed the entities used in their policy by class of financial instrument. Another 10% listed the entities without clarifying which entity was used for what class of instrument. The remaining firms did not provide information on the entities used.

Regulation 106(3)(a) requires that *'an investment firm shall (a) ensure that its order execution policy includes, for each class of financial instruments, information about*

- i. the venues where the investment firm executes its client orders, and*
- ii. the factors affecting the choice of each of the venues*

including but not limited to information explaining how, in its opinion, the use of those venues contributes to enabling the investment firm to consistently obtain the best possible result for the execution of client orders,'

Guidance contained in Question 4.3 of the CESR Q&A provides that *'the execution policy should also set out the execution venues the firm uses. Article 21(3) states that the execution policy 'shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of its client orders'.*

Of the firms authorised to execute orders for clients, only 23% listed the venues used in their policy by class of instrument. The remaining firms did not provide information on the actual venues used. Many listed general types of venues used, i.e. brokers, market makers, MTFs, systematic internalisers and other regulated markets as venues, or listed some of the main stock exchanges used.

The Central Bank considers it a serious issue that 77% of firms that execute, and 84% of firms that receive and transmit orders on behalf of clients do not list the venues or entities used for execution by class of instrument.

2) Provision of appropriate information to clients on the firm's policy

Regulation 98(3)(d) requires firms to *'provide appropriate information to the firm's clients about the policy established in accordance with subparagraph (c)'.*

Regulation 106(3)(b) requires firms to provide appropriate information to its clients on the firm's order execution policy.

Regulation 106(8) requires that *'An investment firm shall provide the firm's retail clients with the following information about the firm's execution policy in good time prior to the provision of services:*

- (a) an account of the relative importance the investment firm assigns, in accordance with the criteria specified in Regulation 97(2), to the following:*
 - (i) the factors referred to in Regulation 106(1);*
 - (ii) the process by which the firm determines the relative importance of those factors;*

- (b) *a list of the execution venues on which the firm places significant reliance in meeting its obligation to take all reasonable steps to obtain on a consistent basis the best possible result for the execution of client orders;*
- (c) *a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions*

and that information shall be provided in a durable medium, or by means of a website (where that does not constitute a durable medium) provided that the conditions specified in Regulation 77(2) are satisfied’.

90% of firms authorised to receive and transmit orders provided information to clients on their policy. Where information was provided to clients, the Authorised Officers are of the opinion that the appropriateness of the information provided is insufficient in 61% of cases. For example, some firms that transmitted orders to a small number of entities or to one entity only did not disclose this to clients. In such instances, the Central Bank expects firms to disclose this information to clients. Question 17.2 of the CESR Q&A provides further guidance on this.

All firms authorised to execute orders on behalf of clients provided information to clients on their execution policy, however, only 15% of these firms met all of the requirements set out in Regulation 106(8).

Question 14.2 of the CESR Q&A states that *‘firms should disclose sufficient information, reflecting any relevant differentiation of the firm’s (execution) policy, to enable clients to make a properly informed decision about whether to utilise the services of the firm’*. Firms should ensure that the information provided to clients is of a sufficient quality for the client to make a properly informed decision about whether to utilise the services offered by the firm. The Central Bank expects relevant firms to immediately review their policy and take necessary remedial action.

3) Firms must ensure that they can demonstrate that they are monitoring the effectiveness of their policy and arrangements, through the assessment of transactions on a regular basis

Regulation 98(3)(e) requires firms to monitor on a regular basis the effectiveness of their policy. Regulation 106(5)(a) requires that *‘an investment firm shall regularly monitor the*

effectiveness of its order execution arrangements and execution policy'. Question 24.1 of the CESR Q&A provides further guidance on this by stating the requirements of investment firms to monitor: *'monitoring is the assessment, on a regular basis, of particular transactions in order to determine whether the investment firm has complied with its (execution) policy and/or arrangements, and whether the resulting transaction has delivered the best possible result for the client'*.

Firms were asked to provide details of how they regularly monitor the effectiveness of their policy and arrangements and to provide a copy of any procedures they have in this regard. Based on the information received all firms authorised to execute assessed particular transactions on a regular basis. However, it appeared that over half of firms authorised to receive and transmit did not assess particular transactions on a regular basis. Instead, examples they gave of the monitoring they carried out included reviewing the policies of entities they used or carrying out an annual review of their own policy.

Firms are expected to monitor the effectiveness of their policy through the assessment of particular transactions on a regular basis. Firms should be cognisant of the execution factors and strategy set out in their policy and the scope of their business when developing monitoring procedures. For example, in some instances, firms just monitor price when they had previously outlined in their policy that total consideration was the most important execution factor. Firms must ensure that monitoring conducted is effective, i.e. that they test the key factors as stated in their policy. Firms should also document such monitoring, so as to be in a position to demonstrate having carried out such monitoring.

4) Provision of information to the Central Bank

It should be noted that 16% of firms did not provide to the Central Bank some or all of the information and documentation initially requested. It was necessary for the Authorised Officers to liaise with the firms over a considerable period of time until they were satisfied with the information and documentation received. The Central Bank does not consider this response by firms to be acceptable, and expects firms to be aware of their best execution requirements under MiFID and be in a position to demonstrate compliance with those requirements promptly when required to do so.

Other Issues Noted

1) **The application of best execution obligations to the service of Portfolio Management**

From the responses received, it was noted that some firms stated that they neither execute nor receive and transmit orders as they are portfolio managers. Regulation 98(1) requires that an investment firm, “... *when providing the service of portfolio management, to comply with Regulation 76 shall act in accordance with the best interests of the firm’s clients when placing, with other entities, execution orders that result from decisions by the firm to deal in financial instruments on behalf of the firm’s client.*” Regulation 98(3)(c) will apply to such firms except to the extent that the firm may follow specific instructions from the client when placing the order with another entity for execution. Where such firms execute these orders themselves, the best execution obligations under Regulations 97 and 106 will apply. Firms should ensure that their execution policy is in line with the nature of the business undertaken by the firm, and its authorisations.

2) **Review of execution policy and arrangements**

Regulation 98(3)(g) requires that firms review their policy both annually and whenever a material change occurs that affects the firm’s ability to obtain the best possible result for the firm’s clients. Regulation 106(7) requires firms to review execution arrangements in conjunction with this policy review.

Question 23.1 of the CESR Q&A provides guidance on this by stating: *the firm should consider whether it could consistently obtain better execution results if it were to:*

- *Include additional or different execution venues or entities;*
- *Assign a different relative importance to the best execution factors; or*
- *Modify any other aspects of its (execution) policy and/or arrangements.*

Most firms stated in their policy that they review their execution policy and arrangements at least annually. Firms must ensure that they are in a position to demonstrate to the Central Bank that they have carried out these reviews.

Regulation 98(3)(c)(ii) ‘*requires that entities have execution arrangements that enable the firm to comply with the obligations under paragraphs (1) and (2) and this Regulation when the firm places or transmits orders to the entities for execution*’.

Question 22.1 and 22.2 of the guidance provided in the CESR Q&A expand further on this by stating that *‘a firm should determine that the entities it uses will enable it to comply with the overarching best execution requirement when placing an order with, or transmitting an order to, another entity for execution’*. Furthermore, *‘a firm should review the execution arrangements of the entities it wishes to use to determine whether they will allow the firm to comply with all its best execution requirements’*.

Most firms authorised to receive and transmit stated in their policy that they reviewed the best execution policies of those entities that they transmitted orders to. Firms should ensure that they are able to demonstrate that they have done so.

3) Assessing the execution venues included in the order execution policy

Regulation 106(5)(b) requires that: *‘an investment firm shall assess whether the execution venues included in the order execution policy provide for the best possible result for clients’*. Most firms stated in their policy that they assess the venues used for obtaining the best possible result for clients.

The Central Bank requires firms to ensure that they are in a position to demonstrate they have carried out the required assessment. Written procedures or documentation in this regard, such as thorough records of evaluation and comparison of venues for performance, will ensure that the venues chosen by the firms are providing for the best possible result for clients, and that the firm has sufficiently followed up on instances where the venue did not provide the best possible result, with an appropriate outcome, i.e. deciding whether to remove the venue from its list, or satisfying itself that the case in question was an isolated incident etc.

4) Adopting a Group Policy for Best Execution

A small number of firms reviewed adopted a policy developed by another firm, i.e. a parent company, or another member of the firm’s Group. A firm may adopt a policy developed by another firm (i.e. a group policy) where such policy is appropriate to meet that firm’s own requirements under MiFID. The Central Bank expects that any group policy adopted should be implemented by the firm, and the policy must contain specific information regarding the firm as required by Regulation 98(3)(c) and/or Regulation 106(3), e.g., if the firm only transmits orders to another firm in its Group, this should be specified in the policy.

Such firm should also ensure that it meets any other obligations that fall to it under best execution such as providing appropriate information to clients on the policy, monitoring the policy on a regular basis and reviewing it at least annually in accordance with MiFID.

5) Firms that only deal with one entity for execution purposes

A number of firms reviewed deal with only one entity for execution purposes. While there are no restrictions on firms dealing with a single entity for execution purposes, firms must ensure that they can demonstrate to the Central Bank that they have complied with the provisions of, inter alia, Regulation 98 of MiFID. Question 9 in the CESR Q&A provides guidance in this regard and states that *‘An investment firm that transmits or places orders with other entities for execution can include a single entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement. In addition, the firm should reasonably expect that the entity it selects will enable it to obtain results for its clients that are at least as good as the results that it reasonably could expect from using alternative entities’*. Question 22.2 states that *‘a firm should review the execution arrangements of the entities it wishes to use to determine whether they will allow the firm to comply with all its best execution requirements’*.

Part Two - Onsite Inspections

1) Firms lack of understanding of the evidential requirements to demonstrate to the Central Bank that orders are executed in accordance with the firm's best execution policy

MiFID Regulation 106(6) requires that: *'An investment firm shall demonstrate to the Bank and shall demonstrate to the firm's clients, at the clients' request, that the firm has executed their orders in accordance with the firm's execution policy'*.

The onsite inspections included a review of evidence provided by the firms in relation to selected transactions to show how they had complied with their order execution policy in order to obtain the best possible result for clients, i.e. to deliver best execution. The Central Bank was concerned that none of the firms inspected were in a position to provide sufficient information in each case to enable Authorised Officers to form a conclusion as to whether the firms best execution policy had been adhered to in order to deliver best execution for their clients. Firms must ensure that they have the ability to demonstrate that orders have been executed in accordance with their execution policy, as required by MiFID, to the Central Bank or on request from a client. Firms should ensure that they take any systems limitations into account when addressing this requirement.

2) Insufficient monitoring of execution policy by firms

None of the firms inspected carried out what the Authorised Officers considered to be a complete process of monitoring of their execution policy. For example, some firms checked the price they obtained versus the price in the market at the time of trading, instead of looking at the trade from the time of instruction through to execution. This process is important, as it identifies whether a limit price may have been hit prior to its actual execution, the sequence of trading and anything else related to the characteristics of the client order and whether this could have affected the choice of execution venue or the result obtained. Also, some firms only tested for price as a factor, instead of taking into consideration whether any particular instruction was given by clients, whether the factors as set out in their policy were met or equally checking the result obtained for retail clients versus the key factor of total consideration. Firms must ensure that they have a regular, robust, holistic approach to monitoring in this area, encompassing all relevant financial instruments, so that it is in a position to meet the requirements in MiFID and that it is in a position to demonstrate to the Central Bank that it has done so.

3) Differences in execution arrangements in practice versus the firm's written policy

In reviewing firms' practices onsite, the Authorised Officers were concerned to find differences in the firms' actual practices and procedures regarding best execution, versus the firm's order execution policy. Firms should ensure that their execution policy is adhered to by all relevant staff. Where discrepancies occur, the firm's monitoring and review procedures should be robust enough to identify and address such discrepancies, by either adapting policies or updating procedures.

4) Poor record keeping relative to monitoring of venues/entities.

Firms were questioned on the monitoring of the venues and entities used. All firms stated that they carried out monitoring of the venues and entities used, however, none were able to provide documentary evidence of such monitoring. The Central Bank considers that in order to ensure that firms are taking all reasonable steps to obtain the best possible result for their clients, firms must ensure that they have effective and robust monitoring of the performance of venues and/or entities used in place. Firms must ensure that it is in a position to demonstrate having complied with its obligations.

5) Lack of follow up of issues identified from best execution monitoring

In reviewing the monitoring of transactions conducted by those firms inspected, Authorised Officers found that issues identified during the course of best execution monitoring did not appear to be followed up by some firms. Whether related to the topic being reviewed or not, firms should ensure all issues found on monitoring are properly investigated, reviewed and addressed. Firms should ensure that investigations are documented.