



MiFID II best execution likely to become international best practice

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The Markets in Financial Instruments Directive (MiFID) II research unbundling and best execution requirements could become best practice worldwide, as commercial pressures are driving asset managers outside the EU to revise their execution processes and policies.

Roland De Marsangy, head of business development, Asia-Pacific at Liquidnet in Hong Kong, said that while many Asia-Pacific investment managers were not directly captured by MiFID II, the best execution requirement was increasingly seen as a commercial obligation and a benchmark for clients' performance assessment.

"MiFID II is a European regulation, so from a regulatory perspective, the obligations on the part of Asia-Pacific asset managers are extremely limited. From a commercial perspective, however, we are noticing that, increasingly, end investors are putting pressure on asset managers to achieve and demonstrate best execution in line with the European MiFID II obligations. That commercial obligation is massive and this will not go away," De Marsangy told Thomson Reuters Regulatory Intelligence (TRRI).

Under the [Markets in Financial Instruments Directive II](#) (MiFID II), which comes into effect on January 3, 2018, asset managers captured by MiFID II will be required to take "sufficient" steps to achieve best execution on orders across a broad spectrum of asset classes considering multiple factors, including price, speed and likelihood of execution and settlement. They should also report these processes for each of their top five execution venues.

In line with these objectives, and as part of a crackdown on the payment of inducements, asset managers will no longer be able to accept free research from third parties. Instead, as stipulated in art 13 of the MiFID II Delegated Directive, they will need either to absorb the research costs themselves, or to set up research payment accounts (RPA), the cost of which can be borne by investors but which entail additional disclosure, budgeting, reporting and audit requirements.

Hani Shalabi, co-head of execution services APAC at Deutsche Bank in Hong Kong, said of all the MiFID II requirements, the combination of research unbundling and best execution was having the greatest impact in Asia Pacific.

"From our perspective, the area of MiFID II that is having the greatest impact outside of the EU is the separation of payments for execution and content. In the past, buy-side firms could send orders to a sell-side institution simply on the basis of research provided or because they had a history of trading with that particular institution and felt comfortable doing so. Going forward, they will need to demonstrate that that choice was based on best execution, that institution's ability to provide the best volume at the best price at that point in time," Shalabi said.

Best execution in practice

However, demonstrating best execution in a MiFID II compliant way is not without challenges. For one, there is no consensus or anything resembling an industry standard way to measure it.

John Greenan, CEO at Alignment Systems in Sydney, said that was in part due to the fact that, as a directive, and therefore subject to national implementation by EU member states, there were differences in the way MiFID II was being implemented by different national competent authorities (NCAs). He also noted differences in the way various MiFID II-regulated institutions interpreted the best execution requirements.

"I've encountered companies that have a very strong sense of what they believe to be the intention of MiFID II, the ability to understand not just best prices but also the performance of brokers over time, and that have invested a lot of money in technology to help them achieve these objectives. At the same time, I am seeing companies that think best execution involves a set of prescriptive requirements around trade reporting and additional data fields, and that meeting those satisfies compliance. Even at this eleventh hour, I don't see a real market consensus," Greenan said.

In liquid equity markets, where data is transparent and readily available, transaction cost analysis (TCA) is typically the first port of

call when complying with best execution requirements, at least insofar as it presents a set of performance metrics that demonstrate the quality of execution of a particular order.

There has also been a fairly large uptick in the number of asset managers using so-called algo wheels and broker wheels to systematically select algorithms and brokers to allocate orders to. This, in turn, can contribute to meeting the MiFID II best execution requirements.

In less liquid markets, however, algo wheels are virtually non-existent and the data required to support the TCA may not be available. Indeed, a recent survey by CRISIL of 92 asset managers subject to the full scope of MiFID II found that more than two-thirds of those surveyed were still undecided about defining the best execution criteria for fixed-income and other non-equity products.

That was due to the lack of appropriate pricing references and viable TCA products for fixed-income and over-the-counter (OTC) offerings. At the same time, firms reported significant challenges with data management (sourcing, retention, integration, quality and validation) across multiple trading channels.

Where there are large orders in less liquid markets, Shalabi said an indication of interest (IOI) could be used to demonstrate best execution, but he added that there was no perfect way to make such assessments.

"In my view best execution is almost impossible to measure. TCA is the best you can do at this point in time, but it's by no means perfect because there are many variables at play. Proving that your algo platform works really well from a performance perspective, from a TCA perspective, and also maximising and cleaning up your IOIs to your clients to ensure they are tagged correctly and actionable are the two things that are going to drive best execution as it stands right now," Shalabi said.

Under MiFID II, however, best execution is about more than price, so relying on TCA alone is not sufficient.

Dan Enstedt, vice president, business development at FlexTrade in Sydney, said MiFID II had shifted the focus of best execution implementation away from price toward the process of deciding on best execution as a whole. "In the past, best execution was all about the outcome and the final execution price. Under MiFID II, it is about the process as a whole, how do you perform best execution and how do you ensure you meet the requirements," Enstedt said.

He said while TCA was a natural first answer to best execution in the liquid markets, best execution under MiFID II was about more than price and transaction costs.

"There are all these other factors that you have to take into consideration and that are not typically included in a standard TCA report. Similarly, simply taking the results from an algo wheel to a regulator does not qualify as a best execution policy; it helps you make a more informed selection but it is only one component of the overall best execution process," Enstedt said.

De Marsangy said that, in future, asset managers would need to demonstrate a much better understanding of the market.

"Requests for quotation [RFQs] will still be part of the process, but when you talk to regulators, the first thing they'll ask you is, 'why did you ask these five brokers'? That selection process will become a key component. It's important on the equity side, but it is even more important for less liquid products because you won't have the data to support proper TCA. Best execution will mean that you have demonstrated that you've gone through the process and that you provide the best service for your end clients. Buy-side traders need to have a good idea of the price they are willing to trade at, in some ways making them price makers instead of price takers," De Marsangy said.

According to Greenan, buy-side firms need to invest more in good-quality data to be able to assess market micro structures and to analyse brokers' execution capabilities on a per stock basis.

"Some people think that best execution means you send a request for quotes to five banks, you take the best price, you execute it and you've got a time-stamped audit trail and history that qualifies as a best execution policy. MiFID II is about more than that, you need to be able to demonstrate why you picked those five banks, why, at any point in time, their best price would have been the best price you could have got had you asked anyone on the street. That is what the more advanced buy-side firms in Europe are now looking to achieve and that requires a significant investment in data and technology," Greenan said.

To what extent MiFID II best execution will be adopted as global best practice remains to be seen.

Jason Foo, director, investment advisory at Deloitte in Sydney, said that in the absence of prescriptive regulatory requirements similar to MiFID II, asset owners should demand accountability and transparency of best execution. "The issue with some of these requirements is that if it doesn't have a commercial impact on business, [has] immaterial performance impact and [is] not driven from the top, there is little incentive to implement. Super funds and asset managers should use this opportunity to develop effective oversight of best execution. Many asset managers in Australia are already conducting sophisticated TCA or have a best execution policy to win institutional mandates," he said.

Greenan said that for fund managers not directly captured by MiFID II, the importance of the best execution requirements might take some time to become apparent but that, over time, winning global business should become contingent on being able to demonstrate best execution.

"Investment allocations are reviewed on a regular basis, but it takes time for all of the mandates to reach their review cycles. As a general rule, asset managers will spend the bare minimum they can get away with, but when a large asset owner requests MiFID II compliance, it will happen. Over the next few years, you can expect a lot of the language covering the mandates to include a requirement for processes to be MiFID II-compliant, and this is what will drive the extraterritorial nature of MiFID II best execution," Greenan said.

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