

ESMA Consultation paper

Draft Technical Standards specifying the criteria for establishing and assessing the effectiveness of investment firms' order execution policies

Response by

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Overview

This response has been prepared on behalf of Deontea Ltd. Deontea Ltd is a highly specialised firm providing tailored regulatory intelligence and quality assurance solutions to the financial industry participants. We operate in the UK, EU and Switzerland. We advise a variety of clients (Investment firms, Asset Managers, Credit Institutions, Payment services, Fund Companies, RegTech or FinTech Firms) in connection to regulatory matters and act as an additional resource in that field. We support firms in meeting their regulatory obligations with confidence and obtain assurance that their systems and controls are proportionate, fit for purpose while staying business friendly.

We welcome the opportunity to comment on this consultation paper. As set out above, we advise a variety of clients who vary in size and sector and some of our collaborators have been instrumental in the design of the current regulatory frameworks whilst working at the NCAs. As such, our views are reflective of the issues and difficulties our clients face to comply with ESMA rules and of the understanding we have of the regulatory rule making. Please note that we include only answers to those questions where we have chosen to respond.

Q1: Do you agree with the proposed categorisation of classes of financial instruments? And could the methodology based on, inter alia, the classification of financial instruments in the MiFID II RTSs 1 and 2 be used in the context of MiFID II transparency reporting be an alternative? Please state the reasons for your answers.

The aim of distinguishing between the different classes of financial instruments offered is to take into account the different ways various financial instruments are traded (e.g., trading platform, trading mode, trading systems) as well inter alia the different execution venues on which those transactions are taking place including the different type of strategies firms have designed to achieve the best possible results for their clients. It also aims at ensuring that potential or existing clients understand how and where the execution of their orders will take place.

ISO classification is indeed a recognised format that can be understood within and outside the EU. It is mainly used in relation with Art. 26 of MiFIR (Transaction reporting). However, whether or not the rules allows for clustering, the proposed solution remains extremely granular on one hand and not enough on the other, i.e., it is a technical classification that is not taking into account several criteria that would be relevant when executing orders such as liquidity pools: most liquid markets are not necessarily the primary listing ones, fees or taxes linked to execution venues location, country reference for swaps, Eurobonds or some other financial instruments are most of the time irrelevant. Consequently, the CFI code classification is not sufficiently flexible to allow for designing effective classes of financial instruments that will provide firms with sufficient variables to construct coherent clusters. Moreover, it may add another layer of complexity as this classification will only be used for the purpose of the Best Execution arrangements without any cross referencing to other regulatory reportings or already existing frameworks.

On the other hand, using the classification developed under RTS 1 and 2 would provide for a better integration of the execution arrangements into existing frameworks such as Transparency requirements or EMIR reporting. One should also take into account that under this draft RTS firms are expected to rely on post-transparency publications to assess the quality of execution obtained. As already mentioned, the classifications developed under RTS1 and 2 are taking into account issues such as liquidity, trading modes and systems and they are more granular/precise in respect of certain classes of derivatives and/or debt instruments.

We would like to stress that the “country” code is often not relevant when executing client orders and/or choosing execution venues: many trading venues (e.g., MTF, OTF) admit to trading instruments issued in various countries. Accordingly, the execution factors firms will take into account when executing client orders are rarely function of the country of issuance of the financial instruments.

Q2: Do you believe that the current wording of the RTS is clear and sufficient with regard to the content of the order execution policy where an investment firm selects only one execution venue to execute all client orders? Or should the RTS provide for specific criteria to be taken into account when assessing if the selected venue achieves the best possible result in the execution of client orders? Please also state the reasons for your answer.

The wording used in recitals in respect of selecting a single entity to execute client orders and/or providing the investment service of reception and transmission of orders when those orders are sent to a single venue are sufficient. Hence, they are present in the recitals and not in the corresponding article within the draft RTS and therefore it may lead to insufficient compliance with the outcome sought and/or poor compliance with the provision stemming from Art. 4. An actual list of criteria to be taken into account, at minima, included within the provisions of the draft RTS would provide for a better regulatory certainty as well as ensure a level playing field between investments firms, i.e., those which select several venues and those which use a single one.

Also, many small entities as well as those that are part of a wider group of companies will send all their orders to a single venue, for the latter because they have capitalistic links with the venue and for the former because the client funds are deposited with a given entity (e.g., depositary bank); those are standard business practices. Whilst in the second case, one may argue that it falls under a “client specific instruction”, we have never seen any explanation of how conflicts of interest are managed when firms are choosing to send their orders solely to a sister company. The draft RTS doesn’t account for those instances and for the technical or economical inability to challenge the quality of execution of those venues and/or the inability of selecting an execution venue which will allow to obtain the best possible results for their clients.

Q3: Do you agree with the proposed factor of “order sizes” respectively for retail and professional clients, to be considered in investment firms’ selection of eligible execution venues in their order execution policy and internal execution arrangements (see Article 4(1)(d)(i) and ii) of the draft RTS)? If not, what alternative factor would you propose?

We understand that when selecting venues for executing client orders, firms should consider various criteria in particular whether they must select a different venue when executing orders for retail or professional clients as often retail client orders are smaller than the professional ones. Hence, it is not the only criteria and is not the most relevant for all classes of financial instruments such as shares. Accordingly, some financial instruments are not or are rarely traded/invested in by retail clients.

Also, the propositions in Art.4.1 are mixing generic considerations that can be applied to classes/clusters of financial instruments with consideration applying to a single financial instrument: 4(1)(d)(ii) and 4(1)(g)(ii) which contradicts the possibility for firms to group financial instruments by classes.

Finally, the requirements in 4(1)(g) may present various challenges for smaller firms (e.g., costs to access reference data) and for smaller execution venues (e.g., provision of reference data) creating an uneven playing field between large institutions and smaller ones as well as hampering competition and the ability for new players to emerge.

We would suggest therefore to amend the wording of Art 4, in such a way that firm may have more flexibility when using the criteria listed:

Art. 4.1: For the purpose of establishing its order execution policy on the initial selection of execution venues, an investment firm shall take into account the characteristics and needs of the clients to which it provides investment services, including **when appropriate**”

Q4: Do you agree with ESMA’s proposals for the specification of the criteria for establishing and assessing the effectiveness of investment firms’ order execution policies? Please also state the reasons for your answer.

Generally, the proposed criteria are sound and should provide for a more effective outcome as it considers the various factors that may jeopardise the overarching rule of obtaining the best possible results when executing clients' orders. We believe, however, that some minor targeted amendments to the existing wording may help clarifying the provision as well as introducing some proportionality, whilst helping to distinguish between on-going and periodic monitoring requirements including proportionate calibration calling for escalation and a more comprehensive review of the effectiveness of the policy.

Art.1. (b): whenever the execution quality of the monitored transactions during a monitoring period breaches **repeatedly and, or materially** a predefined thresholds **or other relevant arrangements designed by the Firm to allow them to obtain, for their client orders, the best possible results.**

Indeed, it may happen that a single order breaches the established thresholds due to a sudden market movement without necessarily requiring to reassess the entire policy. Accordingly, not only thresholds may require reassessing the policy such as a change in the performance of a venue, an alteration of the routing algorithm, an introduction of a new product. We believe consequently that the proposed wording provides for more flexibility as well as extend the scope to other elements that should be taken into account when the on-going monitoring results call for a more comprehensive re-assessment.

Art.2. (c) the speed **and likelihood** of execution

The main execution factors include the likelihood of execution, not only price, speed and costs. We believe that it should be mentioned provided that for some instruments that may be less liquid is an important factor. It is also an important factor when firms want to executed orders that may be large in size without moving the market.

Art.7. To comply with this Article, an investment firm may only rely on an assessment performed by a third party, such as an independent data provider or execution venue, provided that the analyses performed by the third party are representative for the client base of the investment firm with regard to the financial instruments and order sizes assessed **and take into account all relevant execution factors.**

Most firms relying on third parties to assess the quality of execution obtained are using TCAs solutions. While those reports are extremely useful, they are heavily oriented towards measuring price deviations from pre-set benchmarks. Price is an important execution factor, but not the sole one therefore it may be useful to include a reference to the whole panel of execution factors (e.g., speed, likelihood, settlement, costs ...) that should be taken into account when assessing the quality of execution obtained.

Q5: Do you agree with ESMA's proposal that investment firms may rely on monitoring and assessments performed by third parties, such as independent data providers, as long as firms assess the processes of these third parties? Please also state the reasons for your answer.

We agree. First it provides an independent assessment of the quality of execution obtained which contributes to managing conflicts of interests and provides the firms with resources it may not have. Second it is important to ensure as for any outsourced activities that the service provided is fit for purpose including understanding its limitations and planning for possible disruptions of the service provided.

Q6: Concerning the specific client instruction, should it be possible for an investment firm to pre-select an execution venue in the order screen, where the firm invites its clients to choose an executing venue out of multiple options? And if so, do you agree that only if the client chooses a different venue than the one pre-selected by the firm, the choice of execution venue does constitute a specific instruction? Please also state the reasons for your answer.

We are a little confused by this question.

Our experience shows that clients will rarely request to have their orders executed on a specific execution venue with the exception of clients that have their assets deposited with a given financial institution and have provided the portfolio manager with a management mandate. In this case, the firm has a very limited impact on how orders will be executed with the exception of ensuring that the time elapsed between the moment the order was transmitted for execution and the time it is handled by the receiving firm is minimised as much as possible.

The other situation that seems relevant in relation to Q6, is to choose execution venues that are located in countries that will not impose additional costs such as stamp duties for instance when executing transactions in financial instruments. However, the latter should be part of the factors taken into account by firms when selecting venues to execute their clients' orders.

We view the selection of a venue by a client as always being a "specific client instruction", irrespective of the circumstances in which it takes place. Concerning the pre-selection of an execution venue in advance, we would think that is contravenes to the rules stemming from the Best Execution framework. Indeed, how a firm will know which will be the most appropriate venue in advance except if there is only one venue that may execute the order as the given financial instrument is not traded on any other venue.

Q7: Where an investment firm executes client orders by dealing on own account (including back-to-back trading), in light of the specificity of this execution model and since it is bound by the rules governing best execution, do you believe the current text is clear with regard to what kind of obligations investment firm applying such model should comply with? Or do you believe it would be useful to provide in the RTS list and explanations of information that should be included in the order execution policy, such as related to the method and steps to be taken by the firm to establish the price of client transactions in back-to-back trading, or the methodology for the firm's application of mark-ups or mark-downs in such order executions? Please also state the reasons for your answer.

We do not believe that any additional steps should be taken in relation to that specific matter when executing clients' orders for retail clients. Indeed, rules governing costs and charges are already requiring providing clients with information on the costs of services including any mark-ups. As such, Firms must disclose that information and consequently adopt set in advance methodologies.

However, since the entry into force of Directive 2011/338, the costs and charges rules have been discontinued for professional clients when providing RTO, Execution and Dealing on own account services. Consequently, Firms are not required anymore to be transparent on the subject matter which does not raise serious issues for large, sophisticated clients, but may adversely impact less experienced professional clients that rely on the firms to achieve the best possible results.

We consider therefore that adding a requirement in Art. 9 in relation to what type of methodologies firms have designed for the application of mark-ups or mark-downs shouldn't add any additional burden for firms servicing retail clients but would at least provide some clarity for the less sophisticated segment of professional clients. It would also have the benefit of providing firms with an additional monitoring tool to verify the quality of execution obtained.

Q8: Are there any additional comments that you would like to raise and/or information that you would like to provide (for example, relevant information in relation to any expected costs and benefits arising from the proposals)?

We welcome the work carried by the ESMA to clarify further the content of the Order execution policy as well as what adequate monitoring looks like. We would like to stress however, that it is important to take into account that larger, more sophisticated firms have the necessary resources to fully comply with all the provisions, many already do. Hence smaller firms may struggle to comply with such itemised requirements and therefore it is important to provide for some proportionality in the way full compliance with those provision will look like in particular in relation to the use/access to data to carry-out review of the quality of execution obtained.