KPMG

FINANCIAL SERVICES

INTERPRETING 'BEST EXECUTION' IN DEALER MARKETS

Discussion paper for The Futures and Options Association

August 2006

ADVISORY

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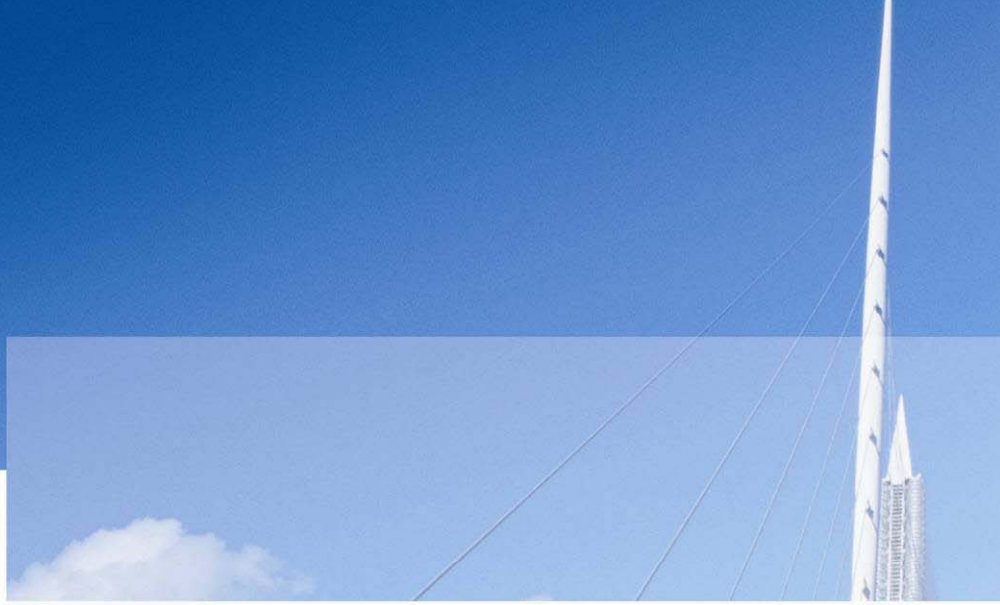


Background

The EU's flagship financial markets regulatory platform – Markets in Financial Instruments Directive ('MiFID') - represents a substantial change in the regulatory landscape for participants in financial markets in Europe. Significant among the issues raised by MiFID are the requirements for Best Execution. While the concept of best execution in regulatory terms is not new, MiFID, while adopting a principles-based approach, brings a broader range of financial instruments into consideration, applies a broader definition of best execution (for example, it allows firms to go beyond just looking at price) and, most importantly of all, extends the requirement to provide best execution to a much wider range of clients than current regulation.

The extension of the scope of Best Execution under MiFID has resulted in extensive consultation by all parties - European regulators, trade associations and market firms. Debate has most recently been focused through the publication of a Best Execution discussion paper (DP06/03) by the Financial Services Authority ('FSA') which presents the concept of "price benchmarking" as a means by which firms could demonstrate Best Execution in Dealer Markets.

Market response to DP06/03 has focused largely on the impracticality of price benchmarking as an approach to demonstrating Best Execution and sustaining FSA's commitment to adopt an "intelligent copy-out" when translating MiFID into UK regulation - rather than adopting a more prescriptive interpretation of the Directive.

In the market's view, intelligent copy-out of the Directive would minimise the risk of regulation having adverse effects on the wholesale markets. MiFID requirements for Best Execution are, nonetheless, complex and many firms will look for guidance to translate a "copy-out" of MiFID requirements into a practical approach which balances the needs of the firm, its clients and the regulator. This will put the onus on firms to define the market approach to Best Execution through industry groups such as MiFID Connect or to the FSA directly.

Our objectives

KPMG was asked by the Futures and Options Association ('FOA') to comment on the market aspects of the FSA's paper - DP06/03 'Implementing MiFID's best execution requirements' - with particular reference to chapter 3 'Dealer Markets' and the price benchmarking proposal in the supporting research paper.

We were asked to use our experience and contacts in the market to suggest further options that could be of use in both interpreting and meeting best execution obligations in dealer markets.

This paper seeks to answer the questions raised by the FOA and concentrates on a number of options which occur to us, from our experience and market input, as likely to address the requirements of MiFID Article 21 when seen from the viewpoints of the three main participants in the debate:

- Regulators
- Buy-Side Firms
- Sell-Side Firms

In response to this mandate, we reviewed the responses made by the trade associations such as the British Bankers Association (BBA) and Investment Management Association (IMA) and also the approach taken by other regulators e.g. the French 'Autorité des Marchés Financiers' (AMF). From this context we began to look for ways forward that would meet all participants' needs. We reviewed and refined the approaches being presented here in a series of meetings with a broad selection of our clients covering both the sell-side and the buy-side - traditional investment managers and hedge funds. We also met the policy team at the FSA.

We would like to extend our thanks to those who helped us by making time for meetings and responding to the ideas in earlier drafts of the report.

Summary conclusions

MiFID's regulatory objectives could be fulfilled without imposing a price benchmarking approach. MiFID allows firms to consider a range of factors in demonstrating best execution and the use of an approach which is reliant on price benchmarking may give undue weight to price in markets and for clients where other factors have as great a role to play. The use of price benchmarking is appropriate for flow transactions in transparent liquid markets; but for the majority of dealer markets this is not the case.

To the extent that there is a broad definition of what constitutes executing an order, there needs to be a correspondingly broad and principles-based approach to defining best execution. From our discussion with market participants we do not foresee the possibility of there being one approach to best execution (or to measuring price) that will be applicable across the range of dealer markets.

As a broadly defined obligation, applied to a wider range of products and clients, the MiFID definition of best execution raises substantial data collection and retention challenges; and firms face the possibility of needing to substantiate a best execution obligation over the years of the lifetime of an OTC contract.

Regulatory objectives in relation to best execution could be fulfilled through a principles-based approach and regulators need not be prescriptive in defining how compliance may be achieved. However, there is a desire amongst many firms to be offered guidance to help them implement the requirements of Best Execution within the context of the clients they serve, the products they offer and the way their firm operates.

From our discussions, we believe that a workable outcome would allow a combination of approaches to demonstrating best execution – including the use of reliable benchmarks, where they are available.

Options for dealer markets

Context

MiFID is aimed at improving investor protection and opening up the financial markets across the EU, and will inevitably drive changes in the relationships firms have with their clients and with the markets.

The concept of 'best execution' is defined in MiFID not only by price, but also allows consideration of costs, speed, likelihood of execution and settlement, size, nature *or any other consideration* related to a particular order. (MiFID Article 21 sets out the requirements, a copy is in Annex 1 of the DP.)

A firm's approach to providing best execution should be set out in an execution policy which, among other things, identifies the execution venues that the firm has chosen to use. The policy must specify the factors which lead to the choice of execution venues. Clients must give prior consent to the execution policy. The effectiveness of the execution policy should be reviewed on a regular basis.

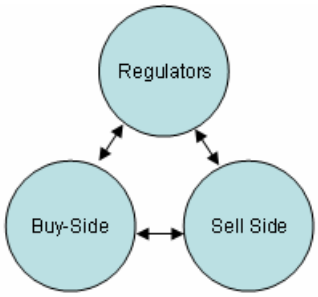
As explained in Chapter 2 of DP06/3, a best execution policy should be appropriate to the services offered. It is relatively straightforward to demonstrate best execution for transactions in liquid markets and when price is the predominant factor. The challenge is to interpret best execution in markets where there are no readily observable prices, and where the product is routinely constructed in response to specific requests from the client.

The approach and the options outlined below were suggested by and reviewed with our contacts. They are presented here as being helpful, and to assist in achieving a consensus on the interpretation of best execution in dealer markets.

A way forward – outline success criteria for the participants.

In defining a way forward for Best Execution under MiFID, we have considered the minimum success critera that the market participants most affected by MiFID might seek to meet in defining policy. It is important to note that firms could exceed these criteria if they see an opportunity for competitive advantage, or are averse to regulatory risk and uncertainty. We have considered each category of participant in the market in turn; the importance of the criteria will vary from firm to firm, from client to client, product to product and market to market.

It is envisaged that all three sets of success criteria should be used together as a tool to assess the effectiveness of approaches to best execution.



Policies must consider the needs of all 3

Given a principles-based approach to regulation, firms could formalise their pricing and execution policies, and associated review processes, in light of the obligations that MiFID imposes on their clients and their regulator.

Perspectives of market participants

1 - From the sell-side

Price is important, but is not the only factor.

MiFID poses sell-side firms with the dilemma of demonstrating that they consistently comply with MiFID best execution requirements whilst maintaining their competitive position and not undermining their prudential standards. While MiFID gives firms the opportunity to consider factors other than price and costs in defining Best Execution policy, firms must consider the possibility that its regulators will ask to review pricing even where the firm has adopted an approach to best execution in which other factors are a significant element of its policy (unless the firm has retail clients for whom price and cost must be considered).

The Sell-side believes that markets are highly competitive and pricing is tight.

We believe sell-side firms will seek to define a policy which avoids major changes in the way they currently interact with their clients or in current acceptable market practice and which protects their investment in intellectual property. We believe firms will also seek to ensure that their policies are cost efficient and do not result in undue risk-taking, such as pricing in-line with competitive pressures irrespective of risk tolerance/measurement or costs.

Firms have different appetities for regulatory certainty.
We believe sell-side firms will wish to reduce regulatory uncertainty, but may see it as advantageous to see how best execution principles evolve and to amend policies as necessary rather than seeking a final solution for day-one.

We have summarised sell-side minimum success criteria as follows:
- Enhance the client base and the way the firm interacts with its clients
- Protect investment in intellectual property
- Recognise and allow appropriate reward for all risks being taken
- Reduced regulatory uncertainty
- Proportionate approach that allows flexibility in how requirements are met
- Minimise disruption in acceptable market practice
- No loss of international competitiveness
- Reasonable cost of implementation and maintenance

2- From the 'buy-side'.

The buy-side represents a broad cross-section of the market from institutional market counterparties, to small corporates and private individuals. The nature of the best execution obligation will vary depending on the products and the ultimate clients involved. For many firms on the buy-side, the issues posed by MiFID for the sell-side will also apply: Investment management firms are under the same obligation to ensure that they obtain the best result for their clients.

In meetings with our market contacts, we were reminded of two key points:

> Buy-side firms seek relationships that deliver the best result over time and for the range of transaction demands that they have.
>
> Buy-side firms do not see themselves as having an information disadvantage. They are accustomed to dealing with a number of firms (e.g. the 3 quote rule), they have access to competitive quotes that dealers cannot always see and they actively monitor sell-side performance.

There is agreement on the buy-side also that markets are competitive and pricing is tight.

Best execution may become an essential component of a brand
Professional and retail firms may come to view best execution as a benefit which helps them further demonstrate to their stake-holders that they are obtaining fair value from the firms they use for financial services and advice.

This would especially be the case if best execution does not result in significantly increased cost to buy-side clients.

The buy-side will seek to be more conservative in its approach to regulation. We see buy-side minimum success criteria as similar to the sell-side. Many buy-side firms shoulder a considerably larger miss-selling risk than their sell-side counterparts in respect of the volume of retail clients they service. Many Buy-side firms will wish to rely on sell-side firms to demonstrate best execution.

We have summarised the likely requirements of buy-side firms as follows:

- Minimise regulatory uncertainty
- Enable reliance on sell-side firms to demonstrate compliance with best execution policy
- Contribute to brand value and help demonstrate value to stake-holders
- Attractive to clients
- Proportionate approach that allows flexibility in how requirements are met
- Minimise disruption to acceptable market practice
- No loss of either liquidity or access to risk management products
- Avoidance of major increase in execution costs
- Low cost of implementation and maintenance

3 - Regulatory

MiFID poses the regulators with the challenge of balancing the demands of the market against those of the customers it services and ensuring costs (both its own in supervising the Directive and the market cost of implementation) are proportionate and reasonable (Principles of Good Regulation). Looking to their own needs, Regulators prefer an approach that is as light-touch as possible, consistent with their public policy objectives and their interpretation of the directive, but which is also compatible with the approaches adopted by other Regulators in the EU and elsewhere. Regulators wish the implementation of MiFID to encourage healthy competition in the markets they supervise.

We have summarised the likely minimum success criteria of the regulators as follows:

- Meets obligations arising from the directive
- Fulfils public policy objectives including providing protection to consumers
- Maintain market efficiency,
- Preserve and enhance the position of the UK markets as a financial centre
- Firm's policies should be capable of being monitored, evidenced and policed effectively
- Provides efficient management of conflicts of interest

Minimum Success Criteria in Practice

We have considered how the minimum success criteria we have defined could inform the drafting of a best execution policy. The following examples have been discussed with a number of buy and sell side firms that represent a large proportion of the London market.

It appears unlikely that firms, especially those trading a broad range of products, to a diverse population of clients, will be able to adopt a single approach to meeting all of its requirements for best execution. We expect, rather, that firms will define a policy framework which has tailored elements for products or product groups (e.g. flow vs structured) and aimed at their clients. Best execution is therefore likely to be an area where firms will seek to differentiate themselves on a competitive basis. An overly prescriptive approach to specifying how firms should meet their best execution obligations would tend to constrain competition and hinder innovation.

Please note that the options we have included are those which were most often posed to us as potential solutions to meeting the requirements of best execution. Firms will need to make their own assessment of what approach is best on the basis of their own unique mix of products, customers, costs and capabilities. We would further caution the adoption of any solution(s) without a thorough assessment of the impact of such arrangements on both the firm and its clients.

Use of Internal Models

The use of internal models is a major element of price formation in most dealer markets irrespective of whether a potential reference price exists. Models are used (and in many cases mandated) because they can offer the best approach to product customisation and because they are integral to the risk and financial management practices of most firms.

Provided that management processes surrounding the use of a firm's models are robust, we believe they could be used as an element of firms' best execution policies. This is clearly attractive for those products where models are largely standardised across the industry and are widely available. Even where products are unique to one supplier, we noted an instance where the buy-side firm had constructed a model for their own reassurance. The

processes would, however, need to provide for review and evaluation independent of the front-office sales and trading functions.

We do not believe that best execution policies should require disclosure of model information; this might result in a loss of both intellectual property and proprietary data. Furthermore, following disclosure, the buy-side could find itself obliged to verify the appropriateness of the model for their transactions.

Benchmarking

There are many well-documented issues with the use of a benchmark prices as an approach to demonstrating best execution in dealer markets. However, while benchmarking does appear to answer many market participants' minimum success criteria, this only applies to a relatively small proportion of their trades i.e. those that are most liquid. The FSA suggests that best execution is assured by disclosing the reference price and then adding a dealing spread that has to be within pre-agreed limits. Even in these cases, firms must be allowed sufficient freedom between their price and the nominated benchmark to allow for costs, financial risk, short-term liquidity issues, the need to make a profit and other factors which are unique to their execution venues.

If the benchmarking approach were to be extended to markets where liquidity is not generally sufficient to identify a clear benchmark, we would expect serious issues over its robustness and relevance, and the cost of implementation and maintenance.

If price benchmarking is employed where it is not truly appropriate, firms may find themselves in further difficulty when reviewing the effectiveness of their execution policies (as required by Article 21.4). A review that focuses on price might raise questions around trades with outlying prices for which other execution factors were more important.

The practicability of benchmarks, we suggest, should be left to the market to determine and not be suggested by the regulator as the preferred approach.

Reliance on Client Instructions

The possibility of treating the requirements of the client as a specific client instruction (for the purpose of defining best execution) is attractive and represents an avenue we believe many firms wish to explore, especially in relation to request-for-quote ('RFQ') markets and structured OTC derivative trades. However, it should be noted that:

- Reliance on client instructions does not remove the need for a policy which outlines how best execution will be achieved in the absence of specific instructions;
- The draft MiFID Level 2 implementing measures currently state that specific client instructions provide an exemption only from those factors or aspects of the order to which they apply, and not to best execution as a whole.

Sell- and buy-side firms were keen to stress that the use of client instructions should not be regarded as an avoidance device because they are central to the execution of an OTC transaction and are also often vital in achieving the desired outcome in some exchange-traded transactions (for example when a client wishes to minimise the impact of a large trade.) In the case of RFQ markets, the view was strongly put that, if used in line with market practice, the acceptance of a quote must surely be an over-riding specific instruction from the client to deal at the price and other terms quoted. Given a suitable interpretation of 'specific instructions' that reflected its ordinary, natural language meaning the use of client instructions could form a key component of firm's policies.

Agree best execution bilaterally / trade-by-trade

For more complex trades, where speed of execution is not usually of paramount importance, the opportunity arises for agreeing what constitutes best execution on a bi-lateral basis and within the context of the specific order under discussion. This approach allows for customised weighting of all the factors available under MiFID and allows best execution to be shaped by client need.

This approach has the advantage of demonstrating that the firm has not sought to avoid the need to provide best execution. However, it does not remove the need for a policy which outlines how best execution will be achieved in the absence of any such bilateral agreement.

Agency or quasi-agency arrangements

Firms may wish to explore providing best execution by way of a third-party service which compares the firm's price against those of other firms and venues. While we believe agency arrangements would tend to add cost, the process of comparing other firm's prices does achieve some degree of transparency with respect to how price has been achieved. However, agency

arrangements may also act to limit the amount of information and advice that is often made available to clients when negotiating a trade on a principal basis; thus eliminating the opportunity for clients to shape what constitutes best execution in the context of their own specific needs.

The view has been firmly expressed to us that neither the buy- nor sell-side see benefit from adding a new service layer between them; ultimately, in this approach, the added cost would be borne by the buy-side or the investors/unit holders.

We believe this has its advantages but it will add to the cost of execution and may not deliver what is in the best interests of sell and buy-side firms.

Relating price to yield or effective interest rate

Some trades can be decomposed to a series of actual or projected cash-flows occurring over time and we wonder whether firms would wish to consider representing their product as an effective interest rate, yield or other performance measure which is then compared to some readily available market benchmark.

After discussion, we conclude that this approach has little to offer beyond the range of instruments for which it is straightforward; for products that involve optionality, the contingent cash flows are derived from a model, which is then subject to the discussion above.

The use of publicly-available third-party models

We have noted the emergence of third-party (often web-based) models and valuation tools and considered whether they could play a role in proving best execution. For example, a firm might not wish to disclose its own model but could refer to a non-proprietary third-party model to calculate a "fair value" for the transaction in question.

We are, however, concerned that third-party models would not adequately represent the product complexity and the variety of inputs used in the internal model. The introduction of such unfocused factors into the process could make the approach unworkable.

Circumstances where the Best Execution obligation does not apply

The DP suggested three routes that do not involve imposing a best execution obligation on principal dealers.

- Trading only with eligible counterparties,
- Providing best execution through intermediaries,
- Trading through a Multi-lateral Trading Facility ('MTF') or regulated market.

In our discussions we encountered the view that an appropriate definition of 'order' could allow much OTC business to be seen as the bilateral negotiation of a contract to which best execution obligations did not apply.

It was further suggested that trades executed on Electronic Communications Networks ('ECNs') or platforms should not constitute client orders, since they are executed by the buyer on the basis of an 'offer' at a price.

At the time of writing, the FSA has not yet provided its views as to what constitutes an 'order' an 'offer' or an 'execution'.

Detailed observations

We present our observations in the order of the structure of FSA's DP06/03 and comment on the accompanying research paper in the context and order in which it is relevant to the FSA DP. (References in brackets are to paragraphs of the DP.)

Chapter 2 - Execution policies and arrangements

A key point made in Chapter 2 is that all firms in a chain of execution are subject to best execution requirements; but the requirement is to implement an execution policy that is appropriate to the nature of the services offered. Firms can delegate the function of (but not the responsibility for) securing best execution. Firms are allowed to determine the relative importance of the factors that determine best execution (price, costs, timeliness, liquidity etc). Overall, there is a requirement to demonstrate to a client that all reasonable steps have been taken to achieve the best possible result, best execution is not an absolute obligation.

What constitutes Best Possible Result?

One of the inherent problems with Best Execution is that it places a generic burden of providing the best possible result on firms whereas what is actually "best" will vary depending on the client's actual needs at the time of trading and the nature of the client's instructions. So, while for many clients and products, the best result may be determined predominantly by price and cost, for others it may be determined by timeliness or by total return or even by whether the investment has been achieved at all (e.g. if a firm has been willing to extend credit or has the ability to provide the required product). The result will also vary depending on the size of the order, the size of the client firm, the nature of the relationship, the purpose of the investment, the type of market and a variety of other factors, which can only be known in the context of the needs of the client. These transaction-specific elements, taken together with the varying circumstances of risk-taking dealers and the variety of their business models militate against an overly prescriptive approach towards standardising the concept of best execution or setting regulatory parameters around the process for delivering it.

Chapter 3 - Dealer Markets

Options for Dealers (Paragraph 3.12 onwards)

The FSA suggests that a MiFID compliance problem might arise in OTC markets if a non-eligible client wishes to trade directly with a risk-taking dealer. The DP (3.13, pg 23), suggests that the best execution requirements could instead lead dealers in OTC markets to:

1 – Deal only with eligible counterparties that do not demand best execution;
2 – Trade only through brokers for clients that require best execution;
3 – Deal on Multi-lateral Trading Facilities (MTF) or regulated markets.

We agree that these outcomes are logically possible and would help firms avoid some aspects of providing best execution. However, on examination, these options would reduce customer choice, increase the costs of execution, and/or compel firms to change their business models or their market strategy for purely regulatory reasons, possibly to their and the market's commercial disadvantage.

To consider each of these suggestions in turn:

Deal only with eligible counterparties

- Our contacts in the market suggest that the sell-side will not wish to restrict itself to serving only eligible counterparties;
- The FSA and many firms predict that many eligible firms will seek best execution anyway as part of their need to provide best execution to their clients;
- The withdrawal of certain products and capabilities from non-eligible clients would be unhelpful (in some cases severely) to those clients who are fully capable of managing the performance dynamics of working with large sell-side firms, who are dependent on the use of such instruments, but who still need to achieve best execution for the transaction;
- Professional counterparties will have a narrower band of dealers with whom they are able to enter into transactions.

This is an unattractive fall-back position for both sides of the market and would involve extensive negotiation between buy- and sell-side firms to establish eligible counterparty status and service agreements.

Trade through brokers

- The use of agency structures in OTC markets would help buy-side firms show they have achieved the best price but not necessarily the best consideration or result;

- Agents would want to be to be paid for the value they provide and this cost would ultimately be borne by the client;
- Reliance on an agent also creates a potential barrier to the client accessing the best expertise and advice available in the market and therefore potentially the best result.

For those clients, however, who do prioritise price in terms of best execution and who do not wish to undertake their own due diligence, the Agency model may be attractive, notwithstanding that it will entail extra costs.

Use of MTFs, regulated markets or other venues

Transactions executed on an MTF or a regulated market are not, as the FSA noted, subject to best execution.

Transactions completed on ECNs and other platforms might not be subject to best execution if the transaction could be seen as acceptance of an offer rather than execution of an order. Guidance is required from the regulators before it will be possible to determine how the definition of 'Order' might help in lightening the obligation to provide best execution.

The value added by third-party venues adds cost and unless the venue is efficient and competitive, the use of a venue will act to increase cost. Where individual firms are willing to provide significant levels of liquidity in a given product it may be possible for buy-side firms to achieve both better pricing and lower overall costs by avoiding the use of a third-party venue altogether (as, for example, trading off-exchange in the equity markets today).

The use of benchmarks to manage conflicts of interest (3.18 onwards)

FSA assumed that a risk-taking dealer may benefit from an information asymmetry as regards the pricing of transactions and that this could generate a conflict of interest. As a result, FSA has proposed (3.18, p24) that such conflicts of interest i.e. between his firm's position and the client's best execution requirements, might be managed by referring the dealer's price to a benchmark that could be used to substantiate best execution.

In proposing a price benchmark, what is being sought is something that has the simplicity, robustness, transparency and explanatory power of the benchmarks available in the equity markets for highly-liquid securities (VWAP, opening price, and closing price). An exchange carefully manages its trading system and opening hours to ensure adequate liquidity but only achieves this goal for its largest and most widely-traded issues. By definition, there is no equivalent

exchange in OTC markets. The prices that are observable e.g. on broker's screens are usually indicative and cannot be directly traded.

Dealer markets are very varied and liquidity is not a static one-dimensional spectrum. Whilst the bond market as a whole might show steady liquidity, the market for particular issues (which is ultimately defined by the size of the issue) does not. Other markets suffer from similar issues: for example, liquidity in credit default products varies widely according to the expectation of default events.

Price is only one factor in best execution

One could ask how much of the client's 'best possible result' is delivered through a benchmark price? MiFID Article 21 allows consideration of seven factors – including a catch-all category for any factors not foreseen at the time the directive and its recitals were written and, other than in the case of retail executions, it allows the firms to exercise their own discretion as to the selection, prioritisation and measurement of those factors, subject to any instructions given to the dealer by the customer. In exchange traded equity markets where the best execution concept is most at home, the client and broker can agree how the order will be worked and best execution can be subsequently referenced to a benchmark. Both parties recognise a trade-off, dictated by available liquidity, between trade size and price certainty.

One key factor that goes to the determination of price in a risk-taking dealer market is the risk of the transaction to the dealer and it is critical this is taken into full account because the transaction involves putting the firm's capital at risk. The dealer will set a price using criteria which will be, in many cases, unique to that dealer at that moment and this is one of the key elements that militates against uniformity in approach to best execution and standardisation of price through a benchmarking process.

The proposal to reference a benchmark in OTC markets would only be relevant in some markets and would comprise only one methodology for measuring only one factor amongst several, namely price.

Addressing conflicts of interest in pricing

MiFID creates a greater focus on the identification and disclosure of conflicts of interests to clients and the FSA has suggested that firms can use benchmarking as a means of addressing the conflicts they see arising in dealer markets. While we believe benchmarking could be used to provide a degree of assurance

to clients that these perceived conflicts are managed, we would also see arrangements that firms have in place to manage the relationship of the trading function vs. the sales function as useful in addressing potential conflicts. We believe firms could also point to measures such as transfer pricing arrangements, limitations on direct trader / sales discussions from the price formation process, the separation of reporting lines, pay and remuneration between trading and sales, limits and even elimination of proprietary trading (as is common in many firms) as arrangements which help address the risks of conflict in respect of pricing.

Characteristics of robust benchmarks (3.23)

Will MiFID result in the creation of additional benchmarks?

FSA suggests (DP 3.26 and 3.29) that a benchmark could apply not only to the issue or instrument that forms the benchmark, but to other instruments via a spread. The FSA is supported in this suggestion by the notion that most pricing is based on observable inputs to the models used by firms to manage financial risk. However, the construction and maintenance of relative benchmarks would be costly and complex requiring the consideration of many factors:

- Identification of the liquid reference asset or instrument,
- A means of establishing its use as the reference for other assets (that is, an understanding of the relationship between the assets),
- Agreed source(s) for the price of the reference asset,
- An algorithm to calculate the reference price (e.g. where it is not simply the best price on a particular screen),
- A matrix of spreads versus the reference to cover related assets,
- Monitoring of the behaviour of the market for the reference asset (for example to check that it is still sufficiently liquid)
- Monitoring of correlation and spreads of related assets to ensure that they do still trade with constant relation to the reference,
- Agreement on what to do when correlations change,
- Ownership, governance and independence for the process.

The question remains as to who would maintain relative benchmarks and how they would be made available to the market.

Spread limits (3.35)

The DP suggests that, in applying the benchmark, the spread limits on the reference price should be set by prior agreement. It is proposed that best execution is assured by disclosing the reference price and then adding the dealing spread. The dealing spread would have to be within pre-agreed limits (which might vary for different types of client). Either the spreads will have to be set very wide, in which case little reassurance is given, or, if set too tight, the trader will have no scope to allow for the impact of other factors on the outcome.

Internal benchmarks (3.36)

There may be commercial opportunities that some firms wish to take in which they disclose or share information about their model with a client. Disclosure of product modelling information is especially relevant to situations where firms are providing financial structures which are ultimately sold on to retail investors.

The disclosure of model information occurs to us as potentially obliging the buy-side to assess the model and the prices it generates; we wonder, therefore, whether this disclosure would place an unnecessary burden on buyers. We also recognise that firms have a duty to protect intellectual property and worry that model disclosure runs counter to this obligation.

Conclusion

We do not believe that the regulatory promptings for price benchmarking in dealer markets, while understandable, are appropriate. Reference to a price benchmark in a liquid market would clearly be a reasonable step for a firm to take; equally it would be unreasonable expect a firm to devise a price benchmark in a market where one does not exist.

Market-driven changes in the trading environment may well bring about the establishment of new and transparent benchmarks, but, in our view, this should continue to be a market-driven change. In the absence of demonstrable and evidenced market need, such as significant counterparty demand or proven market failure, we do not believe that the FSA should feel constrained to require, or promote as a preferred option, the use of price benchmarks in dealer markets.

We do not believe that the FSA is seeking to impose price benchmarking on dealer markets or to become a judge of best execution at the level of individual

transactions. We also note FSA's emphasis that the paper in question is a Discussion Paper and that price benchmarking in dealer markets is an "option" for measuring the quality of price in an execution. However, if the FSA is thought to be promoting price benchmarking as a preferred option, it would not only become a 'soft' regulatory burden on firms and, as such, become a critical part of the supervisory process, but it could also serve as a disincentive to firms to use other more appropriate means of measuring price.

Given the range of factors allowed for consideration in Article 21, the burden of proof as regards best execution cannot be satisfactorily discharged through any priority given to price benchmarking.

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