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FSA Discussion Paper 06/3: Implementing MIFID's best execution requirements

Response by the London Investment Banking Association (LIBA)

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Summary

1. DP06/3 is a Discussion Paper in two halves. Except for a small number of problem areas (notably the approach to client instructions, which is too restrictive), Chapters 2 and 4 set out a generally sensible, proportionate, workable, flexible, interpretation of best execution requirements which is consistent with MIFID and with its efficient and rapid transposition and implementation in the UK, and which we strongly support. The October consultation paper needs to follow these lines in order to ensure that market participants can comment on it efficiently and easily within the proposed one month deadline.

2. The status and scope of the benchmarking proposal in Chapter 3 needs further clarification before its impact can effectively be assessed. As regards scope, it is vital that 'order' and 'executing client orders' are correctly interpreted, as we propose in paragraphs 4 to 16 below, and that 'client instructions' is interpreted to retain the existing freedom and flexibility for market users, as set out in paragraph 30 below. As regards status, Chapter 3 implies that "robust" price benchmarking is the only valid means of achieving and demonstrating best execution. Applying the benchmarking approach in this way would cut across, conflict with, and contradict the approach set out in Chapters 2 and 4. We think that it would be unworkable and unwarranted, could damage the efficiency and international competitiveness of dealer markets, would be inconsistent with MIFID itself, would gold-plate MIFID by restricting the factors which firms might need to take into account to provide best execution, and would also conflict with other elements of FSA's policy work on MIFID (see paragraphs 32 to 103 below). Particular examples of these inconsistencies are:

i. Chapter 2 of DP06/3 rightly emphasises the need for flexibility and to take account of all relevant factors; the benchmarking approach inappropriately focuses just on the price factor.

ii. Chapter 2 also rightly emphasises the centrality of the execution policy and the importance of a process-driven approach; the benchmarking approach focuses on calculation and disclosure of the result for each transaction.
iii. Chapter 3 does not seem to be consistent with FSA's policy on bond market transparency, as set out in DP 05/5 and FS 06/4.
iv. CP06/9 rightly makes clear (consistently with MIFID) that there needs to be a duty to the client before a conflict exists, and that making a profit does not per se imply a conflict; the benchmarking approach implies that a conflict is inherent in a dealer's profit motive. Furthermore, even if a conflict did exist, Chapter 3 would not be consistent with MIFID and CP06/9 provisions on disclosure of conflicts which cannot be managed.

3. We recommend that FSA's approach to the October CP should be to follow an intelligent copy-out approach, preserving the full flexibility which is contained in the MIFID text, and providing helpful interpretation of crucial areas such as the interpretation of 'executing a client order', the interaction between dealing on own account and execution of client orders, and the interpretation of 'client instructions'. We set out in our comments on Chapter 3 below our many concerns about the benchmarking approach. Such detailed material about the application of best execution requirements to particular markets should be dealt with, if at all, either as non-binding guidance on particular aspects where they are relevant, or through MIFID Connect guidelines.

In addition to the above, we also draw attention to the following particularly important points which we make in our response:

i. FSA should not be prescriptive as regards the means by which firms monitor execution quality (see paragraphs 122 to 125, 132, and 141 below).
ii. We disagree with FSA's analysis of how requirements to review and monitor might apply in dealer markets (see paragraphs 135 to 138 below).
iii. FSA should not be prescriptive as regards the means by which firms demonstrate to clients that they have followed their execution policy (see paragraphs 144 to 145 below).

Interpretation of "Orders" and "Executing Client Orders"

4. Footnote 9 and paragraph 3.9 state that DP06/3 does not address the question of when firms do or do not execute client orders. We think that this is a crucial starting point in the discussion of best execution. We set out below a basis for interpreting 'order' and 'executing a client order' which we recommend that FSA should follow.

5. FSA's handbook defines 'customer order' as (our emphasis):

(a) an order to a firm from a customer to execute a transaction <u>as agent</u>,
(b) any other order to a firm from a customer to execute a transaction <u>in circumstances giving rise to duties similar to those arising on an order to execute a transaction as agent</u>;
(c) a decision by a firm <u>in the exercise of discretion</u> to execute a transaction with or for a customer.

6. This definition emphasises that an order exists when a firm acts on behalf of a client, or has another relationship with him which implies an obligation to act on his behalf and in his interests.

7. MIFID Level 1 Article 4.1.8 defines ‘Execution of orders on behalf of clients’ as: “acting to conclude agreements to buy or sell one or more financial instruments on behalf of clients”.

8. MIFID Level 1 Recital 33 supplements this definition, and clarifies its application to Article 21: “It is necessary to impose an effective ‘best execution’ obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. This obligation should apply to the firm which owes contractual or agency obligations to the client.”

9. MIFID Level 1 Article 21.1 itself states that: “Member States shall require that investment firms take all reasonable steps to obtain, when executing client orders, the best possible result for their clients…”

10. These three provisions of the Level 1 Directive point strongly to an interpretation which is similar to the FSA Handbook definition, so that a firm ‘executes a client order’ when it executes a transaction and is acting on behalf of, or is for other reasons obliged to act in the interests of, the client.

11. MIFID Level 2 Directive Recital 69[1] needs to be interpreted consistently with this approach. As the European Commission said in its comments to the European Parliament’s ECON Committee on the latter’s proposed modification of Recital 63: “COM is in favour of clarifying that investment firms, when executing client orders by dealing on own account, should be subject to best execution obligations. ... this issue is already covered by Recital 69 of the draft Level 2 implementing Directive in combination with Recital 33 of the MIFID Level 1 Directive which specifies that best execution applies when a firm owes ‘contractual or agency obligations to clients’. Recital 69 of the Level 2 Directive has to be seen as a provision within the scope of Recital 33 of the Level 1 Directive, i.e. that best execution applies when a firm owes ‘contractual or agency obligations’ to a client”.

12. This interpretation is supported also by MIFID Level 1 Article 4.1.10: “ ‘Client’ means any natural or legal person to whom an investment firm provides investment and/or ancillary services”. ‘Services’ in this context implies that the firm has undertaken to ‘serve’ the client.

13. This interpretation is also consistent with MIFID Level 2 Article 44.1, which recognises market makers and liquidity providers as "execution venues". At no point in Level 1 or 2 is there any suggestion that execution venues are expected to provide best execution. Best execution obligations fall on firms which have agency or contractual obligations, not execution venues.

14. The consequence of interpreting ‘order’ and ‘executing a client order’ in line with MIFID is therefore to exclude from best execution obligations any dealing on own

[1] “Dealing on own account with clients by an investment firm should be considered as the execution of client orders, and therefore subject to…obligations in relation to best execution…”

account where the firm does not act on behalf of, or otherwise owe an agency or similar contractual obligation to, a client. Any dealing with market participants where the firm does not act on behalf of the client, thereby owing the client agency or similar contractual obligations, cannot under MIFID be considered as executing a client order, and so cannot be subject to best execution obligations. This is as it should be, since the bulk of activity in dealer markets involves market participants who choose to deal with the dealer on a principal basis, and do not expect the firm to owe them an agency obligation. FSA is therefore wrong to argue in paragraph 3.13 that a firm would need to deal exclusively with eligible counterparties in order for best execution obligations not to apply. For a market to exist there must be a coincidence of needs. The current successful UK model, in place since 1987, relies on a combination of "price takers" on both sides of the market combined with "price givers" who make supply available at certain prices and sizes at which the "price givers" are prepared to take position risk. Those price givers act both on- and off-exchange, and without them markets would not work as efficiently. Any imposition of best execution obligations on firms acting in that "principal-risk" capacity would have a significant impact on spreads and reduce liquidity.

15. Buy-side institutions acting in a price taking capacity understand the operation of the market and act accordingly. Many professional clients will seek to negotiate with the firm all the terms of a transaction. In those circumstances the final negotiated terms of the transaction, including price, are the terms which satisfy both parties. Therefore, this should not constitute 'executing of a client order'. The professional client has enough experience, knowledge, and commercial relationships to obtain quotes from more than one source and evaluate and compare them. In the case of two parties negotiating with each other, it makes no sense to seek to determine who is giving an order to whom. On the other hand, if for example a client asks a firm to sell a security on its behalf, the firm thereby assumes a fiduciary responsibility towards the client. This should constitute the execution of a client order, even if the firm executes as principal for example by using discretion given to it by the client on how to execute by taking the other side of the trade. Only an activity which involves the assumption of some fiduciary responsibility should constitute order execution.

16. FSA partly recognises this interpretation in Paragraph 2.15. However, in its consultation paper FSA should expand the analysis in Paragraph 2.15 in a way which is as helpful as possible to the needs of users of dealer markets, as set out above.

Chapter 2

Paragraphs 2.1 to 2.6

17. We agree strongly with FSA's statement in paragraph 2.1 that "…best execution is more than the achievement of best price. Price is significant – but execution quality can depend on other factors as well", and in paragraph 2.5 that "[MIFID Level 1 Article 21] does not prescribe in detail how its requirements apply to the diverse circumstances in which client orders are executed". FSA should apply these principles in its approach to best execution (where it applies), in dealer markets, rather than following the benchmarking approach set out in Chapter 3.

Q2.1*: Do you agree with the above analysis which takes a flexible approach to the application of the requirements to firms in a chain of execution, depending on the nature of the activities they perform and the degree of control over the execution of the client orders?*

18. Broadly, yes. We also agree with the examples that FSA gives under paragraph 2.15 where best execution is limited or does not apply. However, these examples need to be considerably expanded as explained above in paragraphs 4 to 16 above.

Q2.2*: Do you agree with our views on the relevance of the specific factors in Article 21?*

19. Yes, and we agree strongly with FSA's emphasis on process (paragraph 2.16). We stress in particular Paragraph 2.21's emphasis that there is no one right answer, that the importance and significance of the factors may vary between clients and instruments, and that there may be more than one way to achieve the best possible result. We also stress Paragraph 2.30's emphasis that it is for the firm to determine the relative importance of the factors. FSA's benchmarking proposals in Chapter 3 are not consistent with this interpretation. Should FSA think it necessary to bring forward any specific proposals on the application of best execution provisions to dealer markets, it should ensure that they are fully consistent with the approach set out in Chapter 2. Where a dealer and a professional client agree that the best possible result should be based on best price, they would be free to agree the details of a benchmarking and disclosure procedure which meets their objectives. The FSA should not exert pressure on either party to adopt any exclusive single method, whether the full Chapter 3 approach or any other.

Q2.3*: What additional costs will the requirements to have an execution policy and execution arrangements impose on your firm?*

20. Costs will arise from the need to formalise the policy, and ensure that the firm's systems (including IT systems) reflect it. The scale of additional costs will depend very much on how FSA interprets and applies the new requirements. In many ways Article 21 reflects processes that firms already use, either to provide best execution under existing rules, or under existing practices to provide client with the best possible results in order to compete for business in what are very competitive markets. FSA should design the rules implementing Article 21 to accommodate those existing arrangements and minimise the extent of change required by enabling firms to take account of the flexibility that Article 21 provides. Our concerns about the benchmarking proposal stem from the fact that it departs from such an approach in a way that would be very costly not only to firms but to market users as well.

Q2.4*: Do you agree that price and cost are the most important factors for retail clients?*

21. In general they are likely to be. However, as specified in MIFID Level 2 Recital 67, other factors may also be relevant, and in some circumstances may be more important, particularly, for example, in the case of less liquid securities where certainty of execution and settlement may be more important, or where a retail client's

need to liquidate a position quickly means that speed is more important than other factors.

Paragraphs 2.31 to 2.33: How many execution venues?

22. We agree in general with FSA's analysis of the circumstances in which it would be appropriate for firms to include only one execution venue in their execution policy. However, it is important to ensure, in the example in paragraph 2.33, that using a single venue is not restricted to circumstances where client orders are 'particularly homogeneous'. It should be quite possible for a full-service firm to have a policy which executes non-homogeneous orders appropriately via a single venue where it is able to obtain the best possible result there on a consistent basis.

Paragraphs 2.34 to 2.36: Dealing on own account to execute client orders

23. We agree with FSA that best execution requirements apply when a firm executes a client order, even when it does so by dealing on own account. On the interaction between 'dealing on own account' and 'execution of orders on behalf of clients', and the interpretation of MIFID Level 2 Directive Recital 69, FSA should follow the approach set out in paragraphs 4 to 16 above.

Paragraphs 2.37, 2.38, and 3.14 – Client instructions

24. There are several aspects of FSA's approach to client instructions with which we disagree.

25. We do not understand FSA's analysis in paragraph 2.37 that "[provisions on client instructions] should not be taken as providing a means for avoiding the best execution requirements" and that "It would not be consistent with the policy objectives of Article 21 for that provision to be regarded as permitting firms (via its terms of business or otherwise) to obtain instructions from clients and to circumvent the best execution requirements." As FSA acknowledges, Article 21.1 provides specifically that firms must follow 'specific client instructions'. Furthermore, Article 21.1 provides that a specific client instruction overrides the general best execution obligation ("…Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction."), and MIFID Level 2 Directive Recital 68 states that a firm that follows client instructions should be treated as having satisfied its best execution obligations. Following client instructions therefore cannot be a circumvention of best execution obligations. It is true that Recital 68 also states that "An investment firm should not induce a client to instruct it to execute an order in a particular way, by expressly indicating or implicitly suggesting the content of the instruction to the client, when the firm ought reasonably to know that an instruction to that effect is likely to prevent it from obtaining the best possible result for that client." But this anti-avoidance provision in no way invalidates the fact that following client instructions constitutes best execution, and limits or eliminates the application of the firm's execution policy.

26. We disagree with FSA's analysis in Paragraph 3.14: "Some have suggested that a dealer subject to Article 21 could comply by operating on a request-for-quote basis and then deem any resulting orders as 'instructions' to deal at the quotes provided.

We do not consider this to be consistent with the provision in Article 21 on client instructions but rather an avoidance device." In the first instance, it is necessary to distinguish carefully between (1) circumstances where best execution does not apply (because the client is giving an instruction in circumstances where the firm owes no agency or similar contractual obligation - see paragraphs 4 to 16 above) and (2) circumstances where best execution applies but is limited by client instructions. In the latter case, it is necessary to distinguish further between (a) circumstances where the firm is seeking to induce the client to instruct the firm to act in a way that it contrary to the agency obligation that it owes the client (as proscribed by Recital 68), and (b) circumstances where the firm provides a request for quote service, and the client decides, without being induced or instructed, to give an instruction that it wants to deal on the terms offered. In case (b), the firm is obliged under Article 21.1 to follow the client's instructions.

27. In any event, it is wrong to assume that firms try to "avoid" providing best execution when operating on a request-for-quote basis. On the contrary, they seek to give clients the best possible results because it makes commercial sense to do so. Indeed, it would be quite possible for a firm to operate a model under which it derived requested quotes in accordance with relevant factors as set out in its execution policy.

28. We also disagree with FSA's analysis in Paragraph 2.38 that 'Client instructions are likely to address only some aspects of execution' and that 'a firm that receives a specific client instruction regarding…execution venue selection…would need to follow relevant provisions of its execution policy and arrangements for those aspects of the transaction that are not governed by the instruction.' This may be the case in some circumstances, but typically an instruction to use a particular execution venue will govern not only the venue that the firm uses (thereby excluding the other venues in the firm's policy), but also override the relevant factors which underlie the policy as well. For example, a client's specific instruction may be motivated by self-selection of the factor that is most relevant (for example speed, or certainty of execution and settlement) in a way that overrides the other factors.

29. Examples include:

i. A limit order is a specific client instruction and therefore following the instruction to fill the order within the stated price limit satisfies best execution. By giving a limit order, the client has specified that this is the only objective that matters.

ii. A client instruction to route a market order to a particular venue encapsulates the entire instruction.

iii. An instruction from a client to execute a trade at VWAP over a period of time is completely fulfilled by providing that execution. There is no other aspect of best execution that would be avoided by acting in that way.

iv. An instruction to execute an order " carefully over the day" is more vague but the firm will attempt to do that whilst also achieving the best price, depending on market conditions.

v. Direct Market Access (DMA) is one of the suite of facilities offered by an investment firm to its clients. To the extent that clients wish for immediacy and want to route their orders directly to a market, they can do so through DMA mechanisms. Although formally speaking DMA may constitute 'execution or orders on behalf of clients', so that best execution applies, in

practice the client chooses whether to route his order immediately to a particular venue or to search other venues. What the DMA facility provides is prompt and certain execution. But apart from those criteria, it is necessary to give full weight to the specific instruction provisions.

30. DP06/3 says a great deal about FSA's views (with which we disagree as explained above) on what scenarios are not client instructions. We think that it is crucial for the interpretation and application of MIFID best execution provisions to specify what specific client instructions are. We recommend that FSA should interpret 'specific instruction from the client' as covering any circumstance where, in giving an order or specifying a course of action that the firm should take when executing the client's orders over an extended period, the client specifies any aspect of how, where, when, or with whom it wishes the firm to execute the order or orders. Professional clients in particular have the experience and knowledge to seek quotes from more than one source, evaluate them, and issue a specific instruction accordingly. Anti-avoidance provisions should be restricted, in accordance with the copy-out approach, to the circumstances set out in MIFID Level 2 Recital 68 only.

Q2.5*: What information will be appropriate in order to enable clients to be sufficiently informed about the execution arrangements of the firm and how will this differ as between retail and professional clients?*

31. FSA should adopt a copy-out approach. It is important not to overload retail clients with information about the firm's execution policy. It should be enough for retail clients to know what factors the firm takes into account and the relative importance the firm assigns to them, and summary information about the types of venue it uses, including the prescribed information about venues on which it places significant reliance. There is no need to prescribe any more detail than is set out in Level 1 Article 21.3 as regards professional clients, who have the expertise to seek any further information that they need without the need for regulation.

Chapter 3

Application of the benchmark approach in fixed income instruments and OTC derivative markets

32. LIBA has worked closely with BMA, ICMA, and ISDA in the preparation of their comments on Chapter 3's impact on fixed income and derivative markets. We agree with those comments in their entirety, and reproduce them here as part of LIBA's response.

Preliminary issues

33. There are two preliminary issues which the FSA has left unanswered, but which are fundamental to a full assessment of the benchmarking proposal. One relates to the status of the proposal, and the other to its scope.

(i) The status of the benchmarking proposal

34. The proposal on benchmarking is put forward in Chapter 3 as an option by means of which firms could demonstrate best execution. For example, in paragraph 3.19, the FSA says that "we are seeking further discussion with industry on whether it could be a useful additional option for firms". But much of the language of Chapter 3 implies that "robust" price benchmarking is the only valid means by which dealers could consistently achieve best execution, and demonstrate that they have done so. No other options are put forward in Chapter 3. Indeed, the IBM Paper states: "We have given some consideration to whether there are viable alternatives to the benchmark modelling approach outlined here. … We do not believe there are."[2] In our view, it would be quite wrong, and inconsistent with the proportionate and practical approach that FSA sets out in Chapter 2, to limit firms' options in the way that Chapter 3 proposes.

(ii) The scope of the benchmarking proposal

35. The scope of benchmarking would depend on what constitutes the execution of a client order. But DP06/3 avoids answering this fundamental question[3]. We refer FSA to our analysis in paragraphs 4 to 16 above, and our conclusion that the consequence of interpreting 'order' and 'executing a client order' in line with MIFID is to exclude from best execution obligations any dealing on own account where the firm does not act on behalf of, or otherwise owe an agency or similar contractual obligation to, a client. Any dealing with clients where the firm does not act on behalf of the client, thereby owing the client agency or similar contractual obligations, cannot under MIFID be considered as executing a client order, and so cannot be subject to best execution obligations. This is as it should be, since the bulk of activity in dealer markets involves clients who choose to deal with the dealer on a principal basis, and do not expect the firm to owe them an agency obligation.

36. While DP06/3 does not answer the question of what constitutes a client order, it does inappropriately limit the requirement in MIFID to follow client instructions. We refer FSA to our analysis under in paragraphs 24 to 30 above of how FSA should interpret 'specific instruction from the client' as covering any circumstance where, in giving an order or specifying a course of action that the firm should take when executing the client's orders over an extended period, the client specifies any aspect of how, where, when, or with whom it wishes the firm to execute the order or orders. Anti-avoidance provisions should be restricted, in accordance with the copy-out approach, to the circumstances set out in MIFID Level 2 Recital 68 only.

Assessment of the benchmarking proposal

37. We have organised our response on this issue into four main sections:

i. Is benchmarking necessary?
ii. Would benchmarking work?

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[2] IBM Paper #2.5

[3] DP 06/3 #3.9 and footnote 9)

iii. What are the implications of benchmarking?
iv. Is there an alternative to benchmarking?

38. For the sake of brevity, we do not reproduce Annexes A (analysis of assumptions in the IBM Paper) and B (fundamentals of bond, derivatives, and structured products markets) to BMA/ICMA/ISDA's response. But we do agree with them.

(i) Is benchmarking necessary?

There is no evidence of a market failure to justify the benchmarking proposal

39. No market failure analysis on the provision of best execution in dealer markets has been undertaken by the FSA to demonstrate a need for benchmarking of best price. Nor is there any evidence of a market failure in price transparency, to which the benchmarking proposal relates. In the absence of a market failure being demonstrated, we believe that competition – and not additional regulation – continues to be the best way of ensuring that best execution is achieved in the fixed income and derivatives markets, which are institutional rather than retail.

40. Little consideration seems to have been given by the authors of Chapter 3 to: (i) the FSA's own Discussion Paper, "Trading transparency in the UK secondary bond market" (DP 05/5) and industry responses reflected in the FSA Feedback statement (FS 06/4)[4]; or (ii) recent independent research, which highlights the overall efficiency and competitive nature of the EU bond markets and does not find evidence of a market failure in the provision of best execution or price transparency[5]; or (iii) the important role that OTC derivatives and structured products play in corporate risk management and in the efficient transfer and allocation of risk generally.

41. This suggests either that the authors of Chapter 3 are not prepared to take proper account of the economics of fixed income and derivatives markets or that there is a separate agenda to turn them into quasi-agency markets. If such a fundamental transformation of the market under MIFID had been intended, it should surely have been flagged at an earlier stage.

There has been no industry input into the IBM benchmarking paper

42. In its executive summary, IBM says: "As agreed with the FSA, our work on this project has been completed without direct input from the industry." Initial concerns – including concerns about a possible benchmarking proposal – raised by several trade associations in informal bilateral meetings with the FSA prior to the publication of DP 06/3 have been ignored. As a result, the majority of the assumptions made in the IBM paper are flawed.

[4] "… We do not see any evidence of substantial market failures related to transparency in wholesale bond markets based in the UK. We agree with the view of the majority of respondents that a combination of competition, market-driven transparency, the interaction between cash and credit derivatives markets, and regulation seems sufficient, in general, to deliver efficient pricing and fair executions" (FS 06/4, #1.7).

[5] CEPR reports on transparency, liquidity and efficiency of European government and corporate bond markets (May 2006)

43. We are therefore particularly concerned that the FSA is commending DP 06/3 to the Commission and CESR as "a useful resource for implementation discussions".[6] By commending the benchmarking proposal in this way, the FSA appears to be pre-judging not only the conclusions it will reach before it has received any industry input on DP06/3, but also those that the Commission will reach in its Article 65 report on price transparency, despite the FSA's previous statement in DP 05/5 that it would not do so.[7]

The benchmarking proposal is not consistent with the FSA's commitment to principles-based regulation and "intelligent copy-out"

44. The FSA is committed to principles-based regulation[8], and the Chancellor in his Mansion House speech committed the Government to a regulatory environment which is "predictable and light touch".[9] These commitments are not carried out in the case of Chapter 3. On the contrary, the FSA appears to be proposing to micro-manage the relationship between firms and their clients, including professional clients, which is contrary to both the spirit and the letter of MIFID. Indeed, Chapter 3 is inconsistent with the principles laid out in Chapter 2.

45. The FSA is also committed to "intelligent copy out" of EU Directives[10]. Chapter 3 proposes to go way beyond "intelligent copy out", without establishing evidence of market failure or conducting a cost-benefit analysis, and in contravention of the copy-out approach implicit in Chapter 2. It is not at all clear that the benchmarking proposal is consistent with Article 21 of MIFID on best execution (see paragraph 46 below). There is nothing in the Level 1 or Level 2 measures that requires the use of benchmarking in the way in which Chapter 3 proposes. The benchmarking proposal also appears to be gold-plating MIFID, which would be incompatible with Article 4 of the Implementing Directive. We do not consider that it would be justified in this case to treat such gold-plating as "exceptional".

The benchmarking proposal is inconsistent with MIFID Article 21 on best execution

46. There are at least six factors to be taken into account in the best execution requirements in Article 21 of MIFID, in cases in which best execution applies. Chapter 2 of DP06/3 stresses this point on several occasions. By contrast, Chapter 3 focuses only on best price and offers benchmarking as a means of obtaining best

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[6] DP 06/3 #1.13

[7] "We would propose introducing new transparency requirements for the trading of bonds in the UK only in response to an identified market failure. And in any event we do not intend proposing changes to our regulations ahead of the outcome of the Commission's review." (FSA DP 05/5 #7.1)

[8] e.g. John Tiner: "I believe that we should move to a more principles-based approach": 9 May 2006.

[9] The Mansion House speech, 21 June 2006. Callum McCarthy also said on 21 June 2006: "Any sensible regulator, … certainly the FSA, believes that the best outcomes for both producer and customer come from efficient markets, not from regulation. You should therefore expect measures which work with the grain of the market… "

[10] e.g. Hector Sants, 25 July 2005: "Our approach to implementation is intelligent copy-out of the MIFID text, with requirements tougher than the Directive only where this can be justified by cost benefit analysis."

execution, as an alternative to interposing an agency broker model or dealing only with eligible counterparties. This focus on best price in markets that are overwhelmingly wholesale is inconsistent with MIFID Article 21, as well as with the way in which such markets operate. There are clearly other means of obtaining best execution which the FSA has not discussed. So presenting the benchmarking proposal as the only option for dealer markets on the grounds that the only other options under MIFID are to avoid best execution (paragraph 3.13 of DP 06/3) is misleading.

The analysis of conflicts on interest in DP06/3 is inconsistent with other FSA analysis and out of touch with the way dealer markets work

47. First of all, the conflict of interest analysis in DP 06/3 runs counter to the FSA's Consultation Paper (CP 06/9), Organisational systems and controls (SYSC), which is based on straight "copy out". The two are inconsistent. SYSC correctly states that there needs to be a duty to the client before a conflict of interest exists (and that making a profit does not *per se* imply a conflict).

48. Second, there is no substance to the allegation in paragraph 3.16 of DP06/3, based on information asymmetries, that dealers take advantage of their clients.[11] Professional investors are at least as well informed as, and often better informed than, dealers, since each individual dealer may know only what it is quoting to a client, while a client with access to multiple dealers can take a broader view. It is professional investors who choose between various dealers (i.e. "execution venues") rather than the other way round.

49. Third, where conflicts of interest do arise, the FSA has itself argued that good policy making should focus on how best to manage such conflicts. The benchmarking proposal goes much further by attempting to eradicate conflicts altogether. This is inconsistent, unrealistic and disproportionate.

50. Fourth, dealers operate as principals in extremely competitive markets in which, therefore, client relationships and reputation matter. If a dealer, in providing quotes, were to take solely the short term view of its interests portrayed by the FSA, it would be likely to lose the client. As a result of the competitive environment, there has been a reduction in dealer spreads over the years across all market segments. The FSA's own analysis in FS 06/4 confirms this[12], and the authors of Chapter 3 of DP 06/3 should take it into account.

[11] "We are not clear that existing differences in the availability of trading information to different types of institutional participant reflects a market failure per se, as in any market there will be those participants with better access to information than others. This is a consequence of how markets function, and the nature of the role that particular participants play." (FS 06/4, #4.13)

[12] FS 06/4, #3.10, which concludes: "Our analysis, while limited, does not provide any particular indication that dealers are able to systematically buy bonds at one price and sell at a notably higher price."

The proposal is inconsistent with practice and regulation in the global markets (e.g. in the US)

51. The FSA benchmarking proposal is out of step with corresponding NASD regulations both in the scope and substance of its proposals on best execution, which creates significant legal, compliance and operational risks for financial services firms operating globally.

i. NASD's best execution Rule 2320(a) states in paragraph (f): 'The obligations described in paragraphs (a) through (e) above exist not only where the member acts as agent for the account of his customer but also where retail transactions are executed as principal and contemporaneously offset. Such obligations do not relate to the reasonableness of commission rates, mark-ups or markdowns which are governed by Rule 2440."

ii. Rule 2440 in turns states that: "In over-the-counter securities transactions …, if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that he is entitled to a profit; and if he acts as agent for his customer in any such transaction, he shall not charge his customer more than a fair commission or service charge, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service he may have rendered by reason of his experience in and knowledge of such security and the market therefor."

52. In September, 2005, the NASD filed Amendment No. Rule 2320 with the Securities and Exchange Commission for the purpose of clarifying its members' duties with respect to best execution in any transaction "for or with a customer of another broker-dealer". Amendment No. 4 states that a NASD member firm's duty to provide best execution "does not apply when another broker-dealer is simply executing a customer order against the member's quote" and that "the duty to provide best execution to customer orders arises only when an order is routed from the broker-dealer to the member for the purposes of order handling and execution". Amendment 4 remains deficient in so far as it fails affirmatively to include situations where the order is presented by the customer himself (not only by the customer's broker-dealer). However, it does support the fundamental premise that best execution is strictly an agency concept by clarifying that a dealer does not owe best execution to the customer of another dealer in instances where it is simply providing quotes acting in a principal capacity. In addition, the NASD Rule does provide for additional protections to retail investors (as does MIFID).

53. Therefore, in its current iteration, the obligation to provide best execution in both US equity and fixed-income markets[13] exists where a member firm acts as agent for the account of any customer and where retail transactions are executed as principal and simultaneously offset (i.e. riskless principal transactions). When it comes to price, the obligation on principal dealers is to provide a fair price and the obligation on agents to charge a fair commission. Subject to the deficiency highlighted above,

[13] Derivatives are excluded, other than stock options.

we believe that this is the correct approach. It is also consistent with our analysis of scope in paragraphs 35 and 36 above.

The proposal is distracting attention from implementing MIFID

54. Finally, the benchmarking proposal is distracting scarce resources from the essential task of implementing MIFID on time. Many firms have also stopped work on planning how to implement MIFID's best execution provisions, because they consider that implementing this proposal is not practicable and because DP 06/3 puts a question mark over other acceptable methods of complying.

(ii) Would benchmarking work?

55. The FSA makes the assumption that benchmarking will work, though the IBM Paper says that, in the case of illiquid or complex products, there are no external benchmarks. Instead, reliance would have to be placed on firms' internal models. But the FSA is "predisposed against reliance on internal models". [14]

56. In order to analyse whether benchmarking would work, it is important to emphasise the diversity of the different segments of the fixed income and derivatives markets. Fixed income and derivatives products exist in a continuum ranging from:

i. listed and exchange-traded products, which (in the case of bonds) represent less than 1% of the total; to
ii. liquid cash bonds and "plain vanilla" derivatives, some of which may be transacted on electronic trading platforms (which should not be confused with exchanges); and
iii. everything else (the vast majority in the case of both bonds and derivatives).

57. It is important also to clarify what we mean by "benchmark" in this response, given the variety of uses of the term in the market. The FSA describes the ideal benchmark as one that needs to be "robust" for the purposes of achieving best execution. The key determinants of a robust benchmark would be that: (a) it must "be an accurate reflection of real prices for the relevant instrument"[15] and (b) it would be "drawn directly from a relevant pool of liquidity"[16].

58. The quality of a benchmark of that kind is based on the following four factors:

i. the number of dealers making markets;
ii. the frequency of price updates;
iii. the firmness of the price; and
iv. the size for which the price is firm.

This is therefore the context in which we assess the feasibility of the FSA's proposal on benchmarking in Chapter 3.

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[14] DP 06/3, #3.39
[15] DP 06/3, #3.24

[16] DP 06/3, #3.25

There are no "robust" benchmarks for most fixed income nor for any OTC derivatives and structured products

59. On that basis, there are no "robust" benchmarks for most fixed income products and benchmarking is incompatible with OTC derivatives and structured products. This is because the benchmarking proposal is based on the fundamentally erroneous premise that there is a continuously "real" common price, available from a predominant source of liquidity, for instruments traded in dealer markets. That is not the case for most of the instruments traded in these markets, as explained in detail in BMA/ICMA/ISDA's Annex B. Benchmarking would be feasible in theory for the instruments listed in paragraph 56 above in category (i), and possibly for the most liquid securities listed in category (ii), where dealers provide continuous firm quotes. However, for the vast majority of instruments in the fixed income and derivatives markets (both in terms of number of trades and volumes), there are no "robust" externally verifiable benchmarks.[17]

60. IBM is therefore correct to state that there are no external benchmarks in the case of the great majority of bonds and derivatives and that, to obtain a benchmark, it would be necessary to rely on internal models. However, internal models could not in practice be used as benchmarks. It would not be possible to construct a meaningful benchmark against price (and size) by breaking down the constituent parts of an illiquid or complex product. Even the limited number of "vanilla" bonds which are liquid and traded on ECNs are diverse, making any formulaic benchmark virtually meaningless.

61. IBM does not set out the basis for determining which type of benchmark to use in which circumstances. Different firms have different models even for plain vanilla products; and different benchmarks would be used by different firms for the same asset, depending (say) on size and liquidity, and potentially resulting in at least three different available reference prices: an ECN-based reference price; an IDB-based price; and internal model-based prices. Over the trading pattern of its life a security may change dynamically to fit into one or other of these frames of reference. Much of the IBM analysis is, however, based on the assumption that reference prices would be identical and that competition thereafter would affect only the size of the dealer spread. This assumption is wrong. Even where dealers and institutional customers use the same pricing model, the model often involves several different inputs; different parties can use different inputs and derive different valuations using the same model.

In the limited areas where benchmarking would in theory be feasible, it is not necessary and would be expensive to implement in practice

62. Benchmarking would in theory be feasible in the case of exchange-traded and highly liquid bonds traded on IDBs and ECNs. However, the universe of highly

[17] There are 110,000 bonds on CUPID, of which 10,000 are government bonds. Of the remaining 100,000 corporate bonds, 8% are traded on IDBs, but only 3% on ECNs. Benchmarking would only theoretically be feasible in the case of 3,000 corporate bonds. IBM's conclusion that 92% of bonds in TRAX have ECN and IDB prices is not relevant, as ECNs and IDBs quote bonds in which there is potential trading activity as a result of dealer and client interest, and those transactions are reported post-trade to TRAX.

liquid bonds is diverse and their liquidity profile can vary over time: most bonds are liquid, if ever, only for the few days or weeks after issue.[18] In addition, in the case of highly liquid bonds, prices are visible to most dealers and professional investors, and consequently there is already a standard for best price without the straitjacket of a benchmark. Finally, we disagree with IBM that implementing benchmarking would be cheap in the more liquid products. We believe that benchmarking would be expensive to implement in practice.

OTC derivatives are incompatible with benchmarking

63. In the case of OTC derivatives, the "instrument" does not even exist unless and until a strictly bilateral contract is concluded between the counterparties. Even in their most commonly written form, OTC derivatives are therefore, in concept, fundamentally incompatible with the benchmarking approach. MIFID requires that the diversity of different products should be taken into account in its approach to best execution[19].

64. Although some OTC derivatives are loosely referred to as "liquid", the instruments themselves are never transferred. Any appearance of fungibility – and therefore liquidity – in OTC derivatives is just that: appearance. The key to a customer's ability to transfer risk through OTC derivatives depends on the willingness and ability of a dealer to stand as principal to the contract. The extent to which dealers are able to offset this risk will depend on other parties themselves acting as principal. In practice, the degree of offset can vary considerably, and will rarely be perfect. This characteristic extends to instruments such as structured notes, which consist of a combination of derivatives and other instruments, typically bonds.

65. Since OTC derivatives are bilateral contracts which incur credit exposure, benchmarking would require adjusting a transacted price for the implied credit spread of the counterparty before applying this credit-adjusted price to a non-existent benchmark price. As the process becomes more and more complex, it becomes less and less meaningful.

66. It is important also to distinguish between benchmarking and the "price verification", which is used by some firms for OTC derivatives. Firms engaged in risk control of their OTC derivatives positions do in some cases feed prices into a central facility, which then makes aggregate information available to the participants. Such information is typically end-of-day only, and not in any case intended for live transactions.

[18] This was accepted in DP 05/5, but has not been taken into account in DP 06/3.

[19] " ... Best execution obligations should ... be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instruments. For example, transactions involving a customised OTC financial instrument that involve a unique contractual relationship tailored to the circumstances of the client and the investment firm may not be comparable for best execution purposes with transactions involving shares traded on centralised execution venues." (MIFID Level 2 Directive, Recital 70)

Structured products are also incompatible with benchmarking

67. The assumption that benchmarking can be applied generally to structured products is misguided. It is generally not possible or desirable for a firm to hedge or price every component of a structured product individually; and it is not clear that a fixed structuring commission or spread limit is practicable, as it assumes that different markets have the same and/or constant volatility. Moreover, where structured credit products are concerned, the tranching process creates unique combinations of underlying assets with specific structures that are extremely difficult to hedge since by definition they are custom-tailored. In other words, a benchmark used to reference a specific deal is unlikely to be comparable, since the collateral and structure is unlikely to be identical. In any form of structured product, the problems with the benchmarking approach would be acute, and applying it to the component parts would merely compound the problem.

Spread-betting is not a precedent

68. Spread-betting and CFDs represent a small part of the market where benchmarking might be made to work, for contracts based on liquid exchange-traded equities and offered in retail size, though that would not necessarily mean that this would be desirable. We understand that spread-betting firms are concerned about the loss of their exemption from best execution.[20] An alternative approach would be to impose MIFID's suitability and appropriateness requirements, and the venue selection factor set out in MIFID Level 2 Directive Article 44(1)(d). In any case, imposing benchmarking on the market as a whole because it might work in a small market segment would be like using a sledgehammer to crack a nut.

It is not possible to monitor benchmarks in any meaningful way

69. Since it is not possible to construct robust benchmarks in most dealer markets, there is no robust benchmark against which to monitor prices. If benchmarking is imposed on certain sectors of the market, it is not clear how dealers could monitor benchmarks in real time. IBM makes the specific point that post-trade transparency would not solve this problem. It says that benchmarking would only work with pre-trade benchmarks. A pre-trade price could only be used as a guide price, as many such prices could not be executed. Existing pre-trade ECN prices are only seen by buy-side customers. If the sell side were to see them, this would be a substantial change in market practice. There would also be a potential problem if a change in the benchmark lagged changes in individual dealer quotes. To this extent, the benchmark price might be better or worse than the actual price prevailing in the market.

The benchmarking proposal fails to reflect the economic function of dealer markets

70. The benchmarking proposal fails to reflect the economic function of dealer markets in which firms act as principals. This is evident from the FSA and IBM discussion of bid-offer versus mid-price reference prices and the proposed separate arrangements for charging commission.

[20] FT, 23 June 2006

71. In an order-driven market, "natural" buyers and sellers have an investment view that they wish to buy/sell a particular instrument. A dealer has no fundamental view of the market. The dealer is merely a facilitator/liquidity provider. For whatever it buys or sells, the dealer looks to reverse that transaction as quickly as possible. The dealer charges the investor as compensation for the risk of taking on a position which, but for the dealer, the investor would have had to retain itself.

72. This charge is reflected in the dealer spread.[21] When markets become volatile or liquidity decreases, the spread increases. This is because of the additional risk that the dealer may incur a loss in reversing the transaction. Hence a dealer spread is qualitatively different from charging a commission to execute a client order on an order book. In the former case, there is an additional facility provided by the firm in assuming the risk which would continue to be held by the buyer/seller in the absence of the dealer. In the latter case, the firm takes on no position risk in executing an order between two investors.

73. Therefore, in terms of the two different options presented (bid-offer and mid-point) as possible reference price for the benchmark, dealers do not deal at the mid-point. A quote given by a dealer takes account of a wide range of variables, including the dealer's own position and risk appetite. The result cannot be compared with an artificial benchmark price extracted from the data, even if data are readily available.[22]

74. Even in order book trading, trades are not executed at the mid-point between the bid and offer. An investor wishing to trade at better than the existing bid/offer may attempt to do so by entering a limit order improving the side of the market it wishes to be on. However, it does this at the risk of the market moving away, and thus having to accept a transaction at a worse price than the one existing prior to it entering a limit order, or worse, at the risk of not being able to execute at all. Dealer markets provide immediacy, the price of which is included in the dealer's spread.

75. However, using best bid-offer is problematic too, especially for illiquid products which have fewer dealers – and sometimes only one dealer – giving quotes, but also in times of market stress.[23]

76. Similar considerations to the fixed income markets apply in the OTC derivatives markets.

[21] As bond dealers are not in general rewarded via commission, market users pay for this access to dealer liquidity through the dealer's bid-offer spread." "... Where dealers compete to make markets the bids and offers quoted still need to be sufficiently competitive to attract order flow." (DP 05/5, #2.29-30)

[22] "The size of spread that might indicate an inefficiency is complex to assess (especially for infrequently traded bonds), and in any event spreads vary considerably between instruments and over time. The position may be further complicated by any cross-subsidisation between firms' market making and other business lines..." (DP 05/5, #5.7)

[23] "In times of market stress ... liquidity is not well measured by bid-ask spreads, not least because it is highly variable. ... the quoted spreads are often not representative of the spreads that market participants are paying." ECB Occasional Paper, *Implications for liquidity from innovation and transparency in the corporate bond market* (April 2006 draft, page 15).

Conclusions on feasibility

77. In sum, the robustness of a benchmark will depend on four main factors:

i. the number of dealers making markets: this varies, depending on the nature of, and demand for, the product;
ii. the frequency of price updates: this varies by firm and by instrument (in the case of some securities ranging from "real time" to monthly, and in the case of OTC derivatives only at the point of contracting);
iii. the firmness of the price: this, too, is variable, including in liquid bonds traded on ECNs[24]; and
iv. the size in which the price is firm, which is also variable.

Since there is no consistency in any of these four factors, this will invariably reduce the quality of the benchmark.[25]

78. Given that the benchmark model is (i) inapplicable or unworkable in very large parts of dealer markets; and (ii) would only work in theory in the case of instruments which are already very transparent and liquid throughout their life (i.e. are already in effect used as "benchmarks")[26], the cost-benefit of implementing such a model seems wholly unjustified.

(iii) What are the implications of benchmarking?

79. What would be the implications if benchmarking was imposed on the market in a situation in which a dealer was executing a client order?

Impact on dealers' customers

80. Firms could in theory avoid the possibility of benchmarking by dealing only with eligible counterparties (ECP).[27] But in the case of most firms, this would not appear to be commercially practicable[28]. In other cases, regulatory limitations would proscribe dealing with certain clients as ECPs. Even if it were practicable to deal only with ECPs, and firms took advantage of this to avoid benchmarking, that would have an adverse effect on liquidity available to non-ECP clients of the dealer. As benchmarking would only be feasible in theory for a narrow group of instruments, firms would be likely to withdraw from providing liquidity to non-ECP clients in a

[24] E.g. on 15 June, in cash bonds available on Bloomberg, only 66% of the volumes transacted were done at prices quoted as firm.

[25] E.g. a reasonably liquid corporate bond such as REW 6.125 12 has up to 30 dealers making markets, in sizes from 100,000 to 5 million , some two-way, some one-way, some firm, some indicative.

[26] "We tend to agree with the majority of respondents that greater transparency for benchmark bonds would offer little additional benefit." (FS 06/4, page 35).

[27] There is also a question about whether "eligible counterparties" will be defined in different Member States in the same way. Some Member States may not allow corporates to act as such.

[28] There are a number of reasons for this: (i) it may not always be possible to classify a professional client as en eligible counterparty; (ii) some entities may simply be unwilling to be classified as eligible counterparties; (iii) even if the counterparty is willing for some purposes, firms may wish to avoid dual classification of counterparties (i.e. eligible counterparties for some purposes and professional clients for others); and (iv) size criteria for classifying entities as professionals or eligible counterparties may exclude eligible counterparties.

large number of instruments. In addition, companies – especially SMEs – would be deprived of valuable risk management facilities in the form of OTC derivatives.

Impact on liquidity

81. If a benchmarking model was imposed, any dealers wishing to carry out a trade would need to trade inside the benchmark price in order to capture the trade from the competition. This would potentially compress spreads (though see the section on "Impact on investors" below), and undermine the willingness of dealers to trade in large sizes.[29] Given the significant implementation costs also involved, there is a very real risk that dealers would withdraw liquidity from benchmarked instruments, in particular those dealers in inventory-driven markets, because of the costs and risks and the increase in disclosure involved. This would undermine the composite benchmarks concerned, which would then cease to be useful (i.e. an example of Goodhart's Law). Although benchmarking may be feasible in theory in the case of highly and continuously liquid bonds, the effect of introducing it could be to reduce liquidity across the market as a whole. At the very least, this risk should be properly discussed and analysed over an extended period and not disregarded in order to impose detailed rules in the very limited period available for implementing MIFID.

82. The impact on liquidity would be similar in the OTC derivatives market. An attempt to introduce benchmarking would reduce the willingness of firms to make capital available to support risk transfer. This would have a clear knock-on effect on SMEs in the real economy. Large corporates would qualify as "professional" under the client categorisation in MIFID, and could therefore opt to become eligible counterparties.

83. The impact on liquidity in the structured product markets would also be similar. Liquidity is a major factor in pricing structured products affecting key questions: how quickly and cheaply; and to what extent the dealer can hedge his risks. This is a matter of judgment and difficult to justify empirically. The dealer will quote different prices under different market conditions for the same internal model price. Therefore, not only are internal models of little value as benchmarks, but also the liquidity in those products would be likely to dry up should they have to be disclosed, as hedging would become much more difficult.

Impact on financial stability and innovation

84. Requiring firms to disclose their internal models could have a harmful impact on financial stability. That is because the markets most significantly affected by this requirement would be the tailored (OTC) derivatives and structured products markets,

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[29] "Market efficiency is not just about the tightness of spreads. The sizes quoted are also of importance. Where competition exists between dealers pricing improves. But prices and quote sizes may react differently to increases in transparency, with quoted spreads tightening while the size quoted falls." (FS 06/4). See also the speech by Malcolm Knight, General Manager of the BIS, on *Promoting liquidity in domestic bonds markets* (May 2006): "Even though bid/offer spreads in some parts of East Asia appear at first sight to be quite narrow, this may partly reflect government or exchanges rules that constrain market makers' spreads. These rules can undermine the willingness of market makers to deal in size, so the cost of this apparent liquidity may in fact be a reduction in market depth."

which have become central to the efficient transfer of risk between the cash and derivatives markets.[30] Banks currently have an incentive to build sophisticated models because they hope to benefit by managing their risks better and at lower costs. Requiring significant information about models to be disclosed would mean that their proprietary value would be lost. Innovation would stop.

85. By having to disclose proprietary information, dealers would also be exposing themselves to the distorting effects of gaming, particularly by hedge fund clients, who are active in these markets, have access to full information across the various products and do not run the risk to their book that dealers face. Many hedge funds hold larger positions and have better access to information and prices than many dealers.

Impact on competitiveness of UK financial markets[31]

86. The proposed disclosure regime implies that Chapter 3's objective is, at a minimum, to secure full transparency of mark-ups and perhaps even to turn dealer markets into quasi-agency markets. If an agency market were to be imposed in the UK by means of over-regulation in this way, there would be a risk that the market would move "offshore" (just as the Eurobond market originally developed in London in response to changes to tax law in the US). Driving business offshore would clearly not be consistent with the FSA's legislative principle of good regulation to maintain the international competitiveness of UK financial markets.

Impact on market structure and firms' business models

87. Our member firms have indicated that they use the principal dealer quote-driven model for at least 95% of their institutional fixed-income operations. By contrast, most firms' retail operations are conducted via an agency desk that is effectively segregated from the firms' dealing arms. Introducing an intermediary agency-type model within firms' wholesale operations would not be a viable alternative for these firms. It would require firms entirely to reconfigure their business models, and would be likely to make it no longer viable for them to remain in the market. This is why it is essential that the FSA interprets "executing a client order" and "client instructions" in the way proposed in paragraphs 4 to 16 above.

88. A further significant concern is that the benchmarking proposal alone could create a dysfunctional market structure. In promoting the use of e-trading systems as a means to obtain the price information necessary for delivering and monitoring best execution, the proposal fails to recognise the importance of the voice market as an essential complement to other forms of trading, including in the price formation process.[32] This could also lead to a competitive distortion in the market in favour of

[30] See ECB Occasion Paper (op cit.)

[31] "Financial firms based on London account for approximately 60% of the book-running of all international bond issues, as well as about 70% of secondary market trading. In addition, UK-based firms are commonly estimated to account for 80% or more of inter-professional trading." (FSA DP 05/5 #2.9). According to the latest BIS Triennial Survey, London is also the largest global centre for booking OTC derivatives trades.

[32] "Electronic platforms are usually described as transparent and voice communication as opaque, but which of these trading mechanisms will provide the most efficient pricing will depend on circumstances. … A voice-brokered market can be more price efficient than an electronic market because it allows a more sophisticated response to trades that are in fact uninformative. …

dealing through an electronic request-for-quote (RFQ) model in an MTF, which would not be required to deliver best execution under MIFID.[33]

Impact on investors

89. Taking account of all these factors, it is very likely that dealers would pass on to their clients the increase in their costs arising from the introduction of benchmarking, probably via a commission-based structure, as suggested in Chapter 3. As a result, the imposition of "best execution" would actually cost investors more than the current system.

90. Disclosure requirements drafted with equity markets in mind in the Market Abuse Directive have led to a reduced volume of research in fixed income markets. The benchmarking proposal – which also appears to have been drafted in places with equity markets in mind – risks further information being withdrawn from fixed income markets, to the detriment of investors, in particular those that DP 06/3 and the IBM Paper are specifically arguing will benefit (i.e. small institutional and retail investors).

91. Benchmarking would not directly benefit retail investors. Both smaller institutions and retail investors access the market through financial intermediaries and distribution networks. They do not go directly to dealers' trading desks.[34] In those circumstances, it is the responsibility of the retail broker to obtain the best possible result.[35]

92. There would also be a risk of mis-selling if the spurious accuracy of benchmarking created a false sense of security among retail investors. Investors need to understand the market and credit risk that they take on when they make an investment in a security. A benchmark would not replace this.[36]

Transparency of a less efficient price from an electronic setting may not be as desirable as a somewhat less transparent but more efficient price from a voice-brokered market. ... This is particularly relevant for the B2C segment of the market. A customer with a large position to trade may be better off communicating this to a single liquidity provider, sparing him both the likelihood of experiencing a winner's curse and the fear that there is an impending adverse information event." (CEPR Report cited above, pages 12-13)

[33] MIFID requires that transactions made with clients through an MTF or regulated market should not be subject to best execution. In the same spirit, the FSA should adopt a flexible position regarding agreements between professional investors and dealers as to the detail of the best execution policy offered by the dealer on a bilateral basis. For example, an order arising from a dealer quote provided to a professional client should be capable of being categorised as a specific instruction to deal at the quoted price for the purposes of Article 21(1) of MIFID, if that is set out in the firm's best execution policy and has been agreed with the client. DP 06/3 appears to be proposing to adopt a policy which will accept as legitimate only a very narrow, price-focused, best execution policy, regardless of client wishes.

[34] See the chain of execution model used in Chapter 2 of DP 06/3.

[35] "Given that the number of UK retail investors participating directly in the secondary bond markets appears to be small, it may be that the cost of providing these investors with better information is disproportionate to the benefit." (DP 05/5, #5.18)

[36] "One important issue is that many retail investors have very limited knowledge of the bond markets. Nevertheless, we feel that there are sufficient sources of information available to investors – particularly via the internet – to learn about bonds for these to be no obvious need for an FSA-led consumer awareness campaign in this respect." (FS 06/4, #4.17)

The costs and risks of the proposal far outweigh any benefits

93. In summary, the costs to the industry and market users would be unquantifiable but enormous, and the risks in terms of impact on market structure and liquidity far outweigh any benefits that the benchmarking proposal might bring in some limited areas. It would be complex to introduce, and involve a long lead-time; there would be a lack of data in support; and it would be conceptually flawed, owing to failure to take proper account of the economics of dealer markets. The costs of introducing the scheme would ultimately be borne by clients, especially as a result of the reduction in liquidity and, to a lesser extent, greater compliance costs, without countervailing benefits in terms of market efficiency and investor protection. All of these effects would have an impact on market structure and firms' business models in a way that could impair and imperil the international competitiveness of the UK financial services industry.

(iv) Is there an alternative to benchmarking?

94. There is an alternative approach to benchmarking readily available. The alternative would be to adopt a principles-based approach based on "intelligent copy out" of the best execution provisions of MIFID, as set out in parts of Chapter 2 of DP 06/3. For example:

i. " … best execution [is] more than the achievement of best price. Price is significant – but execution quality can depend on other factors as well." (paragraph 2.1)
ii. "[MIFID Level 1 Article 21] does not prescribe in detail how its requirements apply to the diverse circumstances in which client orders are executed." (paragraph 2.5)
iii. "We suggest Article 21 does not presume that there is one right answer – the importance and significant of the factors may vary between clients and instruments. And it may be possible for there to be more than one way to execute a particular order and achieve best possible result." (paragraph 2.21)
iv. "MIFID recognises that while the factors it specifies are likely to be the most important in achieving best execution, it is for the firm to determine the relative importance of these and other factors." (paragraph 2.30)

95. In the same way, FSA's framework principles should allow firms operating in dealer markets the flexibility to develop their own detailed approaches to best execution policy. Since best execution is likely to be an area where firms will seek to differentiate themselves on a competitive basis, it is important that the FSA avoids being overly prescriptive in specifying how firms should meet their best execution obligations. By contrast, Chapter 3 of DP 06/3 appears to be proposing to adopt a policy which would accept as legitimate only a very narrow, price-focused, best execution policy, regardless of client wishes.

96. MIFID Connect Industry guidance on particular aspects of best execution should be used to supplement FSA's framework principles, where market participants think it useful or necessary.

Application of the benchmark approach in equity dealer markets

97. Many problems and impracticalities similar to those described in paragraphs 32 to 96 above on application of the benchmark approach to dealer markets in fixed income instruments and OTC derivatives markets would also arise as a result of applying the benchmark approach to dealers in equity markets.

98. For more liquid equities, the price benchmark applied would presumably be the best bid or offer on a regulated market or MTF (though these benchmarks might change if the location of pools of liquidity changes after MIFID implementation). LSE provides a central pool of liquidity which provides immediacy for all normal-sized orders and is thus the benchmark by which best execution in equities is currently measured. As in the case of other dealer markets, however, these prices are already used to the extent that the market finds them useful, either as a regulatory benchmark to measure best execution, or commercially as a reference to measure the quality of execution where best execution regulation does not apply. However, even for liquid equities, price may not be the only relevant factor.

99. Where the disclosed price of a less liquid equity is indicative, or where the size does not correspond to the size associated with the benchmark price, they can be used only as the starting point for negotiations which take account of a range of factors other than price.

100. The problems of benchmarking illiquid equities are similar to the problems of benchmarking illiquid bonds. While using market prices as a benchmark would be more reliable for more liquid equities than for less liquid instruments, since they reflect the natural investor interest, the prices used for marking to market in illiquid equities are not reliable. Indicative prices cannot be used as a benchmark. When prices are indicative, firms need to probe the market to see what price they can get. This is not a process which is susceptible to mechanisation. The execution policy for such shares would need to reflect that market reality. Generally, for both large trades in more liquid shares and smaller trades in less liquid shares, illiquidity signifies that supply and demand relationships have a great impact on price formation. However, the impact of supply and demand on the price of each individual instrument is a factor which is unique to that instrument, which means that benchmarking would not be a workable approach. A firm's determination of the appropriate price will vary both by comparison with other firms and over time. For example, there will be situations when one firm because it has a large long position may be able to make a better offer price than a similar price giver which has a short position in the particular stock. Both firms should be able to decide their price freely based on their consideration of the market, the extent to which they are comfortable holding the position, and the need to reduce exposure, without being constrained by a pre-determined spread against a 'benchmark' price.

101. For smaller transactions in more liquid equities, exchange prices are used as benchmarks against which to measure the quality of execution, and certain services guarantee to beat the best bid and offer. However, for larger transactions and for less liquid equities, any limitation of the spread against the benchmark, and any requirement to disclose the benchmark, maximum spread, or the firm's pricing model

would have a similar distorting effect on the benchmark, and similarly inhibit liquidity provision, as in the fixed income and OTC derivative markets.

102. There is always a size associated with a benchmark price. Large size trades in equities are negotiated. They have by definition gone beyond the size where a transaction in normal size would take place. They can therefore never fall into a benchmark model. They are given to one dealer to negotiate and execute. There are no competing quotes or prices for that size, and any attempt to obtain them would move the prices against the trade. Making the process more transparent under the benchmarking approach would work negatively against the quality of execution. The price of such transactions is heavily dependent on unbenchmarkable supply and demand factors. It is because they have to be fed into the market in a different way that block trades are difficult to price. The firm must probe the market, and the price is of necessity opaque.

103. The position of contracts for difference and other complex equity products parallels the instruments which underlie them. The market uses benchmark prices to the extent they are useful, for example to price liquid single stock retail CFDs. But for more complex CFDs or structured equity products, such as notes which reference various equity underlyings (indices, baskets, funds, or hedge funds), often with leverage, similar problems would arise from the price benchmarking approach as in other markets, and for similar reasons. Lack of liquidity means that there are no meaningful external benchmarks. Internal models use a variety of parameters, many involving subjective trader judgement. Firms are unwilling to reveal proprietary model information. Some sophisticated clients, such as hedge funds, already have superior information, because they trade with several dealers. An approach based on fixed commission or fixed spread assumes wrongly that dealers can hedge out all risks, in a similar way to an agency broker. But dealers often have to hold unhedgeable and long-dated risks. The benchmarking approach would unfairly impose the same remuneration for different products with different risks. Even for the same product, the liquidity and volatility can vary during its life. In these markets, clients, regardless of their sophistication, talk to competing dealers to achieve the best outcome. It would be wrong to impose fundamental change to standardise markets which serve specialised needs simply for the sake of mechanising an arbitrary measure of best execution.

Q3.1*: Do you agree that under MIFID there may be demand from retail and professional clients for best execution in relation to financial instruments typically available from dealers? If so, how significant is this likely to be?*

104. Most activity in dealer markets will occur in circumstances where firms are not ‘executing client orders’. See our comments in paragraphs 4 to 16 above on Interpreting ‘order’ and ‘executing client orders’. Where dealers are ‘executing client orders’ on behalf of retail clients, the level of demand will probably be unchanged from where it stands today. As regards orders executed on behalf of professional clients, it would be wrong to assume that those clients are not already getting good and efficient execution for their orders. The application of best execution to professional clients is effectively a regulatory formalisation of an existing process. However, a vital element of enabling firms to continue to provide that quality of execution is to continue to allow the client to designate how it wants its order to be

executed. Without sufficient flexibility for firms to follow client instructions, the imposition of restrictive best execution obligations is likely to make regulatory ‘best execution’ less attractive to professional clients. FSA should therefore not try to prejudge the decisions firms may take as regards the factors that will be important, of which price will merely be one. Many professional clients who will fall automatically into the category of eligible counterparty may be content to accept that status and achieve the “best possible result” for their underlying clients from their own resources, as is the case today with those clients who have “opted out”. Professional clients who do not fall automatically into eligible counterparty status may choose it for the same reason. Even if they remain as professionals, they may wish to achieve the same effect by providing specific instructions.

Q3.2*: Do you consider that the benchmark execution model may provide a useful additional approach by which dealers may be able to satisfy the best execution requirements? If so, in what markets will it be of most use?*

105. No. As more fully described in paragraphs 32 to 103 above, the benchmark execution model is unnecessary, unworkable in most parts of the dealer markets, potentially damaging to market structure and firms’ business models and the competitiveness of UK financial markets more generally. The costs and risks of implementing it would far outweigh any benefits.

Q3.3*: What would be the likely costs of this approach?*

106. Unnecessarily high. In the limited areas in which it would theoretically be feasible at all, it would be very expensive to implement in practice (see our detailed comments above). Some have suggested that the cost of implementation would exceed all other MIFID implementation costs put together, as a result of its potential impact on market structure and firms’ existing business models. The diversion of effort would be an enormous and unnecessary opportunity cost. The resulting uncertainty is also deeply damaging to the efficiency of firms’ preparation for MIFID implementation.

Q3.4*: What particular characteristics of reference prices make them suitable benchmarks for particular instruments or in particular circumstances?*

107. This would only be the case where the reference shows firm prices in the necessary size on which the dealer can trade directly – see paragraphs 57-58 and 77-78, 98, and 101 above. In other circumstances, they are unsuitable because the reference prices serve an unrelated purpose. However, even in these circumstances, other features of the benchmark model could distort the reference prices, for example if rigid price-based best execution requirements led to a withdrawal of liquidity from the market, the quality of market prices could suffer because of the decline in activity by natural investors. Reference prices might also be unsuitable because they show firm and non-firm prices with no indication of which are firm and which are not, so that a benchmark could not be derived from them. FSA should resist proposals which would provide only a spurious impression of accuracy.

***Q3.5**: Do you agree that a dealer could construct its prices by extrapolating from indirectly referable benchmark prices and thereby satisfy MIFID's best execution? Please give examples for specific financial instruments.*

108. No. See our detailed comments above. The premise, that best execution is measurable solely by price, is not correct.

***Q3.6**: In what circumstances could financial or economic indicators or indices be relevant benchmarks?*

109. Several financial/economic indicator, indices and other relevant macro-economic factors and sources of price information are used by market participants to inform them about the price of different instruments, and inform their views on particular sectors. These are all relevant <u>factors</u>. However, we cannot think of any circumstances or examples in which they are or could be used as relevant <u>benchmarks</u>, for the reasons set out above. (See also our response to Q3.9.).

***Q3.7**: Would dealers consider charging clients an additional fee or commission for providing best execution?*

110. They would almost certainly need to do so, if the benchmark approach were imposed, since the flexibility and competition regarding non-price execution quality factors, which currently characterises the market and which is reflected in dealers' spreads, would have to be squeezed into the firm's commission. But it would be counter-intuitive to construct a model where firms were constrained on price-making ability by imposing benchmarks but could add extra commission for providing best execution. It is best to leave the current market model as it is, to avoid restricting and stultifying the market, to the disadvantage of those clients to whom best execution obligations applied.

111. It is important to bear in mind that commissions are typically charged where a firm intermediates between natural investors, whereas a dealer is remunerated in a more nimble and flexible way, taking account of the uncertainties and risks involved in the dealer's role, through spreads. Prices in the fixed income market are "net" because this allows the investor to compare yields across competing products. Forcing dealers to adopt a commission-based model of remuneration would reduce flexibility, increase volatility, increase costs, and diminish the quality of execution, integrity of markets, and investor protection. It could give rise to a situation where clients would be forced to issue specific instructions to enable the firm to obtain a better result than by following the execution policy which regulation had imposed on it. It would be unacceptable in terms of better regulation, for the reasons set out above, to use the implementation of MIFID provisions on best execution to propose a fundamental restructuring of dealer markets, where the proposals are not within the requirements of MIFID.

Q3.8*: Are there any circumstances in which an execution model which uses internal benchmarks could be sufficiently robust to satisfy the best execution requirements? If so, what?*

112. This question assumes that it is possible to determine an "objective" price for illiquid instruments. The reality is that it is not possible, and that there is of necessity a level of subjectivity. If the firm disagreed with the imposed "objective" standard, it would not be prepared to take on risk, and would not deal on that basis, thereby withdrawing liquidity and creating wider spreads for any market participants that remained.

113. Internal modelling will be relevant to the firm's judgment of the price at which it deals, though several other factors will also provide the basis by which a dealer delivers "the best possible result".

114. We disagree with the premise of this question that a 'robust' benchmark (as defined in DP 06/3) is needed to measure the price dimension of best execution in dealer markets.

115. We also disagree with the imputation that internal models do not enable dealers to provide good quality execution - firms remain subject to FSA Principles.

Q3.9*: What are your views on the possible benchmarks identified in paragraph 3.43? Are there other potentially available benchmarks?*

116. As regards IDB and/or ECN benchmarks, we believe that there are no robust benchmarks that can be established in most dealer markets for the purposes of providing clients with best execution, as more fully set out above.

117. BBA LIBOR can be useful as a factor in pricing certain transactions (as an indicator of the financing cost), but there are many other elements which determine the price of the product as a whole. Fundamentally, it is not used for execution measurement purposes. Consequently, as the BBA says in its response to DP 06/3: "Knowing what BBA LIBOR is on a particular day is valuable to know the precise amount of interest which has to be paid but it is not particularly useful in telling whether the counterparty to the instrument has obtained a good, or a bad, deal."

118. In terms of indices such as the IIC iBoxx and iTraxx indices, similar considerations apply. iBoxx is an index that computes indicative bid and ask quotes from 10 dealers on the most liquid plain vanilla investment grade bonds. This index is very useful for investors to use to negotiate relevant trades or value their portfolio. However, the computed price is not necessarily a reflection of the price of a particular bond in the index. Several bonds are excluded as outliers from the computed average. This index is therefore a reliable indicator in terms of sectors and categories of bonds with similar features, but not necessarily in terms of each individual bond comprising the index.[37]

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[37] "Because the IIC bond prices are reliable, they can be used by investors as a benchmark when *negotiating* (our italics) trades with dealers, or to value their portfolios." (CEPR European Corporate Bond Report, page 31).

119. These pricing reference tools have developed over time and as a response to industry, not regulatory, demand. Imposing them or others for use as rigid best execution measurement tools would distort them and diminish their usefulness for market users.

Q3.10*: Would trade associations be willing to develop such benchmarks for the purposes of best execution? If so for what products / instruments?*

120. No, because of the fundamental flaws that we have described. But if the FSA were to impose – contrary to its own principles-based approach to regulation, as set out in Chapter 2, and contrary to MIFID itself – a rigid, single option, best price rule for best execution, as responsible bodies some trade associations or SROs would need to consider how best to meet the needs of their members and how best to mitigate the damage to dealer markets such an approach would cause.

Q3.11*: Do you agree that the benchmark execution model can work for financial spread bets and CFDs?*

121. The same problems would arise as in relation to the underlying. The benchmark model would not be appropriate beyond contracts based on liquid exchange-traded instruments in retail size.

Chapter 4

Q4.1*: Do you agree with our analysis of the requirements to review and monitor?*

122. While in general FSA's approach seems sensible, except in respect of dealer markets (see our response to Q4.5), it is important that FSA's interpretation of how firms approach the review and monitoring of execution quality does not become too prescriptive, so that firms are not forced to devote excessive costs and time to complex methodologies which do not add value. This is particularly important in fixed-income and derivatives markets because of their decentralised market structure, making monitoring much more intensive.

123. FSA should adopt a copy-out approach in this area, and not impose additional requirements or expectations (for example, see our concerns below on Paragraph 4.11). We agree with FSA's statement in paragraph 4.14 that MIFID leaves decisions about the choice of methodology to firms: FSA should follow this approach, and not prescribe a process as set out for example in paragraph 4.12. We also agree with FSA's statement in paragraph 4.8 that the materiality of any change in execution arrangements must be a matter for judgement by the firm.

Q4.2*: On monitoring: do you agree with the comparisons suggested in paragraph 4.11? If not, how would you assess the effectiveness of your arrangements? Will firms monitor their trading on a daily, weekly or monthly basis?*

124. The approach set out in Paragraph 4.11 to test 'whether the firm is actually obtaining the best possible result for its clients, and if not, why not' risks an over-prescriptive and over-mechanistic approach to monitoring and reviewing execution policy. Our Member firms typically execute tens of thousands of trades per day, of

many different types. It may be possible for firms to run reports to identify outliers in price against what was available in the market concerned and other alternative markets, and investigate the reasons. But as a general means of assessment, the approach is not necessarily feasible, especially bearing in mind the economic difference between (1) exchanges and other platforms that provide interaction between natural buyers and sellers, and (2) dealers that have no market view, are not natural buyers and sellers, and simply provide liquidity; and the fact that trades may be of many different types to which different criteria apply. Furthermore, the approach would be unworkable where there is only one execution venue for an instrument, or where the firm is acting as the execution venue.

125. FSA should not be prescriptive in this area, but should accept that there are a number of ways in which a firm could monitor whether best possible result was achieved. While price-based reports will have a role in many cases – but with flexibility over sources of comparable prices for different markets and instruments – other factors will be important to monitoring execution quality (e.g. valuation reports, settlement and confirmation reports, size of trades). It should be left to firms to determine what are the most appropriate comparisons, what thresholds apply, and how often they make them.

Q4.3*: On reviewing: do you conduct qualitative or quantitative reviews of brokers, regulated markets or MTFs now? If so, how frequently?*

126. Our Members typically undertake both qualitative and quantitative reviews on a regular basis.

127. In terms of the dealer-to-customer segment in dealer markets, most dealers support one or more of the five leading ECNs for fixed income products (Bloomberg, TradeWeb, MarketAxess, BondVision and Reuters).

128. One of the key factors in their qualitative review or decision to support new ECNs is the capability for the platform to provide and prove "best execution" (meaning in this specific context the ability for the platform to provide an audit trail to the investor showing the price at which the investor executed from amongst the number of quotes received by him from several dealers put in competition via an RFQ facility). Supporting electronic platforms is an expensive and time-consuming exercise for firms, and it is extremely important to manage the client relationship in that process. Consequently, dealers would not support platforms which did not fully respond to their client expectations or would not survive market conditions in the long term.

129. From a quantitative perspective, dealers review their participation in different ECNs based on the MIS activity report that they receive from each platform, coupled with their own internal analysis. In this review, dealers look at client and product activity as well as their performance on the platform. In addition, they review their electronic portfolio of ECNs' participation by comparing incurred connection costs versus executed client activity.

130. It is important to emphasise, however, that the review process is two-way. Most fixed income investors also review their execution venues (including dealers) on a

regular basis. They review more than just price. Some examples of other important criteria are sales coverage service, research trade ideas, access to trading for additional flow information, e-Business service, operational service (e.g. number of failed trades or missing confirmations). The operational aspect is becoming more and more important as a result of increased electronic trading and investor requirements for integration of the pre-trade, trade and post-trade processes ("straight-through processing") via linkages between trading platforms systems and investors' internal Order Management Systems.

131. The review process also takes account of relevant material changes. For example, the regulator in Belgium recently allowed asset managers in Belgium to trade CDS. Asset managers interested in these products have naturally reviewed their broker list and contracted the major CDS players in the market in order to extend the range of traded products.

***Q4.4**: Please estimate and explain any incremental costs that you will incur to comply with these requirements.*

132. It is always difficult to estimate costs without knowing exactly what the rules are going to be. Incremental costs will depend on the availability of data, the charges for access to it, and additional costs of capturing and storing data. They would also depend crucially on the type of rules that were imposed. Prescriptive rules would cause costs to rise exponentially.

133. It is impossible to provide any meaningful estimate of additional monitoring costs caused by any benchmarking proposal until the FSA provides more clarity on the scope of the proposal so that the impact on market structure and firms' business models may be better assessed. But the magnitude of incremental costs is likely to be large.

134. Assuming FSA's clarification on scope agrees with ours, there would still be important implementation and review costs in the limited areas where benchmarking may be imposed, depending on the availability of data, the charges for access to it, and additional costs of capturing and storing data.

***Q4.5**: Do you agree with our analysis of how the requirements to review and monitor might apply in dealer markets? In particular, will dealers be able to compare and evaluate benchmarks?*

135. No. Since it is not possible to construct robust benchmarks in most dealer markets, there is no robust benchmark against which to monitor prices. As mentioned in response to Q4.3, dealers already monitor on an on-going basis their execution arrangements with a view to providing the best possible result to their client.

136. The FSA's analysis on pages 34 and 35 of DP 06/3 regarding proposed review and monitoring of benchmark prices is a natural consequence from the incorrect starting assumption behind the benchmarking proposal: i.e. that there is such a thing as a constant "real" price obtainable form a predominant liquidity pool.

137. In dealer markets, the FSA's analysis would require each dealer to review each of its competitors since each of them is a liquidity pool.

138. Several references are made to the BMA's e-commerce annual survey of e-trading in fixed income markets. This survey has been welcomed by market participants on all sides as a useful source of information, and shows the variety of models and trading mechanisms that have developed to bring transparency and efficiencies to the diverse fixed-income markets. It needs to be read in the context of the BMA/ICMA/ISDA's description of bond markets fundamentals. There follows a brief list of points that clarify possible misinterpretation by the FSA about the results of the survey:

i. A large proportion of the trading platforms included in the survey (and therefore of the respondents) are single dealer platforms.
ii. Most of the volumes traded in fixed-income markets are traded by voice (including in the so-called most liquid markets, e.g. government bonds).
iii. Most of the price information made available is of an indicative nature.
iv. Executable quotes are not necessarily available for both bids and asks, tend to be in respect of smaller sizes in the more liquid instruments and do not mean that a dealer may not need to refresh his price when asked for a quote.
v. The growth of e-trading across a more diverse range of products is a welcome market-led development driven by investor demand. However, the FSA would be misled to think that these markets have become electronic. We refer to page 13 of the BMA's March 2006 Electronic Trading Survey showing the average estimated percentage of EU fixed-income volumes and tickets traded OTC versus Multi-dealer B2C.

Q4.6*: Have you considered what data you will need to review and monitor?*

139. Firms would need to capture information relating to the relevant dimensions of assessing venues' ability to deliver best execution on a consistent basis, including for example, where relevant, prices, charges, certainty of execution, settlement services, search costs, and development costs.

140. With specific respect to dealer markets, it is difficult to respond to this question without clarity on scope. It is also difficult to work out what data might be relevant for the purposes of monitoring something that cannot be constructed.

Q4.7*: Have you considered any changes that may be needed to order management systems to capture data for monitoring?*

141. The costs of data capture would be significant, and require major changes to systems and data storage. Firms would be required to build comprehensive data systems capturing all available data for external referencing, including – in dealer markets – data from trading platforms or voice brokers with whom dealers have no relationship and data from competitors which they will not be provided with. In order to avoid excessive additional cost it is thus especially important to leave it to firms to determine the most appropriate methods and comparisons (see answers to Q4.1 and Q4.2 above).

Q4.8: Will execution venues provide data to firms to demonstrate their execution quality and compete for order flow?

142. Yes and no. IDBs and ECNs already make data available to their users for a variety of purposes. Dealers who are also execution venues will obviously not make data available to competing dealers, but will make data available to clients (including clients who are eligible counterparties). But for execution venues to provide data, there must be a consistent pool of liquidity against which to measure execution quality. Where the characteristics of the instrument or dealers' view of them changes over time, it is not possible to provide data which are consistently useful.

143. However, it is important to take account of the availability, meaningfulness, and cost of the data provided, and the implications for firms' record-keeping burden.

Q4.9: What other approaches do you suggest to demonstrate that client orders have been executed in accordance with a firm's policy?

144. FSA has not expressed an opinion in Paragraph 4.44 as to whether a firm would, for example, be required to maintain full records of relevant quotes to demonstrate compliance with the firm's execution policy. Firms should not be required to do this. The requirement of MIFID Level 1 Article 21.5 is to demonstrate compliance with the firm's execution policy, not to demonstrate for each transaction that the firm did indeed obtain the best possible result. The lack of tradeable price data to build meaningful benchmarks and the difficulty of evidencing best price in dealer markets are two sides of the same coin. There is no point in detailed record keeping of unreliable price data when in the end the trader exercises his subjective judgement taking account of liquidity, extrapolation from such data, the parameters of his internal model, and what his position is at the particular time.

145. Examples of alternative possible approaches, when a firm is executing client orders and its execution policy therefore applies, include the following. But there may be many others. FSA should not seek to be prescriptive on this point.

i. Where price is the most relevant factor, use of third party data such as time and sales data to show consistency of the outcome of the firm's policy with the result available in the market.

ii. Designing the firm's systems themselves to implement the execution policy algorithmically, so that showing that the transaction was executed through the system demonstrated compliance with the firm's policy.

iii. Where price benchmarks are not available, for professional clients, and taking into account Level 2 Directive Recital 70, the most appropriate approach to evidencing compliance with the firm's policy might be to accept implicitly the status quo, recognising that the client has access to enough market information to be able to gauge the quality of execution, and relying on a case by case assessment of any challenge that the client makes.

iv. Where price is not the most relevant factor in the execution policy, for example because certainty of execution or settlement, or speed, are the relevant factors, evidence of compliance with the policy could take the form of the fact that the trade was executed and settled, or the time that elapsed between the order and the execution.

v. Where market impact is the most relevant factor, evidence that the firm had followed its execution policy would necessarily be more qualitative, and rely on a case by case assessment of any challenge that the client makes.

Q4.10: *Is there a role for an industry-led initiative to address these issues [information on execution quality; consolidation of data]?*

146. The industry is constantly addressing these issues, and has an important role in helping prepare for the Commission's November 2008 review under Level 2 Directive Recital 76. It is important for regulators to have a thorough understanding of how markets work, and of possible pitfalls in what they might propose.

London Investment Banking Association
17th July 2006