

## Global Developments on Best Execution

***Best execution is currently a hot topic for global regulators and the past year has seen notable regulatory focus in this area. Amid this development, firms are recommended to review their global best execution compliance practices.***

During the past year, best execution has become a topical issue globally as regulators in different jurisdictions have highlighted best execution as a significant area of focus. In particular, the Hong Kong Securities and Futures Commission (SFC) concluded its thematic review on best execution and published its report in January 2018, the Monetary Authority of Singapore (MAS) issued a consultation paper on best execution in November 2017, and the United Kingdom Financial Conduct Authority (FCA) announced in March 2017 that best execution remains an issue following the regulator's thematic review on the asset management industry. Against this backdrop, the revised Markets in Financial Instruments Directive (MiFID II), which came into effect in January 2018, has also built on the best execution requirements under MiFID I.

This *Client Alert* outlines recent developments on best execution in Hong Kong, Singapore, the United Kingdom, and the United States, and examines key themes that have consequently emerged. In general, regulators have increasingly: (1) emphasized considering various factors for best execution, in addition to price; (2) emphasized applying best execution to products other than equities (such as over-the-counter (OTC) fixed income products and derivatives), and (3) scrutinized how firms implement and monitor best execution. Based on these developments, heightened regulatory attention to best execution is likely in the upcoming year. Firms should therefore review their best execution practices and ensure that they are in compliance with best execution requirements.

### Hong Kong

In January 2018, the SFC issued a [circular](#) outlining guidance on the standards of conduct and internal controls the SFC expects of licensed corporations in delivering best execution (SFC Circular), and a [report](#) on the thematic review of best execution (SFC Report). The SFC Circular and the SFC Report follow a [thematic review](#) of 21 licensed corporations by the SFC, which assessed the effectiveness and adequacy of arrangements for delivering best execution, and provided guidance to market participants on the best execution requirement. The SFC's guidance on best execution is both welcome and overdue, as the best execution requirement in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) lacked detail.<sup>1</sup>

Following the thematic review, the SFC identified a number of practices in the market that fell below its expected standards. The SFC found, in particular, that licensed corporations:

- Did not take into account factors that may be relevant to best execution
- Incorrectly excluded certain transactions, such as OTC transactions and principal transactions, from the scope of best execution
- Did not monitor and assess orders placed with affiliates, connected parties, or other third parties for best execution, if client orders were routed to such persons for execution

The SFC also highlighted other deficiencies, including inadequate internal policies, governance, supervision, controls, and monitoring in respect of best execution.

The SFC Report provides some helpful insight on the SFC's expectations on best execution, with the key points outlined below:

- On the factors to be taken into account for best execution, the SFC expects firms to take sufficient steps to obtain the best available terms when executing client orders, considering price, cost, speed of execution, likelihood of execution, speed of settlement, likelihood of settlement, size and nature of the order, and any other relevant considerations. The relative importance of each best execution factor may vary from case to case, and best execution of certain types of transactions should be assessed against multiple factors. The SFC highlighted that a good practice would be for firms to establish a policy outlining specific best execution factors relevant to their businesses, prioritizing different factors under different circumstances.
- On the scope of the best execution requirement, the SFC noted that firms should establish policies and procedures regarding best execution to cover different types of financial instruments, including both listed and OTC products. Moreover, the SFC expects firms to deliver best execution in respect of agency or back-to-back principal transactions if clients rely on firms to protect their interests in order execution. If firms enter into principal transactions with clients, other than those that are back-to-back in nature, the SFC expects firms to carry out their own assessments to determine whether clients are relying on firms to protect their interests, and whether the best execution obligation is owed, before applying any carve outs. Despite this guidance, there is some ambiguity as to what the SFC means by clients relying on firms to protect their interests in order execution.
- The SFC expects firms to establish internal policies, proper supervision, and a systematic process to monitor execution outcomes continuously. For example, in relation to the use of third parties for execution, the SFC clarified that regardless of whether orders are executed through affiliates, connected parties, or third parties, the obligation to deliver best execution remains with the licensed firm. The SFC expects firms to carry out due diligence on affiliates, connected parties, or third parties engaged for execution.

While SFC enforcement actions for a failure to comply with the best execution requirement has been limited in recent years, market participants will need to be vigilant as this will be an area of increasing regulatory focus in the future. Market participants should also note that the SFC [fined](#) FXCM Asia Limited HKD4 million in October 2016 for regulatory breaches related to FXCM Asia Limited's order execution practices for foreign exchange trading. The SFC found, among other actions, that FXCM Asia Limited failed to treat its clients fairly, execute client orders on the best available terms, and act in clients' best interests as required by the Code of Conduct.

## Singapore

In Singapore, in November 2017, the MAS published its “[Consultation on Execution of Customers’ Orders](#)” (the MAS Consultation), along with a [draft notice](#) and [draft guidelines](#). These publications formalized the MAS’ expectations for capital market service license holders, banks, merchant banks, and finance companies that conduct certain regulated activities (Capital Markets Intermediaries) to establish best execution policies and procedures. The MAS Consultation closed on December 18, 2017, and the MAS is expected to publish the final notice and guidelines reflecting the proposed requirements later this year.

The MAS Consultation generally contained themes that are similar to those outlined in the Hong Kong section above:

- On the factors to be taken into account for best execution, the MAS expects Capital Markets Intermediaries to consider holistically different factors such as price, costs, speed, likelihood of execution and settlement, and size and nature of the customer’s order, if appropriate, to achieve the best available terms for their customers. The relative importance of the different factors should take into account the characteristics of the order and type of capital markets product, as well as customer categorization.
- On the scope of the best execution requirement, the MAS noted that the best execution policies and procedures should cover all customers’ orders, regardless of the capacity in which a Capital Markets Intermediary is acting (*i.e.*, whether as agent or principal).
- In addition to establishing and implementing best execution policies and procedures, the MAS also emphasized the importance for a Capital Markets Intermediary to monitor the effectiveness of its best execution policies and procedures. Moreover, the MAS expects a Capital Markets Intermediary to implement a monitoring framework, commensurate with its size and complexity of operations.

Notably, the MAS also mentioned that, when dealing with a customer who is an accredited investor, expert investor, or institutional investor, a Capital Markets Intermediary may exercise and document its judgment to determine the circumstances under which such customer does not rely on the intermediary to place or execute his order(s) on the best available terms. These circumstances may include whether the customer initiates the order, or whether the customer specifies the venue and price at which the order should be executed.

## United Kingdom

In March 2017, the FCA [announced](#) that best execution remains a problem in the asset management industry. The FCA stated that many firms failed to update their practices following the FCA’s identification of widespread failings across the broader financial services industry, set out in its July 2014 [Thematic Review on Best Execution and Payment for Order Flow](#). The FCA has also indicated that regulatory attention is now turning to fixed income and OTC markets. Whilst the 2014 Thematic Review focused on equities, exchange traded derivatives, and contracts for difference, the FCA’s more recent announcement highlighted the relative lack of sophistication in best execution monitoring for fixed income products. Additionally, the FCA indicated a need for firms to improve practices in OTC and bespoke products due to incoming MiFID II requirements.

In January 2018, MiFID II came into effect in the UK and other EU Member States. MiFID II has raised the best execution standard to require firms to take “all sufficient steps” to obtain best execution, rather than simply “*all reasonable steps*” (as was the case under MiFID I). In addition, MiFID II places a specific

obligation on firms to use market data to check the fairness of prices proposed to clients when executing orders or taking decisions to deal in OTC products. Finally, MiFID II imposes substantive new reporting requirements on execution venues and systematic internalizers (such as large broker-dealers) to publish information on execution quality, as well as on firms executing client orders to publish information on execution venue selection.

Therefore, heightened regulatory attention to best execution is likely in the coming year, particularly in the fixed income, currency and commodities (FICC), and OTC space. Notably, MiFID II not only raises the standards applicable to firms, but also enables greater regulatory scrutiny of the extent to which firms are implementing the necessary practices to deliver best execution to their clients through its enhanced disclosure requirements.

## United States

In the United States, the applicable requirements and regulations regarding best execution with respect to securities are well-established. Best execution is a consistent examination and enforcement priority for the US Securities and Exchange Commission (SEC) and for the self-regulatory organization for firms registered as broker-dealers in the United States, the Financial Industry Regulatory Authority, Inc. (FINRA).

Firms that are registered with the SEC as broker-dealers owe their clients a duty of best execution as a result of the anti-fraud provisions in the Securities Exchange Act of 1934 (Exchange Act). According to the SEC, the duty of best execution requires broker-dealers to seek to execute customers' trades at the most favorable terms reasonably available under the circumstances. Traditionally, price has been the predominant factor in determining whether a broker-dealer satisfied its best execution obligations, but the SEC has stated that the broker-dealer should also consider additional factors, including:

- The size of the order
- The speed of execution available on competing markets
- The trading characteristics of the security
- The availability of accurate information comparing markets and the technology to process the data
- The availability of access to competing markets
- The cost of such access

The duty of best execution applies whether the broker-dealer is acting as agent or as principal.

FINRA Rule 5310 further requires that a broker-dealer use reasonable diligence to ascertain the best market for a security, and buy or sell in such market so that the resultant price to the customer is as favorable as possible under the prevailing market conditions. Some of the factors that FINRA considers in determining whether a broker-dealer has used "reasonable diligence" are similar to those enumerated in the list above. FINRA rules further provide that firms must have procedures in place to ensure that the broker-dealer periodically conducts "regular and rigorous" reviews of the quality of the executions of their customers' orders, to the extent the broker-dealer does not conduct an order-by-order review. The review must be conducted on a security-by-security, type-of-order basis (*e.g.*, limit order, market order, and market on open order). The review must also compare, among other factors, the quality of the executions

the firm is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the member could obtain from competing markets.

Separately, asset managers that qualify as “investment advisers” under the Investment Advisers Act of 1940 (the Advisers Act) also have a duty of best execution. Such that, if an adviser has responsibility to direct client brokerage, the adviser has an obligation to seek best execution of its clients’ securities transactions. In discharging its duty, an adviser must seek the execution of transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances. In assessing whether an adviser meets this standard, the SEC generally expects that the adviser consider the full range and quality of a broker’s services when placing brokerage. This includes, among other factors, execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research, if any, provided. The SEC has stated that an investment adviser should also “periodically and systematically” evaluate the execution the advisor is receiving for clients. Depending on the particular facts and circumstances, certain additional restrictions and requirements may also apply to the adviser. For example, an adviser is generally relieved of its obligation when a client directs the adviser to use a particular broker, but is required to make additional disclosure to clients when it receives some benefit from the direction of the trade. Similarly, the Advisers Act does not prohibit advisers from using an affiliated broker to execute client trades, but use of an affiliate involves a conflict of interest that must be disclosed to the client.

With respect to derivatives, the US Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) do not have specific rules governing best execution and fair commissions, other than with respect to security futures contracts. Best execution rules have not traditionally been a focus of the CFTC, which has primary jurisdiction over the futures and OTC derivatives markets in the US, or the NFA, the self-regulatory organization for firms registered with the CFTC. While the SEC has mandated the creation of a national market system whereby securities are offered on multiple platforms and exchanges, futures markets have traditionally operated independent of one another with limited inter-market competition. Broker-dealers transacting in security futures contracts (which are regulated by both the SEC and the CFTC) are subject to similar best execution standards imposed by the NFA under NFA Rule 2-4 as those of the SEC. Such rules require NFA members to use reasonable diligence to ensure that customer orders receive the most favorable terms under the circumstances. NFA members must consider, among other things:

- Market character: including, price, volatility, liquidity, depth, speed of execution, and pressure on available communications
- Size and type of transaction, including the type of order
- Location, reliability, and accessibility to the customer’s intermediary of primary markets and quotation sources

Moreover, in cases in which a customer’s order may be executed on two or more markets trading security futures contracts that are not materially different, brokers must ascertain the market in which the customer will receive the most favorable price under prevailing market conditions. Best execution standards, similar to those imposed by MiFID II with respect to derivatives and futures products (other than for security futures contracts), do not exist in the US. However, commodity brokers and advisors may, depending on the circumstances, owe a common law fiduciary duty to their clients and are subject to anti-fraud provisions under the Commodity Exchange Act.

Finally, since the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), more than 20 trading platforms have registered as swap execution facilities (SEFs), listing swaps and other derivatives that have traditionally been traded OTC. While a stated purpose of the SEF rules is to promote price competition among markets, the SEF rules do not explicitly mandate that a broker or advisor direct execution to a particular platform for “best execution.” Should the CFTC find implementing such rules and regulations necessary in the future, the agency may look to rely on its expanded authority under the Dodd-Frank Act.

## **Conclusion**

In conclusion, best execution has been a key focus area among global regulators in the past year. Based on recent developments, a few common themes have emerged across jurisdictions. First, regulators have emphasized that a number of factors, in addition to price, should be considered for the purposes of best execution. Second, regulators have increasingly emphasized the application of best execution to products other than equities (such as OTC fixed income products and derivatives), as the implementation of best execution is sometimes lacking with respect to these products. Third, regulators have turned their attention to how firms implement and monitor best execution, as deficiencies have been identified in this space. Increased regulatory attention on best execution is likely following the various developments mentioned in this *Client Alert*. Firms should therefore review their best execution practices and ensure that they are in compliance with best execution requirements.

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#### **Endnotes**

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- <sup>1</sup> The best execution requirement in the Code of Conduct requires that a licensed or registered person when acting for or with clients should execute client orders on the best available terms.