

Full Disclosure? The UK Financial Services Authority's Latest Pronouncements on Best Execution

The UK Financial Services Authority ("FSA") recently issued Policy Statement 07/15 (the "Statement") in response to issues raised by respondents to previous FSA papers on the implementation of the Markets in Financial Instruments Directive ("MiFID") requirements for best execution.

The Statement refers to the questions and answers ("Q&A") on best execution published in May by the Committee of European Securities Regulators ("CESR"). The FSA agrees with the content of the Q&A, regarding it as a "useful resource" for firms, and helpfully includes the Q&A in the Statement. Consequently, when the CESR Q&A covers an issue raised by respondents to the previous FSA consultations, the CESR comment effectively becomes the FSA response. Examples given are:

- whether a firm can include only one venue or entity in its execution policy (answer: yes, in certain circumstances);
- the differences between prior consent and prior express consent, and how the latter might be obtained (answer: prior consent may be tacit, but express consent requires actual demonstration of consent via signature, or orally via telephone call or in person, or via a check on a webpage); and
- the extent to which a portfolio manager or a firm that receives and transmits orders may rely on another entity, such as a broker, to provide best execution to its clients (answer: it can, provided that it is satisfied that those entities allow the firm to comply with the best execution requirement to obtain the best possible result for its clients; where that entity is itself subject to MiFID best execution requirements, the firm would be complying with its MiFID best execution requirements simply by placing orders with or transmitting them to that entity).

Where the CESR Q&A does not address issues raised by FSA's respondents, the FSA supplies separate feedback, covering the following:

- whether a firm must obtain consent from clients to material changes in its execution policy: the FSA points out that the MiFID obligation is to notify only, so client consent is not required;
- whether a firm can make contractual promises about execution quality to eligible counterparties without becoming subject to regulatory requirements for best execution: the FSA thinks that "contractual best execution" (as opposed to "regulatory best execution") is possible, though it observes that firms must be careful to make the position clear, and not lead the counterparty to think that it is being treated as a professional or retail client;
- whether the FSA will provide execution quality data on over-the-counter (OTC) markets: the FSA states that it has no plans to do so;
- the nature of the requirement to manage implicit costs: the FSA's view is that firms should consider whether costs attributable to how the trade is executed are relevant for client orders and take all reasonable steps to manage them (this is not a particularly helpful answer, and some examples would have been useful);
- whether a portfolio manager needs to establish both an execution policy and a "transmission" policy if it reserves the option to either place orders with other entities or execute its own client orders: the FSA's answer is no; and

- whether a firm must consider instruments that are economically similar to the instrument that is the subject of the order when providing best execution: the FSA's answer appears to be yes, if this constitutes “reasonable steps to obtain the best possible result”, unless the firm is acting under specific instructions.

The Statement also contains an examination of certain scope issues and in this context refers to the Commission's response to questions put to it by CESR published in March 2007.

The FSA indicates that it will be proceeding on the basis of the Commission's response. In broad terms, this means that:

- in quote-driven or “dealer” markets, the key concept is whether the firm is acting “on behalf of the client” when executing its order (the Commission provides a number of non-exhaustive tests to assist in answering this question);
- in ordinary circumstances, MiFID's intended outcome is that retail clients should receive best execution; and
- where spread betting is concerned, whether best execution applies will depend on all the facts and circumstances; where it does apply, FSA's view is that one way in which best execution may be achieved is by obtaining best execution for the instrument underlying the spread bet and disclosing how a firm's fees and charges are calculated.

The bald statement that the FSA “will proceed on the basis of the Commission's response” is not quite the whole story. In October 2006 the FSA produced a “legal opinion” from its General Counsel's Division, which argued that in quote-driven markets, best execution might not apply, on the grounds that there was no client and no client order. This view has been robustly and expressly rejected by the Commission. It is true that there were few who thought the FSA opinion was correct, and that the FSA's glossing over the position in the Statement can be justified by the old adage “when you're in a hole, stop digging”. But the outcome – abandoning its own legal opinion – is embarrassing for the FSA, and is one which it will be in no hurry to repeat.

A copy of the Statement is available at http://www.fsa.gov.uk/pubs/policy/ps07_15.pdf

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