



## **AMF Position – Recommendation 2014-07 Guide to best execution**

**References: Articles L533-18, L533-19, L533-20 of the Monetary and Financial Code and 314-69, 314-70, 314-71, 314-72, 314-73, 314-74, 314-75, 314-76 of the AMF General Regulation.**

This guide was compiled following interviews with intermediaries and several meetings of a working group comprising finance industry professionals and representatives of retail investors.

The AMF felt the need to take stock of practices among investment services providers (ISPs) with a view to identifying areas of weakness or risk and clarifying the implementing procedures for regulatory provisions.

Moreover, at a time when savers are becoming generally warier of financial markets, the AMF wants to play its part in restoring confidence among retail investors by clarifying its expectations in an effort to promote reliable, high-quality financial intermediation. Such was the aim set forth in the second priority work area of the AMF's 2013-2016 strategic plan.

The work done by the AMF revealed disparities in both the interpretation and the application of best execution rules in a number of areas, namely the content and review of execution policy, the relationship between the execution policy and selection policy, and client disclosures. The existence of practices involving payment for order flow was also highlighted.

Given the diverse practices of firms in the above areas, the AMF felt the need to clarify its interpretation of the rules. This guide does not go into all the rules applicable to best execution and best selection, but seeks to clarify policy-related issues identified by the AMF.

The guide also draws on a set of questions and answers (Q&A) published by the Committee of European Securities Regulators (CESR) in May 2007<sup>1</sup>. This document was the subject of a news release<sup>2</sup> on 30 October 2007 in which the AMF called on professionals to refer to CESR's recommendations. Some of the guide's positions and recommendations draw on the comments provided in the Q&A, giving them additional scope.

This guide has three objectives:

- ensure that investors receive the protection to which they are entitled;
- suggest simple principles for ISPs to help them implement the arrangements best suited to their strategy, business and clients;
- provide clear guidelines on how the AMF expects best execution rules to be applied.

**Since the provisions in the guide merely clarify rules that are already in force, they are applicable immediately, with the exception of positions and recommendations on reviewing best execution and best selection policies. These are to be applied in the next round of annual policy reviews following publication of this guide.**

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<sup>1</sup> The Q&A is available on the website of the European Securities and Markets Authority (ESMA) under "Guidelines and Recommendations, MiFID", ref. 07-320. The AMF has prepared a French translation.

<sup>2</sup> Cf. Annex

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### 1. Scope

- Clients

Article L 533-20<sup>3</sup> of the Monetary and Financial Code transposing Article 24<sup>4</sup> of Directive 2004/39/EC<sup>5</sup> stipulates that transactions brought about or entered into with eligible counterparties are not subject to the rules of business conduct, including the best execution obligation.

<sup>3</sup> Article L. 533-20 of the Monetary and Financial Code: Investment services providers who are authorised to receive and transmit orders on behalf of third parties, to execute orders for third parties or to trade for their own account may generate transactions between eligible counterparties or enter into transactions with such counterparties without complying with the



Accordingly, this guide does not pertain to relations with eligible counterparties; it chiefly concerns relations with retail clients. However, where specified, some recommendations/positions and/or rule reminders may apply to relations with professional clients.

- Financial instruments

Recital 70<sup>6</sup> of Implementing Directive 2006/73/EC<sup>7</sup> stipulates that **the best execution obligation applies to all types of financial instruments** but that it should however be applied in a way that takes account of “differences in market structures or the structure of financial instruments”. In other words, the best execution obligation should be applied taking account of the specific features of different types of financial instruments.

**Unless otherwise stated with reference to a specific asset class, the recommendations/positions and rule reminders in this guide apply to all financial instruments.** However, with the exception of paragraphs 2.4.2 and 3.2.3.2, the guide does not deal specifically with products that are mainly traded over the counter (OTC) (such as bonds, interest rate swaps and structured products).

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obligations referred to in Articles L. 533-11 to L. 533-16, L. 533-18 and the first paragraph of L. 533-19 for said transactions or for any related service directly linked to them.

A decree shall set forth the criteria according to which counterparties shall be deemed to be eligible counterparties.

The General Regulation of the Autorité des Marchés Financiers sets forth the conditions under which eligible counterparties may ask to be treated as clients.

<sup>4</sup> Article 24 of Markets in Financial Instruments Directive 2004-39:

1. Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account and/or to receive and transmit orders, may bring about or enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 19, 21 and 22(1) in respect of those transactions or in respect of any ancillary service directly related to those transactions.

<sup>5</sup> Referred to as the Level 1 Directive in the guide.

<sup>6</sup> Recital (70) of the Implementing Directive:

The obligation to deliver the best possible result when executing client orders applies in relation to all types of financial instruments. However, given the differences in market structures or the structure of financial instruments, it may be difficult to identify and apply a uniform standard of and procedure for best execution that would be valid and effective for all classes of instrument. Best execution obligations should therefore 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.

<sup>7</sup> Referred to as the Implementing Directive in the guide.

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- Investment service provided

The best execution principle is applied taking into account the service provided by the ISP:

- ✓ It applies in full to ISPs that execute orders or decisions to deal.
- ✓ It also applies in modified form to ISPs that transmit orders resulting from their own decisions to deal or orders they have received and do not execute themselves to other entities. To avoid duplicating best execution efforts, investment firms that transmit or place orders with other entities for execution must **prepare and implement a “selection policy”**. Pursuant to V of Article 314-75 of the AMF General Regulation “such policies shall select the entities to which orders for each class of instruments are transmitted for execution”. Selected entities must enable ISPs to comply with their obligation to provide the best possible result for their clients.

This guide covers both situations: sections 2 and 3 describe the applicable provisions in terms of execution policy, while sections 4 to 6 describe the applicable provisions in terms of selection policy. An institution may be led to provide different investment services to its clients and thus be subject to best execution or best selection obligations, or even to both sets of obligations (depending on the type of instrument, for example).

In addition, the AMF reiterates, as stated in Recital 69 of the Implementing Directive, that “dealing on own account with clients by an investment firm should be considered as the execution of client orders, and therefore subject to the requirements under Directive 2004/39/EC and this Directive and, in particular, those obligations in relation to best execution”. However, this recital should be read in the light of the answer provided by the European Commission to CESR<sup>8</sup>, which states that:

- “application or otherwise of best execution will depend on whether the execution of the client’s order can be seen as truly done on behalf of the client”;
  - “under ordinary circumstances, a retail client legitimately relies on the investment firm to protect his or her interests in relation to the pricing and other elements of the transaction”;
  - “in the wholesale markets, clients do not rely on the firm in the same way”.
- Instructions received

Pursuant to Article L. 533-18 I of the Monetary and Financial Code, wherever there is a specific instruction given by the client, the intermediary shall execute the order in accordance with said instruction. However, if a client has given a specific instruction that covers only one portion or aspect of the order, the ISP must comply with its best execution obligation for any other portion or aspect of the order not covered by such instructions. The specific instruction may refer to an execution venue or any other characteristic of the order.

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<sup>8</sup> Commission answer to question 1 “Dealing on quotes” appended to the CESR Q&A.



## 2. Preparation of the execution policy

The best execution obligation is defined in Article L. 533-18, I of the Monetary and Financial Code<sup>9</sup> as the requirement "to take all reasonable measures [when executing orders] to obtain the best possible result for [...] clients".

In accordance with this article, the best possible result **is assessed with regard to seven broad factors**: price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.

Under Article 314-69 of the AMF General Regulation, **ISPs should determine the relative importance of these factors based on a series of criteria** that consider "the characteristics of the clients, including their status as professional or retail clients", "the characteristics of the order concerned", "the characteristics of the financial instruments covered by the order", and "the characteristics of the execution venues to which the order may be routed".

Compliance with the best execution obligation is achieved by **implementing order execution arrangements and a policy** that enable ISPs to obtain the best possible result for client orders.

Answer 5 in the CESR Q&A of May 2007 states that "execution arrangements' are the means that an investment firm employs to obtain the best possible result when executing orders or decisions to deal, while the 'execution policy' may be understood as a document that describes the most important and/or relevant elements of those execution arrangements".

### 2.1. To what extent should the execution policy be differentiated?

Article 314-69<sup>10</sup> of the AMF General Regulation states that to determine their execution policy, and notably the relative importance of the factors used to assess best execution, ISPs shall take account, in particular, of the characteristics of their clients and the financial instruments traded.

In point 7.3 of its Q&A, CESR specifies that "the (execution) policy will also need to address the distinction between retail and professional clients to the extent that the firm treats each such category of clients differently".

<sup>9</sup> Article L533-18-I "When executing orders, investment service providers shall take all reasonable measures to obtain the best possible result for their clients, taking account of the price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction".

<sup>10</sup> Article 314-69:

For the purposes of I of Article L. 533-18 of the Monetary and Financial Code, investment services providers executing client orders shall take account of the following criteria to determine the relative importance of the factors referred to in I of the said Article:

1° The characteristics of the clients, including their status as professional or retail clients;

2° The characteristics of the order concerned;

3° The characteristics of the financial instruments covered by the order;

4° The characteristics of the execution venues to which the order may be routed...



**Position:**

Consistent with answer 7.3 in CESR's Best Execution Q&A, and to the extent that different treatments are applied, ISPs should distinguish in their execution policies the different types of financial instruments for which they carry out orders and address the distinction between different types of clients (professional or retail). In addition, in accordance with Article 314-69, an ISP may choose to establish a finer-grained classification within a particular client category if it feels it is appropriate to tailor its execution policy more closely to its clients' knowledge and experience.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

2.2. Factors in the best execution policy

In accordance with I of Article L. 533-18 of the Monetary and Financial Code, the factors that ISPs should take into account to obtain the best possible result for clients are the following: price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order. Article 314-71 of the AMF General Regulation also specifies that "where investment services providers execute orders on behalf of retail clients, best execution shall be determined on the basis of the total cost".

Article 314-71 of the AMF General Regulation defines total cost as "the price of the financial instrument, plus the costs relating to execution, including all the expenses incurred by the client that are directly linked to the execution of an order, along with the charges specific to the execution venue, clearing and settlement charges and all other charges that may be paid to third parties participating in the execution of an order".

Among the other considerations pertinent to order execution mentioned in Article L. 533-18 of the Monetary and Financial Code, qualitative elements may be taken into account, such as for example the complexity of execution mechanisms and difficulty in providing clients with comprehensive information on these mechanisms.

**Recommendation:**

**The AMF suggests a non-exhaustive list of qualitative factors that may be taken into account in the execution policy**, depending on the client category (professional or retail), such as a venue's use of a central counterparty, transparency of the price formation process (pre-trade), the simplicity of execution mechanisms, the diversity of services provided (extended listing times, types of orders offered) and the ability to provide clients with complete and intelligible information on execution mechanisms. If the ISP has concerns about the reliability and robustness of a venue and/or its sustainability, it may legitimately consider that this could impact its ability to deliver best execution to its client and accordingly exclude the venue from its execution policy.

Another factor that may be relevant to professional clients is implementation shortfall, an indicator used to measure an order's impact on the market. For some professionals, this factor may be more important than speed of execution.

However, when including qualitative criteria in the execution policy for retail clients, it should be remembered that total cost is the most important criterion for this category. That said, Recital 67 of the Implementing Directive permits other criteria to be given precedence insofar "as they are instrumental in delivering the best possible result in terms of the total consideration to the retail client".

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

2.3. Determining the execution venues to include in the execution policy

Paragraph 2° of Article 314-72 of the AMF General Regulation, which takes up Article 46 of the Implementing Directive, states that ISPs must include in their execution policy "a list of the execution venues in which the investment services provider has the most confidence for meeting its obligation to take all reasonable measures to obtain the best execution of its client orders on a consistent basis".

**Position:**

Consistent with answer 12.2 provided in the CESR Q&A, the AMF considers that when selecting venues to be included in its execution policy, an ISP should concentrate on the extent to which these venues allow it to obtain in most cases the best possible result for client order execution; it should not take account of the fees and commissions it will charge the client.

However, Q&A answer 8.2 introduces the idea that the ISP should also consider the costs of including an execution venue in its policy, to the extent that these costs are passed on to clients, and should compare these to the improvement in terms of execution quality. These integration costs should include the cost and any operational risk entailed in adapting front office systems (connection to trading systems of the new execution venue) and back office systems (settlement chains).

As a result, ISPs have to examine all venues on which they are likely to execute client orders, without taking into account the fees and commissions they will charge; but in terms of their policy execution, they are not required to include venues for which the gain obtained could be outweighed by the costs (where these are passed on to clients) arising from the inclusion of these new venues in the policy.

The AMF therefore considers that an execution policy may include a single execution venue provided the ISP is able to show that it obtains the best possible result in most cases with the selected venue.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

#### 2.4. What should an execution policy contain?

##### 2.4.1. *For all financial instruments*

Answer 4 in the Q&A details a number of elements that should be addressed in the execution policy, no matter what the type of financial instruments (including those that are mainly traded OTC) or the client category.

**Position:**

The items detailed in question 4 of the CESR Q&A should be included in the execution policy:

- the ISP's strategy for obtaining the best possible result for the execution of orders;
- the relative importance placed by the ISP on best execution factors or the process used to determine the relative importance and information on how these factors influence the choice of execution venues;
- the venues that the ISP will use to execute orders: the firm should at least specify the type of venue (regulated market (RM), multilateral trading facility (MTF), etc.) with a reference to a link updating the list of all possible execution venues according to the types of financial instruments traded.

For the other items, the ISP is free to determine the content of its execution policy.

Consistent with Q&A answer 4.3, the AMF notes that the ISP may however, in certain cases, use venues not included in its policy, for example on a provisional basis at its own initiative or to accommodate a client request to trade in an unusual instrument, with a view to satisfying the best execution requirement.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

#### 2.4.2. For instruments that are mainly traded OTC

**Position:**

The AMF considers that it is crucial, in the case of financial instruments that are mainly traded OTC, for execution policies to specify the execution arrangements so that the investor understands how his or her orders are executed (over the counter trade with the firm dealing on own account or with another counterparty, or, even on an exceptional basis, on a trading venue such as an RM or MTF to which the ISP belongs). If orders are executed through OTC trades with counterparties, the policy should also detail the process for selecting counterparties.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

#### 2.4.3. Specific case of CFDs and warrants/certificates

In the case of CFDs, warrants/certificates, and, more generally, financial instruments that are designed to capture the performance of an independently listed underlying asset and that are intended for retail clients, the execution policy should detail the price formation process. Moreover, pursuant to Articles 314-33 *et seq.* of the AMF General Regulation, the ISP should provide its client with “a general description of the nature and risks of financial instruments” and notably (2° of Article 314-34 of the AMF General Regulation<sup>11</sup>) specific information concerning the sensitivity of the price to changes in different market parameters. The information specific to these products may be supplied to clients on variety of materials (product sheet, etc.).

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<sup>11</sup>Article 314-34 2°: “The volatility of the price of such instruments and any limitations on the available market for such instruments”.





**Position:**

As regards these instruments, the execution policy should specify:

- execution procedures, explaining how orders are executed and by whom;
- price formation procedures, notably indicating the reference market.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

2.5. Obtaining the client's express consent before executing orders outside an RM or MTF

**Position:**

The final sub-paragraph of III of Article L. 533-18 of the Monetary and Financial Code provides that ISPs must "obtain their clients' express consent before executing their orders outside a regulated market or a multilateral trading facility".

It also states that ISPs may "obtain such consent either through a general agreement or for specific transactions"<sup>12</sup>.

The AMF asks that firms apply Q&A answer 21.1, which indicates that unlike prior consent, prior express consent entails an actual demonstration of consent by the client, which may be provided by signature in writing or an equivalent means (electronic signature), by a click on a web page or orally by telephone or in person, with appropriate record-keeping in each case.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

Case of OTC bond transactions with professional clients:

The AMF acknowledges the commercial difficulties represented by this obligation for ISPs that execute OTC bond transactions on **behalf of professional clients**.

**Position:**

The AMF considers that when an ISP that executes orders for professional clients has included in its execution policy, in addition to an RM or MTF, an execution venue that is neither an RM nor an MTF, because this venue is among those that will enable it to obtain the best possible result in most cases, it should determine the arrangements for executing orders of this client category in the light of its professional obligations, which include the obligation "to obtain clients' express consent before executing orders outside an RM or MTF"<sup>13</sup> and the obligation to act in the best interests of clients<sup>14</sup>, which is a general principle that should be followed in all circumstances. If complying with this principle would lead the ISP to carry out an OTC transaction without being able to obtain the prior express consent of its professional client, the ISP should have made its best efforts to obtain such consent and be able to prove this.

This position applies to all ISPs serving professional clients.

**3. Monitoring and review of the execution policy**

<sup>12</sup> Article L. 533-18 of the Monetary and Financial Code transposes Article 21 3° of the Markets in Financial Instruments Level 1 Directive verbatim.

<sup>13</sup> Provided for in the final sub-paragraph of III of Article L. 533-18 of the Monetary and Financial Code.

<sup>14</sup> Provided for in Article L. 533-11 of the Monetary and Financial Code.



### 3.1. Monitoring the effectiveness of order execution arrangements on a regular basis

Article 314-73 of the AMF General Regulation provides that “investment services providers shall supervise the effectiveness of their arrangements for order execution and their policy on this matter in order to detect any deficiencies and to remedy them as appropriate. In particular, they shall periodically verify whether the execution systems stipulated under their order execution policies obtain the best possible result for the client or whether they need to modify their execution arrangements. Investment services providers shall notify clients of any material changes in their order execution arrangements or policies”.

**Position:**

The AMF considers, as reiterated in Q&A answer 24, that the abovementioned ongoing supervision is intended to determine whether the investment firm has “complied with its (execution) policy and/or arrangements, and whether the resulting transaction has delivered the best possible result for the client”.

Accordingly the AMF calls for firms to apply the terms of Q&A answer 24, which states that:

- “Monitoring may include comparing similar transactions:

(i) on the same execution venue or with the same entity, in order to test whether a firm's judgement about how orders are executed is correct, or

(ii) on different execution venues or entities chosen from among those in the firm's (execution) policy, in order to test whether the 'best' execution venue or entity is being chosen for a given type of transaction;

- the monitoring methodology is at the discretion of the firm. Where monitoring every transaction would be disproportionate, other approaches, such as **appropriate methodologies for sampling**<sup>15</sup>, may suffice;

- where monitoring reveals that a firm has fallen short of obtaining the best possible result, the firm should consider whether this is because the firm has failed to follow its (execution) policy and/or arrangements or because of a deficiency in such policy and/or arrangements, and make appropriate amendments”.

A review of customer complaints regarding order execution may also be a way to detect errors in processes and/or parameters.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

Examples:

An ISP offering access to multiple execution venues must ensure that the parameters of its Smart Order Router (SOR) comply with the execution policy.

If one of the important policy factors is a low market impact, the ISP should analyse orders executed with a substantial “implementation shortfall” to see whether this was due to deficiencies in execution arrangements and take corrective measures where appropriate.

<sup>15</sup> Sampling checks should be representative and tailored to the firm's business/clientele/size/order types.



**Regular monitoring of “the effectiveness of their arrangements for order execution and their policy on this matter in order to detect any deficiencies and to remedy them as appropriate” does not relieve ISPs of the responsibility for reviewing their best execution policies,** pursuant to the provisions of Article 314-73 of the AMF General Regulation.

### 3.2. Review of the execution policy

#### 3.2.1. *Obligation to review*

Article 314-74 of the AMF General Regulation states that “investment services providers shall conduct an annual review of their order execution arrangements and policies”, adding that “such a review must also be conducted whenever a material change occurs affecting the investment services provider’s ability to continue obtaining best execution for its clients on a consistent basis using the execution venues stipulated under its order execution policy”.

**Position:**

Pursuant to Article 314-74 of its General Regulation, the AMF recalls that ISPs are required to conduct, at least annually, a review of order execution arrangements and policies regardless of the financial instrument and client category for which they are intended.

The AMF specifies that this review should be formally recorded in a summary document that reports on the elements covered by the review, the execution venues examined, policy amendments and the reasons for these amendments (or alternatively continued application of the current policy) as well as the arguments supporting the decision to add (or not add) new execution venues (RM, MTF, SI, other brokers, etc.).

**Position:**

Based on 5 of Article L. 533-10 of the Monetary and Financial Code and Article 313-49 of the AMF General Regulation, the AMF asks ISPs to keep<sup>16</sup> the summary documents constituting the formal record of the annual review of their execution policy for at least five years.

These positions apply to all ISPs, regardless of its client categories (professional and/or retail).

#### 3.2.2. *Events necessitating a review of the execution policy*

In addition to the annual review, Article 314-74 of the AMF General Regulation also requires the execution policy to be reviewed whenever there is a “material change”. This wording leaves ISPs considerable latitude to determine their course of action.

<sup>16</sup> Article 313-49 of the AMF General Regulation: “Investment services providers shall retain the records referred to in Article L. 533-8 and in 5 of Article L. 533-10 of the Monetary and Financial Code for at least five years”.



**Recommendation:**

Between two annual reviews, the ISP must determine whether to review the policy depending on internal or outside events assessed by the firm. Among the elements that might affect its ability to consistently obtain the best possible result for client order execution, the AMF considers that the ISP could take account of the following:

- material market impact;
- material change in the level of costs resulting from connection to a venue;
- change in the scope of financial instruments traded on a venue;
- development of significant new execution procedures or a change in the market model of an existing venue;
- major change to existing arrangements, such as a material change in the human or technical resources that the company relies on to provide best execution;
- client complaints that point to a major problem<sup>17</sup>.

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

*3.2.3. Due diligence to be conducted when reviewing the execution policy*

*3.2.3.1 For all financial instruments*

**Position:**

The AMF asks, consistent with answer 23 in the CESR Q&A, that the review of the execution policy should consist of an overall assessment of whether the execution policy and/or arrangements include all reasonable steps that the investment firm could be taking to obtain the best possible result for the execution of its client orders. The execution policy may no longer be able to deliver the best possible result if the characteristics of the clientele, order type or execution venues have changed materially since the last review.

During the annual review of its execution policy, the ISP should seek to correct anomalies identified in the current policy and not addressed as part of monitoring the effectiveness of order execution arrangements.

**The ISP should first determine whether its current execution policy delivers the best possible result across the selected universe of venues.** To address this question, the ISP shall conduct checks on the quality of execution obtained with reference to the factors included in its policy. These checks should be formally recorded by the firm and be suited to its business/clientele/size/order types. Sampling methods that take a statistical approach to ensure a representative sample might thus be considered.

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<sup>17</sup> A review of a client complaint revealing non-compliance of arrangements with the execution policy does not necessarily trigger a review of the entire policy.



The ISP should then assess whether it would consistently obtain the best results in terms of execution in the following cases:

- if it assigned a different relative importance to the best execution factors or if it changed any other aspect of its execution policy and/or arrangements;
- if it included different or additional execution venues or entities.

**The ISP should consider whether adding new execution venues or assigning venues differently to different categories of financial instruments, clients or orders would improve the quality of execution.**

This position is not intended to steer ISPs towards offering multiple execution choices but rather to encourage ISPs to consider their ability to offer best execution to clients.

Illustration: assessment of other execution venues:

- an ISP could assess whether the emergence of a new venue or increased liquidity on an execution venue that is not included in its execution policy might warrant inclusion of this venue in the policy to enhance execution quality. Firms without access to the corresponding market data under reasonable conditions may use public aggregate statistics to assess such venues. When considering the merits of connecting to a new venue, the ISP could look at the qualitative criteria described in the recommendations in paragraphs 2.2 and 2.3;
- on markets that traditionally operate OTC such as the bond market, ISPs should regularly study potential alternatives on RMs or MTFs, such as the new venues launched as part of market-wide initiatives or by intermediaries.

Illustration: change in the relative importance of certain factors of the execution policy:

An ISP offering multiple execution venues to professional clients that prioritise low market impact over speed of execution could compare this factor for a given type of order on different execution venues and accordingly adjust the size of orders sent to each venue.

**Position:**

During the annual review of its execution policy, the ISP shall consider potential commercial demand in favour of amendments to its execution policy. However, the lack of such demand shall not be enough by itself to rule out connecting to new execution venues or amending the execution policy. However, when deciding to modify execution arrangements or include a new execution venue in the policy, a firm may legitimately take into account the assessment of its clients' ability to properly understand the complexity of systems.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

In addition to the abovementioned positions, which apply to all financial instruments, clarifications concerning the AMF's expectations for certain specific asset classes are provided below.

*3.2.3.2 For financial instruments that are mainly traded OTC*

The difficulty in reviewing the execution policy for products that are mainly traded OTC lies in the lack or virtual lack of tools to measure the quality of execution, unlike in the case of equities.

**Recommendation:**



Where products are quoted by several counterparties selected in the execution policy, the AMF considers that an overall statistical analysis of a representative sample in terms of securities, size, etc., may be conducted to assess the best execution of orders by the selected counterparty.

Furthermore, the ISP could consider the possibility of contacting counterparties and entities other than those selected in its policy.

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

### 3.2.3.3 For warrants/certificates

#### **Recommendation:**

If these products are multi-listed, an overall statistical analysis of a representative sample in terms of securities, size, etc., may be conducted to assess the best execution of orders received (comparative statistical analysis covering prices and costs borne on other markets included in the execution policy).

Furthermore, the ISP could consider whether to connect to other execution venues and carry out a special assessment to justify its choice either way.

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

### 3.2.3.4 For CFDs

#### **Position:**

The ISP should review the appropriateness of qualitative factors (such as trading hours) and quantitative factors (such as the speed with which quotes are refreshed and orders are executed) taken into account in its policy. The firm is responsible for determining whether it should make other changes to its execution model.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

## **4. Best selection policy**

Pursuant to Article L. 533-18-V of the Monetary and Financial Code, in addition to the obligations placed on ISPs in charge of order execution, specific obligations apply to ISPs that send orders that they receive (and do not execute themselves) to a third party for execution. Specific obligations also apply to ISPs that manage portfolios or collective investment schemes (CIS) and whose decisions to deal give rise to orders that they send to a third party for execution.

These service providers are subject to the specific obligations set out in Article 314-75 of the AMF General Regulation under their obligation to act in the best interests of clients when they send orders resulting either from decisions to deal or as part of a reception and transmission service to a third party for execution.

As indicated in the first part of the guide, these obligations are not intended to result in execution efforts being duplicated in cases where a service provider supplying the services of reception and transmission of orders (RTO) or portfolio or CIS management transmits orders for execution to another ISP. Rather the aim is to organise a chain of cascading responsibilities.



**Position:**

As indicated in Q&A question 22, an ISP that transmits orders must ensure that the selected entity has a best execution obligation with respect to the ISP:

- either because the entity is itself subject to best execution obligations and has agreed to treat the ISP as a professional or retail client;
- or because the entity has undertaken by contract to comply with any or all best execution obligations.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

Accordingly, when it transmits to a third party orders received from its clients for execution or resulting from its investment decisions, the ISP must take all reasonable measures to obtain the best possible result, taking account of the factors listed in L. 533-18 of the Monetary and Financial Code (see 2.2 of this guide) and the criteria listed in Article 314-69 of the AMF General Regulation (characteristics of the client, order, financial instruments, traders to which the order may be directed).

To satisfy the above obligation, the firm must establish a policy that selects, for each category of instruments, the ISP or ISPs to which orders are transmitted. These ISPs must have an execution policy that enables the firm that implements a selection policy to meet its own obligations. The firm should monitor the effectiveness of this policy, in particular checking the quality of execution of selected traders, and correct deficiencies. Moreover, it should revise its policy annually and whenever there is a material change that impacts its ability to continue to obtain the best possible result for the client.

4.1. Preparation of the selection policy

Article 314-75 sub-paragraph V of the AMF General Regulation states that ISPs that receive and transmit orders or that manage portfolios or CIS “shall establish and implement policies that enable them to comply with the obligation referred to in IV<sup>18</sup>”.

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<sup>18</sup> IV. - Investment services providers shall take all reasonable measure to obtain the best possible results for their clients or for the collective investment schemes that they manage, taking into account the measures referred to in Article L. 533-18 of the Monetary and Financial Code. The relative importance of these factors shall be determined with reference to the criteria defined in Article 314-69, and, in the case of retail clients, the requirement laid down in I of Article 314-71.

Investment services providers sending orders to another entity for execution shall meet the obligations referred to in I or II and shall not be required to take the measures referred to in the preceding paragraph in cases where they follow specific instructions from their clients.



**Position:**

In accordance with Q&A question 9, the AMF considers that an ISP that transmits or places orders with other entities for execution can include a single entity in its policy if it is able to show that this allows it to satisfy the overarching best execution requirement.

This position applies to all ISPs, regardless which client categories they serve (professional and/or retail).

The rules do not give details on the content of an adequate selection policy. CESR provides some guidance in questions 6 and 17 of the Q&A.

**Recommendation:**

The AMF recommends that, for each class of financial instrument, the ISP's selection policy should:

- define the strategy, key measures taken to comply with the obligation to obtain the best possible result and how these measures enable this outcome to be achieved;
- describe the relative importance, or the procedure used to determine the relative importance, assigned to factors of best execution and how these factors impact the firm's choice when entrusting an order to a given entity for execution;
- mention ISPs used<sup>19</sup> and the criteria used to select them;
- contain information on the execution policies of selected ISPs for different categories of financial instruments;
- mention the terms under which the ISP may transmit specific instructions to a firm in charge of order execution and the consequences of these specific instructions;
- specify the terms under which the ISP monitors and, where necessary, reviews the appropriateness of its selection.

In addition, the ISP may choose to establish a finer-grained classification within a particular client category if it feels it is appropriate to tailor its execution policy more closely to its clients' knowledge and experience.

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

**Recommendation:**

To satisfy the client disclosure obligation<sup>20</sup>, most ISPs make their selection policy available to clients on their website. In this case, the AMF suggests to **ISPs serving retail clients** that selection policies provided in this manner should refer to a link that displays a summary table listing, for each category of financial instruments typically traded by clients, the brokers used plus the execution venues used by these brokers to offer best execution. This table should be updated whenever the policy changes.

This recommendation applies to all ISPs with retail clients.

#### 4.2. Case of orders executed outside RMs and MTFs

Unlike investment firms that execute orders, firms that transmit or place orders with other entities for execution, where these orders are executed outside an RM or MTF, are not required to obtain their clients' prior consent. Literal application of the rules would result in the vast majority of end clients not being informed ahead of time about the execution arrangements for their orders.

<sup>19</sup> However, consistent with Q&A answer 4.3 on the terms of application of the best execution policy, which may be extended to the best selection policy: [...A firm may however in exceptional circumstances use venues not listed in its policy, for example on a provisional basis or to accommodate a client request to trade in an unusual instrument, with a view to satisfying the overarching best execution requirement ...]."

<sup>20</sup> Cf. Article 314-75-V of the AMF General Regulation.





For example, if an investor sends an order to an entity providing RTO services (“RTO entity”), which routes the order to an ISP for execution, there is no requirement for the RTO entity to obtain the end client’s consent for the execution policy of the ISP executing the order. The rules provide in this case that it is the RTO entity, in its capacity as a client, that consents to the execution policy of the entity executing the order<sup>21</sup>. The RTO entity should in turn draw up a best selection policy that should be provided to its own clients, without the need to obtain their consent.

In practice, firms acting as RTO entities often go beyond the regulatory requirements by at least informing end clients about the execution policy of the ISP that will execute their orders under the RTO entity’s best selection policy.

**Recommendation:**

In a situation where the **transmitted order might ultimately be executed outside an RM or MTF**, the selection policy should clearly specify this and detail the consequences for the client (e.g. counterparty risk, lack of an order book).

This recommendation applies to all ISPs, regardless of its client categories (professional and/or retail).

**5. Monitoring and review of the selection policy**

5.1. Monitoring on a regular basis of the selection policy

The AMF recalls that sub-paragraphs V and VI of Article 314-75 of its General Regulation provide that “ISPs shall monitor the effectiveness of the policies [...] on a regular basis, especially with regard to the quality of the execution provided by the entities selected under their policies. Where appropriate, they shall remedy any deficiencies brought to light”.

**Position:**

As with the review of the execution policy and in accordance with answer 24 in the CESR Q&A, the AMF asks that monitoring should seek to determine whether the ISP is complying with its policy and/or arrangements and whether the resulting transactions made it possible to obtain the best possible result for the client.

The CESR Q&A also states that:

- “Monitoring may include comparing similar transactions:

(i) with the same entity, in order to test whether a firm’s judgement about how orders are executed is correct, or

(ii) (with) different [...] entities chosen from among those in the firm’s (execution) policy, in order to test whether the ‘best’ execution [...] entity is being chosen for a given type of transaction;

- the monitoring methodology is at the discretion of the firm. Where monitoring every transaction would be disproportionate, other approaches, such as **appropriate methodologies for sampling**<sup>22</sup> may suffice;

- where monitoring reveals that a firm has fallen short of obtaining the best possible result, the firm should consider whether this is because the firm has failed to follow its (execution) policy and/or arrangements or because of a deficiency in such policy and/or arrangements, and make appropriate amendments”.

The review shall cover:

- the ISP’s own actions when transmitting orders to selected entities;

<sup>21</sup> Provided the RTO entity is treated as a client by the trader and not as an eligible counterparty.

<sup>22</sup> Sampling checks should be representative and tailored to the firm’s business/clientele/size/order types.



- the quality of execution of selected entities. In this regard, **an examination of execution reports provided by ISPs selected for execution is a necessary condition** but is not enough to satisfy the requirements for ISPs that transmit orders to monitor the effectiveness of their best selection policies. This examination could notably be supplemented by specific questions for ISPs in charge of executing orders (e.g. request for details on the execution of one or more transactions).

A review of customer complaints regarding order execution may also be a way to detect errors in processes and/or parameters.

This position applies to all ISPs, regardless of its client categories (professional and/or retail).

#### 5.2. Formalisation of the selection policy review

The AMF General Regulation requires that ISPs “conduct an annual review of [their] policies. [...] Such a review must also be conducted whenever a material change occurs affecting the investment services provider’s ability to continue obtaining best execution for its clients [...] “(cf. Article 314-75-VI).

#### **Position:**

The annual review of the selection policy should be formally recorded in a summary document that reports on policy amendments and the reasons for these amendments (or alternatively continued application of the current policy) as well as the arguments supporting the decision to add (or not add) new ISPs for order execution.

#### **Position:**

Based on point 5 of Article L. 533-10 of the Monetary and Financial Code and Article 313-49 of its General Regulation, the AMF asks ISPs to keep the summary documents constituting the formal record of the annual review of their selection policy for at least five years.

These positions apply to all ISPs, regardless of its client categories (professional and/or retail).

#### 5.3. Events necessitating a review of the selection policy

The reasons for a review of the selection policy are the same as for execution policies, with adjustments to suit the business of the ISP.

#### **Position:**

ISPs are asked to ensure that the contractual relationship with firms selected for order execution includes a clause requiring notification in the event of amendments to the execution policy.

#### **Recommendation:**

The AMF recommends that when determining whether to conduct a review of their selection policy, ISPs should consider any material change in the products and services offered by ISPs selected for execution (material change in pricing, abrupt deterioration in execution arrangements, which may be evidenced in a variety of ways, including restrictions on the scope of traded securities, discontinued access to a particular market, or restructuring with the potential to generate major operational risks)

This position and recommendation apply to all ISPs, regardless of its client categories (professional and/or retail).

#### 5.4. Due diligence to be conducted when reviewing the selection policy

**Position:**

Consistent with answer 25.2 in the Q&A, ISPs that transmit or place orders with other entities for execution may need to take different approaches [from that of paragraph 25.1<sup>23</sup>] to their review and monitoring requirements, depending on how much control they exercise over the way their orders are executed.

It is certainly the case that the approaches taken may differ depending on how much control ISPs exercise over the way orders are executed. A firm that merely sends orders for execution will rely to a high degree on the executing entity. Alternatively, a firm that sends an order with instructions about how the order is to be executed “should monitor and review its own actions and their impact on the execution quality it is obtaining”.

Example: an ISP acting as RTO entity that receives an order to sell 50,000 securities and decides to split it into five orders of 10,000 securities for five different brokers should determine whether each broker has obtained best execution for the order to sell 10,000 securities rather than conduct an overall review of the execution terms for its order to sell 50,000 securities. The firm should also consider how appropriately it split up the order.

**Position:**

In accordance with answer 25.4 in the CESR Q&A, an ISP that transmits orders should also, during its review, consider the quality of execution actually provided by the entities to which it has entrusted the execution of client orders.

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<sup>23</sup> Investment firms that execute orders or decisions to deal should review and monitor the measures that they take to obtain the best possible result, as well as the performances of the execution venues that they use.

An ISP with the authorisation or status required to transmit orders and execute orders by itself shall furthermore compare the results obtained from these entities with those that it would obtain by executing the orders itself. Moreover, the firm shall examine the possibility of using other entities or of executing transactions itself provided that this is permitted under its authorisations.

These positions apply to all ISPs, regardless of its client categories (professional and/or retail)

## 6. Links between research and selection

To avoid a misinterpretation that would result in quality of research being excluded from the possible criteria for broker selection on the buy-side, the AMF stresses that, as indicated in the answer provided by the European Commission to question 112 of its Q&A<sup>24</sup>, while research does not have to be included in the criteria used to assess best selection, it may naturally be part of the overall policy for selecting brokers provided that an analysis of the quality of execution has been performed and that the cost of research is compatible with the need to act in the client's best interests.

## 7. Practices involving payment for order flows

In some situations, the best execution obligation has to be combined with other professional obligations placed on ISPs, such as those pertaining to benefits and remuneration and the identification and management of conflicts of interest.

This is notably the case for several practices that the AMF has become aware of that entail the granting of monetary or non-monetary benefits by some trading venues to certain members in exchange for order flows. These benefits may take the following forms:

- non-public price reductions;
- provision of tools or payment of connection fees, where the venue (or its operators) provides tools to connect to the venue free of charge;
- allocation of free shares, where members are offered an ownership stake in a venue.

These comments do not concern the standing pricing policies of execution venues that provide pricing benefits according to the volume of orders transmitted by members, as long as these policies are public and fair. They concern non-transparent practices that grant these benefits to certain members only.

### 7.1. Non-public price reductions

To be considered lawful, this practice must be assessed with regard to 2°) of Article 314-76 of the AMF General Regulation<sup>25</sup>, which establishes three criteria, all of which must be satisfied: transparency vis-à-vis clients, enhancement of the service rendered and compliance with the duty to act in the best interests of the client.

<sup>24</sup> cf. [http://ec.europa.eu/internal\\_market/securities/docs/isd/questions/questions\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/isd/questions/questions_en.pdf)

<sup>25</sup> 2° A fee, commission or non-monetary benefit paid or provided to or by a third party or a person acting on behalf of a third party, where the following conditions are satisfied:

a) The client is clearly informed of the existence, nature and amount of the fee, commission or benefit, or, where the amount cannot be ascertained, the method of calculating that amount. This disclosure is made in a manner that is comprehensive, accurate and understandable, prior to the provision of the relevant investment or ancillary service. Investment services providers may disclose the essential terms of the arrangements relating to the fees, commissions or non-monetary benefits in summary form, provided that they undertake to disclose further details at the request of the client and provided that they honour that undertaking.

b) The payment of the fee or commission, or the provision of the non-monetary benefit must be designed to enhance the quality of the relevant service to the client and not impair compliance with the investment services provider's duty to act in the best interests of the client;



**Position:**

The AMF considers that the criteria relating to enhancement of the service rendered and compliance with the duty to act in the best interests of the client set out in Article 314-76 may be satisfied only if these price reductions are both fairly and fully or partly passed on to clients. An ISP that kept such benefits might be encouraged to direct client order flows to the venue that grants them, which might not be in the best interests of its clients. Accordingly, in such a situation, the ISP must review these practices with regard to the obligations pertaining to the identification and management of conflicts of interest.

The AMF also recalls that pursuant to a) of 2° of Article 314-76, information should be provided to clients about such price reductions.

It additionally reiterates that the choice of trading venue should be made in a manner that complies with best execution obligations.

As the European rules currently stand, the AMF is not allowed to forbid this practice. However, an ISP that eschewed this type of practice could point this out to its clients.

7.2. Connection offers

**Position:**

The AMF considers that, to be acceptable, practices entailing the provision of connection tools must meet the following criteria:

- information about the connection offer should be made public by the venue and be available to all members and future members;
- the offer should not be dependent on reaching a certain volume of flows, which could encourage the ISP to not act in the best interests of clients by directing orders to the venue;
- clients must be informed about receipt of this benefit by their intermediary.

In addition, the choice of venue should be made in a manner that complies with best execution obligations and obligations relating to the prevention and management of conflicts of interest.

7.3. Allocations of free shares

**Position:**

The AMF considers that the allocation to an ISP of free shares by the operator of a trading venue in exchange for a given volume of order flows creates too great a risk that the ISP might not act in an honest, fair and professional manner that serves the best interests of its clients.

This position does not concern free shares allocated to established shareholders in proportion to their capital stake.

These positions apply to all ISPs, regardless of its client categories (professional and/or retail).

**8. Client disclosure concerning order execution procedures and financial instruments traded**

The AMF has noted an increase in complaints from individuals about CFDs, warrants and certificate products. Some of these point to a lack of understanding among investors about the products that they are dealing in, sometimes because they have received incomplete or confusing information.



The AMF reiterates that, in accordance with Articles 314-10 *et seq.* of its General Regulation, all ISPs must provide their clients with accurate, clear, non-misleading information.

Yet through its supervision of ISPs and in connection with its survey of best execution provided to retail clients, the AMF found that the information provided to clients – and on which they base their investment decisions – was sometimes unclear, incomplete or even misleading.

**Position:**

The examples given below are a sample of **practices that the AMF has observed and that contravene the obligation to provide clients with accurate, clear, non-misleading information:**

Example 1: confusing information on order placement screens

On an order placement screen, the displayed order book refers to a different market from the likely execution venue given the ISP's execution policy, potentially misleading the client about the execution venue.

Example 2: the ISP prioritises an execution venue solely because the execution fees charged by the venue are lower, concealing other material factors such as available liquidity

A balanced description must be provided of the risks and rewards, in accordance with the requirements set out in Articles 314-10 *et seq.* of the AMF General Regulation concerning clear and non-misleading information. Moreover, the type of communication cited in the example could encourage an investor to give specific instructions concerning the execution venue, so relieving the ISP of its best execution obligation towards the client in terms of the choice of execution venue.

Example 3: misleading CFD names

Some online CFD trading platforms offer products whose names may be misleading because they merely use the name of the underlying instrument.

Any communication that leads to confusion between equities and CFDs on equities should be banned. The name of the CFD should be clear and not create confusion with the underlying instrument.

Example 4: inadequate information on CFD expenses

If the expenses borne by the investor do not take the form of a commission but comprise a spread, the client is not provided with information about the size of the spread. The AMF considers that information should be provided on maximum remuneration spreads and the benchmark used to set the spread (example: mid-point of the underlying instrument on the reference market).

Example 5: the ISP creates confusion over dividend payouts in the case of a long position in a CFD on equities

Communications of this sort should be avoided. The ISP should clearly inform its clients that a long position in a CFD does not give entitlement to the same dividend payout as if the client owned the corresponding shares.



The AMF has also identified a number of good practices that it would like to recommend for application by ISPs:

**Recommendation:**

As regards CFDs, in general, information about the reference market<sup>26</sup> of the underlying instrument should be provided along with the price of the underlying instrument on said market to improve price transparency vis-à-vis clients.

However, while such information is easily achievable for an equity index or equities (because the underlying market is transparent), it is harder to provide in the case of other types of underlying (e.g. forex).

Furthermore, the AMF has noted that retail investors sometimes have a vague, even mistaken, understanding of the factors that determine the prices of certain traded financial instruments (particularly warrants and certificates). An explanation should be provided in a durable medium (for example, product information sheet, order placement screen) about the instrument's price sensitivity with respect to the main parameters.

**Recommendation:**

To provide the information referred to in Articles 314-33 *et seq.* of the AMF General Regulation, the ISP should inform its client of all the factors that influence the price and cost of the traded instrument.

In the case of warrants, the ISP should provide more extensive disclosures about the various factors influencing the price and highlight those that play a major role in valuation.

Note also that the provision of this information in no way relieves ISPs of the need to verify the appropriateness<sup>27</sup> of the proposed financial instrument or investment service as mentioned in Articles 314-49 *et seq.*

This position and these recommendations apply to all ISPs, regardless of its client categories (professional and/or retail).

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<sup>26</sup> The reference market means the most liquid market.

<sup>27</sup> Cf. AMF Position 2013-02 on gathering know-your-customer information.

## **MiFID: BEST EXECUTION / BEST SELECTION RULE**

### **CESR recommendations and clarification from the European Commission**

On 29 May 2007, the Committee of European Securities Regulators (CESR) published a set of recommendations<sup>1</sup> on applying the arrangements for best execution of orders under the Markets in Financial Instruments Directive (MiFID). The recommendations came with an annex providing clarification from the European Commission on the scope of the best execution rule, particularly in terms of its application to dealer markets, structured products, and investment services providers (ISPs) managing portfolios and receiving and transmitting orders. CESR's recommendations clarify a number of other points, including the content of the execution and selection policy, the scope of client disclosures and procedures for obtaining client consent, the respective responsibilities of ISPs that receive and transmit orders, ISPs managing portfolios and the firms with responsibility for order execution, monitoring of the quality of execution obtained, and effectiveness of the policy.

The analysis and guidelines proposed in the AMF consultation paper published in late July 2006 are now covered by European recommendations, which the AMF helped to prepare and which it has endorsed. The recommendations and clarification provided at European level provide European regulators with a shared interpretation of the provisions of the directive, which in most Member States and certainly in France, has been transposed verbatim into domestic regulations.

The AMF calls on ISPs, when implementing the rules, to refer to CESR's recommendations and the clarification provided by the European Commission, a French version of which is available on the AMF website. The recitals to MiFID and its implementing directive also provide useful information on interpreting the rules.

The AMF continues to dialogue with professional associations on applying the arrangements and notes that some associations are planning to prepare practical documentation for their members.

Based on the lessons learned during the first few months of applying the new rules, the AMF will work with affected parties, intermediaries and investors to review the merits of preparing specific guides for the different groups affected by best execution/best selection arrangements.

The document is available on the AMF website under Texts > Directives, CESR Recommendations, Acts, Decrees and Orders > CESR Recommendations.

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<sup>1</sup> CESR/07-320