Briefing

Financial Services Series
#10

BURGES SALMON

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Financial Conduct Authority thematic review: best execution and payment for order flow

This briefing looks at the FCA's findings from its thematic review of best execution and payment for order flow (PFOF). The results of this review were published in July.

The FCA's review is relevant to:

- firms which execute, receive, transmit or place orders for execution;
- portfolio managers; and
- buy-side firms.

as well as the advisers of such firms.

Key points from the Review

Best execution

Most firms reviewed were not doing enough to ensure that best execution is consistently delivered to clients. Appropriate management, front office business practices and support must be in place to deliver best execution.

Firms must understand the scope of their obligations in the area of best execution. One specific area of concern is firms' mistaken belief that best execution does not apply if any elements of a client's instruction do not allow for a firm's discretion. This is incorrect and in fact the remaining elements of the instruction will still be subject to the best execution policy.

PFOF

PFOF is the practice of an investment firm which executes client orders receiving commission both from the client originating the order and also from the counterparty with whom the trade is then executed.

The way execution services are paid for must be in the best interest of clients and be transparent enough to uphold integrity. The FCA does not consider PFOF to be compatible with the aims of transparency, efficiency or clients' best interests. The FCA has published detailed commentary on PFOF in FG12/13 but this review includes a reminder that action will be taken against firms which do not heed the FCA's warnings on PFOF.

Main issues identified by the review

Scope

This review has revealed failures of firms to understand the scope of the best execution obligation. Staff at the reviewed firms did not display sufficient comprehension of the best execution obligation and when it ought to be applied.

Monitoring

Pre- and post-trade monitoring was deemed to be inadequate at reviewed firms. The FCA emphasised that both front office staff and compliance departments should be involved in monitoring. Pre-trade monitoring is key to select appropriate execution venues while post-trade monitoring allows evaluation of trade performance. Measuring performance against a benchmark within permitted tolerances may be acceptable provided the benchmark and tolerance are selected appropriately.

Execution internally or through connected parties

The internalisation of orders and orders executed through connected parties were not found to be appropriately subjected to conflict management procedures. Internalisation of client orders may achieve benefits for clients and satisfy the best execution obligation, but firms must routinely monitor internal execution to ensure that an external third party would not be more beneficial for the client needs.

Accountability

Reviewed firms did not demonstrate sufficient internal structures of responsibility and accountability for best execution policies. Allocation of responsibilities should be reviewed annually and also whenever a material change arises.

Payment for order flow

Some firms continue to operate PFOF despite the FCA's previous warnings in FG 12/13. This review reasserts that firms which act as brokers and receive commission from both the ordering client and the counterparty will likely be acting in a conflict of interest and also breach inducement rules in COBS.

Actions

In light of this review and the warnings the FCA has issued about consequences if firms fail to revise their practices, firms should undertake the following actions as required:

- cease any existing PFOF arrangements;
- review the firm's execution policies in the context of when best execution is owed and what factors must be considered for best execution;
- distinguish between elements of client orders which are specific instructions and elements of orders giving the firm discretion thus demanding best execution policy be followed;
- consider systems in place for carrying out internalised client orders and orders executed through connected parties;
- review/produce client documentation which outlines execution policies to clients;
- review/establish training/monitoring/recording systems throughout the firm to ensure staff are aware of best execution obligations and the successes/failures of their firm's policy.

The FCA has indicated concern at the findings of this review and is likely to increase its focus on non-compliance with best execution obligations. Firms may wish to review their existing best execution policies in light of the FCA's recommendations, and seek guidance on any areas of uncertainty.

This briefing is a concise summary of some key issues raised by the review. Burges Salmon is well placed to offer more detailed advice on the contents of the review and how it applies to specific firms.

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