

Report on the Thematic Review of Best Execution

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Introduction

1. This report summarises the key observations identified in the Securities and Futures Commission's (SFC) thematic review on best execution. The review aimed to assess the effectiveness and adequacy of the systems and controls implemented by licensed corporations (LCs) to deliver best execution as required under the Code of Conduct¹ as well as to gather views on the latest market developments.
2. Delivering best execution is fundamental to market integrity and protection of investors who rely on LCs to act in their best interests during the execution process.
3. LCs should have in place arrangements to obtain the best available terms in respect of all types of financial instruments when executing client orders, taking into account price, cost, speed and likelihood of execution, speed and likelihood of settlement, size and nature of the order and any other relevant considerations. They should also take into account the characteristics of the financial instruments and the complexity and scale of their own operations.
4. The arrangements should be subject to periodic review to ensure best execution is delivered consistently. They should include controls, monitoring and management supervision to protect clients' best interests and ensure their fair treatment as well as to minimise conflicts of interest.
5. The review, covering 21 LCs including global financial institutions, asset management firms and local brokers, employed the following methodology.
 - a. The SFC sent questionnaires to the LCs to understand their practices in relation to best execution, o

7. This report highlights some good practices which go beyond our expected standards. It also outlines some less satisfactory practices which do not meet our expected standards. The examples of good practices are non-exhaustive and LCs should not regard them as

Findings

I. Governance and management supervision

Expected standards

Sufficient management oversight should be in place to ensure that trade exceptions and other matters related to best execution are brought to management's attention for timely review.

Policies and procedures regarding best execution should be established to cover different types of financial instruments, including both listed and over-the-counter (OTC) products, and should be reviewed and updated on a regular basis.

At a minimum, these policies and procedures should address the following areas:

- factors to be considered in delivering best execution;
- applicability of best execution and carve outs;
- monitoring and control mechanisms to review execution quality of trades; and
- the respective roles of the operational and control functions in ensuring best execution.

Where applicable, these policies and procedures should also address:

- handling clients' orders in cases where multiple quotes exist and where pricing information is insufficient or quotes are absent; and
- disclosure to clients of best execution arrangements including carve outs and the exclusive use of affiliates, connected parties and third parties.

All relevant staff should be provided with the necessary training and resources to ensure the effective implementation of best execution policies and procedures.

Policies and procedures on disclosure of best execution arrangements

5. Some LCs made policies and procedures available on public websites to disclose their general execution arrangements.
6. One LC would provide the written policies and procedures on best execution to clients when they opened accounts as a way to disclose best execution arrangements including carve outs for specific products and trade scenarios, rebates and soft dollar arrangements, exclusive use of affiliates and preferred brokers.
7. Another LC required its staff to maintain order execution records showing the time of order receipt and execution, quotes obtained and other information to evidence best execution. These records would be provided to clients upon request.

Good practices

Some LCs had post-trade execution reports, eg, reports comparing the execution outcomes of their clients' orders with bench(t)-6.6L4(4p(epo12.9(e)1

II. Best execution factors

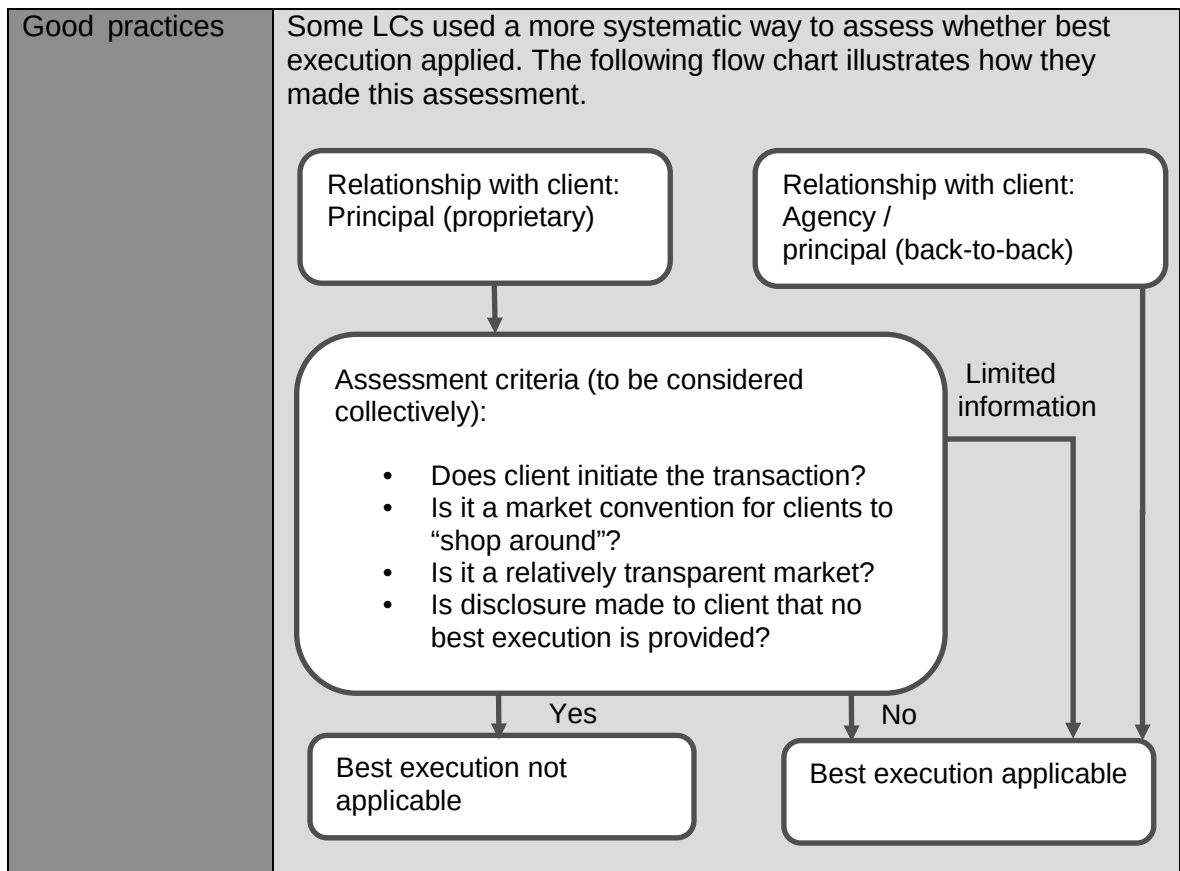
Expected standards

Sufficient steps should be taken to obtain the best available terms when executing client orders, taking into account 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 instructions should be assessed against multiple factors. Where a client has given specific instructions which cover one part or aspect of an order, this should not be treated as releasing LCs from their best execution obligations for other parts or aspects of the order.
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Observations

11. Some LCs listed in their policies and procedures different best execution factors, such as price, cost, speed and likelihood of execution, speed and likelihood of settlement and size and nature of order.
12. The LCs which specified execution factors all agreed that clients' requirements were



IV. Responsibilities of execution staff

Expected standards

Execution staff and their supervisors form an important first line of defence in the trade execution process. Reasonable diligence should be demonstrated in handling client instructions, monitoring execution outcomes and, where applicable, taking steps to obtain multiple quotes. In the absence of multiple quotes, execution staff should obtain sufficient pricing information on a best-effort basis to validate quotes provided to clients.
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Observations

Handling client instructions

18. Cases where execution staff might occasionally exercise discretion in executing client orders were common. For control and monitoring purposes, one LC required execution staff to properly record all orders requiring their discretion.
19. We observed the following practice which deviated from the expected standards.

For orders to be split for were common

V. Controls and monitoring

Expected standards

Controls and monitoring carried out by second and third lines of defence

VI. Arrangements with affiliates, connected parties and third parties

Expected standards
Due diligence should be carried out on affiliates, connected parties or third parties engaged for execution, and a systematic process should be in place to continuously monitor execution outcomes. LCs should take action to ensure that execution arrangements with affiliates, connected parties and third parties do not undermine the delivery of best execution. Regardless of whether orders are executed through affiliates, connected parties or third parties, the obligation to deliver best execution remains with LCs.

Observations

Selection and monitoring

29. A number of LCs engaged affiliates, connected parties or third parties to execute orders for their clients for various reasons, such as to execute orders for OTC products or overseas equities which were not directly accessible by the LCs. In general, they were able to demonstrate adequate selection criteria.
30. LCs' monitoring and controls for the selection of third parties differed. They also had different responses where the execution quality of third parties did not meet their expectations. In the case of a third party's poor performance, such as frequent execution failure, one LC would ban it for a period of time, reduce future transaction volume directed to it or even remove it from the approval list for execution.
31. We observed the following practices which deviated from the expected standards.

A number of LCs did not conduct ongoing monitoring or assessment of the execution quality of the affiliates, connected parties and third parties engaged for execution.

Some LCs did not have controls and monitoring for orders placed with affiliates and

Inducement arrangements

32. A number of LCs understood the implications of inducement arrangements with affiliates, connected parties or third parties. They stressed that obligations to deliver best execution to their clients remained the key priority. Soft dollars, rebates and other inducement arrangements would be clearly disclosed to clients in accordance with applicable regulatory requirements.

33. We observed the following practice which deviated from the expected standards.

Without other further assessment, one LC indicated that anticipating reciprocal order flows was a key consideration when selecting third parties for order execution.