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Iseli, Thomas; Wagner, Alexander F; Weber, Rolf H

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This paper explores the implications for investment firms and clients that arise out of an interpretation of the Market in Financial Instruments Directive (MiFID) best execution requirements from a law and economics perspective. While best execution is often framed as a matter of investor protection, research on market microstructure suggests that there is, in fact, an efficiency rationale (and not only a distributional rationale) for having some degree of best execution regulation. In terms of the specific rules of MiFID, the analysis reveals that an investment firm’s best execution policy will play a central role. MiFID’s best execution concept is process-based, ie investment firms need to show that they took measures leading to best execution in expectation; actual best execution is not required. The paper also discusses current issues such as the form of the execution policy and the appropriate number of execution venues.

A. Introduction

The Markets in Financial Instruments Directive (MiFID) will, for the first time, introduce unified requirements for the best execution of client orders in financial instruments in Europe. The concept of best execution itself is not new; on the contrary, it is one of the essential features in a principal–agent relationship such as that between an investor and his broker. What is new, however, is that the European Union has agreed to implement a legal context under which best execution is regulated in a common framework. Best execution is one of the central pillars of the MiFID and, as such, it holds numerous conceptual and practical challenges. Some estimate that the cost of MiFID could reach as much as €9bn over the coming years.

In this paper, we explore the practical implications for investment firms and clients that arise out of an interpretation of best execution requirements from a law and economics perspective. Investment firms throughout the EU — as well as in countries that have a close relationship with the EU such as Switzerland — are working to adjust their internal procedures to the requirements of the new directive. The purpose of this article is to provide a general background against which these attempts should be evaluated as well as practical guidance for investment firms in their endeavours.

We begin in Section B by describing the current framework of rules of best execution, ie the governing regulation before the MiFID was implemented, and juxtaposing it with the new MiFID rules. The central insight one obtains from comparing various existing rules is that MiFID brings a substantial change in the meaning of best execution for many European countries. Only a third of EU countries had a generalised best execution duty as envisioned by the MiFID; two-thirds concentrated on more specific criteria such as price.

To understand how to interpret those terms which necessarily remain imprecisely defined in MiFID, it is essential to have a sound understanding of the economic principles underlying the notion of best execution. Therefore, Section C motivates the need for best execution regulation, both in individual countries as well as across the European Union. The guiding principle that emerges is that best execution regulation should be understood to aim at minimising total transaction costs. This, in turn, allows more efficient interactions, leading to greater liquidity, market efficiency and, ultimately, greater allocative efficiency.

Section D then turns to the actual rules contained in MiFID. We find that they match well with the conceptual ideas of the economics of best execution discussed in Section C. Further we elaborate on the question of how investor protection and market efficiency are related and how potential conflicts between the two can be resolved.

Section E discusses how investment firms are to satisfy the best execution requirements in practice. A central point is that MiFID is a process-based set of requirements. This means that rather than actually providing best execution in each and every specific case, investment firms have a primary responsibility to have the proper policies and behaviours in place that in principle allow best execution to be achieved. We discuss special issues such as client instructions, number of execution venues, dealing on own accounts, and the format and content of execution policies.

Section F presents the planned next steps in implementation in EU Member States.

Section G addresses the issue of how firms that are active in the EU and in non-Member States need to approach best execution. In particular, we consider the case of Switzerland.
and the United States. While Switzerland knows a generalised best execution requirement, the US regulation currently is focused primarily on price and cost as the central criteria.

Section H concludes with three major principles and a concluding remark.

B. Current framework of rules of best execution

To set the stage for the analysis that follows, first the current legal situation in Europe is briefly outlined.³

1. EU-level (Investment Services Directive)

The primary target of the Investment Services Directive (ISD)⁴ was the procedure of admission and supervision of investment firms to harmonise to a minimum, EU-wide level.⁵

Although the ISD was wide-ranging in its scope, it did not specifically discuss best execution, much less provide a common definition or policy. Best execution would likely fall within the scope of its Article 11:⁶

“Member States shall draw up rules of conduct which investment firms shall observe at all times. Such rules must implement at least the principles set out in the following indents and must be applied in such a way as to take account of the professional nature of the person for whom the service is provided. . . . These principles shall ensure that an investment firm:

- acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market,
- acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market . . .”

Although a best execution rule may be implied from Article 11 ISD, the range of actual best execution policies implemented in practice demonstrates that European countries interpreted this concept quite broadly.⁷ Section B.2 provides details.

2. European and other countries

As mentioned above, there has been no standard definition of best execution in the European Union, since there is no single regulator to co-ordinate or direct changes to regulation. Each country in Europe has (under ISD) operated its own concept of best execution, making use of different terms with differing emphasis and levels of specificity.⁸

Table 1 summarises the key phrases from several European regulators in respect of the rules relating to best execution.⁹

Table 2 summarises the key phrases from other regulators in respect of the rules relating to best execution.

Taking these rules together, the following facts become apparent:

Table 2

<table>
<thead>
<tr>
<th>Country</th>
<th>Best Execution Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>“. . . all reasonable steps . . . in accordance with the instructions of clients and on the best available terms.”¹⁰</td>
</tr>
<tr>
<td>Switzerland</td>
<td>“. . . the orders of his customer are executed in the best way possible . . .”¹¹</td>
</tr>
<tr>
<td>USA</td>
<td>“. . . reasonable diligence to ascertain the best market . . .”¹²</td>
</tr>
</tbody>
</table>

³Art 5 para 2 Financial Advisers Act (Monetary Authority of Singapore, ACT 43 OF 2001); see also Investment Management Association of Singapore, Code of Ethics & Standards of Professional Conduct, Art 3 para 3: “Members should execute client orders on the best available terms, taking into account the relevant market at the time for transactions of the kind and size concerned.”
⁴Art 11 para 1(b) Swiss Federal Act on Stock Exchanges and Securities Trading (SESTA).
⁵NASD Rule 2320: “(a) In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favourable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a member has used ‘reasonable diligence’ are: (1) the character of the market for the security, eg price, volatility, relative liquidity, and pressure on available communications; (2) the size and type of transaction; (3) the number of markets checked; (4) access ability of the quotation; and (5) the terms and conditions of the order which result in the transaction, as communicated to the member and persons associated with the member.”
⁶
• There is great heterogeneity in terms of the rules that countries have implemented with respect to best execution.
• Eight out of the 15 surveyed countries (Finland, France, Holland, Ireland, Portugal, Singapore, Spain and Switzerland) have a generalised best execution concept.
• Four out of 15 countries focus on price alone (Denmark, Germany, Italy and Norway).
• The remaining three countries list price and execution time as the relevant criteria (Austria, Belgium, Greece).

Regarding the application of Article 11 ISD and its transformation into national legislation, no coherent court practice is known regarding these best execution rules.

The fact that Article 11 ISD was construed by the Member States in very different ways leads to juridical insecurity and considerably higher costs for investment firms and their customers involved. In 2001, the European Parliament reported the defects of the current regulation in Article 11 ISD. The Parliament found that the different way of implementing Article 11 ISD in national laws led to overlaps, to conflicts in the national legislation and finally to juridical insecurity. The reasons for these problems are the interpretation and conversion difficulties, which result from the current wording. In particular, the rules for monitoring of the best execution obligation led to misunderstandings. Another problem is that national legislation usually does not differ between private and professional investors (according to the idea of ISD, retail investors need more protection than professional investors). To eliminate these problems, the Parliament suggested adjustments and asked the Commission to discuss a proposal for a better regulation.

Given the fact that the MiFID introduces a generalised notion of best execution, the changes brought about by MiFID can be therefore dramatic for some countries. Since it is not yet known how countries will precisely implement (and goldplate) MiFID individually, this paper assumes that the best execution guidelines will be implemented as MiFID proposes.

C. The economics of best execution

To understand how any regulation of best execution (and MiFID in particular) is interpreted, it is necessary to understand what the purpose of rules requiring “best execution” is in the first place. The starting point is the idea that clients would like their brokers and the brokers’ dealers to most closely replicate their will in executing their orders. Thus, best execution is welfare-maximising execution, where the interest of clients may involve any number of inputs, including price, cost, speed and likelihood of execution, etc.

The chain of execution can take various forms. The Committee of European Securities Regulators has discussed a number of possible chains of execution. The basic arrangement is one where a firm exercises full control over how its client orders are executed (including, but not limited to, the venue selection), perhaps doing this on a case-by-case basis. For other types of trading, a firm creates trading strategies (including venue selection) for particular order categories. A third chain of execution involves a firm arranging for the execution of client orders indirectly via one or more intermediaries. This may still imply a significant degree of control on the part of the firm, because the firm may instruct the intermediary to use a specific execution venue. A fourth common setup involves the firm receiving the client order delegating control over the trading process to another execution intermediary. There are other approaches as well. All of these approaches fall under the category of agency trading. This method has the advantage of relatively low fees, but the implicit market risk costs fall to the investor.

To evaluate various ways of regulating best execution, a useful benchmark to keep in mind is the following: suppose that regulations designed to make the common market in Europe more competitive actually achieve this goal. That is, consider a perfectly competitive market. Then, the way best execution is regulated will not, in the end, affect net transaction costs for market orders. To see why, note that if brokers (or regulators) demand that dealers provide higher execution quality, retail commissions will rise (and/or ancillary services will fall). In other words, there is a trade-off between execution quality and the price and level of brokerage services.

However, in the real world, markets are not perfectly competitive. In particular, the relationship between traders and their brokers is a principal–agent relationship, i.e., a relationship characterised by diverging interests and, importantly, asymmetric information. A broker does not have the same interests as his client; on the contrary, while the client wants him to spend more effort finding better execution venues, the broker wants to minimise these search efforts, but the client cannot perfectly monitor these efforts. What results is a moral hazard problem, especially in illiquid markets. In addition, brokers possess private information about market situations that are not easily available to their principals, leading to a situation of adverse selection.

Because of both versions of the principal–agent problem, efficiency losses may arise. It is worthwhile noting that society at large – and not only specific investors – therefore suffer from poor execution standards. This is particularly obvious when one considers that economic agents do not know for sure on which side of a transaction they will be in the future, i.e., they are behind a veil of ignorance in that respect. Even that is not enough to lead to the conclusion that regulation is required, though. After all, although this conclusion seems merited in a static context, a dynamic perspective may imply a different outcome. In particular, one could argue that poorly executing brokers will die out anyway. Thus, customers looking out for their own interests would reward good brokers and punish bad brokers, leading to improved execution quality over time.

Still, there is a consensus – correctly, in our view – that market discipline alone is not sufficient if it is not accompanied by at least a basic, flexible type of regulation. The reason for this is simple. Market discipline only works if customers can in fact cheaply audit the quality of execution. More precisely, competitive market forces will induce brokers to supply exactly those services that customers can
easily audit. A central problem of any market discipline argument (also in other contexts) is that “you can’t buy what you can’t see”. Thus, suppliers who offer expensive quality that buyers cannot recognise can be undercut by those who claim to do so but do not. Most customers probably give more weight to their visible commission costs than to their less obvious built-in transaction costs. Thus, brokerages prefer low commission to good executions, because low commissions encourage customers to trade. More generally, investment managers and traders tend to focus on explicit transaction costs (broker commissions, exchange fees, taxes and stamp duties), while awareness of implicit costs such as bid–ask spread, market impact and especially operational opportunity costs, timing opportunity costs and missed trade opportunity costs tends to be much lower, even though impact on overall success may be much higher. Thus, buyers cannot recognise can be undercut by those who in some markets. As a general rule, it seems plausible that if buyers can’t see”.

The only way to measure total execution price quality is to compare actual execution prices with simultaneous trade prices and quotes, factoring in explicit and implicit transaction costs. Few retail traders have access to the transaction and quote records surrounding their trades. The process of comparing actual and potential prices is also time consuming: for an individual, the resulting information is quite costly relative to its value. For limit orders (which are advocated by virtually all trading handbooks for retail traders), verifying execution quality is even trickier. For example, how can a customer determine whether a limit order should have been executed. Finally, even if traders measure execution quality, what is the standard against which they measure it? One possibility is to trade with multiple brokerages to establish standards and use relative performance evaluation, but this takes time and effort.

All of this implies that market discipline alone is unlikely to be sufficient to eliminate less-than-optimal execution. In addition to the notion that individual efficiency losses are neither bounded by nor eliminated by long-term market discipline, a second insight is also relevant for best execution: efficiency losses due to asymmetric information are not restricted to individual agents. Rather, they add up and, indeed, can multiply. In particular, welfare will suffer when there is an externality in addition to the presence of asymmetric information. If two principals do not get best execution in buying and selling securities, this negatively affects market efficiency and liquidity, which in turn limits the efficiency-enhancing role of financial markets. Because liquidity and market efficiency are inextricably linked, and market efficiency is a necessary precondition for achieving allocative efficiency, it is appropriate to direct significant effort at the question of how to ensure minimal transaction costs on financial markets. In short, we can think of legal rules addressing the client–broker relationship as ways by which economic agents aim to encourage transactions by economising on transaction costs.

Because best execution rules are, therefore, in the public interest, it seems plausible that some sort of regulatory involvement can lead to welfare improvements. On a general level, economists have provided a number of conditions under which there is scope for welfare-improving restrictions on private contracts. In particular, regulating private contracts can be welfare enhancing if: (i) there is asymmetric information between the parties at the time of contracting; (ii) the contract between the two parties has an externality on a third party; or (iii) the courts can impose a remedy or penalty not available to the parties privately.

Our analysis in this section has shown that all three conditions are fulfilled in the context of best execution: brokers and dealers possess substantial asymmetric information at the time a client submits an order; there are potentially significant externalities on other market participants in terms of liquidity and market efficiency; and private parties have difficulties (or lack of incentives) in obtaining the information that would be required to measure best execution and hold investment firms responsible.

In a nutshell, then, there is a sound economic argument in favour of market-wide regulation of best execution. Nonetheless, significant challenges exist in the step from this general insight to an actual implementation of regulation consistent with the insight. The next section demonstrates how MiFID aims to address these challenges.

D. EU developments: the new best-execution MiFID rules

1. Background for new rules

The new Directive on Markets in Financial Instruments was developed against the backdrop of profound changes in the capital market and supervisory structures that resulted in recent years from the further development and diversification of capital investment instruments, trading systems and increased investor-protection requirements. As part of the drive towards a truly common market, MiFID aims to increase the level of transparency, the efficiency and liquidity of European capital markets. The new rules of best execution should also take defects of Article 11 ISD into account.

From 1999 to 2005, the EU-wide overarching policy and strategy in financial services and financial markets was delivered in the framework of the Financial Services Action Plan (FSAP). The Commission continues to regularly monitor progress made in implementing the FSAP, for instance through making twice-monthly updates to its FSAP transposition tables. Work also continues on co-ordinating the initiatives driven by the FSAP, including the structured financial services committee architecture (Lamfalussy approach), the Inter-institutional Monitoring Group and supervisory convergence. The FSAP laid the foundations for a strong financial market in the EU and has already brought about many changes; MiFID is one example of the efforts to complete the single market in financial services.

In the case of MiFID, the Lamfalussy approach has been used; this aims at efficient adjustments and supervision structure of the regulation as well as fast decision-making and an appropriate standardisation of the supervision rules.
Under the Lamfalussy approach (applied to the securities sector since 2002), framework Directives agreed by co-decision – such as those on Market Abuse and on Prospectuses – set out clear principles to be followed. They also define the scope for technical implementing instruments to be decided by the Commission, with the assistance of the European Securities Committee (ESC) made up of Member State representatives and taking into account technical advice received from the Committee of European Securities Regulators (CESR), composed of national supervisory authorities. CESR also aims to ensure the consistent implementation of EU securities law in the Member States.30

2. A brief history of MiFID

In 2000, the Commission released a paper about the application of conduct of business rules under Article 11 ISD and the experience of Member States in adopting detailed national provisions implementing the general principles of Article 11 ISD. They have introduced conduct of business rules to protect consumers and investors which cover also fair dealing requirements such as “best execution”.31 As shown above,32 the national rules are not unitary. Member States differ in terms of the procedures used to give effect to best execution. For example, Member States place different emphasis on prevention of conflict of interest, prohibition of activities such as churning, prescriptive rules on order and time limits, allotment and information disclosure.33

In 2001, one core element of the preliminary consultation of the revision of ISD was the modernisation and harmonisation of the investor protection rules incumbent on investment firms so as to ensure a high level of investor protection and facilitate the cross-border provision of investment services and to promote the integrity of the market.34 In other words, best execution should be an instrument to protect “public goods” and to establish clear “lines in the sand” to protect investors.35


In 2004, the European Parliament approved the proposed Directive.38 Rules about best execution are found under Article 21 with the title “Obligation to execute orders on terms most favourable to the client.”39

In 2005, a proposal for a directive extending the transaction and application deadlines for MiFID was published. This Directive40 finally was published in 2006.

In 2006, the Commission published the draft of the Implementing Directive and consultation responses received during public consultations in 2005 on DG Internal Market Services’ working documents on the possible implementing measures under MiFID.41 Finally, in September 2006, the Implementing Regulation42 and Implementing Directive43 were published in the Official Journal.44

3. Main goals of best execution according to MiFID

MiFID’s perspective on best execution is generally consistent with the economic interpretation of the best execution principle that we gave above. In particular, MiFID speaks both to the individual level and to the social (market) level.

(a) Favourable terms for clients and market efficiency

The main target of the new best execution rules under MiFID is investor protection, as MiFID states itself in a preliminary remark:

“It is necessary to impose an effective ‘best execution’ obligation to ensure that investment firms execute client orders on terms that are most favorable to the client. This obligation should apply to the firm which owes contractual or agency obligations to the client.”45

As well as safeguarding investors’ interests, best execution shall improve market efficiency by making sure the most efficient trading arenas, with the lowest costs to the client, are rewarded with more business.46 Article 21 MiFID also references the “the fair and orderly functioning of markets”.47

In the light of these goals, MiFID aims to reinforce the existing best execution obligations of ISD with stronger requirements and make them more homogeneous across all European countries to make sure investment firms execute orders in a way that provides best value for the client.48

(b) Relationship between the goals

MiFID does not discuss a priority of either investor protection or market efficiency, but rather assumes that the two are always compatible. It is obvious that this is not necessarily so when one considers multiple clients that are trading against each other. From a social perspective, it can be desirable that trade occurs, eg because it induces greater volume on the market, which in turn positively affects the willingness of other agents to enter the market, making it more liquid and ultimately more efficient. But protection of individual interests might imply that trade should not occur because each investor would be better off with execution on a different market.

The solution to this conundrum is to recall what the basic guiding principle of best execution is, namely to minimise transaction costs, independent of whether a particular transaction that is desired by two parties is in the best interest of the parties. Best execution regulation can only address one issue, namely transaction costs. It is true that there is also the question of how to allow people actually to make better choices on markets; however, one should not – and cannot – expect one instrument to deliver two goals at once.

There is also a second kind of conflict between the goals of best execution that can be resolved with this sort of approach. In particular, consider a “behavioural investor”, ie an investor who is not behaving according to the same principles as Homo economicus. There is now a large amount of evidence that individuals – “mom and pop” investors as well as professional investors – suffer from cognitive biases,
use rules of thumb, show regret and aversion to losses, etc.\(^5\) When such an investor sends an order to his broker, it is not clear that, objectively speaking, this order is in the best interest of the investor. It could be that adding this order increases liquidity on the market and therefore has social benefits, while actually hurting the welfare of the investor. In principle, the answer to this question is straightforward: best execution is not designed to solve the cognitive deficiencies of investors; it is designed to allow investors who, for whatever reason, have subjective preferences for a certain trade to be implemented to achieve this goal in the best possible way. In this sense, best execution is a formal criterion, not a content criterion. This viewpoint also avoids the problem that it would otherwise be possible and desirable for investors to claim deviating “true” interests. What matters is the will of the investor that is communicated at the time of the order. Summarising this analysis, one way to interpret the goals of best execution regulation is that it aspires to help minimising societal (not only individual investor) transaction costs. It does so by protecting investors within the range of their stated preferences, and thus smoothing the functioning of markets, but not by aiming to improve decisions made by individual traders.

E. Scope and detailed requirements of the new MiFID best execution rules

1. Basic considerations

The impact of the MiFID best execution rule is on investment firms.\(^5\) “Member States shall require that investment firms take all reasonable steps to obtain, when executing orders, the best possible result for their clients.”\(^5\) MiFID applies to client orders in relation to financial instruments, including fixed-income and over-the-counter (OTC) (structured) products, thus extending the scope of products covered compared to previous regulation. “Execution” is defined reasonably broadly, but not extremely so. For example, when an investment bank receives the mandate to find a buyer for a company, this is not qualified as an order to be best executed.\(^5\) In other words, MiFID proposes a benefit–cost calculation: improving best execution for clients yields additional benefits, but it also brings with it increased cost for the investment firms. The general rule presented by Article 21 MiFID does not provide a benchmark for what “reasonable” steps are, but the spirit of MiFID seems to suggest that the present level (ISD) of effort of many firms is not yet sufficient. The FSA states that the new framework established by Article 21 is therefore a reasonably high level.\(^5\)

2. Relevant aspects of best execution according to MiFID

Welfare of investors giving orders to their brokers derives from numerous factors. For individual investors, price at first sight appears likely to be most important. (To be more precise, it is price net of costs.) For quantitative and professional traders, speed matters a lot. But things are not so simple and clear cut. For example, a 2000 survey\(^5\) indicates that 58 per cent of online investors value speed over price. The reason for this high number is probably that people wildly overestimate their trading ability or the degree of private information they have. In particular, information is short lived. Thus, if an investor has — or believes he has — superior information, he will generally be less patient, and fast execution becomes more important.\(^5\) Note that speed also matters indirectly to retail investors even if they do not possess private information themselves, because the fortunes of investors’ funds may depend on it.

Accordingly, MiFID recognises as relevant factors the price, cost, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order.\(^5\) At the very least, these are the criteria that need to be measured in order to be able to verify the quality of execution. There is a basic match of these criteria with the explicit and implicit transaction costs listed earlier.

3. Criteria for determining the relative importance of the factors

The flexibility offered by MiFID is both appealing and challenging, on a theoretical and practical level. To see this, consider two “execution vectors” with two elements (price and speed) each. The only circumstance in which we can unambiguously say that execution was better is when price is lower and speed is faster in one of the two cases. For example, one sale was executed at €15 within 1 minute, while the other trade was executed at €14 within 90 seconds. In this case, the first trade clearly was better executed. But this is rarely the case. A more likely scenario is that, for example, one sale was executed at €15 within 1 minute, while the other trade was executed at €14.95 within 45 seconds. Thus, we must consider trade-offs. Empirically, there seems to be a trade-off between price and speed, for example, at least in US equities trading.\(^5\) A more subtle, but also important type of trade-off exists between opportunity costs and market impact. For example, splitting large orders over time to reduce market impact can lead to larger opportunity costs and vice versa.

Consistent with the idea that nobody knows which factors are the most important in a particular case, MiFID defines some general aspects according to which the trade-off between factors can be defined. Article 21 paragraph 1 of MiFID defines the following criteria for determining the relative importance of the factors (price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order)\(^5\) referred to above as “relevant factors”:\(^5\) (a) the characteristics of the client, including the categorisation of the client as retail or professional; (b) the characteristics of the client order; (c) the characteristics of financial instruments that are the subject of that order; (d) the characteristics of the execution venues to which that order can be directed.\(^5\)
4. The central role of the execution policy

Summarising the previous two sections, we can see that the system of MiFID is to (a) define relevant factors for best execution (but not weigh them), and to (b) define relevant characteristics for weighing the relevant factors (but not weigh them either).

This system of governance is interesting from a theoretical point of view and quite reasonable from a practical point of view. It posits that regulators at the European level (and at a Member State level) know which factors matter, but do not know how much they matter. Thus, MiFID leaves some flexibility to investment firms in determining the relative weighting of factors. But because the relevant factors as well as the characteristics for weighing the relevant factors are listed, investment firms need to specify how and why certain characteristics matter in this or that way.

Investment firms have to be able to prove that they considered both the factors and also the criteria for determining the relative importance of these factors. The tool MiFID gives firms for documenting their views and promised actions is the so-called “execution policy”. The specification of the execution policy is perhaps the central issue for investment firms. MiFID really concerns the process by which an investment firm aims to achieve results for its clients, not the actual outcomes.

Investment firms are required to establish and implement an order execution policy to allow them to obtain, for their client orders, the best possible result. The order execution policy shall include, in respect of each class of instruments, information on the different venues where the investment firm executes its client orders and the factors affecting the choice of execution venue; it shall at least include those venues that enable the investment firm to obtain on a consistent basis the best possible result for the execution of client orders. Investment firms have to provide appropriate information to their clients about their order execution policy and obtain the prior consent of their clients to the execution policy. The implementing measures provide that a firm also must disclose to retail clients the execution venues in its execution policy on which it places “significant reliance”. An important issue for firms is whether they can satisfy MiFID requirements if their execution policy includes just one execution venue or execution provider. It is quite likely that firms can minimise execution costs by doing so, because there may be volume discounts. Similarly, choosing one affiliate firm for executing all client orders would not appear to violate best execution requirements in general. For example, in practice, a client (C) of a portfolio manager (M) may be served best if the manager selects an appropriate investment firm (F) for executing all his orders. It seems reasonable to require that M retains competitive offers every now and then, checking in detail to which extent C would recognise F’s execution as “best execution” if C dealt directly with F. Factors such as the size of the market and the characteristics of the financial instruments traded need to be taken into account in this consideration, and no final statement can yet be made on the general appropriateness of a regime with a single execution partner.

With these new rules, investment firms will formulate the execution policy and reflect it in general terms and conditions. The client has to consent to the execution policy as well as to the possibility that his orders may be executed outside a regulated market or a MTF. The client will in reality usually be able to negotiate this contract. If he refuses to sign, the investment firm will no longer accept him as a client. In contrast to this, another point may be positive for clients: unlike the existing regime (especially in the UK), there is no longer any facility for contracting out of best execution.

Investment firms also have to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies. In particular, they must assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or if they need to make changes to their execution arrangements. Investment firms have to notify clients of any material changes to their order execution arrangements or execution policy. Finally, investment firms have to be able to demonstrate to their clients, at their request, that they have executed their orders in accordance with the firm’s execution policy.

From an economic, incentives-based point of view, the central challenge in implementing execution policies is how to design them so that they are credible. Because transaction cost indicators are numerous and subject to significant interpretation problems (see Section E.6(b) below), achieving this credibility is not trivial. A successful execution policy explains how the indicators used to measure transaction costs overcome the problems of noise in measurement and bias in estimation. But there are not only technical issues. Importantly, there are potential “gaming problems”, i.e., problems arising out of the asymmetric information rampant in this context. In particular, intermediaries may be able to use their superior knowledge about the benchmark price that will be used to measure transaction costs to the disadvantage of clients by timing the trade accordingly. Establishing an execution policy alone may not be enough to overcome the credibility challenge that these possibilities pose. Instead, it is a matter of the general credibility of an investment firm.

The bottom line of all of this analysis is that the execution policy which documents how an investment firm intends to create value for its customers will be an extremely important factor in credibly communicating about execution quality. There is an interesting strategic interplay: investment firms have an incentive to ensure that they obtain execution quality sufficient to satisfy their clients – to the extent that clients can recognise such quality. If the execution policy shows clients which features are part of the execution quality auditing, they will pay greater attention, increasing the incentives for the investment firm to do so as well. As such, specifying a demanding execution policy can also provide an opportunity for investment firms to improve their internal workings in the process of implementing MiFID.

In order to comply with the requirements of MiFID and national implementing legislation, investment firms and
other regulated entities may have to introduce new information technology systems, new organisational structures, and reporting and record-keeping procedures, or to make significant modifications to existing systems and practices. This can only be done once the contents of the implementing measures to be adopted by the Commission and of the national legislation transposing the Directive are settled. An active best execution policy should ensure that investment firms consider trading conditions on a range of trading venues, and make use therefore of “smart” order-routing techniques in order to seek out the best bargains for their clients according to the policy. An important element of the provision of best execution is the requirement that the investment firm regularly reviews the procedures that it operates so as to obtain best execution on behalf of its clients. The investment firm should continually assess and update the arrangements which it employs to execute client orders to ensure that they are delivering the best possible result for client orders. The data that investment firms should record and report naturally differ by order type. For market orders, descriptive statistics include average price improvement and average time to fill. (These data are especially informative when they are classified by prevailing bid/ask spread, order size, security size, etc). For limit orders, interesting statistics include fill rate and time-to-fill distributions, classified by limit price position. Classifications by prevailing bid–ask spread, order size, primary listing market and time of submission prove helpful. The information necessary to evaluate the effect of cancellations should also be available. That these statistics should be available is not asking too much (for liquid markets in particular), particularly given the requirements faced other industries. (For example, it is standard that airlines must report their on-time performance.) As we have discussed earlier, only if all this information is available will customers have a chance to choose the service they want. Thus, it is in the interest of the best executing firms to publish their statistics. This is not the place to review transaction costs indicators comprehensively. Edhec–Risk–Advisory provides a critical analysis of some of the most popular indicators, including (1) spread midpoint benchmarks (which are easy to implement but which do not indicate whether the trade is well timed and deliver poor insight into the quality of execution for large orders completed through multiple trades); (2) volume-weighted average price (which indicates whether the trader received a higher or lower price than did the average trader, but which is noisy, potentially biased (eg for momentum traders), subject to gaming and particularly uninformative if the trade being analysed is the dominant trade in the measurement interval); (3) closing price benchmark (which has the advantage that it cannot in general be gamed, but which suffers from noisiness for trades completed at the start of the day); (4) average of the lowest, highest, opening and closing prices (which is common, but ignores market depth and may include irrelevant reference prices); and (5) implementation shortfall (which is the primary method aimed at estimating implicit transaction costs, but which requires a large amount of data and requires a benchmark price which may be hard to determine). Edhec–Risk–Advisory also presents an alternative method which does not permit us to review here. An open question is the extent to which execution policy will become a matter of competition between investment firms, or whether one single policy will be adopted by virtually everyone. Only time will tell. 5. Specific issues related to best execution (a) OTC markets Member States shall require that, where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the investment firm shall, inform its clients about this possibility. Member States must require that investment firms obtain the prior express consent of their clients before proceeding to execute their orders outside a regulated market or an MTF. Investment firms may obtain this consent either in the form of a general agreement (execution policy) or in respect of individual transactions. The Committee of European Securities Regulators (CESR) is expected to amend its previous consultation (level 3) on OTC markets soon; it then remains to be seen how Member States react. (b) Customer instructions Whenever there is a specific instruction from the client, the investment firm shall execute the order following the specific instruction. Investment firms must in that case provide retail clients (in good time prior to the provision of the service) with a clear and prominent warning that any specific instructions from a client may prevent the firm from taking the steps that it has designed and implemented in its execution policy to obtain the best possible result for the execution of those orders in respect of the elements covered by those instructions. Client instructions are likely to address only some aspects of execution. Even if a firm receives a specific client instruction regarding, say, execution venue selection, that firm would need to follow relevant provisions of its execution policy and agreements for those aspects of the transaction that are not governed by the instruction. (c) Standards The competent authority is not required to verify that the investment firm obtains the best price in respect of all transactions that it undertakes on behalf of clients. Instead, the competent authority has to verify that the investment firm operates procedures which maximise the probability of its clients obtaining best execution having regard to the best terms that are available at the different execution points that make up the marketplace. This rule makes sense from an economic point of view. An important aspect of a successful provision will be to provide an indication of the conditions under which an investment firm can be considered to have undertaken reasonable endeavours to obtain best execution on behalf of its client – notably by ensuring that it has access to a sufficient range of the venues which consistently deliver best execution.
F. Implementation of the MiFID best execution requirements

1. Process of implementation

Originally it was planned that national legislators would be required to implement MiFID by 31 January 2007, whereas investment firms would be obliged to apply the Directive by 1 November 2007.

In April 2006, the European Parliament implemented a Directive to shift certain deadlines for the national adoption of MiFID. The Parliament states in that directive the following: given the postponed deadline between the obligation for Member States to transpose MiFID into national law and the deadline for investment firms and credit institutions to comply with the new requirements, the provisions of MiFID will remain ineffective until 1 November 2007.

In its work programme published in December 2006, the CESR (Level 3 of the Lamfalussy procedure) sets out its immediate priorities; these also include best execution. Papers on best execution are planned for publication. CESR is aiming to reach conclusions on all of these pieces of work. In February the CESR published a consultation paper, which was discussed at an open hearing on 7 March 2007. The consultation was closed on 16 March 2007, but the results of the consultation are not yet published.

2. Preparations for implementation in countries

With the examples of the UK, Germany and France, we can see how the EU Member States have started to plan the conversion of the MiFID regulations with special regard to the best execution conversion.

(a) UK

In May 2006, the Treasury and FSA jointly published an implementation plan for the MiFID. This plan sets out the approach to, and programme for, consulting on and making the necessary changes to the Financial Services and Markets Act (FSMA) and its secondary legislation, as well as the FSA Handbook, to meet the transposition deadline. That consultation programme was complete in January 2007 and the necessary changes to FSMA and its secondary legislation, and to the FSA Handbook, to deliver transposition had been made.

The proposed approach (“key issues”) to the transposition of the MiFID by the FSA was: to intelligently copy out the relevant MiFID requirements; to remove existing provisions that were, as a consequence, inconsistent, considered redundant or unnecessarily prescriptive – reflecting the move towards more principles-based regulation; to be sparing in the use of guidance; and to retain or add other requirements beyond the MiFID minimum only where necessary for delivery of UK statutory market confidence and consumer protection objectives, where justified in their own right (including on grounds of a suitable cost–benefit analysis), and where permissible under the terms of the Directive – including, where relevant, Article 4 of the Level 2 Implementing Directive.

The FSA published a Discussion Paper (DP) on MiFID’s best execution requirements in May 2006 and a policy statement in January 2007, which also deals in detail with best execution. Many firms, trade associations and other interested parties have provided detailed responses to the DP, commenting on the issues discussed in the DP and raising a myriad of other issues. The FSA has taken this feedback into account and it will also continue discussions with stakeholders about more specific issues of implementation. The FSA intended to delete all the existing COB requirements and replace them in NEWCOB with “intelligent copy out” of the MiFID text. There are no proposals to apply these requirements to any business other than MiFID business. The FSA will review its implementation approach on best execution once the outcome of CESR (level 3) is known.

(b) Germany

The Federal Department of Finance published in September 2006 a draft for the conversion of MiFID, which transforms the rules of MiFID in large parts one to one. The legislative procedure was finished in March 2007. The German Bundestag concluded the act on 29 March 2007, and finally discussions on this by the Bundesrat are due to take place in May 2007.

The implementation of MiFID by the financial market conversion law will considerably change German banking, stock exchange and capital market law. The German legislator is planning not only to implement the Directive, but it is also envisaged to change certain information requirements with regard to forward transactions at the same time. The rules of best execution are stated in paragraph 33a of the changed securities trading law.

The German Stock Exchange in Frankfurt implemented several steps to ensure best execution compliant with MiFID for investment firms trading with “Xetra BEST”. The stock exchange in Stuttgart also published a manual about best execution containing their measures to fulfil the new MiFID rules.

(c) France

In July 2006, L’Autorité des marchés financiers (AMF) published a consultation paper on enforcing the best execution principles in MiFID and its implementing directive. The framework stemming from MiFID is similar to the general principles embodied in the AMF General Regulation, but MiFID sets rules that are far more detailed than the existing provision of the AMF General Regulation on the same subject.

The AMF has made the “better regulation” approach recommended by the EC a central goal of its rule-making policy for the years ahead. Accordingly, when it transposes MiFID into its General Regulation, the AMF ensures that the European rules are incorporated as faithfully as possible into the French regulatory corpus.

The AMF’s paper on interpreting the best execution rule, which was put out to consultation in July 2006, will be finalised in the context of CESR-led work (level 3).
AMF additionally launched a consultation on draft amend-
ments to Book V (Market Infrastructures) of its General
Regulation with a view to transposing MiFID in delay.105

G. Some aspects of the relation to non-Member
States

We cannot comprehensively discuss the implication of
MiFID’s rules for non-Member States. However, we wish to
highlight a few aspects for Switzerland and the US.

1. Switzerland

As a non-EU Member State, Switzerland is not legally
required to modify its laws, regulations and administrative
provisions to comply with MiFID. However, some Swiss
Institutions may see benefits of becoming MiFID compliant
because of competitive market pressures, even if they do not
offer cross-border services according to MiFID’s scope and
do not fall under EU regulation from a formal legal
perspective. For that reason, MiFID will not be without
influence for the Swiss finance community.106

In particular, European-wide and globally acting Swiss
banks and investment firms formed working groups in order
to evaluate the effects of MiFID for their institute and to
conclude appropriate measures. UBS, for example, does not
plan a complete conversion of the MiFID rules, but they
want to be ready with some adjustments for MiFID by
November 2007. They see the conversion particularly as an
IT problem with regard to smart order routing technologies.
The largest Swiss bank sees also business chances due to the
new rules in the European bank industry.107 Another very
important point for Swiss banks is the question of liability.
The banks should validate and adjust internal processes and
record every contact with the client to have proof in case of a
liability lawsuit.108

Furthermore, the Swiss Federal Banking Commission109
built a taskforce to analyse the new MiFID rules and their
impact on Swiss firms.110 They also held conversations with
the Swiss Bankers Association, SWX Swiss Exchange and
the national fiscal department to these developments. The
Banking Commission wants to strengthen exchange of
views with the market participants in Switzerland and in
Europe. It continues to pursue the developments of Europe
and examine the need for possible regulatory action. The
Banking Commission is very interested in the latest
developments in Europe and so, in Autumn 2006, a meeting
took place in Paris between the CESR and the Swiss
Banking Commission at which it was agreed to continue
the dialogue between these two parties annually.111 The
Banking Commission has not yet published results of the
work in the taskforce.

The Swiss Bankers Association112 also formed a working
group to analyse impacts, chances and risks of MiFID for
Swiss banks. The working group suggests that banks and
especially Swiss politicians are waiting for the final
conversion of MiFID in European countries before getting
active.113

2. United States of America

It is possible that a number of the US (and also
non-European) investment banks may decide to sell off their
European business to European banks that will have
expended considerable effort to comply with MiFID.114 On
the other hand, 60 per cent of US investment firms are using
or experimenting with algorithmic trading. Algorithmic
trading is a logical extension of rules-based trading – it is
just that over the last five years, the rules deployed by
execution agents have become increasingly sophisticated.115
In that sense, the investment firms would be ready to adapt
new rules (like best execution in MiFID) relatively easily.

The US Securities and Exchange Commission (SEC) has
a MiFID-like approach to best execution and formally
approved in June 2005 the Regulation National Market
System (NMS).116 Scheduled to be fully implemented (like
MiFID) by November 2007, these new rules are designed to
strengthen and modernise the regulatory structure of US
security markets. In particular, they are intended to provide
better transparency and consistent access to market and
offers regardless of trading centre.117

According to meet appropriate measures, big US investment
firms with adequate resources would like the big Swiss
banks to check what influence MiFID could have on their
businesses, especially with Europe, and therefore check with
working groups which measures would be appropriate
concerning the new European regime.

H. Concluding remarks

The best execution obligation under MiFID is governed by
three major principles:

1. an obligation of establishing means of usually achieving
   the best net result for the client;
2. documentation of an execution policy that includes the
   execution venues and documentation of the parameters
   that justify these choices;
3. an obligation for investment firms to demonstrate, at the
   demand of the client, that execution has been carried
   out in accordance with the agreed execution policy and
   that the execution policy allows achievement of the best
   possible result on a consistent basis.

All three parts indicate that best execution is a process-based
requirement for firms.

In interpreting these basic principles, we have adopted a
law and economics analysis. While investor protection is a
central motivation for MiFID, the analysis reveals that, in
many cases at least, effective investor protection will also
have positive externalities on the functioning of markets. In
particular, better execution requirements are likely to result
in a reduction in total implicit transaction costs. Of course,
achieving this goal can be costly, and it seems surprising that
little analysis is available that rigorously compares the social
benefits with the total costs of implementing the new
requirements. It is true that MiFID is likely to help the
European Union single market take another step forward, and one is inclined to believe in the overall positive net present value of the project. Nonetheless, it would appear prudent in future regulatory attempts to begin with a standard, best-practice benefit–cost analysis. In policymaking, that would be best execution.

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Best execution is partly determined by the market environment in which it is placed and has also become a cross-market issue and therefore cannot be viewed in the isolation of a single market. S McCleskey, Achieving Market Integration (Oxford University Press, 2004), 41.


4 See P Nobel, Schweizerisches Finanzmarktrecht (Bern 2004), s 5, n 122ff for details.

5 McCleskey, supra n 3, 60.

6 McCleskey, supra n 3, 60.

7 See KID Garbade and WL Silber, “Best Execution in Securities Markets: An Application of Signaling and Agency Theory” (1982) 37 Journal of Finance 493–504, for the definition of best execution in terms of how a rational agent would trade his own securities. A separate question is whether investor protection per se is the goal of best execution regulation, or whether there are additional aspects.

We will return to this question below.

8 LE Harris, The Economics of Best Execution (1996).

9 ibid, 3. For one of the earliest empirical analyses trying to quantify various costs for the New York Stock Exchange, see H Demsetz, “The Cost of Transacting” (1968) 82(1) Quarterly Journal of Economics 33–53.

10 For a detailed summary of explicit and implicit transaction costs, see Edhec-Risk-Advisory, supra n 2.


12 It is worth noting that MiFID does not address another important component of total execution costs, namely, settlement costs at all.


15 As Macey and O’Hara, put it: “The rules requiring best execution supply for free certain contractual terms to everybody who buys or sells securities through an agent. . . . From this viewpoint, the law of best execution supplements, but never displaces the actual bargains that exist between traders.” See JR Macey and M O‘Hara, “The Law and Economics of Best Execution” (1997) 6 Journal of Financial Intermediation 193.


19 Indeed, BE Hermelin and ML Katz, “Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach” (1999) 9 Journal of Law, Economics, and Organization 230–55 establish that these are the only three possible cases in which outside interference in private contracting has the potential to be welfare improving when agents are rational.


21 cc.europa.eu/internal_market/finances/index_en.htm.

22 See also RH Weber and T Iseli, Solvenzaufsicht als Risikokontrollinstrument im Versicherungsbereich, in RH Weber and D Zobl (eds), Risikomangement durch Recht im Banken- und Versicherungsbereich (Zürich, Basel, Genf, 2006), 75, 88–89.

23 IP/03/1507.
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32 See Section B.2.
33 Commission, supra n. 31, 9.
35 Keynote Speech by Director-General Alexander Schaub, Conference on European Regulation of Investment Services (Copenhagen, 2002), 9–10; see also Section C of this paper.
36 Art 19 para 1 of the proposal: “Member States shall require that investment firms providing services which entail the execution, whether by the firm itself or another investment firm, of client orders in financial instruments ensure that those orders are executed in such a way that the client obtains the best possible result in terms of price, costs, speed and likelihood of execution, taking into account the time, size and nature of customer orders, and any specific instructions from the client.”
37 See IP/03/1352.
38 Directive 2004/39/EC.
39 This rule is discussed in section 5 of this paper.
40 Directive 2006/31/EC.
44 An overview of the EU Developments can also be found at the MiFID–Websites: ec.europa.eu/internal_market/securities/isd/index_en.htm and ec.europa.eu/internal_market/securities/isd/mifid2_en.htm.

71 Bordernote 33 MiFID.
45 The best execution obligation not only applies to investment firms that execute client orders. It also applies to portfolio managers who in the course of doing so place orders with third parties (T Bischof, “The Markets in Financial Instruments Directive (MiFID), its Impact on Firms and Markets, and Potential Impacts on the Swiss Capital Market”, in TU Reutter and T Werlen (eds), Kapitalmarktransaktionen vol II (Zürich, Basel, Genf, 2007), 127–56, 145).
51 Art 21 para 1 MiFID.
52 Portfolio managers probably do not have to monitor all the steps that execution intermediaries take on their behalf in executing their client orders.
53 FSA, supra n 16, 11.
54 Cited in Harris, supra n 18, 3.
55 Note also that the same is true when the investor merely thinks she has superior information. We suspect that the latter effect was especially pronounced in the internet bubble.
56 Art 21 para 1 MiFID.
57 The US SEC has favoured the trade-through rule, ie the notion that price is the most important factor and that it is not allowed to execute faster but at a slightly worse price. We will come back later to a more detailed comparative analysis of European and US rules. To our knowledge, no comparable study exists for European equities prices. See X Cai, “Treading Through Trade-through: A Law and Economics Analysis of SEC Proposed Regulation NMS” (2005) Cornell Law Review, who provides a nice overview of the ongoing discussion.
58 Art 21 para 1 MiFID.
59 Art 44 para 1 of the Commission Directive 2006/73/EC.
60 Art 21 para 6 MiFID.
61 See also Art 21 para 2 MiFID.
62 Art 21 para 3 et seq. MiFID.
63 Art 42 para 2(b) Directive 2006/73/EC.
64 After the definition of the implementing Directive, a “trading venue” means “a regulated market, MTF or systematic internaliser acting in its capacity as such, and, where appropriate, a system outside the Community with similar functions to a regulated market or MTF” See Art 8 para 2 Implementing Directive 2004/39/EC.
65 Bordernote 35 MiFID.
67 The Commission Directive 2006/73/EC Art 46 para 1 states to do this annually.
68 Art 21 para 4 MiFID.
70 It is not clear yet, how precise execution policies must be phrased. A one-to-one copy-out of MiFID requirements would surely not suffice.
71 We do not generally believe that regulation should be, or can be, in the business of indicating to firms inefficiencies in

72 Bordernote 3 Directive 2006/31/EC.
75 Edhec-Risk-Advisory, supra n 2.
76 Ibid.
77 One further possibility to reap the flexibility advantages of the concept of best execution without being restricted by the informational defects of the regulator and the efficiency losses from fixed standards would be to let each security issuer define what are the best execution standards for his security (JR Macey and M O’Hara, From Orders to Markets, Regulation 28, No 2, 2005, 62–70). The obvious disadvantage is the additional demands on the investor’s attention when the standards differ from security to security.
78 Art 21 para 3 MiFID.
79 Bischof, supra n 50, 145.
80 Art 21 para 1 MiFID.
81 Art 46 para 2(c) Directive 2006/73/EC.
82 Recital 75 Directive 2006/73/EC; see also Bischof, supra n 50, 146.
86 CESR also agreed to establish a new single “MiFID Level 3 Group” (the “Group”). This group is not intended to be of permanent nature; it aims to achieve most of its results to facilitate a smooth and consistent implementation of the new regime (see: www.cesr-eu.org/-index.php?page=grupos& mac=0&kid=53).
89 Ibid, 4.
92 FSA, supra n 91, 94.
94 FSA, supra n 89, 7.
95 Finanzmarktrichtlinie-Umsetzungsgesetz (FRUG).
96 www.bundesanzeiger.de/lang_de/DE/Aktuelles/044.html.
97 www.bundesanzeiger.de/lang_de/DE/Aktuelles/Pressemitteilungen/2007/03/20072903_PM03-3.html
102 Available at www.boerse-stuttgart.de/div/mifid/body.htm.
104 Ibid, 4 f.
109 www.ebk.ch.
112 www.swisssbanking.org.
113 Eichmann and Grieber, supra n 107, 49.
117 www.toomre.com/RegNMSandMiFID.