

# **Report on Order Routing Incentives**

## **Consultation Report**



**OICU-IOSCO**

**The Board  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

**CR07/2016**

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This paper is for public consultation purposes only. It has not been approved for any other purpose by the IOSCO Board or any of its members.

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## Foreword

### **CR07/16 Report on Order Routing Incentives**

This report provides a review of the approaches and practices used by regulators in their respective markets regarding incentives for order routing and execution that may influence the behaviour of intermediaries. The report also examines practices by intermediaries, as well as planned reforms by a number of IOSCO member jurisdictions in this area. Given the forthcoming changes and existing differences in regulatory frameworks and national markets, IOSCO at this stage does not propose next steps beyond this report. However, it welcomes stakeholder views on its findings and on whether it should undertake any further work in this area.

### **How to Submit Comments**

Comments may be submitted by one of the three following methods **on or before Tuesday 21 February**. To help us process and review your comments more efficiently, please use only one method.

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

#### **1. Email**

- Send comments to [consultation-2016-07@iosco.org](mailto:consultation-2016-07@iosco.org)
- The subject line of your message must indicate ‘*Report on Order Routing Incentives.*’
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

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**Alp Eroglu**

International Organization of Securities Commissions (IOSCO)

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Your comment letter should indicate prominently that it is a ‘*Public Comment on Report on Order Routing Incentives.*’

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## I. Executive Summary

In 2015 the IOSCO Board approved a project by its Committee on Regulation of Market Intermediaries (C3) to explore approaches by regulators and practices in their respective markets around incentives related to order routing and execution that may influence the behaviour of intermediaries ('order routing incentives'). This provides a timely review by IOSCO since a number of regulators have recently focused on issues relating to order routing incentives in their respective jurisdictions.

This consultation report surveys regulatory conduct requirements on brokers to manage conflicts of interest associated with order routing and obtaining best execution, where applicable, and assesses how this interacts with market practices around order routing incentives. It does not consider the impact of venue fee models or dark liquidity on the efficiency of price formation and liquidity in markets, which has been more frequently examined by academics and regulatory bodies, including in earlier IOSCO reports.<sup>1</sup>

In summary, the main proposed findings and conclusions of this consultation report are as follows:

### 1. *Monetary incentives paid or received by brokers to or from third parties*

Only a handful of jurisdictions ban or effectively prohibit intermediaries' ability to receive third party payments in relation to order execution, including India, Australia, and a few EU member states. Despite this fact, a majority of intermediaries surveyed state that they do not receive any third party payments relating to the routing or execution of client/customer orders. Where they do arise, payments tend to be either venue rebates or payment for order flow between two broker intermediaries. Jurisdictions that do not prohibit such payments apply relatively consistent requirements on firms to manage the potential conflict of interest they create with the duty of a firm to act in a client's best interests and provide best execution, where applicable. In most cases, where surveyed firms do receive third party payments, it was identified as a potential conflict of interest and firms took steps to manage it, most commonly through disclosures. The report also shows that payment for order flow and best execution have been the focus of a number of jurisdictions' supervisory reviews in recent years, indicating global scrutiny of this issue.

### 2. *Internalisation and use of affiliated venues that may have commercial benefits for a broker*

Among C3 jurisdictions, internalisation is a more common feature of developed markets.<sup>2</sup> Use of internal crossing networks has both benefits and potential risks for customers.<sup>3</sup> This report suggests that where brokers offer internal crossing networks, there are potential risks around the clarity of terms used where they offer client or order flow categorisation and that cost savings from executing in internal networks are not necessarily passed to a client. However, it appears that many intermediaries have taken steps to provide enhanced disclosure on how their crossing systems work, to monitor execution quality when using internal networks in a similar way to external venues, and have applied strong information controls and governance around best execution to manage the potential conflict of interests when executing client orders through an internal network. In some cases, this reflects

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<sup>1</sup> IOSCO Final Report, 'Trading Fee Models and their Impact on Trading Behaviour,' December 2013, and IOSCO Final Report, 'Regulatory Issues Raised by Changes in Market Structure,' December 2013, and IOSCO Consultation Report 'Issues Raised by Dark Liquidity,' December 2010 and Final Report 'Principles for Dark Liquidity,' May 2011.

<sup>2</sup> Internalisation refers to the practice of brokers routing orders through their own market-makers or internal crossing networks.

<sup>3</sup> An internal crossing network is a broker-operated in-house electronic trading platform that acts as a pool within its broader platform. The broker then matches buyers and sellers of stock directly in a pool without routing them out to an exchange.

changes by jurisdictions to apply more tailored regulations that have mandated certain disclosures and controls for internal networks.

### *3. Provision of goods and services bundled with execution by brokers, such as research.*

Only one C3 member jurisdiction<sup>4</sup> applies specific regulations to address the *provision* of additional goods and services by brokers alongside order execution, with the vast majority of C3 regulators only applying general conflicts of interest and best execution rules to intermediaries. A larger number of jurisdictions apply more specific requirements to the *recipients* of bundled goods and services (such as inducements or ‘soft dollar’ regimes). The bundling of goods and services – primarily research and corporate access – linked to order routing is prevalent, with two-thirds of responding intermediaries stating that they do so. Respondents indicated that these bundled services are generally not charged for separately, but are effectively paid for through brokerage commissions. Some brokers also indicate they may award favourable allocations of meetings with corporate issuers or Initial Public Offers (IPOs) to investor clients based on the level of brokerage commission they pay. Some jurisdictions have raised concerns that allocation of corporate access and IPOs in this way may pose a conflict of interest, which firms should identify and manage, and that bundling reduces transparency over the costs of goods and services provided, such as research. A few firms have implemented written allocation policies for capital raising events and use objective factors to determine IPO allocations. In one case, a firm applies similar discipline to the allocation of corporate access meetings, to manage the potential conflict of interests.

#### *Future reforms and next steps*

In all three areas, some IOSCO Committee 3 member jurisdictions have either made or plan future reforms. Forthcoming EU legislation under MiFID II, expected in 2018, includes significant changes that will require reforms to broker crossing networks, enhance best execution obligations, and place a new requirement on intermediaries providing execution services and research services to price and supply them separately. Hong Kong’s SFC has also recently introduced reforms to its alternative liquidity provider’s (ALPs) regime, which will change future practices in their market. Finally, in the US, the SEC has consulted on potential changes to its alternative trading systems (ATS) regulation, and the CFTC has proposed new regulations that would require exchanges to provide disclosure and implement other controls regarding their market maker and trading incentive programs.

Based on these forthcoming changes, **IOSCO does not propose immediate next steps beyond obtaining comments on this consultation report and its findings for a final report.** However, IOSCO encourages market participants to consider this report, and welcomes views from stakeholders in response to this consultation on the following:

- **Do market participants have any comments on the proposed findings of this report on order routing incentives or any views on whether IOSCO should undertake any further work to explore any of the issues raised in this report now or in the future?**

IOSCO seeks comments within 60 days after publication of the consultation report and will issue a final report on this area in due course to reflect any comments received. Otherwise, IOSCO Committee 3 will consider revisiting this work at a later stage once new reforms in jurisdictions have taken effect, or if jurisdictions detect new trends or developments relating to these issues that warrant further exploration.

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<sup>4</sup> In Canada, a National Instrument requirement restricts broker intermediaries from accepting or forwarding to a third party brokerage commissions in return for the provision of goods and services other than order execution or research goods and services.

## II. Background

### A. Introduction

This IOSCO project set out to survey members on current and/or publicly proposed regulatory initiatives relating to incentives that may influence the routing of customer orders for execution (“order routing incentives”) at regulated market intermediaries<sup>5</sup> (referred to henceforth as simply “brokers” or “firms”), such as discounts or rebates provided to direct order flow to one particular venue or payments from one intermediary to another to receive their order flow. It also examines current market practices by intermediaries in IOSCO member jurisdictions. The goal is to enhance IOSCO’s understanding of firm behaviour relating to order execution services and the incentives that may influence order routing behaviour, and whether, in the context of the regulatory principles of fairness, transparency and conflicts management, the treatment of the underlying customers of broker-dealers is impacted by order routing incentives.

### B. Previous Work

#### *Summary of IOSCO work undertaken by Committee 2 – Regulation of Secondary Markets*

IOSCO Committee 2 on the Regulation of Secondary Markets (C2) published two reports in late 2013 that have relevance to the C3 work on order routing incentives, which were:

1. *Trading Fee Models and their Impact on Trading Behaviour: Final Report (FR12/13)*<sup>6</sup>
2. *Regulatory Issues Raised by Changes in Market Structure: Final Report (FR13/13)*<sup>7</sup>

It is therefore useful to provide a brief summary of some of the key findings in these reports as context to this work on order routing incentives and the impact on market intermediaries’ order routing behaviours.

#### *Final report on Trading Fee Models and their Impact on Trading Behaviour (FR12/13)*

The report into Trading Fee Models and their Impact on Trading Behaviour is particularly relevant to this work. FR12/13 points out that there is significant competition amongst markets trading the same securities in a number of jurisdictions, which has resulted in a lowering of fees charged by those trading venues. It also highlights the discounts offered by venues. These appear to have been created with the objective of attracting order flow, with rebates based on volume or value of the securities traded.

FR12/13 also noted that with multiple marketplaces potentially charging differing fees, there is the potential for conflicts of interest in regard to routing decisions. Directing order flow to a particular

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<sup>5</sup> According to the *IOSCO Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, p.175 (Sept. 2011, revised Aug. 2013, see: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>), the term “market intermediaries” generally includes those “who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities.” Although a jurisdiction may also choose to regulate an entity that engages in a number of other activities as a market intermediary, the meaning for purposes of this project is restricted to the above definition. The term does not include for purposes of this project entities that only provide advice, but do not execute orders on behalf of their customers. Some brokers/firms will be excluded by virtue of the limitation of the securities covered in this project specification. However, securities brokers, futures brokers and introducing brokers will be included.

<sup>6</sup> IOSCO, *Trading Fee Models and their Impact on Trading Behaviour: Final Report (FR12/13)*, December 2013. Source: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD430.pdf>

<sup>7</sup> IOSCO, *Regulatory Issues Raised by Changes in Market Structure: Final Report (FR13/13)*, December 2013. Source: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD431.pdf>



venue with the aim of reducing costs for the intermediary may not necessarily be consistent with the best interests of the client because it has been observed that discounts are not generally passed by the participant to the underlying investor. For example, the report notes some survey responses stating that retail clients are charged a flat fee and the trading fee models applied by marketplaces do not impact these flat fees. The report also acknowledges stakeholder views that suggest that maker-taker fee structures may lead to trading strategies aimed at optimising rebates received for providing liquidity. In such cases the trading activity may be designed to make money from liquidity rebates rather than based on the fundamentals of supply and demand for the security itself.

FR12/13 concluded that the surveys and literature review carried out did not provide a sufficient basis for definitive conclusions about the impact or effect of trading fees and trading fee models. Although some issues were raised, they were not common across all or most jurisdictions at the time.

### *Final report on Regulatory Issues Raised by Changes in Market Structure (FR13/13)*

FR13/13 looked at the trading of equities and exchange-traded funds on the most common trading spaces, including exchange trading market systems, non-exchange trading market systems (i.e. ATSS and Multilateral Trading Facilities (MTFs)), and trading over-the-counter (OTC). It excluded the trading of derivatives products.<sup>8</sup>

The report made four recommendations to promote market liquidity and efficiency, price transparency and investors' execution quality in a fragmented environment. It identified possible outstanding issues and risks posed by existing or developing market structures, and described how these risks should be addressed. It also recommended that regulators monitor the impact of fragmentation on market integrity and efficiency, availability and timeliness of information, order handling rules and best execution, and access to liquidity.

## **C. Scope and focus of this report**

Most member jurisdictions have best execution obligations for brokers who execute client orders. Best execution, a regulatory concept applicable to a firm's order routing decisions, is defined and regulated in different ways by member jurisdictions. Notwithstanding the underlying differences between regulatory approaches relating to best execution, the IOSCO Methodology for implementation of the principles for market intermediaries states, among other things, that "a firm should act with due care and diligence in the best interests of its clients and the integrity of the market" and that "the oversight of market intermediaries should primarily be directed to the areas where their capital, client assets and public confidence may most be put at risk."<sup>9</sup>

This report surveys the regulatory requirements on brokers to manage conflicts of interest associated with order routing and obtaining best execution, where applicable, and assesses how this interacts with market practices around monetary and non-monetary incentives provided to or by brokers in relation to order execution. It also identifies instances where best execution is not applicable to certain types of trading in a jurisdiction, but where alternative measures are used, as relevant, to seek

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<sup>8</sup> See report for a full explanation of terms and definitions used therein.

<sup>9</sup> *IOSCO Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, pp. 173-174.

to ensure fair dealing between brokers and customers.<sup>10</sup> The focus is on conduct issues, rather than aspects such as market liquidity that have more frequently been linked to venue fee models, for example.

There are various monetary and non-monetary order routing incentives that may influence intermediaries' behaviour with respect to their routing of orders for execution. This report considers three main types of incentive arrangements or commercial practices that could potentially influence order routing behaviour by intermediaries, which are explained in turn below.

### ***1) Monetary incentives received by brokers from third parties that may influence order routing behaviour:***

Monetary incentives to direct order flow to one particular execution venue, or intermediary, over another could give rise to a number of conflicts of interest. Practices include payment for order flow between intermediaries and maker/taker pricing offered by venues, which are considered as follows:

- Payment for order flow<sup>11</sup> ("PFOF") can take many forms. It includes circumstances where a liquidity provider pays a third party intermediary to receive order flow. Intermediaries may charge liquidity providers to execute against the firm's customer orders, or agree to sell their retail order flow to other brokers. In the UK, the FCA observe that in its jurisdiction it included the practice of an investment firm which executes client orders (the broker) receiving commission both from the client originating the order and also from the counterparty with whom the trade is executed.<sup>12</sup>
- Maker/taker pricing models are used by trading venues and involve the trading venue paying its members a rebate to provide (i.e. "make") liquidity in the form of resting orders and levy a fee on those members who remove (i.e. "take") liquidity.<sup>13</sup>

While the previous IOSCO report FR12/13, among other things, identified the potential for different fee models to impact the trading behaviour or routing decisions of intermediaries, it was not the main focus of that work.<sup>14</sup> However, the existence of explicit payments between intermediaries to direct order flow could clearly have the potential to create a conflict of interest that may impact an intermediary's duty to its customers to seek best execution, where applicable. This report explores these specific payments and their potential impact on firm behaviours, and measures taken by regulators and / or firms to mitigate any perceived conduct risks.

### ***2) Internalisation and the use of affiliated venues***

A broker executing orders on behalf of a client may also operate an internal crossing system or network. Such systems can offer potential benefits to customers from spread capture; the reduction of

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<sup>10</sup> A specific example of this is the trading of futures contracts in the United States, where best execution does not apply. However, other regulatory requirements including disclosure, managing conflicts of interest and other rules of fair dealing and internal business conduct, may apply to such activities.

<sup>11</sup> In the United State, payment for order flow is defined in Rule 10b-10(d)(8). In May 2012 the UK FSA provided guidance on the practice of 'Payment for Order Flow' - FSA FG12/13, see: <http://www.fsa.gov.uk/static/pubs/guidance/fg12-13.pdf>

<sup>12</sup> The FSA originally identified concerns with PFOF practices on what was then the London International Financial Futures and Options Exchange (LIFFE), where brokers called around to market makers in order to get quotes that are not displayed on the electronic order book.

<sup>13</sup> Inverse maker/taker pricing provides rewards to those that take liquidity. Trading fee schedules are usually publicly available.

<sup>14</sup> See <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD430.pdf> (Dec. 2013).

explicit costs (e.g., exchange fees and clearing and settlement fees) and the ability to minimise market impact by controlling information leakage from public lit markets.<sup>15</sup> However, these potential benefits may not be fully realised and the intermediary, rather than their customers, may benefit from cost reductions or from the informational advantages offered by internalising customer order flow. For example, a best execution review by the FCA in 2014 revealed that some firms routed significant volumes of orders through their internal systems but did not adequately consider the associated conflicts of interests nor apply sufficient scrutiny over whether they achieved best execution for their clients.<sup>16</sup> ASIC also identified similar conduct issues in Australia, taking steps to explore and address concerns over the transparency of crossing systems, firm's controls and oversight of such systems, and whether they ensured fair treatment of users of their crossing systems.<sup>17</sup>

A broker routing orders to an affiliated venue may also gain cost efficiencies or a commercial benefit, which may or may not coincide with a benefit for the customer and the provision of best execution, and so could also pose a conflict of interests for the intermediary.

This report sought to identify jurisdictions where internalisation and execution through affiliated venues is a relevant issue, and then ascertain the potential influence on broker's order routing behaviour when executing orders on behalf of their customers and how conduct risks are managed to ensure customers are treated fairly.

### ***3) Provision of non-monetary goods and services bundled with execution by brokers:***

In some jurisdictions, brokers that operate in the securities markets and offer a variety of different financial services (for example, investment banks) might bundle other goods and services – primarily research and corporate access – together with order execution in return for increased transaction commissions paid by their customers. The receipt of such bundled goods and services creates a more apparent conflict of interest for an investment advisor or asset manager, since they often pass increased costs for receiving these goods and service onto their customers. However, the bundled provision of such services by intermediaries may also raise concerns. For example, it could potentially obscure the assessment of whether best execution is achieved or reduce transparency around the cost and quality of the discrete research service offered by brokers. A broker may also offer favourable corporate access and IPO allocations to customers that direct more order flow and pay high execution commissions to it. This could create a conflict of interest for a broker if it only offers access to an IPO to certain clients on this basis and / or also acts for the corporate issuer. This report surveys whether or not brokers providing bundled goods and services linked to order execution identify this as potential a conflict of interest, and if so, whether it is adequately managed.

## **D. Methodology**

The project carried out surveys of both IOSCO Committee 3 member regulators, and a sample of intermediaries in their markets, on their approaches to order routing incentives and behaviours in their respective jurisdictions to develop IOSCO members' understanding of current and/or publicly

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<sup>15</sup> Dark pools and dark orders ('dark liquidity') have previously been considered by IOSCO reports in 2010-11, *Issues Raised by Dark Liquidity: Consultation Report CR05/10* (October 2010) and *Principles for Dark Liquidity: Final Report FR06/11* (May 2011).

<sup>16</sup> UK FCA Thematic Review 14/13, *Best execution and payment for order flow* (July 2014), see: <http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-13>

<sup>17</sup> ASIC Report 452, 'Review of high-frequency trading and dark liquidity,' October 2015, see: <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-452-review-of-high-frequency-trading-and-dark-liquidity>

proposed regulatory steps and market trends. The surveys explored the three main types of order routing incentives as described above.

The report also includes a short review of selected studies by member jurisdictions, market participants or academics as relevant to order routing incentives. For this purpose, the report did not consider studies or reports already noted in the IOSCO Committee 2 work in 2013 (as referenced above).

### **III. Monetary incentives provided or received by intermediaries from third parties in relation to order routing**

#### **A. Regulatory frameworks for order routing and third party payments**

##### **1. Existing regulatory approaches**

A minority of regulators such as the US SEC, CFTC and Dutch AFM have specific regulatory requirements to address the receipt or provision of monetary incentives in relation to order routing.

In the US, broker-dealers are subject to a best execution obligation. The duty of best execution requires broker-dealers to execute customers' trades, in accordance with the conditions of the order, at the most favourable terms available under the circumstances, *e.g.*, at the best reasonably available price. FINRA's response referred to its rules on best execution that require firms to ascertain, in any transaction for their customer, the best price for the customer. Supplementary material to FINRA's rules on best execution also provide that firms that route orders, externally or internally, must regularly review the quality of order execution for its clients. Firms are required to compare the quality of order execution to that otherwise obtainable on the market and ensure it can justify its execution arrangements on the basis of best execution.<sup>18</sup>

SEC Rule 606 requires brokers or dealers to disclose certain order routing information, including information about the material aspects of the broker or dealer's relationship with each venue identified. This information would include a description of any payment for order flow arrangement or profit-sharing relationship.<sup>19</sup> In addition, SEC Rule 607 requires brokers or dealers that act as an agent for a customer to inform the customer in writing on their policies regarding receipt of payment for order flow along with details of the payment for order flow received and policies determining where client orders are routed.<sup>20</sup> In the US, exchanges must also file with the SEC any fees programs, including rebates.<sup>21</sup>

The CFTC addresses monetary incentives from third parties by requiring regulated exchanges to submit self-certifications for any new incentive programmes and changes to existing programmes. The CFTC reviews the certifications against the relevant core principles within its rules that address issues such as preventing market disruption, financial integrity of transactions, protection of market participants, conflicts of interest, antitrust considerations, and systems safeguards.<sup>22</sup>

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<sup>18</sup> In Regulatory Notice 15-46 (November 2015) FINRA provided guidance on how firms can satisfy their best execution obligations, including a "regular and vigorous review" for execution quality; this guidance is available at: <https://www.finra.org/industry/notices/15-46>.

<sup>19</sup> The SEC recently proposed to expand and enhance the disclosure requirements under Rule 606. *See* <https://www.sec.gov/rules/proposed/2016/34-78309.pdf>.

<sup>20</sup> The SEC staff in its response referred to Rule 607 of Regulation NMS, amongst other things, which requires brokers or dealers to inform its customers for whom it acts as an agent, in writing, upon opening a new account and on an annual basis thereafter, on their policies for determining where to route customer orders that are subject to payment for order flow. It also referred to its Rule 10b-10, which provides that brokers must disclose whether payment for order flow is received for certain securities and that customer may request information about the source and nature of the compensation received in connection with a particular transaction.

<sup>21</sup> *See* Section 6(b)(4) and 19(b) of the Securities Exchange Act of 1934 and Rule 19b-4. *See also* Rule 610 of Regulation NMS which addresses fees for access to quotations.

<sup>22</sup> This language is consistent with the CFTC's interpretation of regulation 40.1(i) (definition of "Rule") as it is currently written, pursuant to which DCMs must submit new rules and rule amendments with respect to market maker and trading incentive programs. Proposed Reg AT would amend 40.1(i) to expressly reference market maker and trading incentive programs. *See* Reg AT NPRM, at 78870.

For EU members, the Market in Financial Instruments Directive (MiFID) provides the relevant regulatory framework on monetary incentives received or paid by brokers that may influence order routing behaviour. The most relevant rules relate to the identification and management of conflicts of interest, the receipt of inducements,<sup>23</sup> and best execution. The Dutch AFM stated that it applies higher standards than the MiFID provisions on inducements since January 2014 by banning all third party payments which relate to retail clients.<sup>24</sup> The AFM also issued guidance on the ban on inducements in the context of payments by one broker to another. The guidance prohibits commission payments by the executing broker to the introducing broker or portfolio manager paid out of execution fees paid by retail clients directly to the executing broker.

The FCA (previously the FSA) issued guidance on payment for order flow in 2012, which indicated that arrangements whereby brokers receive payments from market making intermediaries in exchange for routing orders to them were unlikely to be compatible with MiFID-derived rules on inducements, best execution and conflicts of interest.<sup>25</sup>

In India and Australia, brokers are prohibited from receiving monetary incentives from third parties that may influence order routing.

In Switzerland and Japan brokers are subject to best execution requirements and are required to ensure that when conflicts of interest arise, they are managed such that client interests are not adversely affected. Japan requires firms to adopt control systems to deter and manage any conflicts of interests. Singapore also requires firms to manage conflicts of interest to ensure that customers' interests are not compromised when they trade with or through a broker. In Japan, the Financial Instruments and Exchange Act also stipulates that exchanges are prohibited from applying unjust discriminatory treatment to a particular market participant.

Hong Kong's SFC similarly requires firms to ensure that where conflicts of interest cannot be prevented, clients are nevertheless treated fairly. Brokers are also required to disclose any material interest in a transaction that is a conflict of interest to clients. Firms that exercise investment discretion on behalf of clients may only receive goods and services from a broker in relation to directing business to them if they benefit the client, the execution is consistent with the best execution standards, the client has consented in writing to the receipt of the goods and/ or services and disclosure on the firm's practices for receiving the goods and/ or services is made to the client.

In Canada, dealers are required under their best execution and supervisory obligations to maintain policies and procedures reasonably designed to achieve the best execution possible under prevailing conditions. In particular, the policies and procedures must address how a dealer will ensure best execution in circumstances when the dealer has an "incentive" arrangement with a particular marketplace (including ownership, payments or discounts based on the number, value or volume associated with orders entered on or trades executed on that particular marketplace). Also in Canada, the Universal Market Integrity Rules have the effect of prohibiting payment for order flow by a Canadian dealer.<sup>26</sup> There are also rules in place relating to the identification, management and

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<sup>23</sup> Any third party payments or benefits received by an investment firm in relation to services to clients.

<sup>24</sup> Under Article 26 of the MiFID Implementing Directive (2006/73/EC), firms can receive third party fees, commissions or benefits in relation to an investment service provided to a client if it is designed to enhance the quality of service to the client; it does not impair the firm's duty to act in the best interests of the client; and the existence, nature and amount of the fee, commission or benefit is disclosed.

<sup>25</sup> FSA FG 12/13, 'Guidance on the practice of payment for order flow' (May 2012).

<sup>26</sup> See Universal Market Integrity Rule and Policy 7.5.

disclosure of conflicts of interest. With respect to fees charged or rebates provided by trading venues, because of regulatory requirements and prohibitions, trading venues (both exchanges and alternative trading systems) operating in Canada cannot create incentives that are specific to one party. Incentives can be directed to a class of participants only if it is not unreasonable and with prior approval.

Turkey, Pakistan, México, Morocco and Brazil all reported that they do not have specific rules or guidance on monetary incentives that may influence order routing behaviour. Three of these respondents, Mexico, Brazil, and Turkey, stated that they only have a single trading venue in their jurisdictions, and therefore brokers do not have a choice over where to route orders.

## **2. Supervisory initiatives**

BaFIN stated that it has carried out a survey on order flow payments in spring 2015. The responses revealed that some, but not all, market participants receive payments from execution venues for so-called free buy, free trade and flat buy measures as compensation for the lack of order charges against the clients. The amount of the payments is generally based on the order volume (with an agreed minimum or maximum order volume). Furthermore, the responses revealed that a few market participants receive payments by issuers of certificates (as market makers) for the clients' order volume that they have generated. However, the responses noted that many market participants do not receive such payments. BaFIN's survey also found that brokers generally inform their clients in their terms and conditions about the fact that they receive inducements for the execution of client orders.

In connection with the introduction of the Dutch ban on all third party payments relating to services for retail clients since January 1, 2014, the AFM issued guidance on the ban on inducements in the context of payments by one broker to another. The AFM subsequently assessed certain order execution models for compliance with the new ban. The findings revealed that several introducing brokers and portfolio managers changed their execution model by taking responsibility for execution and charging the client directly in order to be in line with the rules. Also, the AFM found that certain executing brokers could dominate the Dutch market by giving retail clients a rebate on transaction costs when buying structured products issued by the executing broker themselves. Dutch firms asked for guidance from the AFM on whether this would be allowed. Following AFM's guidance, the firms stopped paying these rebates. The AFM also conducted thematic reviews of best execution in 2008 and 2010/2011 but did not find any evidence of payment for order flow.

In the UK, the FCA undertook a supervisory thematic review into best execution and payment for order flow ("PFOF") in 2014 involving 36 firms, including investment banks and other brokers. The review found that most firms were not able to demonstrate that they had fulfilled all of the requirements under the best execution rules and had not assessed which parts of their business those rules were applied appropriately. The review also found that, despite the publication of FSA guidance on PFOF in 2012, a small number of market participants in the review still continued to receive PFOF by changing the description of the service they provided to clients in an attempt to avoid the rules. Subsequently, the FCA contacted the firms within the sample that were relying on these new arrangements and they ceased receiving PFOF.<sup>27</sup>

The OSC and Québec AMF in Canada reported that the Investment Industry Regulatory Organisation of Canada (IIROC) conducted a survey of dealers on best execution. This review took place during

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<sup>27</sup> TR 14/13, Best execution and payment for order flow, (July 2014), available at <https://www.fca.org.uk/publications/thematic-reviews/tr14-13-best-execution-and-payment-order-flow>.

2012-13. The results were published in 2014 and indicated that most brokers do not pass on marketplace rebates to clients and that disclosures on rebates received and retained by the firm are insufficient.<sup>28</sup> The survey indicated that the current level of disclosure related to fees and rebates, whether retained by the firm or passed on to the client, was incomplete and inconsistent among respondents. Since the completion of the survey, both the Canadian Securities Administrators and IIROC have proposed amendments to the best execution framework that, among other things, would specifically require the disclosure of:

- the identity of each type of intermediary to which the dealer would route orders for handling or execution
- the identity of any marketplace to which the dealer would route orders
- the circumstances under which the dealer would route orders to the entities identified above, and
- whether fees are paid or payment or other compensation is received by the dealer for a client order routed to the entities identified above and in which circumstances any cost associated with such compensation would be passed on to the client.<sup>29</sup>

In the US, SEC staff conducted examinations of multiple broker-dealers and FINRA members regarding the order routing and execution quality of customer orders.

FINRA's Trading Examinations Unit recently carried out a review on the potential influence of order routing decisions based upon exchange maker/taker fees and broker-dealer PFOF. Firms stated that the maker/taker fees and PFOF are not determinative factors or are among other factors which are taken into consideration in the decision-making for routing orders. Some firms noted that customers may choose routing methods under different commission plans and so may choose to have orders routed to less expensive market centers or to higher rebate exchanges for cost purposes. FINRA also reported that responses were mixed on whether maker/taker fees are passed to customers. Some firms do not pass any fees/rebates to customers, while others pass through fees/rebates depending on factors such as whether the customer chose a commission plan that includes the passing through of fees/rebates. FINRA reported that most firms have a best execution committee, which meets at least quarterly.

In France, the AMF undertook a supervisory review of best execution in 2013. The review revealed disparities in both the interpretation and the application of the MiFID-derived best execution rules in areas such as the content and review of execution policies, the relationship between the execution policy and selection policy, and client disclosures.<sup>30</sup> Following the review, the AMF clarified its interpretation of the rules on best execution and published further guidance concerning the non-transparent practices that influence order routing decisions.

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<sup>28</sup> See IIROC Notice 14-0082 (March 2014), available at: [http://www.iiroc.ca/Documents/2014/61ec2e27-7e15-4a42-9adc-5c7895d16c81\\_en.pdf](http://www.iiroc.ca/Documents/2014/61ec2e27-7e15-4a42-9adc-5c7895d16c81_en.pdf)

<sup>29</sup> See *CSA Notice and Request for Comment – Proposed Amendments to National Instrument 23-101 Trading Rules* (May 2014), available at: [http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa\\_20140515\\_23-101\\_rfc-pro-amd.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category2/csa_20140515_23-101_rfc-pro-amd.pdf) and IIROC Notice 15-0277 – *Proposed Provisions Respecting Best Execution* (December 10, 2015), available at [http://www.iiroc.ca/Documents/2015/8df7a02c-4491-4fd0-b317-4c90bdc722a2\\_en.pdf](http://www.iiroc.ca/Documents/2015/8df7a02c-4491-4fd0-b317-4c90bdc722a2_en.pdf).

<sup>30</sup> In France, “selection policy” refers to the policy and process applied to choosing a broker who will not execute an order directly but will only choose an executing broker and route orders to that broker, while the term “execution policy” is used to mean the policy and process for choosing the firm that will actually execute the orders (a member of an exchange, for example).



In Australia, ASIC intend to carry out a thematic review on best execution during 2016/17.

A supervisory peer review was also undertaken by ESMA at EU level in relation to the supervision of MiFID best execution requirements in 2015, looking at EU national competent authorities' supervisory approach to monitoring whether firms were complying with these obligations.<sup>31</sup>

### **3. Enforcement actions**

Four regulators have taken enforcement action in this area in the last few years: the Romanian FSA, the Spanish CNMV, the Polish KNF (although they did not specify any further details) and the Dutch AFM. The Romanian FSA reported a case found as part of a thematic inspection on a firm in 2013, whereby bonuses to induce clients to trade on the platform of the firm were offered to clients in a preferential way. The firm in question was not found to act in accordance to the general principles of conduct set by the Romanian FSA.

The Spanish CNMV noted that some firms had been found to have made inadequate disclosures on inducements and breached their obligations on conflicts of interest. In these cases, poor practices have since been corrected.

The Dutch AFM recently investigated a case where a firm operating a trading platform appeared to be inducing asset managers by paying their marketing fees in exchange for the asset managers using the trading platform, and found that the firm was in breach of the AFM's rules banning inducements.

#### **B. Intermediary practices in relation to the receipt or provision of third party payments linked to order routing**

##### *Overview of responses on receiving or paying third party payments*

In total, more than three quarters of respondents stated they did not receive third party payments relating to the routing or execution of client/customer orders. The respondents who did state they receive third party payments relating to the routing or execution of client/customer orders are geographically widely spread and include intermediaries in Canada, the US, Hong Kong, Spain, Germany, Turkey and the UK. The responses also differentiated between third party payments received from venues (i.e. maker / taker fees structures) and third party payments received from other intermediary firms; the scale of the monetary benefits; and whether firms identified receiving them as a potential conflict of interest and took steps to manage this.

##### *Practices relating to the reception or payment of third party payments*

In Canada, responses suggest that the maker/taker pricing model is the predominant model used by trading venues (exchanges and alternative trading systems) with active orders paying to execute and passive orders receiving rebates. One firm noted that there are also numerous venues that use the "inverted maker/taker" pricing model – where active orders receive rebates and passive orders pay trading fees. The same firm also noted that it receives payments when it routes its US retail order flow to a US affiliate, who routes non-marketable orders to exchanges, while marketable orders are sent to market makers or wholesalers. Two other Canadian firms similarly noted that they may pay execution fees or receives rebates when executing in US markets.

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<sup>31</sup> ESMA, 'Best Execution under MiFID : Peer review report' (February 2015), source: [https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-494\\_peer\\_review\\_report\\_on\\_best\\_execution\\_under\\_mifid\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-494_peer_review_report_on_best_execution_under_mifid_0.pdf)

A US firm stated it operates three lines of business: Proprietary Trading, Agency Trading, and Market Making and that for all three the firm receives rebates for marketable and non-marketable orders from exchanges and other execution venues pursuant to their general fee schedules. These rebates are a material source of revenue for the firm, but are largely offset by access fees and other execution expenses. With respect to its market making business, the firm receives payments from other broker-dealers when the firm routes certain less frequent order types to such broker-dealers, such as Stop orders and/or All-or-None orders. However, for other types of orders and other parts of their business they may pay other broker dealers.

A Swiss headquartered firm noted that for its US subsidiary, its cash equity business receives payment for order flow in National Market Securities (NMS) or other equity securities in the form of discounts, rebates, reductions of fees or credits received as a result of sending orders to certain trading centres. It noted that in some circumstances this may result in net remuneration for the firm, although it does not alter their policy to route customer orders to the trading centre where it believes clients will receive the best execution and added that centres paying for order flow may provide execution of orders at prices better than the NBBO.

In Europe, the same Swiss headquartered firm noted that its EU subsidiary's Cash Equity business receives tiered rebates for pre-defined volumes of business on trading venues (i.e. volume discounts) and rebates from venues for placing passive orders. Globally, its listed futures business also receives tiered rebates for pre-defined volumes of business on trading venues (i.e. volume discounts), which are passed onto the client.

One UK firm also noted that they receive rebates and/or may pay zero costs in relation to the execution of passive order flow. The firm noted that many exchanges offer tiered volume discounts (i.e. the more the firm executes orders on a given platform, the lower the exchange fee becomes).

A Hong Kong firm likewise noted that it received and paid to other brokers, fees in relation to securities brokerage orders given or introduced by it and the brokers respectively. Another Hong Kong firm stated that it is the introducing broker and the execution agent of an affiliate and therefore the firm will receive a fraction of revenue from the affiliate under an agreement entered into by it.

A Spanish firm noted it receives rebates for marketable or non-marketable orders. One Turkish firm also stated that it received third party rebates, mostly deriving from funds business.

Aside from rebates, one German firm noted that it received an interest free loan in 2 tranches from another firm to enable them to implement clearing connectivity. The loans become non-repayable on meeting certain requirements, with the first tranche based on the number of clients on boarded, while the second tranche is based on cleared volumes. The firm stated the conditions for Tranche 1 have been met while the conditions for Tranche 2 will be determined pending whether regulations for central clearing becoming mandatory or not.

In terms of the scale of third party payments made or received in relation to order routing over 12 months from October 2014 to September 2015, one firm noted it paid total fees in the region of USD\$20m and received slightly less in rebates, averaging slightly under USD\$20m, from executing orders in its domestic market on venues with maker-taker fee models. The same firm noted that it also received net payments in the region of several million US dollars linked to its retail client's US order flow, which it executes through an affiliate in the US.

Another firm stated that they received approximately USD\$6.5m in rebates from exchanges net of access fees paid to exchanges, and also received over USD\$300,000 in payments from other broker-

dealers. However, in its market making business, this same firm paid around USD\$20m to other broker-dealers for order flow for the 12-month period ended September 30, 2015.

One large firm reported that the value of related fees and rebates they received or paid from 1 October 2014 to 30 September 2015 was a net expense to the firm of nearly USD\$50m in one region, a net expense of USD\$1.5m in another region, and a net receipt of fees of USD\$400,000 in their other regional business.

One firm noted they paid just over USD\$5m and received USD\$1m from 1 October 2014 to 30 September 2015. Three other firms noted that they received monetary payments or benefits linked to order execution over this period of approximately USD\$800,000, USD\$530,000 and USD\$400,000.

#### *Identification of possible conflicts of interest related to third party payments*

One Canadian firm, two Hong Kong firms, one Turkish firm and one US firm all identified a potential conflict of interest that may arise from the receipt of third party payments.

The Canadian firm had established a special committee to manage and mitigate this conflict. Both Hong Kong firms and the US firm disclose the receipt of third party payments to their clients as a means to mitigate this conflict, with the Hong Kong firms both mentioning that it is included in initial client agreements. The US firm additionally manages the conflict of interest risk through internal supervisory policies and procedures. The Turkish firm also stated that it manages the conflict posed by third party rebates through its conflicts of interest policy.

Conversely, one UK firm stated that they did not believe the specific third party payments they received create a conflict of interests. The UK firm viewed rebates or zero costs received in relation to the execution of passive order flow as keeping overall costs down, so did not create a conflict of interest with their clients.

#### *Arrangements in place within firms to ensure the consistency of best outcomes for clients/customers*

Intermediaries provided a varying range of responses on the arrangements they put in place to ensure the consistency of best outcomes when executing orders in relation to which third party payments are made or received. These include setting up specific committees, the periodic review of best execution policies and having governance frameworks in place to provide clients with the best possible outcomes in given circumstances.

Three Canadian firms, a US firm and a UK firm reported that best execution is regularly monitored by a specific committee. The US and UK firms both mentioned that this committee meets at least quarterly. The US firm further described that this committee coordinates across the firm's market making business to ensure a regular and rigorous review of its execution performance.

A Swiss headquartered firm also noted that it maintains a system of best execution controls and supervisory procedures that are designed to ensure the best execution of client orders. Its US subsidiary performs surveillance of daily activity for execution timeliness and price dis-improvement, as well as quarterly best execution governance. Their European business also has a best execution governance framework that seeks to provide clients with the best possible outcome. Specifically for cash equities, the firm has a governance forum which meets quarterly to review the results of monitoring undertaken during that period. The firm noted that in its business in Asia, different jurisdictions have different best execution regulatory expectations. However, all executions are

compared against best bid and offer prices and trades that exceed a predefined threshold will be reviewed.

The Spanish firm noted that third party payments are only received from their foreign intermediary where the firm is unable to access those foreign markets directly, and the firm reviews the intermediary's best execution policy at least once a year. Meanwhile, a Turkish firm indicated they manage the conflicts of interest by way of their execution and dealing on own account policies.

*Who receives the benefits from incentive arrangements?*

From the intermediary survey, responses regarding who ultimately benefits from the receipt of third party payments were diverse, ranging from both the intermediary and client benefiting from the arrangements, to only certain categories of clients or the intermediary being the beneficiary.

For example, in Canada, responses varied – one firm stated that it receives benefits, while another indicated that both clients and the firm benefit. A third firm indicated that treatment is different between retail and institutional clients, noting that some but not all of its institutional clients operate on a “cost-plus” arrangement, and so who receives the benefit from exchange rebates will vary.

The Swiss headquartered firm also noted that in the US and Europe, depending on the venue, and its interaction with a venue (e.g., volume, add/take), it may incur a cost, execute at no cost, or receive a rebate. A client's fee arrangement with it (e.g., “Cost Plus” or “All In”) will determine whether or not these economies are passed back to the client. However, for some parts of Asia, the exchange fees are added to the commissions and passed back to the client.

One Hong Kong firm noted that it has agreements with brokers in markets it does not directly cover - they note that the client receives a competitively priced service and any payments received by the firm do not adversely impact the client's total execution costs.

A German firm with the non-repayable loans arrangement noted that the benefits of third party payments are not recognised on a trade by trade basis but are driven by commercial targets.

A Spanish firm noted that it and its clients receive the benefit of third party payments but did not specify if rebates were directly passed on to clients.

One US firm noted that with respect to its proprietary trading business, the firm benefits directly from third-party monetary incentives received. With respect to their agency trading business, third-party monetary incentives received by the firm are passed through to the firm's customers. For the firm's market making business, it does not charge broker-dealer clients a commission for executions. The firm is solely responsible for any fees, commissions or other expenses that arise in connection with orders received from other broker-dealers (except for certain applicable regulatory fees). Those costs are offset by the rebates the firm receives from third-parties both for routing orders for its own account, as well as in connection with orders received from other broker-dealers.

*What disclosures are provided to clients/customers in respect of the third party payments?*

A Canadian firm noted that marketplace maker/taker prices are listed publicly on the websites of each marketplace and that the firm itself discloses these fees either on its website or in the client account agreement. Similarly, another Canadian firm noted that disclosures are made at the account opening stage and it publishes its best execution policy on its website.

A Hong Kong firm stated that it discloses the payments it receives from third parties. A UK firm noted that it informs its clients that it may receive a fee or other benefit from third parties through its terms of business disclosures.

One US firm noted that it periodically provides clients of its market making business with written disclosures that include information related to third-party payments. Specifically, these disclosures include an explanation stating that third-party payments are for the sole benefit of the firm and are among the various factors used by the market making business to make order-routing decisions. The disclosures are generally made by e-mail at the time of initial on-boarding of a new broker-dealer client and periodically (at least annually) to all of the current broker-dealer clients of the market making business.

Another US firm stated that it provides notice of the receipt of third party payments on individual customer trade confirmations, as well as at account opening and annually thereafter. In addition, the amount and nature of such payments are disclosed on a quarterly basis with the Material Aspects Disclosure, along with the SEC Rule 606 Routing Report.

The Swiss headquartered firm noted that for its US subsidiary, clients are provided with an annual disclosure letter which contains a number of disclosures. This is provided at the outset as part of the client on boarding process and thereafter sent annually. In its European and Asian subsidiaries, its clients are provided with written terms of business that contain a number of disclosures. This is provided at the outset as part of the client on-boarding process.

The German firm that received two interest-free and potentially non-repayable loans stated that it does not record the receipt of third party payments as a specific conflict of interest nor did they disclose or record these loans as a specific conflict of interest, relying instead on general conflict of interest management arrangements. Other information about fees would be provided on request.

#### *The frequency and review of conflicts of interest policies*

The majority of firms who answered this question stated that they review their conflicts of interest policy at least annually, including a Turkish and UK firm.

However, the Spanish firm stated that they review the policy at least monthly and a Canadian firm said they reviewed it at least quarterly. A Canadian firm stated that it had not recorded any specific conflicts of interest in respect of the rebates it received from Canadian marketplaces for passive and active orders (maker-taker fees).

One Swiss firm noted that it had not changed its policy in the last three years. Another Swiss firm noted that its conflicts of interest policy is reviewed every two years unless there is a material change. Both firms indicated that their internal conflicts of interest policy does not relate specifically to the provision or receipt of third party payments as a potential conflict.

### **C. Planned or proposed reforms to regulatory frameworks**

The EU members note that they will need to update their existing rules on inducements, best execution and conflicts of interest in light of MiFID II reforms expected to come into effect on 3 January 2018. MiFID II will significantly strengthen standards relating to the types of third party inducements firms can receive. MiFID II will also enhance the disclosure requirements around conflicts of interest, requiring more detail to be provided to clients, including on what steps the firm has taken to mitigate conflicts of interest risks arising, although disclosure to clients is a measure of last resort.

In relation to best execution, MiFID II contains an explicit provision that an investment firm shall not receive any remuneration, discount or non-monetary benefit for routing client orders to a particular venue, which would infringe the requirements on conflicts of interest or inducements. MiFID II will

also enhance the detail required in execution policies (covering all asset classes) that firms executing orders should have and will require firms to publish periodically the top 5 venues they have used to execute orders and the quality of execution achieved.<sup>32</sup> This enhanced transparency will provide a strong incentive on brokers to ensure they meet their best execution obligations and are not unduly influenced by rebates provided by certain venues or third parties.

FINMA noted that it plans to enact new rules on conflicts of interests for trading system operators and tariff models in Q1 2016.

In Canada, the OSC and the Quebec AMF intend to cap trading fees and are considering a pilot study examining the impact of disallowing the payment of rebates by marketplaces. As indicated above, both the Canadian regulators and IIROC have proposed enhanced dealer disclosure on best execution policies, which includes disclosure about routing decisions and incentives.

In December 2015, the CFTC proposed new regulations that would require regulated exchanges (“designated contract markets” or “DCMs”), to provide additional public information regarding their market maker and trading incentive programs, restrict certain types of payments by DCMs in connection with such programs, and require DCMs to perform surveillance of such programs to prevent abusive practices.<sup>33</sup> In making the proposal, the CFTC noted that market making and incentive programs were not common in the days of pit trading, but that in the modern trading environment, the number of DCM trading incentive programs that have been self-certified under CFTC procedures has risen sharply in recent years. In 2010, 56 market maker and incentive programs were self-certified by DCMs, but in 2013, DCMs had self-certified 341 programs, an increase of over 600 percent compared to the number of programs self-certified by DCMs in 2010.

The CFTC noted that it does not object to the goals of such programs, which encourage liquidity provision and order flow to electronic trading platforms. The CFTC’s proposed regulations reflect concerns that market maker and trading incentive programs could have the potential to spur market participants to trade in ways designed to collect program benefits, independent of any contribution they may be making to liquidity or price discovery, and may potentially lead to abusive trading practices in violation of DCM and CFTC rules. The proposed rules would require greater disclosure of information to the public and remove any potential ambiguity that may exist regarding the CFTC’s authority over such programs. In addition, the proposed rules would require that information regarding market maker and trading incentive programs be easily located on a DCM’s website. The proposed regulations also are designed to ensure that market maker or trading incentive programs: do not incentivise abusive, manipulative or disruptive trading practices; do not encourage or facilitate behaviour that distorts markets and give the appearance of false market depth; and clarify DCM’s surveillance obligations regarding market maker or trading incentive programs and their participants.

#### **D. Studies and academic literature**

A brief review of publications, studies or market analysis on order routing incentives and their effects on brokers’ order routing behaviours was carried out as part of the project. Three of the publications considered related to the use of maker / taker fees and their impact on the broker’s choice of order execution venue and execution quality, which are as follows:

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<sup>32</sup> Trading venues, execution venues or systematic internalisers will also have to publish data relating to execution quality achieved on an annual basis for a specified range of financial instruments under MiFID II.

<sup>33</sup> See 80 Fed. Reg. 78824, 78881-78884, Dec. 17, 2015, available at: <http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-30533a.pdf>

- Stanislav Dolgoplov, “The Maker-Taker Pricing Model and Its Impact on the Securities Market Structure: A Can of Worms for Securities Fraud?” (2014)
- Larry Harris, “Maker-Taker Pricing Effects on Market Quotations” (Nov. 14, 2013)

In addition, an IIROC report summarising responses to a survey of dealers in relation to best execution: “Best Execution Survey Results” (2014) was considered relevant to the work exploring monetary incentives provided or received by intermediaries in relation to order routing.

In his paper, Dolgoplov suggests that the maker-taker pricing model may be deliberately non-transparent, disproportionately benefit certain market participants, and lead to distortions of the duty of best execution. In discussing the duty of best execution, Dogopolov states that brokers often collect rebates and pay venue fees instead of passing them onto customers. As a result, brokers have an incentive to route liquidity-making orders to trading venues with higher rebates, and liquidity-taking orders to trading venues with lower or zero fees. Dogopolov states that the conflicts posed by the maker-taker pricing model may result in violations of the duty of best execution where routing decisions are based on rebates or fees, as opposed to executing orders promptly or at best price.

Harris identifies a transparency problem in maker-taker pricing. He states that quoted prices do not reflect net pricing due to the narrowing of quoted bid-ask spreads. Harris states that this aggravates agency problems between brokers and clients because most clients do not receive liquidity rebates or pay access fees. While brokers will route standing orders to maker-taker exchanges to avoid access fees and to earn liquidity rebates, takers will route to a traditional exchange before routing to a maker-taker exchange to avoid the access fee. Accordingly, the orders posted at the maker-taker exchanges will be the last to trade.

Harris sets out similar concerns on taker-maker pricing, noting that brokers generally will not send standing buy or sell limit orders to taker-maker exchanges where they would execute faster; but send them to maker-taker exchanges where they will sit unexecuted to the disadvantage of their clients.

IIROC’s survey on best execution practices found that while brokers claimed the receipt of marketplace rebates did not affect their order routing decisions, 76% of the brokers stated that they do not pass such rebates on to their clients. A fifth of these brokers also admitted that while they do not pass the rebates on to their clients, they do pass through some or all of the marketplace fees to the clients. The results also indicate that some brokers only pass on rebates to some of their clients and that disclosure practices on marketplace rebates received and retained by the firms were inconsistent.

Otherwise, the results to IIROC’s survey indicate that dealers considered the likelihood of execution and of price improvement opportunities the most important criteria influencing their order routing. Potential internalisation opportunities, the opportunity to receive rebates and the firm’s ownership of a potential marketplace were considered to be among the least important factors. In the report summarising the results from the survey, IIROC expresses concern that disclosure may be incomplete or inconsistent among dealers.

#### **E. Conclusions on monetary incentives provided to or by intermediaries in relation to order routing**

It is noteworthy that over three quarters of respondents to the firm survey stated that they do not receive third-party payments relating to the routing of client/customer orders from venues or other intermediaries thereby avoiding potential conflict or influence on their order routing practices, even though relatively few jurisdictions completely prohibit the receipt of such payments. From the firms

that do receive payments, most identify it as a conflict of interest and use a mixture of policies, procedures and disclosures to mitigate the risk of detriment to their clients. Many firms rely on best execution frameworks and governance committees, alongside general policies for managing conflicts of interest.

In many instances, firms seek to offset venue rebates against venue fees. It would be necessary to consider this alongside intermediaries' order execution fee arrangements with clients (e.g. flat fee versus cost plus models) to understand whether clients receive a direct or indirect benefit from rebates, or if conversely there is a material benefit for the firm that may pose a conflict of interest with their clients. A detailed assessment of order routing by individual intermediaries and execution quality obtained would be needed to detect if receipt of such payments does impact on best execution outcomes for their customers.

Many, although not all, jurisdictions apply a combination of requirements on conflicts of interest, inducements (in the EU), disclosure (in the US), and best execution that are relevant to the receipt of third party payments and routing customer orders. These regulatory requirements are seen as a means to mitigate the conflicts of interest that can arise when firms receive or pay third party payments. India's SEBI, Australia's ASIC, and the Dutch AFM (for retail clients) have gone further and applied bans on the receipt of such payments by firms.

Further reforms to regulatory frameworks on payments linked to order routing are also planned by the Canadian regulators, the US CFTC and in the EU, focusing on greater transparency and seeking to reduce potential conflicts of interests in how order flow is directed.



## IV. Use of internal or affiliated venues in order routing and order routing behaviours

### A. Regulatory frameworks for use of internal or affiliated venues when order routing

From the survey of IOSCO Committee 3 regulators, it is evident that practices such as internalisation or use of affiliated venues are not relevant in every jurisdiction. For example, Turkey, Morocco, Brazil, México, Pakistan and India reported having no rules or guidance in this area. Several regulators in these cases noted that there is a single national exchange on which all orders are executed in their market,<sup>34</sup> so other affiliated venues do not exist, and intermediaries in their markets do not internalise order flow. In the case of Canada, internalisation of order flow by intermediaries is prohibited for exchange traded securities, and orders must be placed on a marketplace.<sup>35</sup>

Regulators who did recognise these practices as relevant in their jurisdictions include the US, Australia, Japan, Hong Kong, Singapore, Switzerland and several EU members (UK, France, the Netherlands and Italy). However, in the US, the CFTC reported that for futures and swaps made available to trade, internalisation was prohibited, as trading is mandated to be carried out on an exchange or execution platform.<sup>36</sup> Singapore also restricts the ability of brokers executing orders in futures to cross and match client orders internally.<sup>37</sup> The remainder of this section on regulatory frameworks therefore reflects responses from the subset of jurisdictions that observe these practices.

#### 1. Regulatory requirements and approaches

There were two main themes of regulators' responses to this section. A majority of regulators noted that they had general rules concerning conflicts of interest and best execution, which applied to intermediaries routing customer orders regardless of whether those orders may be routed internally, to an affiliate or to another venue.<sup>38</sup> In a smaller number of cases, there were more specific requirements on order routing in particular for internalisation, which were designed in part to give customers whose orders may be routed to such networks a greater level of transparency and protection.<sup>39</sup>

##### *General application of best execution and conflicts of interest requirements*

EU members note that best execution requirements derived from MiFID will apply equally to brokers who choose to internalise client orders. Market intermediaries will need to have execution policies setting out what factors they will prioritise when executing their client orders to ensure they consistently achieve the best possible outcome for clients, and this should include the venues they will consider and how they will prioritise them – including internal networks or systems, affiliated venues

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<sup>34</sup> For example, in Mexico and Brazil.

<sup>35</sup> Marketplace refers to an exchange or alternative trading system (ATS). Where a dealer creates a "crossing network" to execute its clients' orders, that network would have to be regulated as an ATS or exchange, which is subject to disclosure, fair access and other requirements.

<sup>36</sup> In relation to futures, in the US, all futures are required to be traded on a Designated Contract Market (DCM) and abusive trading practices, including improper cross trading on DCMs, are explicitly prohibited by the Commodity Exchange Act.

<sup>37</sup> MAS reported that they require futures brokers to route client's transactions to a futures exchange or recognised market operator, except for permitted situations. A futures broker is not allowed to execute a client's order by offsetting it against the order(s) of another client, unless it is in accordance with the business rules and practices of the futures exchange or recognised market operator.

<sup>38</sup> Including US SEC and FINRA, Hong Kong SFC, Japan FSA, ASIC, and EU members.

<sup>39</sup> ASIC and HK SFC.

or others.<sup>40</sup> MiFID rules on best execution also require intermediaries to gain their client's explicit consent prior to executing their orders outside a regulated market or MTF.

However, market intermediaries operating broker crossing networks (BCNs) in the EU are not currently subject to the same requirements as an MTF or regulated market, which are subject to requirements around non-discriminatory access and disclosure requirements on their rules and operations. A market intermediary operating a BCN is instead subject to high level requirements as applicable to this specific service, so would have to provide clear, fair and not misleading information to clients and ensure they identify and manage any conflicts of interests.

In Japan, brokers are also required to establish a policy and method for executing orders from customers under the best terms and conditions ("Best Execution Policy") and execute orders in accordance with the Best Execution Policy. Before accepting an order from a customer, brokers need to deliver in advance to the customer a document stating the Best Execution Policy. They are prohibited from providing and promising special profits to a particular client. In addition, the FIEA stipulates that brokers must establish internal control systems to deter conflicts of interest, requiring them to appropriately manage information and establish systems that monitor the state of implementation regarding financial instruments business in order to prevent harm to a particular customer's interests.

Under US SEC regulations, broker-dealers that route customer orders in equity and options are required to publish reports that identify the execution venues used. On request, broker-dealers are required to disclose to customers the venues to which their individual orders were routed. The reports must disclose any material interest the broker-dealer has in the venue, along with details of any PFOF and profit-sharing relationship. FINRA's rules, including its best execution rules, expressly address internalisation of customer orders and require firms to compare the quality of execution obtained, including internalised orders, to the quality of execution that could be obtained on the open market.

HK SFC also noted that their general Code of Conduct requires that a licensed or registered person has an obligation to execute client orders on the best available terms and should act in the best interests of its clients in providing services to them. Client order handling obligations also require fair treatment of client orders and that they should be executed in the order they are received. Client orders must be prioritised over those orders that are on the own account of the intermediary, their employees or agents, or for any account in which the intermediary has an interest. HK SFC also requires intermediaries to disclose any monetary or non-monetary benefits as well as any transaction information to the clients, and when there is actual or potential conflict of interest in a transaction with or for a client. In the event that a conflict of interest cannot be avoided, HK SFC requires intermediaries to take all reasonable steps to ensure the client is fairly treated.

ASIC general market integrity rules include requirements on fair treatment, fairness and priority in dealing and opting out by users of crossing systems. ASIC also requires market participants to disclose to wholesale and retail clients the execution venue where a transaction involves a crossing and to confirm when acting as principal. ASIC also notes that best execution monitoring obligations require intermediaries to have adequate policies and procedures in place which must set out a description of arrangements to monitor the policies, procedures and implementation required by best execution and to ensure they continue to be adequate to ensure compliance. Market participants must

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<sup>40</sup> MiFID (Directive 2004/39/EC), Article 21. Under MiFID, best execution is determined according to execution factors including price, cost, speed, likelihood of execution and settlement, size, nature and any other factors relevant to the execution of an order.

be able to demonstrate that their policies and procedures in this area enable them to consistently deliver the best outcomes for clients and that client orders have been handled in accordance with such policies and procedures or with client instructions. Participants must be able to demonstrate evidence of execution performance and order transmission on request by a client. Records which enable the participant to demonstrate compliance with the policies and procedures must be kept for a period of seven years.

As noted above, in Canada, brokers cannot internalise orders for any securities that are exchange traded. However, with respect to use of affiliated venues, marketplace participants are required to disclose any ownership stake in another venue to clients. In addition, marketplaces are required to disclose their conflicts of interest policies on their websites, including whether they or their affiliates trade for their own account on the marketplace against or in competition with clients.

*More specific requirements applying to the operation of internal venues*

In Australia, ASIC introduced more specific rules in 2014 to address concerns and issues identified with firms operating internal crossing systems. ASIC now require market participants that operate a crossing system to:

- a. make certain notifications to ASIC and users of the crossing system (e.g. a description of the order types and their characteristics), and make information about the operation of the crossing system publicly available on a website;
- b. provide fair treatment to all users of a crossing system, including:
  - i. that a crossing system operator's principal orders are not intentionally interposed between client orders; and
  - ii. that clients are able to opt out of having their orders sent to a crossing system without any additional operational or administrative requirements;
- c. monitor activity on the crossing system, report significant breaches of its user obligations and operating procedures to ASIC, and report suspicious activity to ASIC; and
- d. have controls to ensure the efficiency and integrity of the crossing system.

A recent report by ASIC notes that they have seen a subsequent improvement in crossing systems following these changes, especially in the quality of disclosures made to clients and to ASIC, and also transparency of these systems to the wider market.<sup>41</sup> ASIC also received feedback from investors that they now have greater insight into how their orders are being managed, especially where the operator is trading with them as principal. It was also noted that crossing system operators are also providing more options for clients to manage adverse outcomes and market impact (e.g. the ability to opt to avoid interacting with high-frequency traders and to set minimum execution sizes).

Prior to 1 December 2015, HK SFC noted they had some requirements applying to most operators of Alternative Liquidity Pools (ALPs), although this has now been supplemented by more detailed requirements (discussed in Section D below). However, at the time of the survey, HK SFC's regime for ALPs included requirements on the prioritisation of customer orders and information controls, disclosures to customers, and appropriate trading methodology and controls. In addition, requirements also covered the ALP operators' contingency planning, record keeping and transaction reporting.

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<sup>41</sup> ASIC Report 452, 'Review of high-frequency trading and dark liquidity,' October 2015. See: <http://asic.gov.au/regulatory-resources/markets/market-structure/dark-liquidity-and-high-frequency-trading/>

## 2. Findings from recent supervisory inspection work by regulators

Several regulators noted that they had recently undertaken specific supervisory work in this area.

A recently conducted review on order routing practices of firms by FINRA found an instance whereby a broker-dealer allowed its affiliate to unilaterally effect changes to the broker-dealer's order routing schedules and/ or reject certain order flow without a determination of the impact of such conduct to the firm's execution policy. In addition, inadequacies were found with the firm's best execution committee, such that the committee wasn't aware of an affiliated market maker controlling volumes and types of order flow directed to it.

In Switzerland, FINMA noted that a general observation from the supervision of intermediaries was that orders are typically routed to internal venues for price improvement.

The UK FCA reported that they had published findings of a supervisory thematic review into best execution in July 2014 (TR14/13<sup>42</sup>), which included examining intermediaries' approaches when routing orders to internal or affiliated venues. It found that intermediaries who relied heavily on internalisation or executing orders through connected parties were often unable to sufficiently evidence whether this delivered best execution and how they were managing the associated conflicts of interest. In particular, findings included that:

- Some firms executed significant levels of their equities volume through their internal matching facilities, without evidencing whether this delivered best execution;
- Some firms were unable to show how they separated explicit external costs incurred on behalf of clients from internal costs or how their commission structures for internalisation avoided discriminating against other venues; and
- Some firms relied on connected parties for execution of certain order flow but did not manage these relationships in the same way as similar third-party execution relationships they had.

The UK FCA set out a range of good and poor practices regarding best execution monitoring and use of internal venues as part of this report.

The FCA has also recently published findings from a thematic supervisory review (TR16/5) examining a sample of broker-operated crossing networks and dark venues.<sup>43</sup> This work explored issues including brokers' disclosures to clients on how crossing networks operate, the monitoring and oversight of execution quality through internal networks or broker-owned dark venues, and management of conflicts of interest. It also surveyed buy-side users of these dark pools. The report sets out a range of good and poor practices relating to broker crossing networks, in particular, and also poses questions that market participants could apply to their operations to consider if they are meeting the expectations of their clients and the FCA.

The Dutch AFM undertook work to assess certain order execution models when implementing a ban on inducements in relation to services provided to retail clients in 2014. In some cases order crossing practices were looked at also as part of the assessment. The AFM also notes an investigation on a firm

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<sup>42</sup> FCA Thematic Review (TR14/13), 'Best execution and payment for order flow,' July 2014.

<sup>43</sup> FCA Thematic Report (TR16/5): UK equity market dark pools – Role, promotion and oversight in wholesale markets, July 2016. See: <http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr16-05>

whose execution policy stated that that the broker would prefer its affiliated trading venue unless another trading platform to which the broker is electronically connected would offer a better price.

HK SFC recently carried out a review and consultation on their provisions concerning ALPs. As a result of the review, the SFC is proposing amendments to its existing rules (see section D below).

ASIC carried out a review on dark liquidity and high- frequency trading last year. The key findings of the review were published on 26 October 2015 in Report 452.<sup>44</sup>

CONSOB noted a thematic review that it carried out when it issued a communication on illiquid products, and another review on intermediaries internalising and crossing orders between different individual portfolios of assets they manage.

### **3. Enforcement cases or actions**

Three regulators - FINRA, Hong Kong SFC and CONSOB have undertaken recent enforcement cases in this area or are considering potential actions.

FINRA reported a case where settlement was agreed with a firm that involved the firm internalising profit from customer order flow. The firm, operating an ATS, would execute two principal transactions with customers at different prices within the system and keep the difference in price as compensation. The firm could not establish records of disclosure of the activity and was found to have violated FINRA's conduct rules.

In August 2015, the HK SFC fined BNP Paribas Securities (Asia) Ltd (BNPP) \$15m for dark liquidity pool-related failures. The disciplinary action followed an SFC investigation into BNPP's dark pool trading services, known as the BNP Internal Exchange (BIX). The SFC found that:

- BIX didn't follow the execution policy it had disclosed to its clients. Despite having disclosed that orders would be executed in accordance with order price priority, BIX failed to give priority to higher price orders and treated all orders as having equal priority.
- BNPP suspended BIX service in April 2011 upon the discovery that orders were not matched according to order price priority. BIX services were not fully restored until seven months later and the SFC was not informed of the suspension until 21 months later. This constitutes a breach of BNPP's licencing condition.
- BNPP's licence application stated that client consent would be obtained before their orders were placed on the BIX for matching. However, client orders intended for execution on the Hong Kong Stock Exchange were automatically enabled on the BIX.
- BNPP failed to maintain sufficient trade records identifying the specific auction in which each order participated and coherently document the matching logic to explain the matched trades. This means it is difficult to calculate the precise impact of BIX's failure to implement their disclosed execution policy.

CONSOB noted that its recent thematic review on intermediaries internalising orders may give rise to enforcement actions. In addition, the outcome of the review has also been used to guide CONSOB's further supervisory activities and to evaluate the impact of the new provisions in MiFID II.

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<sup>44</sup> ASIC Report 452, 'Review of high-frequency trading and dark liquidity,' October 2015.

## **B. Intermediary practices in relation to their use of internal or affiliated venues when order routing**

### *Overview of responses on internalisation or use of affiliated venues*

Reflecting the absence or prohibition of internalisation or use of affiliated venues in some jurisdictions noted above, a majority of intermediary responses (32/55) stated that they did not operate an internal venue or service, or use affiliated venues. Several responses from Mexico noted that all orders were routed to the national exchange (MSE) of which they were members and there was no scope to route orders elsewhere. There were several other jurisdictions where none of the responding intermediaries operated an internal venue or used an affiliated venue to which they routed orders.<sup>45</sup>

However, 19 intermediaries stated that they internalised a proportion of their execution business, which appeared to reflect larger and more sophisticated entities. These included one or more firms from across a number of jurisdictions.<sup>46</sup> In some cases, firms operated several crossing networks in different jurisdictions in a region. Eight firms noted use of an affiliated venue or broker.

### *Volume of orders directed to internal networks or affiliated venues*

The volume of orders routed to internal crossing networks in the last 12 months was in all cases a minority of total order flow volume, but within this there was some variation. At the lower end, several firms reported that they internalised less than 5% of order volume.<sup>47</sup> The most common figures stated by respondents were between 5-15% of equities volume.<sup>48</sup> A few intermediaries reported higher levels of internalisation, at slightly over 20% of their equities order flow.<sup>49</sup> Several intermediaries stated they used an internal venue or system, but did not provide figures or provided non-comparable figures.<sup>50</sup>

Only two firms mentioned crossing in relation to derivatives. A Dutch intermediary cited order flow levels at just over 10% for options and less than 5% for futures, compared to over 20% for equities transactions. A Japanese firm stated the volume of crossing in derivatives is marginal. Several other firms explicitly noted that their futures and options business is always traded on external venues or exchanges.

Use of affiliated venues was less common. One respondent from Hong Kong reported use of an affiliated dark venue to which all of their client orders for Japanese equities were first routed (unless the client had opted out of execution on non-lit venues). This intermediary noted that of this order flow, 15% of orders were executed at the affiliated venue with the remainder on-routed to the primary lit exchange. A US intermediary stated they routed all orders to their broker-dealer affiliate, who then determines how the order is routed and executed. This same firm noted that they do not receive any monetary revenues from their affiliate, although the affiliate may earn additional revenue from on-routing their clients' orders.

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<sup>45</sup> Canada, Poland, Brazil, Turkey, Spain, Germany and Romania.

<sup>46</sup> Netherlands, Hong Kong, Australia, Japan, France, Switzerland, the UK, and the US.

<sup>47</sup> One intermediary each from Hong Kong, Australia, France and Japan.

<sup>48</sup> One French, one UK, two Japanese, a Hong Kong firm in two of the three markets it operates in, and one Australia firm.

<sup>49</sup> One Swiss firm, a Hong Kong firm in one market, and one Dutch firm.

<sup>50</sup> One UK firm stated that equity orders were internalised within two categories based on whether they routed via direct market access (DMA) or through their algorithmic trading facility, not allowing an overall comparison. One French intermediary stated they only crossed matching voice trades on an OTC basis, but this was not systematic and did not involve an automated routing engine or crossing network.

A Canadian firm noted that they had a minority stake (less than 10%) in the group company that owned a primary external exchange and held a seat on their board. However, they stated there were no agreements or influence on their firm to direct order flow to that exchange, and that conduct requirements superseded any commercial interest. One German intermediary also stated that while it has a role in a third party dark venue in their jurisdiction and may route client orders to it, they do not internalise any orders themselves, nor do they have a commercial stake in the third party venue. One UK firm similarly noted having small stakes (less than 10%) in several third party venues.

A couple of intermediaries (from Switzerland and Singapore) noted that they used an affiliate only to access certain markets in other jurisdictions, where the firm did not have access to the exchange. In such cases they use a single affiliated third party broker who is a member of the particular exchange they wish to access.

#### *How intermediaries determine when orders are routed to an internal network or affiliated venue*

There was some divergence in market practice between intermediaries depending on the jurisdiction they operated in, usually linked to their best execution requirements. However, most respondents stated that they would route orders to achieve the best cost and price for clients, with a minimum requirement that their internal venue would need to offer execution at a price at least as good as that available on a lit market.

One Hong Kong and one Swiss intermediary specifically stated the primary best bid offer (PBBO<sup>51</sup>) as the benchmark in such cases. Two French intermediaries noted that their crossing networks only executed at the mid-price. Other brokers noted that their internal venues permitted several order types, which would allow a client to opt to either match only at the bid price or to cross only at better than the lit bid price (see next answer below), or always sought to execute inside the spread of the lit market price (one Japanese, one Hong Kong, one Dutch and one UK firm). Smart order routers were, in nearly all cases, used to route orders in line with matching logic / parameters set by the firm.

All three Australian firms noted that they are subject to specific regulatory requirements when executing client order on an internal dark venue, including:

- the requirement to provide fair treatment of all users of a crossing system;
- the best execution obligations owed to all clients;
- the requirement to provide financial services efficiently, honestly and fairly; and
- the requirement to provide meaningful price improvement on dark trades relative to lit market prices.

One of these Australian intermediaries added additional factors that its smart order router considers, including outage handling, protection of client information (e.g., routing that minimises information leakage), and use of standard tick sizes.

A Dutch intermediary noted they would seek better execution than the market execution, although in the EU price improvement is not mandated. There was commonality between the order routing approaches taken by the Australian and EU firms,<sup>52</sup> and one Hong Kong firm (that operates in Australia and Japan, as well as their own jurisdiction). Respondents from these jurisdictions all noted that a decision to route orders internally or to other venues will take into consideration a range of

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<sup>51</sup> PBBO is the best bid and offer price for each stock on the relevant primary exchange on which they are listed.

<sup>52</sup> Including a French, Dutch, and two UK intermediaries.

execution factors, as required by regulations.<sup>53</sup> These respondents also often referred to having an execution policy, usually made available on their website, which sets out their approach.

Other general factors mentioned in addition to the above included speed, fill rates, and fees – with one US respondent noting that rebates and payment for order flow would be considered. Two intermediaries, one Dutch and one UK firm, noted that explicit and implicit costs of execution were considered, among other factors, with the Dutch intermediary adding that a key factor taken into consideration in their automated crossing logic was whether the explicit trading costs for matched participants in their crossing network were lower compared to external venue fees and clearing costs. One Japanese intermediary had a specific requirement that routing to their internal system would only occur if the entire client order could be filled, and also had an upper cap on the size (by monetary value) of order that could be routed internally - otherwise an order would be sent externally.

One French firm noted that they had two crossing networks and a systematic internaliser, which it used for different client flows and with different routing approaches as a result. One of its crossing networks prioritises on a traditional price-time basis but is used only for the firm's own algorithmic trading. The firm's second crossing network groups clients interacting in the pool, and gives the different groups a higher or lower priority in matching.

Responses from one Australian, one French, one Japanese, one UK and one Swiss intermediary each noted that the execution approach depended on the type of order sent to their smart order router (SOR), which can either be aggressive or passive as determined by their clients. These respondents described similar approaches for aggressive orders.<sup>54</sup> If a client had consented to internal crossing, the firm's SOR would prioritise checking liquidity in their own crossing network and other accessible dark venues, and, if present, send 'immediate or cancel' (IOC) orders. If insufficient liquidity was detected in the crossing network or on other dark venues, or a client had not consented to execution outside of a lit market, the firm's SOR would seek the best available prices across selected lit venues and when an optimal aggregate fill price across venues was identified, orders would then be routed to the various venues simultaneously. The Australian and French intermediaries noted that if liquidity was found at the same price on two venues, they would then consider the execution cost of the respective venues. The Japanese intermediary also described the exact order in which their router would consider venues, and set out their rationale for this ordering.<sup>55</sup>

The same five firms described similar approaches for passive orders.<sup>56</sup> This involved seeking larger fills in their own crossing network to minimise information leakage and enhance their ability to track and resolve any quality issues for the client's actual execution, versus an external venue. Orders are sliced and sent in increments to rest on other venues based on similar metrics and historical liquidity analysis,<sup>57</sup> with slightly bigger slices of an order sent to more liquid dark or lit venues, and smaller

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<sup>53</sup> With factors including: price, strategy, client specific configuration or instructions, likelihood of execution, size of the transaction and any other considerations relevant to the execution of the order.

<sup>54</sup> Aggressive orders seek to take existing liquidity from the market by pricing to buy either at or above current offer prices on the market, or to sell at or below current bid prices (e.g. marketable orders).

<sup>55</sup> Factors included, in priority order, the following: likelihood of information leakage; likelihood of execution / level of liquidity; analysis of historical liquidity, quality and hit-ratios of lit venues. They noted that, all execution factors being equal, they would then prefer an affiliated venue (in this case, the affiliated venue was a large lit exchange).

<sup>56</sup> Passive orders provide liquidity as they will rest on an order book at a price not currently available on the market, e.g. priced to buy below current offer price, or to sell above current bid.

<sup>57</sup> Although the Australian intermediary noted that their SOR would also factor in the current quotes available on these venues to avoid sending an order that would be conspicuous (to avoid potentially adverse price movement).



slices in size to less liquid venues. One firm stated their own crossing network is always prioritised on passive orders prior to seeking to route externally.

Three firms (a Japanese, French and US intermediary) mentioned specific algorithms / order types for targeting volume weighted average price (VWAP) trades that may be routed to their own crossing network. The US and Japanese firm noted such orders would primarily be routed to their own matching system designed specifically for these types of orders, but could also be routed to a limited number of alternative external VWAP crossing networks if there was no match in their own system. The French firm implied that VWAP dark orders would almost always cross on their own platform. The US firm also noted their internal venue is used to indirectly facilitate client trades, since if the firm commits capital to trade as principal with a client, it may unwind its own position in part through propriety trading in its crossing network.

A number of responses from multiple jurisdictions stated that client-specific instructions or routing preferences would be followed and take precedence over other factors if provided. Several respondents also noted that clients had a range of options they could select to prioritise specific order routing or opt out of being routed to certain venues.

For the few examples where orders were always routed to either an affiliated broker (to access a specific third country market they could not otherwise trade on) or other entities within a group, the respondents stated there were no criteria to consider.

*Monitoring of orders routed to internal or affiliated venues and approaches taken when orders cannot be immediately executed on such venues*

A few intermediaries noted that their crossing network would only match trades at current market prices, and if there was no matching order, any delay in a price feed, or trading in a reference venue was not in a continuous trading phase (mentioned by a Dutch intermediary), orders would be sent to the primary market immediately. One Hong Kong intermediary stated a similar approach, whereby orders or part orders matching inside the PBBO would be executed, with any balance then immediately routed to the main exchange. Several intermediaries noted that treatment will also depend upon the nature of the client order and instructions.<sup>58</sup>

A second Hong Kong firm noted that, when using an affiliated venue, they perform transaction cost analysis (TCA) to monitor execution quality, and set a defined time period after which the venue should route an order to the primary venue if not executed in their dark pool. A Japanese firm made a similar point, but noted that they would check for sufficient liquidity on the lit venue prior to routing from their crossing network. A Singapore firm noted that execution quality would be assessed by benchmarking the outcome of a trade to the original client request and instruction.

Six firms (one Australian, one Japanese, one French, one Swiss and two UK intermediaries) explicitly stated that their governance and monitoring framework to assess best execution was the same for external and internal venues, although in several other cases a similar approach was also implied. One UK firm also stated that they did not hold on to orders to await execution in their own crossing networks, but sought liquidity on multiple venues simultaneously to ensure the best possible result and likelihood of execution for the client.

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<sup>58</sup> Possible scenarios mentioned include the following: that an order not immediately filled would be cancelled; an order may rest in the internal venue; or it may be on-routed either to a lit market or venue selected by a firm's smart order router, or to another venue if specified by the client.

Three responses (two Japanese, one UK) noted that they analysed order routing on a real-time basis or daily basis, and then analysed execution quality against a historical order database. They noted their assessment approach was the same for all orders routed via their SOR, which routes orders to both internal and external venues, so their analysis of execution quality did not vary by type of venue (e.g. the firm's own crossing network was subject to the same analysis as other venues). The UK intermediary noted that daily monitoring seeks to identify any exceptions by comparing executions to benchmark data, which depending on the order could be based on opening or closing prices, or for intra-day trades would consider price slippage versus arrival price and order benchmarks.

Several other responses noted TCA reports as their main tool for monitoring execution quality, with price reversion and spread capture being common metrics analysed. A Swiss headquartered intermediary noted they have real time execution and risk management processes and monitoring, and assess this information at least monthly. Another Swiss firm noted that for part of its business it uses external third party TCA analysis. One UK firm noted that they were in the process of implementing third party analytics software to supplement internal analysis and strengthen their overall monitoring framework.

A French intermediary provided more detail on their use of TCA, which involved use of a third party tool, alongside their own internal 'toxicity' analysis. The TCA method examines both internal and external venue execution performance. It measures client execution results against arrival price and VWAP, with outliers flagged and reviewed weekly, and monitored in a best execution committee. The toxicity analysis approach is used for dark pool executions, across internal and external dark pools used. The analysis looks firstly at the context of the immediate price achieved (to detect if an order may have been impacted by possible latency arbitrage), and secondly examines subsequent price movement after the fill (to assess if an initial fill on a venue leads to adverse trading conditions for the remainder of the order). The analysis also captures average notional trade sizes and distribution of fill sizes. Regular reports are generated on this analysis and are reviewed at the best execution committee. The French firm also noted specific actions taken as a result of their approach, including turning off one dark venue, and introducing a minimum acceptable quantity on order flow sent to another venue (due to concerns of latency arbitrage).

A few responses also indicated sophisticated monitoring approaches that focused on their own internal crossing networks, whereby the trading behaviour of each client is monitored and reviewed to ensure acceptable execution quality and quantity is achieved, and to ensure individual clients are not exhibiting persistently undesirable trading behaviour.

One Hong Kong firm stated that they track metrics such as order to trade ratios, price reversion after fill, resting times, order and trade sizes and aggressiveness of trading strategies. This is used to identify clients who may be trading in a way that is unfavourable for other clients in its internal network, and based on certain thresholds for these metrics a client may be warned about their trading behaviour. A client exhibiting consistently poor behaviour could have restrictions placed on their order flow or would be disconnected. A Swiss firm also indicated that they conducted analysis by types of counterparties and individual counterparties.

An Australian intermediary periodically reviews volume of orders by clients, price improvement, adverse selection and other quality checks in their own crossing system, and applies a similar approach to other dark venues to which they may route client orders. The firm discloses their venue analysis to their clients on a quarterly basis. A second Australian firm undertakes similar monitoring on a T + 1 basis, and noted that they have formal governance arrangements within the firm to assess execution quality, routing logic and venue assessment. Such policies and procedures applied equally

to use of internal or external venues. All three respondents from Australia who operate a crossing network noted they used the same third party surveillance tool as part of their execution monitoring.

Finally, one Dutch intermediary provided an example of their approach to considering whether to use another venue's smart order router. They have in place a process to test the logic of another router, and require it to fulfil these requirements before they would consider using it for client orders.<sup>59</sup> The Dutch firm noted that if a venue's router did not pass these tests, they may consider building their own SOR, or if a particular venue is offering consistently good execution and / or is directly requested by clients, they would offer to send client orders to that venue on request. They noted a recent example where they had declined to connect to a third party smart order router because it failed their test.

Several responses simply stated that internal monitoring and surveillance tools were used to track order routing and execution quality, but did not provide any specific details.

#### *Use of client categories or filtering of client orders in internal venues or networks*

Responses from intermediaries operating an internal venue fell into two groups – those that applied no filtering, stating that they treat all clients equally in accessing their internal venue or crossing network; and those that applied some form of categorisation and provided options for clients to select which market participants or order flow type they could interact with.

Two Japanese intermediaries and a Dutch firm noted that access to their dark internal venue was on an equal basis, with one of the Japanese firms noting an exception that they excluded single block orders above a certain size. A Hong Kong intermediary also noted that they ensure all orders are treated equally and in particular that proprietary trades are not given priority over client orders. They use anti-gaming logic as part of their crossing network to protect client orders from potential predatory trading behaviour by other participants.

One Australian intermediary noted that they apply a strict price / time priority to all orders, with no 'tiering' offered nor customised order types. However, they distinguish between whether the flow into the pool is via the firm's agency, facilitation or risk desks, and allow clients to opt not to interact with certain types of flow. Another Australian firm noted that access to their crossing network is not tailored for any specific client type but there is an option for clients to opt out of interacting with certain types of flow, e.g. the firm's own principal flow (including from group entities) or market makers present in their crossing system. If a client wishes to access the crossing network using their own electronic system, they also have to do so via a specific protocol.

Two further responses (from an Australian and a French intermediary) had similar arrangements, whereby clients could not directly access their crossing networks and had to use the firm's own algorithms. The Australian firm also noted that while it allows aggregators and liquidity providers to operate in their crossing network, in addition to institutional and agency broker clients, they did not permit market makers or high-frequency trading (HFT) firms – although they did not indicate how they made this distinction. Clients have the option to select which client types they interact with. The firm monitors eligibility against the criteria for each type of client through an annual 'know your customer' (KYC) review.

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<sup>59</sup> The Dutch firm's approach involved testing: (i) where orders are split up, they must arrive a different venues in a non-arbitrageable time difference or, at least, arrive first at the exchange with the highest liquidity; (ii) any surplus should be divided over the other exchanges where the split is based on volume and price in the depth of the order book; and (iii) if an order is passive, it should be sent to the most liquid exchange (i.e. the primary exchange), where resting orders will have the highest probability of execution.

The French intermediary also stated they did not permit HFT firms, though noting the absence of a common definition. For their purposes, they defined a HFT participant as one that appeared to be acting as a market-making liquidity provider exhibiting a high messaging rate and that typically seeks to execute at a bid/offer price point. The intermediary noted that they had declined to permit access to their crossing network for potential clients they had deemed to be HFT market participants, and also clients whose order flow behaviour *appeared* to be market making in nature.

Another Hong Kong intermediary noted that their clients could configure their own controls on an individual basis, including counterparty selection, fill price controls (for example, mid or better) and minimum acceptable quantity. The firm noted that counterparty types are actively used for monitoring ongoing eligibility via a dedicated working group for their crossing network, with all direct participants reviewed by this group.<sup>60</sup>

Six other firms (one French, one Japanese, one Swiss and three UK firms) referred to more detailed client groupings in their dark pools. The French firm separates participants into three groups: 'clients' (which could include asset managers and wealth managers, hedge funds and wealth funds, and third-party brokers routing similar client orders to their pool); their own proprietary or principal trading flow; and finally a group of electronic liquidity providers / market makers made up of one internal desk of the firm, and two external providers. One UK intermediary appeared to make a similar split into institutional, wholesale and principal flow, but did not describe these categories.

A further UK respondent also has three categories: one group for clients who use the firm's own suite of algorithms without any customisation; a second group for institutional clients with direct access to their crossing network; and a final group of broker dealers with direct access to the crossing network. Each group can then choose which of the other groups they can interact with.<sup>61</sup> The respondent introduced this approach to improve transparency after a review of their internal network, and stated that it removed the need to regularly monitor these categories since they are objectively based on the order type, although they review the categories on an annual basis.

The third UK intermediary makes a similar distinction between client flow (any external flow) and their internal firm flow, but also whether trading is conducted on an agency or principal basis. They treat any participant using a direct FIX connection either internally or externally as an electronic liquidity provider. Prioritisation of orders operates on a price-categorisation-time basis.<sup>62</sup>

A Japanese intermediary had a more granular breakdown of five client categories: institutional clients, their own principal flow, market makers, partner brokers (other brokers' order flow on behalf of their underlying clients) and active traders (any other clients). The firm noted that market makers would use low latency infrastructure to access their pool, however they set rules for these participants. These were: (i) a ban on IOC orders (ii) a requirement that they must be net liquidity providers; and (iii) that there should only be minimal price reversion after fills involving those participants. The firm monitors and reviews against these criteria regularly via a monthly governance committee, and can temporarily or permanently exclude participants if necessary.

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<sup>60</sup> This crossing working group sits under a regional execution governance committee that is comprised of various lines of business (e.g. their front office), as well as operational risk, compliance, quantitative strategies, and legal staff.

<sup>61</sup> I.e. they can choose to interact with either (i) only with flow through the firm's standard algorithms; (ii) standard algorithm flow plus institutional clients with direct access, but not broker-dealers using direct access; or (iii) all flows, including other broker-dealers with direct access.

<sup>62</sup> Agency trading is prioritised over principal trading and, by category, client flow has preference over the firm's own flow, and electronic liquidity providers last of all. Client or firm internal flow using the firm's algorithms can limit their interaction with other types of flow.

A Swiss headquartered intermediary also tailored access by types or clients, but based on a client's intended and actual order flow. The firm initially categorises clients into types based on their disclosures to the firm as to the intended nature of their order flow. The firm then assesses clients' actual order flow, based on quantitative analysis mainly looking at the price and spread achieved by orders in their dark pool relative to the PBBO (although it would also consider other factors). A review of this analysis occurs at least monthly, and may lead to a change in the segment into which a client is categorised.

Most responses also noted that clients have the choice to opt out of having their orders routed to an internal crossing network or dark venues completely.

*Disclosures to clients related to the operation of an internal venue or use of affiliated venues*

Several firms, including two Australian and two Hong Kong firms, and a Dutch, Japanese and Swiss intermediary, note that the internal matching policy used is transparently disclosed to clients either separately or as part of the order execution policy, including the types of order available to the client and how they will be treated. Respondents from Hong Kong and Australia noted that regulatory requirements in their jurisdiction required them to disclose publicly on their websites the details of their dark pool operating procedures. The Swiss headquartered intermediary noted that their approach differed for their US business, where the US firm files details on the operation of their internal venue in 'Form ATS' as required by SEC rules, in addition to making this document publicly available.

One Australian firm noted that their operating procedures disclosures included both details on available order routing strategies, and potential conflicts of interest. Another intermediary noted they also disclose potential conflicts of interest, including specifically that the client's order may be matched by the firm itself or affiliated group companies. Another Australian intermediary gave a more detailed list of the topics covered in their crossing network disclosure documents.<sup>63</sup>

One intermediary from France and two UK firms note that their order execution policy is publicly available on their website, with two of these firms noting that this includes a list of the venues that client orders may be routed to by them. However, in each case it was unclear whether the execution policies contain specific detail relating to how their internal crossing network operated.

Another Japanese respondent that grouped participants in their internal venue also referred to providing material that explained these groups and the options for interacting with them. They also offer a more detailed document on their order routing logic on request, although noting that certain details were still omitted to protect their intellectual property.

Two intermediaries – one from Japan and one from Hong Kong – refer to providing a training pack or walk through to prospective dark pool users, which would, for example, provide operational details of the pool; explain the crossing mechanism; and provide trading examples. On a similar theme, a UK respondent said that they have produced a frequently asked questions (FAQs) document for clients, and also provide them with a document that sets out some worked illustrations of order types and the resulting routing decisions.

A number of intermediaries referenced the fact that they provide marketing material to clients on their crossing network, although they did not provide any further detail. They also followed this up with face-to-face meetings or calls in most cases to explain the operation of their internal venue. One UK

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<sup>63</sup> This included access criteria; user arrangements and opt-outs; outage and recovery protocol; maintaining integrity and efficiency of market; anonymity; order types; prioritisation and matching; conflicts of interest management; and fees.

firm noted that any marketing material was subject to internal review and sign off processes. A Hong Kong firm that does not have an internal venue, but uses an affiliated venue, noted that they distribute to their clients the marketing material, best practice guide and strategy documents of that venue.

Nearly all respondents noted that they sought explicit client consent to using their dark pool or crossing network, and / or smart order routing execution service. This was usually sought by the firm as part of initial client agreements and terms of business when opening a trading account.

Most also noted that clients have the option not to interact with either dark pool or affiliated venues if they wish, either by not consenting at the client onboarding stage, or subsequently indicating their preference to opt out of a dark pool or not to be routed to a particular venue. One Australian and one Japanese intermediary noted that they require such instructions or preference to be provided in writing. A Swiss headquartered intermediary noted that in the EU they undertake a client attestation process to establish whether a client consents to their order being routed to their internal venue, and whether they consent to trading outside a Regulated Market or MTF (as required by EU regulations).

A number of firms also note that their conflicts of interest policy is made available on their website, including intermediaries from Australia, France, Japan, and the UK.

#### *Intermediaries' information controls when operating an internal network or using an affiliated venue*

Most responses indicated that they had information controls and policies and procedures around the protection of client information and orders. Most intermediaries note that employees within the firm either cannot access trade data in the crossing network at all, or only on a strictly 'need to know' basis. Commonly, firms refer to technical support staff as the essential individuals who can access the systems, with some noting IT technical support were the only individuals who were permitted access to crossing network data, while others mentioned that market surveillance and monitoring / supervision (compliance) staff also had access to trading information.

Systems security and Chinese walls / information barriers were mentioned as means to ensure unauthorised staff cannot access trading data, and to ensure trading desks cannot access information and are separated from IT support staff. Three firms (from Hong Kong, Australia, UK) noted that this included technological segregation as well as systems access controls, and mentioned physical separation on trading floors as well – although other firms also implied they have similar controls.

One Hong Kong intermediary noted that they have full segregation between different execution channels (High Touch, Portfolio, Electronic, Derivatives), with physical separation on the trading floor, policies and procedures, and system access controls. They noted that order flow and trade data is automatically fed to the relevant systems for surveillance and monitoring purposes in accordance with regulatory obligations. A UK firm also noted physical and technological segregation between its regional high touch cash equities business, and regional electronic cash equities departments.

One French intermediary outsources the operation of their internal venues to a third party operator, and this precludes either market makers or their own internal desks from being able to monitor orders.

The importance of maintaining client trade anonymity was noted by several firms. This includes preventing trading desks within a firm from sharing information on client orders. Several intermediaries (from France, Japan, Singapore and Switzerland) explicitly mentioned that the identity of a client order would not be revealed in the crossing network or when routed to another venue. In cases of routing externally, the order would appear in firm's own name via an omnibus account. The exception would be if the client expressly requested their identity to be visible. One UK firm noted that a client can request that the trading desk have access to certain aspects of their own order flow

information in the firm's crossing network. One Dutch firm stressed that clients have no ability to preview or select which orders they can match with.

Two UK respondents listed various global policies applicable to their procedures with regard to information security standards, privacy and confidentiality policies, and a code of conduct for staff.

*Other policies and procedures relating to operating an internal network or use of an affiliated venue*

In terms of more general policies and procedures, several intermediaries referred to trading controls and their execution policies as key tools to manage any potential conflict of interest for their firm. Many felt that the requirement for crossing networks to offer execution at or better than the price available on a lit exchange limited potential conflicts of interest. The combination of best execution obligations and, in some cases, client-specific instructions, minimised potential conflicts of interests.

One Australian intermediary noted that having and maintaining policies and procedures governing best execution, meaningful price improvement, protection of confidential information, managing conflicts of interest and several other areas were now mandated in regulation (by ASIC) and were reviewed on an annual basis.

A number of other firms noted that they had best execution committees or similar governance structures that would meet regularly to review metrics of trading performance (which are also noted above). In some cases, this would include reviewing if client categorisations remained appropriate. Some noted that their best execution committees will also review the order execution policy periodically as well, and in response to any material event.

One Hong Kong intermediary provided a detailed summary of their governance procedures. They have a regional execution governance committee to review on an ongoing basis the firm's governance framework and order execution arrangements for equities and futures, covering relevant policies, procedures, systems and reporting.<sup>64</sup> Its remit includes best execution, client order handling and routing practices, venue selection, operation and supervision of their crossing network, product and service evolution, and electronic trading risk controls and has a mandate to ensure consistent application of guidelines and processes across their regional business and electronic platforms. A sub-group of this committee examines execution quality, and is responsible for the maintenance and configuration of their smart order router, and a crossing working group looks at the maintenance and arrangements of the internal crossing network.

Another UK intermediary stated a similar comprehensive best execution governance framework which included working groups responsible for overall execution quality monitoring, including oversight of their smart order router and routing logic, and separately, a crossing working group considering their crossing network. They noted this structure had been formalised in 2014, having previously operated similar controls but on a more informal basis.

A French intermediary also gave more detail on their approach, noting that all internalised order flow is included in management information and exception reporting reviewed by a best execution committee, and is assessed in the same manner as external flow. This committee also considers all execution issues and any other material events that could impact the quality of the firm's execution and decides whether any changes need to be made to their execution arrangements. The committee also reviews any significant changes to existing activity that potentially affect the ability to obtain best execution, or which necessitates a change to the execution policy or venues used. The firm noted that

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<sup>64</sup> This committee includes representation from electronic trading, high touch, portfolio trading, product management, technology, legal, operational risk, compliance and additional support/control partners.

their compliance department also reviews the execution policy on a regular basis, and at least annually, to ensure that it remains adequate and accurately reflects their execution arrangements.

A number of responses made general reference to having a conflicts of interest policy, which in some cases was a global policy across the firm rather than specific to their execution business, and having a best execution policy in place but without providing further details. Usually firms also mentioned having a conflict of interest register in place to record more specific issues. One Australian firm noted that their conflicts policy included “dos” and “don’t’s” for staff to provide more practical examples. Another stated various ways in which they managed conflicts of interest, which included fair and open disclosures, policies and training for staff, governance ensuring scrutiny and challenge within the firm, monitoring and supervision, and information controls.

Several respondents noted that their best execution policy is reviewed annually, with some stating that this was also the case for conflicts of interest and information access policies. A majority noted that limited or no changes had been made in the last three years, although one or two noted making an update to either add or remove a venue from their execution policy. For example, one Japanese firm noted that they had made a change to their venue prioritisation in recent years, prioritising one venue for a period, before reverting back to an earlier ordering after reviewing hit ratios and finding they were low, bringing limited benefits for their clients. An Australian firm noted no change since adding Chi-X in 2010.

Two UK and two French firms stated they had made recent revisions to their execution policies following a supervisory report (TR14/13) by the UK FCA. One UK firm noted that they had added more detail on their approach to internalisation of orders in their policy and the factors used to determine which venues they used. A French intermediary stated that in addition to revising their policy, they introduced specific training on the (EU) best execution obligations, extended their existing measurement of execution performance to all execution venues including their internal ones and likewise ensured management information included order flow to all venues.

One Australian respondent felt that since their crossing network was only conducted on an agency basis, with the firm having no principal or proprietary trading in their internal network, no conflicts of interest arose for the firm.

#### *Fee structures for routing to internal venues*

A majority of respondents from various jurisdictions noted that they charge a standard commission for execution, and they do not apply a different charge if an order is executed in their internal crossing network versus an external venue, nor do they receive any rebates if an order is routed externally. Several noted that they do not gain any other revenues from operating an internal crossing network. Some firms noted that they had general fee tables for their equities business, with one firm providing it. Several intermediaries noted that the commission rates are negotiated and agreed with individual clients. One indicated that they have an internal fee table on which they will base their discussions, but they would not disclose specific fee structures to clients. So in the majority of cases, a lower fee was not offered for internally routed orders versus orders routed elsewhere, despite the likely cost savings for a firm where orders are internalised to their own system or venue.

One response suggested, in general terms, that any efficiency gained from executing orders internally was passed on in their general commission rates – e.g. this allowed them to offer slightly more competitive commission rates for all orders.

Only a few respondents noted a different approach. One intermediary from Singapore stated that clients are given a more competitive commission rate when an order is routed to an affiliate for



execution. The Dutch intermediary that routed orders to an internal venue also indicated they were planning to introduce a new charging structure that rebated 20% of the execution commission cost to clients in cases where their order is matched internally, reflecting the lower costs incurred by the firm on such orders.

Two Japanese firms also took a different approach. One firm noted that if a client wanted to access specific venues via DMA, including their internal venues, they would negotiate different fees for each. Another set flat fees in bands by value of individual transactions, and for each band the execution fee for the internal venue was lower than the fee for executing on the primary exchange.

### **C. Planned or proposed reforms to regulatory frameworks**

EU members, FINMA, and HK SFC all reported that there were planned changes to their regulatory regimes in this area. The US SEC also announced that it will consider proposals for new rules to enhance the transparency and oversight of ATSs.<sup>65</sup>

The European members report that their regulatory regimes will be subject to new requirements under EU law in the form of MiFID II, expected to apply from 2018. Changes in MiFID II will effectively prevent market intermediaries from using internal broker crossing networks to execute client orders in equities, which are not currently subject to the same rules as MTFs. Under MiFID II, investment firms will need to operate their own venues either as MTFs, or act as a Systematic Internaliser (SI), which are subject to more formal requirements.<sup>66</sup> There will also be caps on the volume of ‘dark’ trading (not subject to pre-trade transparency), which may have a wider impact on order routing activity.<sup>67</sup>

As discussed above, MiFID II will also introduce changes to the EU rules on best execution, requiring more detail in firms’ execution policies, including where intermediaries make use of their own systems or affiliated venues. Brokers also acting as market makers, liquidity providers or operating a venue will be subject to a new disclosure obligation to publish data on the execution quality obtained. Investment firms routing orders will also have to make public for each class of financial instruments the top five execution venues where they executed client orders in the preceding year and information on the quality of execution obtained. These new requirements will increase transparency to both clients and EU regulators about firms’ execution arrangements and order routing behaviours.

FINMA is planning to introduce more specific rules to cover prevention of conflicts of interest. The proposed rules that will specifically apply to firms operating an organised trading facility (OTF) provide that firms must operate an OTF separately from their other business activities; measures must be taken to identify, monitor and prevent conflicts of interest; and the firms must ensure that client interests are comprehensively protected when they are conducting proprietary transactions on the OTF.

Hong Kong’s SFC consulted on enhancements to its ALP regime during 2015, and issued a policy statement setting out final proposals, which have subsequently come into effect from 1 December

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<sup>65</sup> SEC Press Release 2015-261, see: <http://www.sec.gov/news/pressrelease/2015-261.html>

<sup>66</sup> MTFs are required to have transparent rules, fair access provisions and continuous pricing for the venue. In the case of a systemic internaliser, making public firm quotes is required during normal trading hours provided there is a liquid market for the financial instruments in which they act as an SI.

<sup>67</sup> MiFID II will cap the transactions that can be carried out on a particular ‘dark venue’ in a specific financial instrument to 4% of the total volume of trading in that instrument across other EU venues over the previous 12 months. A second cap will be set on the total level of trading in a financial instrument without pre-trade transparency across the EU at 8% of the total volume traded on all EU venues over the previous 12 months.

2015. The enhanced regime sets out several principles that apply to persons operating ALPs or routing client orders to an ALP. The regime is intended to increase transparency around ALPs, improve investor protection and address some of the inherent conflicts of interest present. The key enhancements by the SFC include the following:

- Restricting user access to ALPs to “institutional investors” - no individual investors will be allowed to use ALPs (including individual professional investors and their wholly owned investment holding corporations, unless such corporations are themselves professional investors);
- Enhancing the level of disclosure to users of ALPs;
- Ensuring user order priority over the proprietary orders of ALP operators and their affiliates – including client facilitation orders, which will be treated as proprietary orders;
- There will be no mandatory “opt-in” requirement before client orders can be routed to ALPs, but ALP operators should permit their clients to opt out of having their orders transacted in ALPs;
- Restricting the level of visibility of trading information available to the staff of ALP operators.
- Ensuring the system adequacy of ALPs by addressing issues such as system controls, reliability, capacity, security and contingency measures; and
- Enhancing risk management control, record keeping and reporting requirements.<sup>68</sup>

#### **D. Studies and academic literature**

Three publications by ASIC were considered relevant to the topic of internalisation:

- ASIC Report 331 ‘Dark liquidity and high-frequency trading’ (REP 331)<sup>69</sup>
- ASIC Consultation Paper 202 ‘Dark liquidity and high-frequency trading: Proposals’ (CP 202)<sup>70</sup>
- ASIC Report 452, ‘Review of high-frequency trading and dark liquidity’ (REP452) October 2015

ASIC observes across these reports that it is common in the Australian market for many of the larger firms to internalise their trading with clients and that firms are incentivised to internalise or match orders, including in their crossing systems, as it could reduce their transaction costs (through lower execution and reporting fees). ASIC found dark trading volume in equities remained within a band of between 25-30% of total trading turnover.<sup>71</sup> However, they note in their earlier reports that these savings generally provide a net benefit to firms because they were rarely, if ever, passed on to clients.

The most recent ASIC Report 452 found general improvements in market practices concerning crossing networks. In particular, ASIC observed that the transparency and integrity of crossing systems offered by intermediaries had improved, and investors using such systems had greater confidence in using them. While generally seeing improvements in dark venues and crossing systems, ASIC did highlight some findings or practices that gave rise to potential concerns, which included:

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<sup>68</sup> Additional measures include: not restricting the hours of operation of ALPs and allowing ALPs to transact overseas listed securities as well as Hong Kong listed securities.

<sup>69</sup> See: <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-331-dark-liquidity-and-high-frequency-trading/>

<sup>70</sup> See: <http://asic.gov.au/regulatory-resources/markets/market-structure/dark-liquidity-and-high-frequency-trading/>

<sup>71</sup> Within this figure, as of the quarter ending in March 2015, dark venues accounted for 37 % of dark trading, while crossing systems only accounted for 9%, and the remaining majority of dark trading consisted of large block trades.

- On dark venues, within a subset of orders on venues where there was not a requirement to trade at the midpoint of the spread, high-frequency trades tended to ‘win’ vis-à-vis their counterparty in a significant majority of trades, which may mean less benefit is realised by other agency trades;<sup>72</sup>
- ASIC expressed a general view that recent initiatives by dark venues or crossing systems to introduce broker preferencing or liquidity segmentation, may have the potential to undermine fair, open and non-discriminatory nature of markets, or the fairness of crossing systems; and
- ASIC also noted that conflicts of interest could in some cases be managed and supervised better by firms, in particular the conflicts between their order facilitation or proprietary trading and agency sales trading desks, for example, suggesting that both physical and technological segregation should be considered, and stressing the importance of client order information remaining confidential.

## **E. Conclusions**

Internalisation occurs in more developed securities markets, although it still accounts for a minority of trading volume in equities and is less common in derivatives (or is prohibited for derivatives in some jurisdictions). Approaches by jurisdictions where internalisation occurs are broadly split into two groups: those that apply general best execution and/or other regulatory requirements such as conflicts of interest, disclosure, fair dealing and internal business conduct requirements to intermediaries routing customer orders to internal venues (EU jurisdictions, Japan, Switzerland and the US); and those that have developed more detailed provisions for this specific activity (Australia and Hong Kong).

Supervisory and enforcement work by regulators highlights both potential benefits to clients (primarily price improvement versus lit markets) but also possible risks that when using internal networks, clients may not be fully aware of how their orders will be routed and executed and there may be specific conflicts of interest for the firm to manage.

From intermediaries’ responses, there are some differences in practices around the operation of internal venues and how client orders are routed. Some specific practices and controls noted by firms in relation to their use of internal networks when routing customer orders, include:

- Disclosure to clients on how an internal venue operates and at least a summary of the order routing logic. Some firms used specific Q&A or training material to provide more information to clients, beyond standard execution policies that may be used by a firm across a range of execution services;
- Applying equally rigorous monitoring and review processes for execution performance and quality of order execution on an internal network (or affiliated venue) as they carry out when routing orders to external venues, including using data or transaction cost analytics, and considering internal venue performance metrics in relevant execution committees. This includes reviewing customer orders routed via the order routing logic of a SOR to internal and external venues, to ensure the ordering and selection of venues remains optimal over time;

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<sup>72</sup> Although, as discussed elsewhere in their report, looking at high frequency trading, ASIC found that exploitation of latency arbitrage between lit and dark venues by HFT firms was not a significant issue impacting the dark execution prices obtained by investors. ASIC found that less than 1% of dark transactions in 2014 were executed outside of best bid offer (less than 300 trades per day), and that this arbitrage was likely to generate total revenues of around AU\$290,000 per year, so was not a significant income source for HFT firms.

- Taking steps to identify and manage specific conflicts of interest in operating an internal crossing network, and linked to their wider electronic trading services. There was widespread recognition of the need to take steps to protect confidentiality of client order information, limiting staff access to order data of internal venues or crossing networks and segregating staff working on different dealing desks acting for different clients;
- In a minority of firms, reduced costs are explicitly passed on to their clients through lower execution fees when a customer order is executed internally.

Responses from intermediaries operating internal crossing networks did indicate that where they seek to categorise participants or order flow types in their systems and provide options for customers linked to such profiling, there are challenges around the consistency of terms used. In particular, reference to HFT, electronic liquidity provider and market maker were used differently between intermediaries, and could potentially be misinterpreted by customers. Some firms using client or order flow categorisation indicated they had adopted enhanced monitoring of execution quality and behaviours of customers in their networks, to ensure they operate in line with customer expectations.

Recent reforms in Hong Kong, potential changes being consulted on by the US SEC and forthcoming EU reforms under MIFID II may lead to further changes to market practices. Use of internal systems or affiliated venues may also emerge in other jurisdictions' secondary trading markets in future. On this basis, it will continue to be an area of interest for IOSCO looking forward.

## **V. Bundled services provided by intermediaries alongside order execution services (including soft commission arrangements)**

### **A. Overview**

In examining incentives provided in relation to order routing, this work has also explored instances where brokers may provide certain non-monetary goods, services or benefits – primarily research and corporate access – linked to order execution. This report has sought to identify any relevant regulatory provisions in IOSCO Committee 3 members’ jurisdictions that govern the *provision* of such additional bundled goods and services provided alongside execution services by intermediaries, as relates to the impact on order routing, and any recent supervisory or enforcement activity undertaken. In conjunction, the report surveys market practices based on a sample of firms across jurisdictions exploring both the types of ancillary goods and services firms may provide linked to order execution services, including access to investment opportunities such as IPOs, and how these are offered and paid for. It explores whether firms identify, and if so manage, any conflict of interest or impact on order routing behaviour that the provision of goods or services alongside the execution of orders may entail, and controls they have in place to ensure they achieve good outcomes for their clients.

In July 2015, IOSCO Committee 5 published a consultation report on ‘Elements of international regulatory standards on fees and expenses of investment funds’ (CR06/2015).<sup>73</sup> This has recently been followed up by a final report setting out a set of common international standards of best practice for the operators of Collective Investment Schemes (CIS). These reports addressed transaction-based fees and expenses, including, among other things, hard and soft commission arrangements linked to transactions, and provided good practices and examples of possible approaches by operators of CISs to address conflicts of interest inherent in such arrangements.<sup>74</sup> While both reports are separate from this work, soft commission arrangements are relevant to this report’s consideration of bundled goods and services (*e.g.* research and corporate access) provided alongside the execution of orders from the perspective of brokers.

### **B. Regulatory frameworks for bundled services provided by intermediaries alongside order execution services (including soft commission arrangements)**

#### **1. Regulatory requirements and approaches**

*Regulatory requirements in relation to the provision of goods and services alongside order execution*

25 C3 members provided a response to the bundling section of the regulator survey. While most applied general provisions on conflicts of interest, best execution and/ or inducements to broker intermediaries, few jurisdictions noted specific regulatory requirements in relation to the provision of goods and services linked to order execution services.

For those jurisdictions who have adopted specific requirements in relation to the provision of such goods and services by brokers in connection with the execution of client order, the requirements are generally directed to the *recipients* of the goods and services. The regulations are often intended to be safeguards around the receipt of research through commissions to address conflicts of interest that may be present in these arrangements. The exception is in Canada, where broker intermediaries are

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<sup>73</sup> See CR06/15: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD491.pdf>

<sup>74</sup> In particular, see pages 20-26 of FR09/16: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf>

restricted from accepting or forwarding to a third party brokerage commissions in return for the provision of goods and services other than order execution or research goods and services.<sup>75</sup>

In Europe, the MiFID rules on conflicts of interest, best execution and inducements, described earlier in this report, apply in this area. Three European members of the IOSCO C3 have gone beyond MiFID requirements when introducing provisions applicable to the provision of goods and services provided alongside execution services:

- In the Netherlands, soft-commissions fall under the ban on inducements to the extent they relate to services provided to retail clients. Certain, minor, non-monetary benefits such as information or documentation relating to a financial instrument, participation in conferences and seminars and hospitality of a *de minimis* value are deemed acceptable.
- Both the UK and France have specific rules on the use of dealing commission, which prevent investment managers from using dealing commission paid to brokers when executing orders on behalf of clients in equities and equity-related derivatives to acquire additional goods and services, except for research that genuinely aids the investment decision and execution-related goods and services.

However, in both the UK and France the specific rules on the use of dealing commission do not extend to brokers, who are only required to comply with more general conflict of interests and best execution rules when providing additional goods and services in connection with execution services.

Canada applies similar requirements to advisers as the UK and France, whereby advisers directing transactions to a broker in return for the provision of additional goods and services are required to ensure that the goods and services received are used to assist with the investment decisions on behalf of the client, that the client receives a reasonable benefit considering the goods and services received and that an appropriate disclosure on the benefits received is provided to the client. Furthermore, brokers are only allowed to accept brokerage commission in return for the provision of order execution goods and research goods and services.

In the US, investment advisers are protected from liability for a breach of fiduciary duty solely on the basis that they paid more than the lowest commission rate in order to receive 'brokerage and research services' provided by a broker-dealer, subject to certain conditions. Asset managers are required to make a good faith determination that the commissions paid are reasonable in relation to the services received. The general conflicts of interest and best execution obligations also apply to broker-dealers in relation to receipt and payment of soft commissions. For commodities, the CFTC requires commodity pool operators to disclose any conflict of interest resulting from soft commissions and specifically that such arrangements may influence them to trade more actively.

In Australia, although non-monetary benefits are not specifically prohibited, firms are required to ensure that non-monetary benefits don't impair the firm's best execution obligations, that any details of such incentives offered or received are appropriately disclosed to clients and that the incentives enhance the quality of service provided to the client.

In Singapore, while a securities broker may receive goods and services from another broker for directing order flow to the latter, there are rules to ensure that the interest of the client is not

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<sup>75</sup> This was noted in responses from the OSC and Québec AMF, who noted that this requirement is established in National Instrument 23-102, which is applicable in all provinces in Canada.

compromised. For example, under such arrangements, the goods or services should assist in the provision of services to the client, and records of the goods and services received by the broker should be maintained. In addition, certain goods such as travel, accommodation and entertainment expenses, general administrative goods, membership fees or employees' salaries do not qualify as acceptable benefits by brokers in connection with directing order flows.

*Brokers executing orders on behalf of customers and also undertaking corporate advisory or underwriting and placing business*

The general provisions on conflicts of interest aside, only three jurisdictions reported on specific provisions that apply to brokers who both execute client orders, but also undertake corporate advisory business, underwriting and placing business and/ or other relevant activities.

The conflicts of interest regime in the UK includes specific provisions on the management of securities offerings, addressing the potential conflicts of interest arising where brokers undertake placing business while simultaneously acting for investment clients. As part of the provisions, the FCA requires brokers to have allocation policies when undertaking a placement.

The FCA has also issued guidance that the service of a broker or another third party arranging meetings with a corporate issuer's management (corporate access) is not considered to be a permissible good or service that can be paid for by investment managers with brokerage commissions. The FCA noted that brokers should be clear over who they are acting for when arranging corporate access, and ensure it is allocated fairly to their investment clients and in the best interests of their issuer client if acting for them, consistent with the duty to act honestly, fairly and professionally.

In France, the AMF general regulation requires the lead manager of an IPO to ensure balanced treatment of different categories of investors. Favourable treatment of certain categories is only possible where adequate disclosure on the applicable conditions is made.

In Singapore, brokers managing a securities offering are required to document the basis of allocations made and provide disclosures if they are bound by an underwriting or sub-underwriting agreement to subscribe for any securities.

*Treatment of fixed income and other instrument traded on OTC basis*

The majority of jurisdictions do not have any requirements or guidance relating to non-monetary goods and services supplied in connection with execution services of fixed income or other instruments traded on an OTC basis.

In the EU, several European jurisdictions<sup>76</sup> noted that MiFID-based rules apply more broadly than just to equities and exchange traded derivatives to also cover fixed income and other OTC instruments.

The OSC rules on the use of client brokerage commissions also cover 'securities' defined as including bonds and other instruments traded on an OTC basis. In Quebec, the definition of security also includes standardised derivatives.

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<sup>76</sup> Hungary, Spain, France and Italy.

## 2. Supervisory initiatives by regulators

There are some authorities that incorporate review of the practices of brokers when bundling goods and services with order execution into their general compliance testing procedures.<sup>77</sup> Two regulatory authorities have recently carried out specific supervisory reviews to examine the practices of brokers where they bundle goods and services along with order execution:

The Dutch AFM has recently carried out an investigation into developments on trading venues through interviews of several active market participants. The participants noted that research coverage on Dutch issuers is declining, partially due to the current payment system for research favouring bundling payments for research with execution fees that benefits large brokers to the detriment of small independent research providers.

The UK FCA carried out thematic supervisory work on the use of brokerage commissions in 2014. Some of the findings included the following:

- There was a lack of clarity from the brokers over whom they are acting for and to whom they owe discrete duties when arranging meetings between issuers and investment managers.
- The large brokers do not price research services, preferring to bundle research with execution of orders in return for higher dealing commissions. On the other side, some investment managers do not disclose the commission split between execution and research and only a small handful are attempting to value payments for research, leading to opacity in the market.
- The lack of transparency means it is unclear whether best execution is achieved or value is being obtained for research and dealing commission payments. The large brokers appeared more likely to derive the benefit from overpayments where managers do not address the link between trading volumes and gross commission payments. By contrast, independent research providers and smaller brokers may benefit from research being priced separately to execution fees to create a discrete market for research services.

## 3. Enforcement cases or actions

None of the C3 regulators participating in the survey had taken any enforcement actions relating to brokers providing non-monetary goods and services in connection with the execution of client orders.<sup>78</sup>

### C. Intermediary practices in relation to offering bundled services alongside the provision of order execution services (including soft commission arrangements)

#### 1. *Intermediary practices relating to bundling of services alongside order execution*

Of the 54 broker intermediaries responding to the firm survey, 35 reported offering additional goods and services such as research or corporate access services as a bundled service alongside order execution services across 13 different jurisdictions.<sup>79</sup> Market practices of bundling additional goods

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<sup>77</sup> For example, Canada.

<sup>78</sup> The lack of enforcement actions does not necessarily suggest that a material regulatory issue is not being addressed. For example, in some jurisdictions, the regulatory focus may be on testing firms' compliance with the relevant rules, which may have led to greater industry compliance and therefore, fewer enforcement actions. In addition, there have been some enforcement actions in this area more generally, though not directed at brokers.

<sup>79</sup> France, Australia, Brazil, Poland, UK, Switzerland, Hong Kong, Japan, Singapore, Mexico, Canada, Romania, and Turkey.



and services alongside execution were therefore similar across many jurisdictions, and particularly prevalent among larger, global brokers.

Different types of research services, such as access to research platforms and reports, or access to research analysts are the most frequently offered additional services alongside order execution. Arranging meetings between corporate and investor clients is another frequently provided additional service offered by brokers in connection with execution services. From the survey responses, other goods and services often bundled alongside order execution include access to data terminals and trading screens, corporate hospitality and conferences.

These additional goods and services are primarily paid for by clients from brokerage commissions, presented as a proportion of the notional transacted. However, the pricing of the different individual items charged through brokerage commissions is opaque, since brokers don't generally attach a separate charge to the relevant goods and services within the bundle. In fact, unless the broker operates a CSA (discussed further below) with the client, the costs for additional goods and services are not separated out from the payment for the execution service at all.

Since no explicit charge is attached to the goods and services offered alongside execution services, brokers generally determine the allocation of bundled goods and services across clients based on the total brokerage commissions paid or expected to be paid by the client. Brokers note that they often separate their clients into tiers based on size, sophistication, relative needs, strategic value and revenue contribution to the firm, and allocate bundled goods and services accordingly. The higher the tier, the more comprehensive the bundle of goods and services a client receives or can access. Brokers may periodically review the tiers to ensure that the services provided to a client is aligned with the overall level of revenues received for order execution or other linked services.

Of the brokers offering bundled services, 18 reported on operating commission sharing arrangements (CSAs) on behalf of their clients.<sup>80</sup> Firms from jurisdictions with regulations restricting the receipt of additional goods and services were more likely to operate CSAs. CSAs allow a commission for research to be separated from a commission paid to the broker for the execution service, and allocated to a separate pool that the broker or a third party administers on behalf of the client. The client can later allocate the accrued commissions to reward research providers they have used.

Only a minority of brokers stated that their soft dollar arrangements to provide additional goods and services paid through brokerage commissions are based upon written agreements or are otherwise separately disclosed to the clients.<sup>81</sup> Only where CSAs are used, are the terms and conditions of CSAs typically agreed with clients in writing.

Most of the brokers' responses were somewhat vague on the nature of disclosures provided to clients, with several indicating they tend to be limited to initial CSA terms and conditions, with a few stating they may also indicate the general nature of research services that may be provided. A number of brokers explicitly stated that they do not provide *any* disclosures or communications regarding additional services.<sup>82</sup>

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<sup>80</sup> 3 French firms, 3 Canadian firms, 3 UK firms, 3 Hong Kong firms, 2 Australian Firms, 1 Polish firm, 1 Swiss firm, and 1 Singapore firm.

<sup>81</sup> 2 French firms, 2 Hong Kong firms, 2 Singapore firms, 1 Polish firm, 1 UK firm, 1 Romanian firm and 1 Swiss firm

<sup>82</sup> 2 Canadian firms, 2 Polish firms, 2 Hong Kong firms, 1 French firm, 1 Australian firm, 1 Brazilian firm, 1 UK firm, 1 Japanese firm and 1 Singapore firm.

Two brokers reported that their commission rates are negotiated on an individual basis according to the level of service required by the client.<sup>83</sup> Another two brokers explained that their bundled brokerage commission rates are often agreed verbally.<sup>84</sup>

## 2. *Corporate access*

Nearly all brokers offering additional goods and services alongside execution services arrange meetings between corporate clients and potential or existing investors. Different types of corporate access arranged include corporate road shows, field trips, conferences or bespoke meetings. Meetings can typically be requested by either type of client. The purpose of the corporate access service is to facilitate investor access to corporate management and for the two sides to build their relationship.

Brokers indicated that they don't typically set an explicit price for arranging such meetings and there is no expectation of an explicit payment for such meetings from either client. However, several brokers responding to our survey acknowledged that remuneration for arranging such meetings is, as with other services bundled alongside order execution, received via brokerage commissions from investors.

Eight brokers noted that they are sometimes remunerated for corporate access separately from brokerage commissions.<sup>85</sup> These firms reported that some UK investors have established price lists for corporate access and informed the brokers that they do not pay for arranging corporate access, but will reimburse the broker for any administrative costs from their own account. In such cases the brokers have complied with the client's request, despite not normally applying specific pricing to corporate access.

It is somewhat unclear from the survey responses as for whom brokers are generally acting when arranging meetings between their corporate clients and potential or existing investors. While most of the respondents indicated that the meetings are arranged for the benefit of the investor clients, others stated that the interest represented depends on which party has requested the meeting or whether the corporate client is the firm's corporate broking client. Several brokers expressed that the meetings add value to both clients. One broker declared that they do not represent anyone's interest and another reported that such service is part of the overall service offering to both constituents. One broker explicitly stated that they represent the interest of their corporates in arranging such meetings.

One broker from Hong Kong stated that where they accept explicit payments from their investor clients for arranging meetings with the corporate client, they issue a separate disclosure to the corporate client informing them of the payment received.

Similarly to allocating research services to different clients, where access to a meeting with a corporate issuer is limited, brokers that responded typically indicated that they allocate access to the meeting based on the investor client's business potential with the broker. Several of the brokers responding to our survey indicated that their sales teams are involved with determining corporate access allocations as they assess the client's ability to pay for access and their overall business potential.<sup>86</sup>

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<sup>83</sup> 1 Swiss firm, 1 Singapore firm.

<sup>84</sup> 1 Turkish firm, 1 Brazilian firm.

<sup>85</sup> 3 Hong Kong firms, 2 French firms, 2 UK firms, 1 Swiss firm.

<sup>86</sup> 2 UK firms, 2 Singapore firms, 1 French firm, 1 Hong Kong firm, 1 Japanese firm.

Other criteria used by broker respondents for determining allocations to meetings with limited access include following the issuer's preferences, and considering the investor's relevance to the issuer. Some respondents mentioned that existing shareholders are typically prioritised.<sup>87</sup> Four brokers stated that the decisions on access to meetings are made by the corporate client.<sup>88</sup>

A Canadian broker reported on following a formal policy when determining allocations to corporate access meetings, however, that they do not disclose the policy to clients.

On other disclosures, a UK broker stated that where they provide corporate access services to their clients, they ensure they include a notification in the corporate access service communications prompting the client to consider the FCA's rules on the use of dealing commissions when receiving corporate access services from the firm. The same firm explained that, where requested, they provide their clients with a detailed list of the advisory services such as analyst meetings, calls, models, corporate access or conferences that they have provided to the client during a defined period.

### *3. Revenues received from non-execution goods and services*

Most of the respondents to the survey stated that they do not separate out their revenues from the provision of non-execution goods and services related to the execution of client orders.

Of the brokers who provided responses, there was a significant variation between the proportion of brokerage commissions that are received in relation to non-execution goods and services provided with firms estimating between 3% and 65% of the total level of execution revenues received to be related to the provision of non-execution goods and services.

A UK broker explained that where investor clients have not pre-agreed a split for the execution and research components of their brokerage commission rate, the firm assigns 47% of the total for execution commission and 53% for research commission. The firm stated that it has determined the split based on its standard rate card and a consideration of external sources indicating average splits in dealing commissions.

One French broker explained that their bundled execution rate is on average 10bps and, of the revenues they receive from bundled equity execution, around a third is derived from execution fees, and two thirds are from fees on non-execution goods and services. Another French firm noted that 60% of the total brokerage fees they received were for research services. Of this, 80% were paid as fully bundled rates. This firm also noted that where commissions were split out for research services (via CSAs), 88% of the commission payments by clients are ultimately retained by the firm itself, while the rest is paid to other research providers.

Half a dozen respondents gave an indication of the monetary value of research commissions or payments received in a 12 month period from 1 October 2014 to 30 September 2015. Five brokers identified or estimated commission payments made specifically for research / non-execution services, with two firms noting payments in the region of USD\$140-150m, two others citing figures between USD\$40-50m, and one firm citing a figure of just over USD\$1.5m (half of the total brokerage commissions they received over the period).

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<sup>87</sup> 1 French firm and 1 Hong Kong firm.

<sup>88</sup> 2 UK firms, 1 French firm, 1 Swiss firm.

One other firm, who could not identify separately the value of the brokerage commissions they received for execution versus non-execution services such as research, noted that the total brokerage commissions received in the last year globally (across regional subsidiaries in the US, Europe and Asia) amounted to approximately USD\$2.5bn.

#### 4. *Management of conflicts of interest*

While none of the brokers responding to the survey reported any specific conflicts of interest that may arise when allocating other goods, services or benefits to clients for whom they also execute client orders, several stated that they monitor any potential conflicts arising on an on-going basis. Some also described how they seek to manage any potential conflicts arising from the interaction between order execution and corporate advisory and placing activity.

A broker from Hong Kong explained they have a set of rules setting out acceptable levels of expenditure that can be allotted to clients outside of typical brokerage services.

A number of brokers engaged in both corporate advisory and placing activity and the execution of client orders reported on managing any conflicts of interest between the two activities by segregating the teams responsible for order execution and allocation of securities in an issuance.<sup>89</sup> Seven brokers reported on managing the conflicts of interest arising from the interaction between the two activities by following an internal allocations policy when determining allocations in an issuance.<sup>90</sup> A Swiss broker noted that their allocations policy requires the firm to inform the issuing client of any potential conflicts of interest the firm may have to manage when carrying out a placing of securities, as well as of behaviour and conduct, such as involvement in quid pro quo or laddering arrangements, that the firm deems unacceptable when undertaking a placing of securities.

A handful of brokers stated that they manage the potential conflicts arising from allocations decisions in issuance by determining allocations on a pro-rata or first-come-first-served basis.<sup>91</sup>

A Brazilian broker stated that while they generally allocate orders based on preference expressed by the issuer, where they have to make an allocation decision between two clients to whom the issuer client has expressed equal preference, the allocation will be given to the investor who generates more brokerage fees for the firm.

Respondent brokers generally apply their controls, policies and procedures consistently across the different product lines and therefore there are typically no differences in the way they manage conflicts of interest arising from allocating benefits to clients for whom they also execute client orders for equities, fixed income, or other exchange or OTC traded instruments. For example, two Canadian brokers noted that while their product offering for fixed income is not as developed as for equities, they seek to apply the same controls to fixed income as they develop their offering as they currently do for equities.

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<sup>89</sup> 4 Singapore firms, 1 Canadian firm, 1 Australian firm, 1 UK firm, 1 Japanese firm, 1 Brazilian firm, 1 Mexican firm.

<sup>90</sup> 3 Hong Kong firms, 2 UK firms, 1 French firm and 1 Swiss firm.

<sup>91</sup> An Australian firm, a Romanian firm and a Mexican firm.

## 5. *Commission Sharing Agreements*

As stated above, around a half of the brokers offering additional goods and services alongside execution services operate CSAs on behalf of their clients. Such arrangements are typically documented under a separate legal contract with the client.

To manage the accounts consistently with the business conduct requirements applicable in the relevant jurisdiction, some brokers reported on their CSA arrangement being administered by a dedicated team, independently from sales and trading functions.<sup>92</sup> On further controls, some explained that the team administering CSAs reviews and reconciles all payments made from the CSA account ensuring that they are appropriate for the intended services and compliant with the regulatory requirements before releasing them to processing. Some brokers reported on conducting due diligence on all new vendors or addressing the use of CSAs in their conflicts of interest policy as a means to manage the accounts in a way that is consistent with the firm's conduct obligations.<sup>93</sup>

A French broker stated that to avoid any conflicts of interest, those responsible for the execution of orders within the firm have no knowledge of the payments made to third parties and that the firm's own research services are only paid upon client instruction.

A Canadian broker reported on making periodic audits of the payments from CSA accounts.

## 6. *Imminent changes to firms' policies and procedures*

Several of the European brokers have acknowledged in their response to the firm survey that their policies and procedures on how they provide additional goods and services linked to execution services may be amended as a result of the implementation of new EU legislation changing the way investment managers can pay for research through brokerage commissions.

Otherwise, only two brokers responding to the survey indicated that they have recently reviewed or are currently reviewing their procedures and policies in this area.<sup>94</sup>

### **D. Planned or proposed reforms to regulatory frameworks**

EU members again noted that MiFID II will bring significant changes in the regulatory regime on inducements, restricting the receipt of any third party payments or material benefits by portfolio managers or independent investment advisers (including broker research). The European Commission MiFID II Delegated Directive on inducements indicates portfolio managers will only be able to receive research from brokers where they either pay for it out of their own resources, or set up a new research payment account funded by a separate research charge to the client based on a budget set by the investment firm, not linked to the volume or value of transactions executed. Brokers will be required to identify separate charges for research and execution services and ensure that execution commissions or costs paid to them by investment firms do not influence the supply of other services offered.<sup>95</sup> It aims to improve transparency and competition, and reduce conflicts of interests for investment firms providing portfolio management or independent advice to clients.

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<sup>92</sup> 2 French firms, 2 UK firms, 1 Hong Kong firm and 1 Canadian firm.

<sup>93</sup> 2 Canadian firms, 1 Hong Kong firm and 1 French firm.

<sup>94</sup> 1 Turkish firm and 1 Canadian firm.

<sup>95</sup> Article 13 and Recitals (26-30) of the draft Commission Delegated Directive (07/04/2015)..

The European Commission's MiFID II Delegated Regulation also includes provisions on managing conflicts of interest where a firm provides underwriting and placing services, as well as secondary market trading services. It states that allocations in a placing provided by brokers to other investment firms in return for past or future payment of fees in unrelated services, such as execution, is considered to be an unacceptable conflict of interest and form of non-monetary inducement.<sup>96</sup>

The OSC and the Québec AMF stated that the Canadian Securities Administrators continue to monitor international developments, especially those occurring in Europe, and that depending on the developments they may propose similar changes to better align regulatory regimes.

Other IOSCO Committee 3 members are currently not planning or proposing changes addressing the bundling of additional goods and services alongside execution services in their regulatory framework.

## E. Conclusions

For the majority of C3 member jurisdictions, the relevant regulatory framework does not specifically address the provision of additional goods and services – primarily research and corporate access – alongside order execution. For those jurisdictions whose regulatory framework does address the area, the applicable provisions are typically directed to the *recipients* of the goods and services.

Most jurisdictions do subject brokers to general rules on conflicts of interests, best execution and inducements. This includes expectations on brokers to identify and manage conflicts of interests and ensure that in providing non-monetary benefits linked to order execution, brokers still act in the best interest of the client when executing orders. However, some jurisdictions have identified a concern that the bundled provision of goods and services alongside execution by brokers can create a lack of transparency for clients, limiting their ability to assess whether the overall benefit and quality of execution and ancillary services, such as research, represent value for money for the total brokerage commissions paid, and may consequently make it more difficult for these firms to exercise controls over the costs for their underlying investors. There were also some concerns expressed that potential conflicts of interest may be created where intermediaries offer corporate access events or IPO allocations linked to the brokerage commissions received from their investor clients.

Most brokers acknowledged that the additional goods and services they provide alongside execution are remunerated through higher brokerage commissions (so are not 'free'), with some indicating that this represented over half of the brokerage commissions paid. While some brokers noted the use of CSAs with clients, to separate commissions for research, generally most responding brokers stated they do not explicitly price or disclose in detail to their clients the different goods and services to be provided under a bundled arrangement with order execution, or the level of payments expected in return. One respondent offering a wider observation on current market practice in this area raised concerns over transparency where research or corporate access is provided in return for brokerage commissions, noting there is "an opaqueness as to the value those commission dollars buy." This same respondent also cited a competition issue arising from the potential for full service brokers to cross-subsidise services, while specialist providers of research, corporate access or execution services – who may offer superior services – may struggle to compete when providing discrete services.

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<sup>96</sup> Article 40 of the Commission Delegated Regulation (25/04/2016).

Several brokers recognised a potential conflict of interest between their order execution services and their corporate advisory and placing business. Some indicated the steps they took to manage this conflict, including having a clear allocations policy both for allocating corporate access and placing a new issue of securities to investor clients. However, for corporate access services, some brokers are not clear as to whom they are acting for and whether they owe obligations to either the issuer or investor clients. Some brokers also explicitly noted they may reward investor clients who generate higher brokerage commissions with preferential allocations of securities in a capital raising event or corporate access opportunities, over other investor clients who pay less order execution commissions, meaning that investor clients' order routing decisions could impact the access they get to IPOs or other events.

European reforms under MiFID II will significantly change the EU regulatory framework applying to firms receiving non-monetary benefits from brokers, and establish a new requirement on brokers to separately price and supply execution and research services. Once introduced, it is possible that these reforms may have a wider impact on the supply of non-monetary benefits linked to execution services in jurisdictions outside the EEA, given the global nature of many asset managers and brokers.

## **VI. Next steps**

This consultation report provides a review of C3 member jurisdictions' approaches to order routing incentives in their markets. It also examines practices by intermediaries in this area, including the influence of such order routing incentives on order routing behaviours if received or provided, and the potential benefits or risks for customers. It also notes planned reforms by a number of C3 member jurisdictions that may impact these areas.

Given these forthcoming changes and existing differences in regulatory frameworks and national markets, IOSCO does not propose next steps beyond receiving comments on this report and its findings within 60 days after which IOSCO will publish a final report. IOSCO will continue to take an interest in this area as new reforms in jurisdictions are implemented and take effect, and if jurisdictions detect new trends or developments relating to these issues. We may update this report or consider further work if evidence suggests material changes have emerged in due course that warrants further exploration by IOSCO.

However, IOSCO encourages market participants to consider this report and provide comments. It may help intermediaries to reflect on their own practices with regards to order routing incentives and the potential impact on order routing behaviours, to ensure they are acting fairly for their customers and in line with regulatory requirements. This report also welcomes views from stakeholders in response to the question below, which could include whether there are any areas where they feel IOSCO could consider further work either now or in the future.

- **Do market participants have any comments on the proposed findings of this report on order routing incentives or any views on whether IOSCO should undertake any further work to explore any of the issues raised in this report now or in the future?**



## Appendix I: Tables of Participating Regulators and Intermediary Responses by Jurisdiction

### A. Participating regulators:

Jurisdiction	Regulator	Acronym
Australia	Australian Securities and Investments Commission	ASIC
Brazil	Comissão de Valores Mobiliários	CVM
Canada	Quebec's l'Autorité des Marchés Financiers	Québec AMF
Canada	Ontario Securities Commission	OSC
France	France's l'Autorité des Marchés Financiers	AMF
Germany	Die Bundesanstalt für Finanzdienstleistungsaufsicht	BaFin
Hong Kong	Securities & Futures Commission of Hong Kong	SFC
Hungary	Magyar Nemzeti Bank (The Central Bank of Hungary)	MNB
India	Securities and Exchange Board of India	SEBI
Italy	La Commissione Nazionale per le Società e la Borsa	CONSOB
Japan	Japan's Financial Services Agency	JFSA
Mexico	Comisión Nacional Bancaria y de Valores	CNBV
Morocco	Le Conseil Déontologique des Valeurs Mobilières	CDVM
The Netherlands	The Netherlands Authority for the Financial Markets	AFM
Pakistan	Securities and Exchange Commission of Pakistan,	SECP
Poland	Komisja Nadzoru Finansowego, Poland	KNF
Romania	Romania's Financial Supervisory Authority	RFSA
Singapore	Monetary Authority of Singapore	MAS
Spain	Comisión Nacional del Mercado de Valores	CNMV
Switzerland	Swiss Financial Market Supervisory Authority	FINMA
Turkey	Capital Markets Board of Turkey	CMB
U.S.	U.S. Commodity Futures Trading Commission	CFTC
U.S.	U.S. Financial Industry Regulatory Authority, FINRA	FINRA
U.S.	U.S. Securities Exchange Commission	SEC
U.K.	The Financial Conduct Authority	FCA
	<b>Total C3 member regulators responding:</b>	<b>25</b>

### B. Intermediary responses:

Jurisdiction	Intermediaries responding
Australia	5
Brazil	3
Canada (Ontario & Quebec)	3
France	3
Germany	1 (4 <sup>97</sup> )
Hong Kong	5
Japan	4
Mexico	4
Netherlands	2
Poland	5
Romania	4
Singapore	4
Spain	1

<sup>97</sup>

BaFin reported that 4 intermediaries responded to the questionnaire by noting that they did not receive or pay any third party inducements related to the execution of customer orders, and did not otherwise respond to the survey. Since this does not address the other two areas the survey focused on, they are only referred to in Section III of the report as relevant.

Switzerland	2
Turkey	2
UK	4
US (FINRA and SEC)	3
Total intermediary responses:	<b>55 (4)</b>