



The article is for general information only and is not intended to constitute legal or other professional advice.

SFC Report on the Thematic Review of Best Execution – Redefine “Best” execution?

A discussion on the Report on the Thematic Review of Best Execution (“Report”) released on 20 January 2018.

Background

Recently, the Securities and Futures Commission of Hong Kong (the “SFC”) conducted a thematic review of selected Licensed Corporations (“LCs”) including global financial institutions, local brokers and asset managers with the aim to assess the effectiveness and adequacy of LCs’ arrangements in delivering best execution. The Report issued by the SFC shared the results of the review and outlined some good industry practices that LCs are expected to take into consideration.

This article aims to discuss the main points to note raised in the Report and the corresponding implications.

Best Execution in SFC context

Based on Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission Paragraph 3.2, a licensed or registered person when acting for or with clients should execute client orders on the **best available terms**.

For fund and discretionary account managers, they should also execute client (funds / discretionary accounts) orders on the **best available terms** taking into account the relevant market at the time for transactions of the kind and size concerned in accordance with Paragraph 3.2 of the SFC Fund Manager Code of Conduct.

Hence, both brokers and asset managers shall comply with corresponding best execution requirements.

While it is difficult to determine the “best available term” by a universal rule, the SFC suggests that LCs need to consider the price, cost, speed and likelihood of execution and settlement, and the nature of investment made based on the Report.

6 building blocks to achieve best execution

According to the Report, the SFC has listed out 6 areas that LCs need to pay attention on in order to achieve best execution. They are:

- Governance and management supervision;
- Best execution factors;
- Applicability of best execution;
- Execution staff;
- Internal Controls and monitoring; and
- Arrangements for affiliate, connected parties and third parties for execution matters

These areas will be discussed below.

1. Governance and management supervision

Governance is the first step for every implementation of internal controls and practices. As a result, the SFC expects sufficient management oversight shall be in place to ensure best execution related matters are brought to the management's attention for timely review. This can imply execution quality is one of an important agenda during the investment meeting of fund managers / general management meeting of brokers.

LCs should also establish policies and procedures in relation to best execution and at a minimum, address areas covering the other 5 building blocks as mentioned in this CP insights and the trade execution for illiquid financial products.

The staff shall also acknowledge the latest best execution standard from the SFC and LCs internally. It can be done through regular trainings by LCs.

During SFC's recent review, it has observed some good practice. For instance, a LC has provided guidance to its staff on definition of best execution, as well as pre-trade and post-trade control measures.

2. Best execution factors

From the Report, LCs should undertake all reasonable and sufficient steps to obtain the **best available terms** and consider variable factors as mentioned in Section "Best Execution in SFC context".

It should also be noted that the best execution factors may vary in different cases. Even when a client has given specific instructions on a particular aspect of an order, it does not mean the LC is discharged from their best execution obligations for other aspects of the order.

As a good practice, the SFC suggested that an LC should have policies outlining specific best execution factors relevant to its business, which should prioritise factors across different types clients (i.e. corporate clients or individual clients), different asset classes/ types (eg, equities or debt securities) and different trading scenarios.

3. Applicability of best execution

Based on the Report, the best execution requirements shall be applied to both “back-to-back principal transactions” in order to protect client’s interest.

The SFC also observes good practice from LCs in determining the applicability of best execution requirements as shown below.

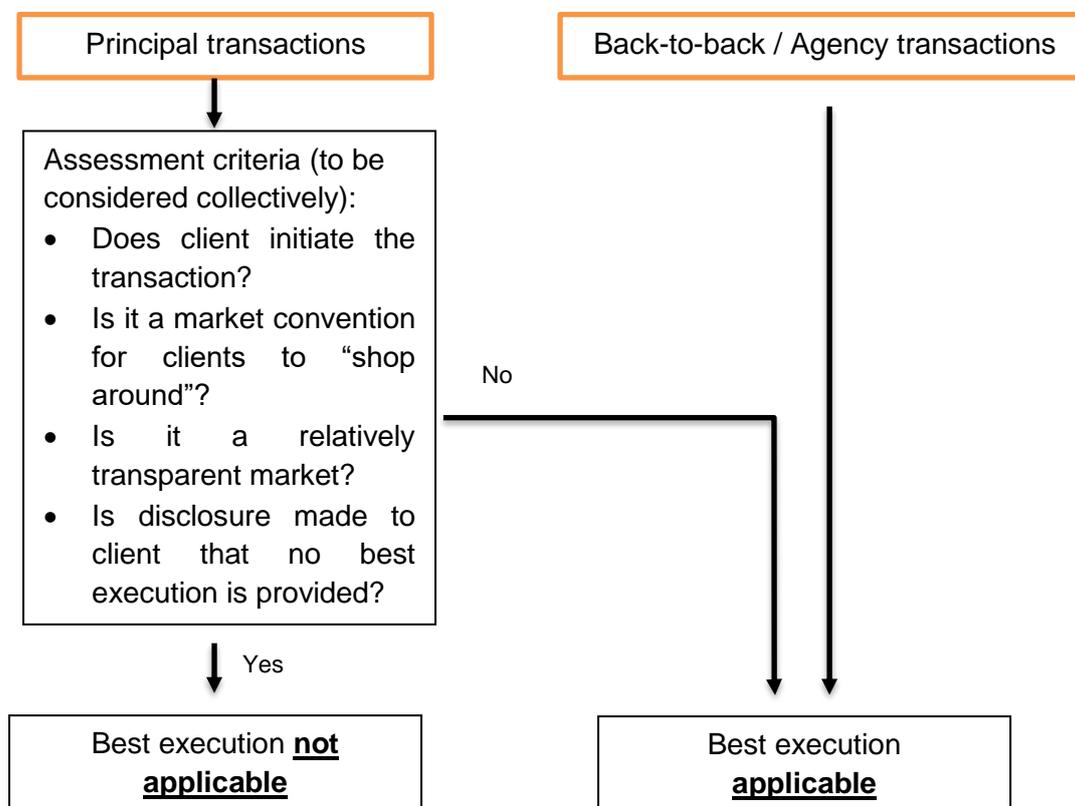


Fig. Good Practice from LCs in determining applicability of best execution requirements (Source: SFC)

4. Responsibilities of execution staff

Execution staff and their supervisors should exercise reasonable diligence in handling client instructions, monitoring execution outcomes and taking steps to obtain multiple quotes. If multiple quotes are unavailable, execution staff should gather sufficient pricing information on a best-effort basis to validate quotes offered to clients. Unsystematic “eye-ball” checking and ad-hoc checking by the staff were not treated as accepted practices when LC was having high daily trade volume.

The SFC suggested that LCs, as good practices, shall:

- obtain quotes from different counterparties for debt securities transactions;

- input the traded price and the next best available quotes obtained in the trading system; and
- post-trade checking on the completeness and accuracy of quotes inputted and whether orders were executed at the prevailing best bid and offer prices.

The above requirements shall also be applicable to asset managers, particularly they are recommended to obtain multiple quotes for debt instruments and structured products when managing debt portfolios (where applicable).

5. Controls and monitoring

As the second and third lines of defence, Compliance and internal audit functions should assess the implementation of execution processes in terms of execution quality so as to meet the best execution requirements. Adequate metrics and reference benchmarks should be in place subject to the nature of different financial transactions, the complexity and scale of the LCs operations. The Report pointed out the good practices and undesirable practices of the controls and monitoring below.

Good Practices	Practices to be improved
<ul style="list-style-type: none"> • Daily Review on execution report with explanation required for any abnormal trades executed; • Sample check on trade record daily with audio recordings of client instructions with comparison on time the order received and executed; • Review best execution policies and procedures; and • Utilizing transaction cost analysis report 	<ul style="list-style-type: none"> • Unclear roles of compliance for controls and monitoring of best execution; • Ineffective controls on monitoring of execution of both OTC and exchange traded products; • Ineffective internal audit function on monitoring best execution; and • No monitoring on trade execution when client placed orders through trading tools which LCs have no intervention on the tools

Table: Good Practices and Bad Practices as listed in the Report (Source: SFC)

From the bad practices above, it also implies the importance of the overall oversight and supervision so as to provide directions on best execution monitoring and controls by compliance and internal audit functions.

While some of the above practices apply to brokers only, asset managers can also consider the above practices and review the compliance controls and monitoring accordingly. For instance, they can review the trade record of funds or discretionary accounts with the investment decision making record such as Investment Meeting Minute, senior investment personnel investment instruction note, etc.

6. Arrangements with affiliates, connected parties and third parties

The SFC expects LCs and persons to conduct due diligence on affiliates, connected parties and third parties engaged for execution. Execution outcomes should be reviewed and monitored systematically on an ongoing basis.

While execution arrangements such as rebates and soft dollars are not automatically banned under the laws and rules in Hong Kong, the onus is on the LC to ensure that such arrangements would not adversely affect the company's ability to deliver best executions and cater for the best interests of its clients.

The obligation of best execution lies strictly with the LC. While the execution function may be delegated to affiliates, connected parties and third parties, the responsibility cannot be shared or passed over. Fair and systematic assessment on execution brokers shall be made regularly to ensure "best execution requirements" are met.

For asset managers, this re-emphasizes the importance of regular broker review. Follow up actions are needed when the execution quality is below standard. Prior to engaging third party brokers, LCs should also ensure that the due diligence questionnaire and the agreement is cleared by all relevant parties, including legal, compliance, operations and IT. Expected execution quality, based upon the best execution factors, should be properly communicated to the execution brokers with respect to the nature of each specific market/product.

Our views

Based on the report, we believe escalation channels should be established such that traders and execution staff such that senior management may be notified promptly of any trade errors or delays. A log should be kept to capture all such events alongside the regular trade blotters.

Post-trade measures such as regular sampling for checks should be performed by compliance to ensure that trades have been executed at the best available price without undue delay.

Internal audit or the management committee should also perform periodic review of best execution policies and documentation every year. It should be ensured that all relevant documents are properly stored and readily available for review by the management or regulators.

LCs shall also review the policies and controls on trade executions with other SFC rules and guidelines such as Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with The Securities and Futures Commission.

We also believe the above good practices are not "hard requirements" that LCs shall make adjustment on their own policies and processes accordingly. For instance, the relevant compliance monitoring and controls can be conducted by compliance function given that no internal audit function is available for local-based fund managers.

Conclusion

Over the years, we have seen best execution being a common topic in SFC inspections and enquiries. The SFC is most concerned with the review and monitoring systems in place,

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

supported by proper record keeping. Following MiFID II and the issuance of the Report, we expect the SFC to pay even more attention on LCs controls in ensuring best execution.

As mentioned by the SFC, some firms may introduce even more robust systems to the above standard procedures. Following the introduction of MiFID II in Europe, there has also been a surge of RegTech firms in the market offering Best Execution solutions and references to financial intermediaries, eg database enabling traders around the globe to share their best execution ratings in respect of the particular market and products they have traded such that intermediaries may have more objective data on hand to choose and review brokers. LCs are encouraged to review their current weaknesses in best execution monitoring and seek for solutions in the market based on their needs.

CompliancePlus is an independent consulting firm focused on providing a complete range of proven and reliable compliance solutions to fund management companies and hedge fund managers in Asia. Our dedicated team of compliance officers has years of professional experience equipped with in-depth knowledge of both functional and compliance experience in managing and minimizing regulatory, operational and reputational risks.

We have been providing real time compliance support and proactive recommendations to start-up hedge funds, fund of hedge funds and multi-strategies hedge funds with our solid compliance knowledge.

By partnering with **CompliancePlus**, our clients gain access to compliance solutions that they can trust and the latest knowledge of regulatory policies and procedures. Through building up strong relationships with our clients and by ensuring our availability to them, we are trusted advisors helping clients to navigate a challenging and changing regulatory environment.

Contact:

Josephine Chung is Director of CompliancePlus Consulting Limited specializing in compliance matters for hedge fund managers and mutual fund management companies with over 15 years of industry experience. Before joining CompliancePlus Consulting, she was the Head of Legal and Compliance for a major asset management company in Hong Kong.

Josephine can be contacted at +852-3487 6333 (email: jchung@complianceplus.hk)

END

copyrights @ Feb 2018 CompliancePlus Consulting Limited All rights reserved