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RE: MiFID II - Best Execution thematic inspection

Dear CEO,

The Central Bank of Ireland ('Central Bank') recently undertook a thematic inspection to review firms' compliance with the 'best execution' requirements as set out in the European Union's Market in Financial Instruments Directive (MiFID II). The best execution requirements play a critical role in the investor protection framework and are fundamental to the delivery of positive outcomes for clients. This work is a key part of the Central Bank's ongoing strategy in the MiFID sector, as it seeks to ensure firms operate in the best interests of their clients and provide the highest levels of investor protection.

In line with the requirements, investment firms must take sufficient steps to obtain the best possible outcome for their clients when executing orders. Where the best execution process is not robust from initial offer, right through to the reporting phase, there is a risk that investment firms may not obtain the best possible result for their clients. This could result in negative outcomes for clients, including less desirable prices, higher costs, and a less favourable return on clients' investments.

The primary objective of the inspection was to assess the design, implementation and operating effectiveness of the firms' best execution frameworks. The key areas in focus were the governance processes, including oversight and monitoring processes; policies and procedures; reporting and record keeping.

Findings

The overarching issue identified from this inspection is firms' failure to demonstrate effective oversight, monitoring and assurance of how best execution requirements were fulfilled. The root cause in many cases related to the lack of resources in compliance functions, which in some cases led to key compliance roles being vacant for prolonged periods and gaps in best execution second line capabilities[1].

This inspection also identified deficiencies in firms' best execution frameworks, governance and assurance testing that must be addressed in order to raise investor protection standards across the industry and mitigate the risk of poor outcomes for clients. Notwithstanding these deficiencies, the inspection team did observe examples of good practices across some firms, examples of which are outlined in Appendix 1. It is noted that the themes and examples of good and poor practices relate to areas evaluated during the inspection and are not an exhaustive list of good and poor practices relating to best execution compliance.

The Central Bank requires firms to review and address these findings in the context of their own best execution arrangements in order to mitigate all consumer protection risks.

1. Best Execution Framework

The inspection found that best execution frameworks are at varying stages of development. The firms with less developed frameworks contributed significantly to the identified poor practices and in many instances non-compliance with best execution requirements. This included a failure by firms to:

- review best execution policies on an annual basis or where material changes occur as required by MiFID II[2];
- have record keeping policies in place as required by MiFID II[3] which in turn contributed to poor record keeping practices; and
- comply with RTS28 reporting as also required by MiFID II[4].

The inspection also observed a lack of awareness of best execution policies and procedures amongst some staff that, in many cases, resulted from little or no best execution training.

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[1] In line with the obligations of MiFID II, firms are required to have a governance structure in place that allows for effective oversight and monitoring of the best execution process. Furthermore, MiFID II also requires that the compliance function has the necessary authority, resources, expertise and access to all relevant information to fulfil its role.

[2] Article 66 of the Commission Delegated Regulation (EU) 2017/565

[3] Article 76 of the Commission Delegated Regulation (EU) 2017/565

[4] Article 65(6) of the Commission Delegated Regulation (EU) 2017/565

A strong and robust best execution framework is critical to delivering good outcomes for clients. Where firms do not review their best execution policy on an annual basis or when 'material changes' occur, there is a risk that the policy is no longer effective in enabling firms to obtain the best possible result for their clients. If staff have a poor understanding of their best execution obligations, there is a risk to clients that their order execution will not deliver the best possible outcome across several areas, including costs, price, speed, likelihood of execution and settlement, size, nature and any other consideration relevant to the execution of the order. It is essential that staff not only understand the firm's policies and procedures, but also the consequences for their clients of failing to adhere to the requirements.

The Central Bank expects firms to review their best execution frameworks and ensure they address the above issues. This includes implementing training programmes with sufficient scope, detail and frequency, to assist staff at all levels in the organisation in the execution of their duties as part of the best execution process.

2. Governance

The inspection found insufficient governance around best execution monitoring. This included:

(i) a lack of clear decision-making processes and governance around adjustments to controls to record and monitor live prices for best execution; and

(ii) a lack of documented formal monitoring processes in place to oversee the quality of service provided by execution providers.

The inspection also observed that compliance monitoring plans around best execution often lacked detail and, in some cases, were treated as 'tick-box' exercises. With respect to senior level involvement, the inspection observed a lack of evidence of Board and/or other committee oversight and challenge of how best execution requirements were met and saw limited involvement by the Risk Function in the best execution process.

A lack of robust governance and clear decision-making processes will ultimately impact upon the end-client. Without sufficient oversight and challenge from senior management, systemic failures in the best execution process may go unchecked over a prolonged period, resulting in poor outcomes for clients, and processes that fail to adapt to regulatory developments or material changes that could impact the parameters of best execution. If the Board and management treat best execution as a static, 'tick-box' process and do not challenge and drive improvement from the top, then the firm cannot properly monitor execution quality and evaluate whether it is achieving the best possible outcomes for its clients.

MiFID II[5] requires that firms have a governance structure in place that allows for effective oversight and monitoring of the best execution process, and the Board has responsibility for ensuring appropriate governance structures deliver sufficient oversight and monitoring capabilities at all levels of the organisation. The Central Bank expects firms to have appropriate channels where results of execution monitoring are escalated to senior management and/or relevant committees for effective challenge and discussion, and fed back into execution policies and arrangements.

3. Assurance Testing

The inspection highlighted a lack of independent reviews conducted by Internal Audit (or similar assurance testing programme) of the end-to-end best execution process. Although a number of internal audit functions performed audits of elements of the best execution process, the end-to-end process was not audited. Where firms did not have internal audit functions, the inspection observed limited assurance testing being completed.

An effective assurance testing programme is critical to evaluating the effectiveness of the firm's best execution controls. Without regular independent challenge and assessment from functions including Risk and Internal Audit, there is a risk that any weaknesses, gaps, or consumer risks inherent in the firm's processes and controls go unnoticed. Firms without this level of formalised testing are unable to verify if their arrangements are effective throughout the entire order execution process.

The Central Bank expects investment firms to have an assurance testing programme in place to review the robustness of their current oversight, monitoring and assurance practices, and to initiate improvements where deficiencies are identified.

Conclusions and Actions

These findings do not reflect consumer-focussed cultures where clients' outcomes are at the forefront of firms' business models and strategies. The Central Bank is concerned that this is

[5] Article 17(2) - (4) SI no. 375 of 2017 European Union (Markets in Financial Instruments) Regulations 2017

indicative of a general trend in the MiFID sector, and notes similarities to findings in the thematic inspection of appropriateness, particularly 'firms failed to provide evidence that they are paying sufficient attention to the application of the appropriateness requirements' and the use of a 'tick-box' approach to compliance.

The lack of evidence of Board and/or committee oversight and challenge, and the lack of involvement of key control functions in the best execution process are particularly concerning. It is the Board's responsibility to ensure that there are adequate governance processes and sufficient resources in place for the effective oversight and monitoring of best execution. The Central Bank expects that firms can demonstrate evidence of a clear understanding at board, board committees and management committees of key consumer protection risks, including those inherent to the best execution process. Firms' attention is drawn to the Central Bank's Guide to CPRA when implementing effective governance that seeks to identify and mitigate consumer risk.

The Central Bank requires all firms to consider the contents of this letter and review their best execution frameworks and processes against the findings above and good practices detailed in the Appendix. Where gaps/weaknesses are identified, firms should develop and implement actions to mitigate any risk to customers immediately. In addition, we are engaging directly with those firms where mitigating action is required. The Central Bank requires this letter to be discussed at the next Board meeting, and for the discussion to be recorded in the meeting minutes.

The Central Bank will have regard to the contents of this letter when conducting future supervisory engagement. Should you have any queries in relation to the contents of this letter, please contact mifidconductofbusiness@centralbank.ie.

Yours sincerely

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Appendix 1

Areas under review	Good Practices Observed	Poor Practices Observed
Best Execution Framework	• A holistic best execution policy in place and reviewed on an annual basis, or whenever a material change occurs. • Best execution policies are subject to a four-eye review by the compliance function. • Staff are required to sign an annual declaration confirming that they have read and understood the best execution policy.	• Shortcomings in the update and approval of the best execution policies and procedures, in line with MiFID II requirements and in some instances the terms as set out in the firm specific policies. • Lack of awareness of best execution policies and procedures amongst staff in some firms. • Inadequate version control on policies and procedures, and updates to best execution documentation were not always captured. • Policies did not reflect the agreed approval processes.
Governance	• Senior Management and Board members demonstrated detailed knowledge of the MiFID II requirements. • Firms were able to evidence Board and/or committee approval of best execution policies and procedures, and any subsequent amendments to same. • Documented segregation of duties in respect of the tasks carried out by the first and second line functions in the monitoring of best execution.	• Lack of documented evidence of oversight and challenge of how best execution requirements were met, at the Board and/or other committee meetings. • Compliance plans did not include best execution activities, and were not approved by the Board. • Resourcing constraints in compliance functions resulting in compliance monitoring and testing not being completed. • A lack of evidence of involvement or challenge by the

	• Bespoke software designed to monitor best execution. This included in-built system parameters to ensure best execution. • Documented annual due diligence review of third party providers, where applicable.	Risk function during the best execution process. • A lack of clear decision-making processes and governance around adjustments to controls used to record and monitor live prices for best execution. • Where best execution is performed by a third party provider, there was a lack of formal monitoring processes in place to oversee the quality of service received from the execution providers. • Errors logs not maintained to capture either internal errors, or external errors where third party providers were appointed.
Assurance	• Firms were able to provide evidence of oversight and monitoring of the best execution process, through assurance testing by Internal Audit (or similar assurance testing programme).	• A lack of independent reviews conducted by Internal Audit (or similar assurance testing programme) of the end-to-end best execution process.
Training	• Training programmes in place, with sufficient scope and frequency, to assist staff at all levels in organisation to ensure the effective execution of their duties, as part of the best execution process. • Training programmes were tailored to the firm's nature, scale and complexity. • Maintenance of training records, which provided evidence of the training provided to the Board,	• No evidence of formal training of best execution provided to the Board, senior management or relevant staff.

	senior management and relevant staff.	
Record Keeping	• Board approved written record keeping policy, which clearly identifies how firms record initial and subsequent orders from clients, intended to result in transactions or that relate to client orders. • Systematic written record keeping procedures, which allow for a full audit trail. • Incorporation of ESMA guidance into the written record keeping policies and procedures. This ensures regulatory requirements are reflected appropriately. • Firms engaged technology firms to ensure the requisite records are retained for the necessary periods.	• Lack of systematic written record keeping procedures, which allow for a full audit trail. • Lack of awareness of record keeping policies amongst staff in executing firms. • Inadequate evidence of monitoring of records. • Inadequate disclosure within record keeping polices in relation to Mobile Devices and the destruction of data.
Client Consent	• The client consent process is included in the client on-boarding process and subject to four and six eye review.	• Best execution policies and procedures are not reflective of existing practices within the firm in relation to seeking client consent. • No evidence of assurance testing completed on client consent by the compliance function
Best Execution Reporting	• The implementation of effective controls to ensure adherence to reporting obligations is considered good practice. For example, inclusion of compliance assurance testing in relation to the RTS 28/Article 65(6)	• A lack of compliance with the prescribed RTS28 timeframe requirements. • Compliance assurance testing in relation to the RTS 28/Article 65(6) reporting requirements

	reporting requirements in the annual compliance plan.	was not included as part of the annual compliance plan.
Inducements	• The inducement policy includes guidance for managers when considering gifts/hospitality. The inclusion of 'decision-tree' flow charts in policies can provide additional clarity. • Inducements policies provide examples of situations, which would be considered as an inducement. • Policies include a Question and Answer (Q&A) section for employees.	• No gift/hospitality log maintained to capture either gifts or inducements. • Gift/hospitality logs were maintained, across various sections within the firm; however, these were not collated into one log to provide a holistic view.
Over the Counter ('OTC') trades	• Establishing a core list of instruments, which increases familiarity and should ensure best execution.	• Best execution policies and procedures not updated to reflect OTC trades, where relevant.