

Research Report

The Implementation of European Best Execution Obligations in Germany

AN EMPIRICAL ANALYSIS OF THE BEST EXECUTION POLICIES OF THE TOP 100 GERMAN FINANCIAL INSTITUTIONS AND THE 15 LARGEST ONLINE BROKERS.

Peter Gomber
Adrian Wranik

Gregor Pujol

Scope

From 01 November 2007 the provisions of the "Markets in Financial Instruments Directive" (MiFID) have to be applied by all firms which provide investment services as well as by all regulated markets throughout Europe. The central innovations of the MiFID are the classification of trading venues (regulated markets, multilateral trading platforms, and systematic internalisers), the definition of "best execution" at European level and the introduction of far-reaching transparency regulations for OTC trading.

Investment firms are obliged to make adequate provisions including processes and IT systems for order routing to achieve the best possible result ("best execution arrangements") in order execution and to disclose sufficient information of the most important measures to their clients ("best execution policies"). Although best execution and the associated duties initially con-

stitute a legal obligation in the relationship between clients and investment firms, at the economic level this topic also decisively affects the interface between investment firms and execution venues. Because of the new regulations for best execution, communication of the execution venues' performance, particularly in terms of price quality and execution costs, has become a major competitive factor.

Data and methodology

Against this background and nine months after the applicability of MiFID, an E-Finance Lab research project examines and compares German "best execution policies". In two studies of the EFL among 200 investment firms in Germany in 2006 and 2007 (Gomber et al. 2007), 32% of the institutions stated that competitive differentiation through the design of the best execution policies has a very high or fairly high competitive potential, and it was thus considered to have the best chances of all services

connected with the introduction of MiFID. Therefore the current study also checks how far this assessment is actually reflected in the best execution policies which were evaluated.

The 100 largest German financial institutions in terms of their total assets in 2006 and the 15 largest online brokers in Germany according to the number of security accounts serve as the starting basis for this study. After adjustments (e.g. removing firms which do not provide investment services) the final sample totals 75 best execution policies (60 financial institutions and 15 online brokers).

A comprehensive list of criteria is developed for the analysis which is based on MiFID's legal requirements and also contains other aspects which resulted from the practical implementation by the investment firms (best practice). These include, for example, the explanations of the factors which were used to evaluate the execution venues. A second part of this analysis then focuses on the execution venues listed in the policies, in particular with regard to the assignment of execution venues to categories of financial instruments and with regard to the existence of a ranking of execution venues in the policies.

Key results concerning the general set-up of execution policies

The most important legal requirements concerning best execution are specified in §33a of the German Securities Trading Act (WpHG). Nearly all investment firms fulfill the minimal obligations which cover aspects such as the

description of the method used for the definition of a best execution policy, details on the process of selecting an execution venue – including a list of the principal execution venues which consistently provide the best possible result for clients – or information on how orders are dealt with when specific instructions are given by the client.

In addition to the minimum requirements, many investment firms provide their clients with further details in their best execution policies. The results show that a "best practice" has established for many measures, e.g. scope of the policies or weighting of the relevant criteria for achieving the best possible result.

While all 75 best execution policies are applicable for private clients, 17 policies exclude the validity for professional clients leaving a total of 58 policies for that client category.

The relevant criteria (e.g. price, costs, speed of execution) and the corresponding weighting for achieving the best possible result were analyzed: No weighting can be recognized in 11% of the policies. The remaining policies provide such a weighting either by ranking the criteria (e.g. price has priority over speed) or even by specifying percentage values concerning the relative weight of the individual criteria. One policy even states to evaluate the appropriate execution venue based on real-time market data for individual orders (order-by-order approach). As required by law, most best execution policies base their decision for a particular execution venue on the total consideration, i.e. execution price plus external costs, except for one policy

that ascribes the greatest importance solely to the price and another policy that assigns the highest priority to total costs, i.e. external costs plus inhouse charges, completely neglecting the criterion price.

Key results concerning the selected execution venues

Finally, details regarding the ranking of the

execution venues were examined. Obviously, from a competitive point of view this ranking is very important for execution venues. Therefore, it is of high interest how concrete and detailed policies list and rank the different execution venues.

It is noticeable that the investment firms primarily prefer abstract and summarizing

descriptions to document their choice of an execution venue (e.g. domestic execution venue, foreign exchange) instead of naming specific execution venues. A concrete execution venue is named only in every fourth policy (24%).

Figure 1 exemplarily lists the 18 best execution policies which named at least one specific execution venue and documented a recognizable ranking for the securities category shares. The figure shows the results for the segments DAX 30, other DAX (MDAX, TECDAX, SDAX), EUROSTOXX 50, DJ STOXX 40, NASDAQ 100 and other domestic shares by showing how often a venue is mentioned and how often it is ranked first or second (although existing, individual rankings beyond rank 2 are not shown here).

The execution venue mentioned most frequently in all segments is Xetra. In some policies precisely one specific execution venue is prioritized and occupies rank 1; in these cases no specific nomination for rank 2 exists – a “domestic floor trading system” or “domestic home exchange” was ranked second. As execution venues of equal rank are also named multiple times in the policies, this indifference with regard to selecting a venue results in a value greater than 18 in the bottom line. It is noticeable that the regional stock exchanges are rarely placed in rank 1 or 2 and that new trading platforms like Chi-X were not mentioned at all in the policies examined in this study.

Conclusion

Nearly all of the investigated best execution policies have recognizably implemented the

minimum legal requirements. However, significant heterogeneity can be recognized between the policies of various investment firms: some policies are extremely comprehensive and describe the procedure selected in great detail, while others are limited to minimum details and are not very meaningful for clients.

In 24 %, i.e. in approximately every fourth policy, specific execution venues are named or a ranking is provided. The short timeframe between the implementation into national law and the final applicability of the new rules may be an important reason for the fact that the use of these policies as a competitive instrument cannot be recognized at present. Future analysis of the policies or even an analysis on a European level will reveal how far MiFID finally achieved to foster competition for investment services in Europe.

References

Gomber, P.; Chlistalla, M.; Gsell, M.; Pujol, G.; Steenbergen, J.: Umsetzung der MiFID in Deutschland – Empirische Studien zu Status Quo und Entwicklung der MiFID-Readiness der deutschen Finanzindustrie. Books on Demand, 2007.

Gomber, P.; Pujol, G.; Wranik, A.: MiFID Umsetzung in Deutschland – Eine Analyse der Grundsätze der Auftragsausführung. Forthcoming In: Zeitschrift für Bankwirtschaft und Bankrecht.

Segment	DAX 30, other DAX (MDAX, TECDAX, SDAX)			EUROSTOXX 50, DJ STOXX 40, NASDAQ 100			Other domestic shares		
	Frequency	Rank 1	Rank 2	Frequency	Rank 1	Rank 2	Frequency	Rank 1	Rank 2
Xetra-Best	1	4	0	3	3	0	1	1	0
Xetra	14	8	5	10	5	4	11	6	4
Berlin	2	0	1	2	1	0	2	0	1
Düsseldorf	2	0	1	2	1	0	2	0	1
Frankfurt	4	0	3	4	1	2	4	2	2
Hamburg	2	1	0	2	2	0	2	2	0
Hannover	1	0	0	1	1	0	1	1	0
München	2	0	2	2	0	2	2	0	2
Stuttgart	2	0	1	2	1	0	2	0	1
Tradegate	1	1	0	1	1	0	1	1	0
OTC	1	1	0	1	1	0	1	1	0
Domestic floor Trading system	3	0	3	4	1	3	4	2	2
Domestic home exchange	2	0	2	2	0	2	1	0	2
Fixed-price business	3	3	0	3	3	0	3	3	0
No details	3	0	3	6	1	5	6	0	6
Total		18	21*		22*	18		19*	21*

* Multiple count of execution venues at the same rank

Figure 1: Segmenting of the securities group shares