

ISLA Response to ESMA Public Consultation on Technical Standards specifying the criteria for establishing and assessing the effectiveness of Investment firms' order execution policies

Link to consultation can be found [here](#)

Note to ESMA:

The International Securities Lending Association (ISLA) is a leading non-profit industry association, representing the common interests of securities financing market participants across Europe, the Middle East, and Africa (focusing primarily on securities lending and borrowing (SLB) activity). ISLA has a diverse membership of over 200 firms including institutional investors, asset managers, custodial banks, prime brokers, and service providers.

MiFID II defines Securities Financing Transactions (SFTs) as outlined in Article 3, point (11) of Regulation (EU) 2015/236521 on the transparency of securities financing transactions and of reuse (SFTR). SFTs are defined as (a) a repurchase transaction, (b) securities or commodities lending and securities or commodities borrowing, (c) a buy-sell back transaction or sell-buy back transaction or (d) a margin lending transaction. For the purposes of this consultation, ISLA will focus on the relevance of the questions as they pertain to the securities lending and securities borrowing businesses of member firms.

Clients for securities lending and borrowing activity are predominantly categorised as professional clients and the best execution obligation applies.

It should be noted that securities lending is a demand driven activity and firms do not generally seek competitive quotes on a transaction-by-transaction basis, rather they react to a market request to borrow an asset. Orders therefore are typically executed on an over the counter (OTC) basis. Where liquidity for a particular security permits i.e., General Collateral (GC), market participants may also execute client orders on a relevant trading venue that specialises in securities lending transactions. With regards to order execution policies, ISLA member firms generally make available to clients an explanation of how they ensure that each client is treated fairly.

The overarching best execution obligation under MiFID requires firms to take all reasonable steps to obtain the best possible result on a consistent basis rather than in respect of each individual transaction, taking into account a range of execution factors when executing client orders or placing orders with (or transmitting orders to) other entities to execute securities lending and borrowing transactions on behalf of a lending client. With regards to this specific type of SFT, the following are examples of such factors and lending parameters which impact the ability of the firm to obtain the best possible outcome for a client. The relative prioritisation of these will vary in each situation and for each client. Such factors may include (but are not restricted to):

- Value of the securities on loan;
- Term or duration of transaction;
- Relative stability of the portfolio/asset;
- Transaction and custody charges;
- Client credit quality and netting status;
- Collateral criteria, including cash or non-cash
- Jurisdiction of client and/or borrower;
- Lending parameters which may include limits on markets, securities, counterparties, and duration.

The various execution factors will not usually be of equal importance. The priority of any of these factors over one another will depend upon any specific client instructions and prevailing market conditions. Several of the execution factors are interchangeable and one could take precedence over another at various times. Firms should ensure that the client is aware of the different factors and any potential impact they may have on performance.

Firms may also offer underlying clients a level of indemnification against counterparty default as part of the commercial agreement between the parties, (the level of protection may differ considerably between firms). Whilst the commercial agreement is not subject to best execution, the provision of indemnification may be a consideration when transacting on behalf of a client, because of internal constraints such as counterparty risk and capital requirements. Firms should ensure that the client is fully aware of the potential impact the provision of indemnification may have on performance. Potential conflicts of interest should be identified by the firm and described to the client as part of the implementation process as well as any controls in place to monitor these potential situations.

We note that many of the requirements in the proposed RTS are not relevant to securities lending and borrowing transactions. As outlined above, the market operates in a considerably different manner to the wider equities market (or other securities markets). Overall, we find the proposal overly prescriptive and the specific requirements largely inappropriate in the context of the SLB business.

ISLA Responses:

Q1: Do you agree with the proposed categorisation of classes of financial instruments? And could the methodology based on, inter alia, the classification of financial instruments in the MiFID II RTSs 1 and 2 be used in the context of MiFID II transparency reporting be an alternative? Please state the reasons for your answers.

ISLA members believe that the current categorisation of financial instruments set out in RTS 28 is adequate however, ISLA members have no strong views on the proposed alternative categorisation of classes of financial instruments, as categorisation would need to be consistent across firms wider equities (or other securities) businesses and thus no specific categorisations for SLB are required.

Q2: Do you believe that the current wording of the RTS is clear and sufficient with regard to the content of the order execution policy where an investment firm selects only one execution venue to execute all client orders? Or should the RTS provide for specific criteria to be taken into account when assessing if the selected venue achieves the best possible result in the execution of client orders? Please also state the reasons for your answer.

ISLA members believe that the current wording of the RTS where an investment firm selects only one execution venue to execute all client orders is sufficient. In relation to the pre-selection of execution venues as outlined in paragraph 23 of the consultation paper, due to the nature of the SLB market as described above, ISLA does not consider that this is applicable to SLB business.

Q3: Do you agree with the proposed factor of “order sizes” respectively for retail and professional clients, to be considered in investment firms’ selection of eligible execution venues in their order execution policy and internal execution arrangements (see Article 4(1)(d)(i) and ii) of the draft RTS)? If not, what alternative factor would you propose?

ISLA members neither agree nor disagree with the proposed factor of order sizes, as we do not see this as strictly applicable to bespoke or OTC types of businesses, including the securities lending and borrowing market. Please refer to the answer to Q4 as to the rationale for this.

Q4: Do you agree with ESMA's proposals for the specification of the criteria for establishing and assessing the effectiveness of investment firms' order execution policies? Please also state the reasons for your answer.

ISLA members do not consider the criteria specified for establishing the effectiveness of investment firms order execution policies as outlined in the proposed RTS, as strictly applicable to bespoke OTC types of businesses, including the SLB market. In the SLB business as previously outlined, the characteristics and needs of the client are primarily focused on credit assessment, counterparty risk, collateral requirements and liquidity, and these factors often drive the selection of execution venues.

Article 64 of Commission Delegated Regulation 2017/565 of April 2016 supplementing MIFID as regards to organisational requirements, which sets out best execution criteria, makes reference to SFTs' distinct characteristics as being a relevant consideration to the execution of SFTs and therefore the further characteristics specified in Article 4(1)(d) - 4(2) in particular, are not suitable to determine best execution for SFTs. In addition, they would likely distort or render meaningless any qualitative assessment based on the criteria set out in Article 4 applied to an SFT order execution policy.

Article 64(1) states:

'1. When executing client orders, investment firms shall take into account the following criteria for determining the relative importance of the factors referred to in Article 27(1) of Directive 2014/65/EU:

(a) the characteristics of the client including the categorisation of the client as retail or professional;

(b) the characteristics of the client order, including where the order involves a securities financing transaction (SFT);

(c) the characteristics of financial instruments that are the subject of that order;

(d) the characteristics of the execution venues to which that order can be directed'

Recital 99 also supports the distinct characteristics of SFTs in the context of order execution policies. It states:

'When establishing its execution policy in accordance with Article 27(4) of Directive 2014/65/EU, an investment firm should determine the relative importance of the factors mentioned in Article 27(1) of that Directive, or at least establish the process by which it determines the relative importance of these factors, so that it can deliver the best possible result to its clients. In order to give effect to that policy, an investment firm should select the execution venues that enable it to obtain on a consistent basis the best possible result for the execution of client orders. In order to comply with the legal obligation of best execution, investment firms, when applying the criteria for best execution for professional clients, will typically not use the same execution venues for securities financing transactions (SFTs) and other transactions. This is because the SFTs are used as a source of funding subject to a commitment that the borrower will return equivalent securities on a future date and the terms of SFTs are typically defined bilaterally between the counterparties ahead of the

execution. Therefore, the choice of execution venues for SFTs is more limited than in the case of other transactions, given that it depends on the particular terms defined in advance between the counterparties and on whether there is a specific demand on those execution venues for the financial instruments involved. As a result, the order execution policy established by investment firms should take into account the particular characteristics of SFTs and it should list separately execution venues used for SFTs. An investment firm should apply its execution policy to each client order that it executes with a view to obtaining the best possible result for the client in accordance with that policy.'

This is mirrored in RTS 28, recital 10 and for this reason SFTs were required to have a separate top 5 execution venue report. Recital 10 also went on to say that *'Due to the specific nature of SFTs and given their large size, they would likely distort the more representative set of client transactions, namely those not involving SFTs.'*

Furthermore, the reason for excluding SFTs from pre-trade obligations under MIFID and RTS 27 was that owing to their nature as financing transactions, they did not contribute to price discovery (i.e., securities price was not the driving factor for determining SFT value or returns). Whilst references to price, reference data and a CTP may be meaningful for criteria to be applied to a securities order execution policy, they are not specific to SFTs. We therefore consider Article 64 (1) to be sufficient to determine the establishment of an SFT order execution policy.

If the proposed RTS proceeds on the basis of the proposed Article 4 criteria, ISLA requests a carve out for SFTs from at least 4(1)(d) - 4(2). Alternatively, if SFTs are not in fact contemplated as being in scope of this proposed RTS, ISLA request that ESMA make this clear.

We note also that whilst we are commenting on the proposed RTS as drafted, any subsequent changes to specific criteria after the consultation may be equally ill-suited to SFTs and therefore reiterate that Article 64(1) is sufficient to determine the establishment of an SFT order execution policy.

Q5: Do you agree with ESMA's proposal that investment firms may rely on monitoring and assessments performed by third parties, such as independent data providers, as long as firms assess the processes of these third parties? Please also state the reasons for your answer.

Yes. Third parties are subject to outsourcing and DORA requirements for assessment and oversight in any event.

Q6: Concerning the specific client instruction, should it be possible for an investment firm to pre-select an execution venue in the order screen, where the firm invites its clients to choose an executing venue out of multiple options? And if so, do you agree that only if the client chooses a different venue than the one pre-selected by the firm, the choice of execution venue does constitute a specific instruction? Please also state the reasons for your answer.

In relation to a specific client instruction, Article 8(4) of the draft RTS states 'where an investment firm offers the client to choose an execution venue'. Due to the nature of the securities lending and borrowing market as described above, clients would not, as a normal course of business be given the option to choose their execution venue and thus ISLA does not consider that this is applicable to SFT business.

Q7: Where an investment firm executes client orders by dealing on own account (including back-to-back trading), in light of the specificity of this execution model and since it is bound by the rules governing best execution, do you believe the current text is clear with regard to what kind of obligations investment firm applying such model should comply with? Or do you believe it would be useful to provide in the RTS list and explanations of information that should be included in the order execution policy, such as related to the method and steps to be taken by the firm to establish the price of client transactions in back-to-back trading, or the methodology for the firm's application of mark-ups or mark-downs in such order executions? Please also state the reasons for your answer.

ISLA members do not consider any specific information as described would be useful to SFTs for the reasons outlined in response to Q4.

Q8: Are there any additional comments that you would like to raise and/or information that you would like to provide (for example, relevant information in relation to any expected costs and benefits arising from the proposals)?

ISLA has responded to the questions in this consultation as they relate to the securities lending and borrowing business. We acknowledge that this proposal will impact the broader secondary securities and derivatives markets. The SFT business plays a central role in facilitating the efficient functioning of these markets in terms of funding, liquidity, collateral transformation, regulatory margin provision, hedging risk and portfolio management techniques, and broadly contributes to operational efficiency and financial market stability.