# Learning Insights

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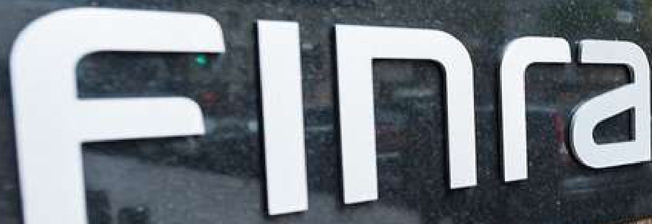


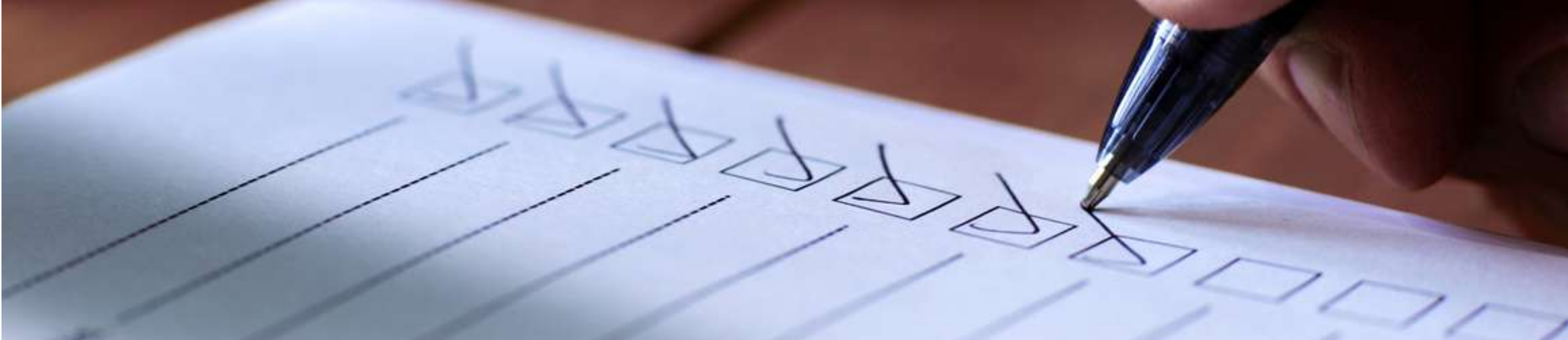

## Best execution: US looks to eliminate conflicts

***Toward the end of 2023, two US-based broker-dealers were subjected to multi-million dollar penalties levied by the Financial Industry Regulatory Authority (FINRA) on grounds of failure to provide "best execution" to their customers. The timing of these sanctions coincided with the introduction by the Securities and Exchange Commission (SEC) of Regulation Best Execution (Reg NMS Rule 606) – the first regulation specifically targeting best execution, as the SEC increases its scrutiny of the actions of broker-dealers in light of their customer obligations.***

The duty of best execution requires a broker-dealer to execute customers' trades at the most favorable terms reasonably available under the circumstances. The best execution principle is considered to comprise four key dimensions.

- **Cost:** The execution of a trade should allow the trader to buy at the lowest publicly-quoted price and sell at the highest publicly-quoted price.
- **Price improvement:** The execution should allow the trader to take advantage of opportunities to trade at prices that are superior to publicly-quoted prices.
- **Speed:** The trade should be processed as quickly as possible.
- **Size:** The trader should be able to execute the given order in the full size at an acceptable price.

While FINRA and the Municipal Securities Rulemaking Board (MSRB) provide rules and guidance around best execution, it wasn't until last year that the SEC proposed Regulation Best Execution – Reg NMS Rule 606, within Regulation NMS (National Market System) – marking the first instance of rules specifically targeting best execution practices. The regulation was introduced in the belief that "customers would benefit from consistently robust best execution practices by broker-dealers, and the execution of retail customer orders by broker-dealers that have certain order handling conflicts of interest warrants heightened attention by those broker-dealers."



## Compliance with best execution

Reg NMS Rule 606 requires broker-dealers to “establish, maintain, and enforce written policies and procedures reasonably designed to comply with that best execution standard.” Those policies and procedures aim to address:

- Compliance with the best execution standard, including identifying material potential liquidity sources and incorporating them into order handling practices, while ensuring efficient access to each source.
- Determining the best market for customer orders received, which involves assessing reasonably accessible and timely pricing information and opportunities for price improvement.

## Rule targets broker-dealer conflicts of interest

The rule recognizes the conflicts of interest for broker-dealers that retail customer transactions can present, such as payment for order flow (PFOF) or internalization.

PFOF is a method of transferring a portion of market makers’ trading profits to the brokers that route customer orders to those market makers for execution.

Internalization occurs when a dealer exclusively matches customer orders without allowing other market participants to compete. This enables the dealer to profit from trading against its own customers' orders.

The conflicts of interest here lie between brokers’ incentive to maximize PFOF and internalization profits for their firms and their fiduciary obligation to route their customers' orders to the best markets. According to the SEC, this revenue could be partially passed on to investors in the form of either reduced commissions or rebates.

### Best execution policies and procedures

Consequently, Reg NMS Rule 606 require a broker-dealer's policies and procedures to address this, including how it would assess a broader range of markets than it would for nonconflicted transactions.

Further, broker-dealers that engage in conflicted transactions with respect to retail customer orders would be subject to additional obligations. Rule 1101(b) of the Regulation defines a conflicted transaction as:

1. Where a broker-dealer executes an order as principal, including riskless principal
2. Routes an order to or receives an order from an affiliate for execution
3. Provides or receives PFOF

Additional requirements include:

- **Compliance documentation:** Broker-dealers must document their compliance with the best execution standard for transactions and any existing PFOF arrangements.
- **Execution quality review:** Broker-dealers are mandated to conduct at least quarterly reviews and documentation of the execution quality of customer transactions. These reviews should compare the execution quality obtained with what could have been achieved from other markets. Insights from these reviews should inform the revision of best execution policies and procedures.
- **Annual review of policies and procedures:** The regulation necessitates an annual review of best execution policies and procedures. This review should encompass order handling practices, and broker-dealers are obligated to prepare and present written reports detailing the results to their boards of directors or equivalent governing bodies.

**Europe revisiting its best execution requirements**

Meanwhile, Europe is taking steps that on the face of it might seem like a partial relaxation of some of its best execution rules, specifically around reporting obligations. This may be surprising to some, given Europe's reputation for some of the toughest regulations globally and the fact that best execution is a cornerstone of Europe's flagship Markets in Financial Instruments Directive (MiFID II).

However, what transpired was more like a case of removing superfluous rules rather than a change of heart by European regulators on the importance of best execution practices. MiFID II recently underwent a review, resulting in the proposed deletion of Articles 27 and 28. Article 27 requires firms to publish reports detailing the top five execution venues in which they executed client orders in the preceding year and disclose information on the quality of the execution obtained. Article 28 details the required disclosure format and content relating to this information.

These proposed deletions resulted from claims by market participants that the reports are all but ignored by investors and that the information they provide does not enable investors or other users to make meaningful comparisons. The European Securities and Markets Authority (ESMA), the EU's financial markets regulator, appears to agree and has directed National Competent Authorities (supervisors) to effectively ignore current reporting obligations in that respect until the MiFID review has been transposed into the national legislation of all the EU Member States.

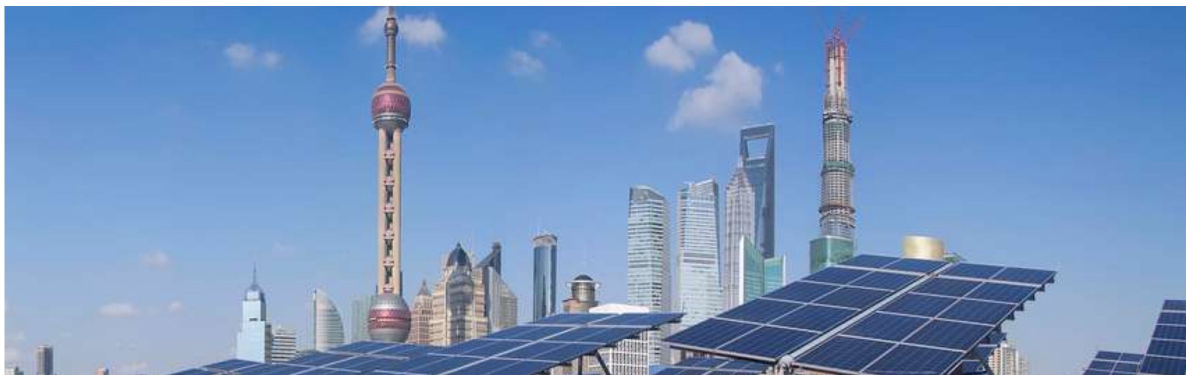
**Intuition *Know-How* has a number of tutorials relevant to the content of this article:**

- Financial Regulation – An Introduction
- Life of a Trade – An Introduction
- Life of a Trade – Execution
- Equity Markets – An Introduction
- Equity Trading – An Introduction
- Financial Authorities (US) – SEC
- MiFID II/MiFIR – Primer
- MiFID II/MiFIR – Key Requirements
- Conflicts of Interest (2024)

## Renewables growth strong but still off required pace

***The world increased its global renewable energy capacity in 2023 by around 500 gigawatts (GW) to over 4,000 GW, according to the International Energy Agency (IEA). While this rate of growth in capacity (50% higher than in 2022) – the fastest in two decades – appears impressive, the same agency warned that the increase is insufficient to achieve last year's COP28 goal of tripling renewable power capacity by 2030.***

Last year was the 22nd consecutive year of record-setting renewable capacity additions globally, with increases in Europe, the US, and Brazil reaching all-time highs. But China was far and away the strongest performer, commissioning as much solar PV in 2023 as the entire world did in 2022 (globally, solar PV alone accounted for three-quarters of renewable capacity additions worldwide). Meanwhile, China's wind capacity additions rose by 66% year-on-year.



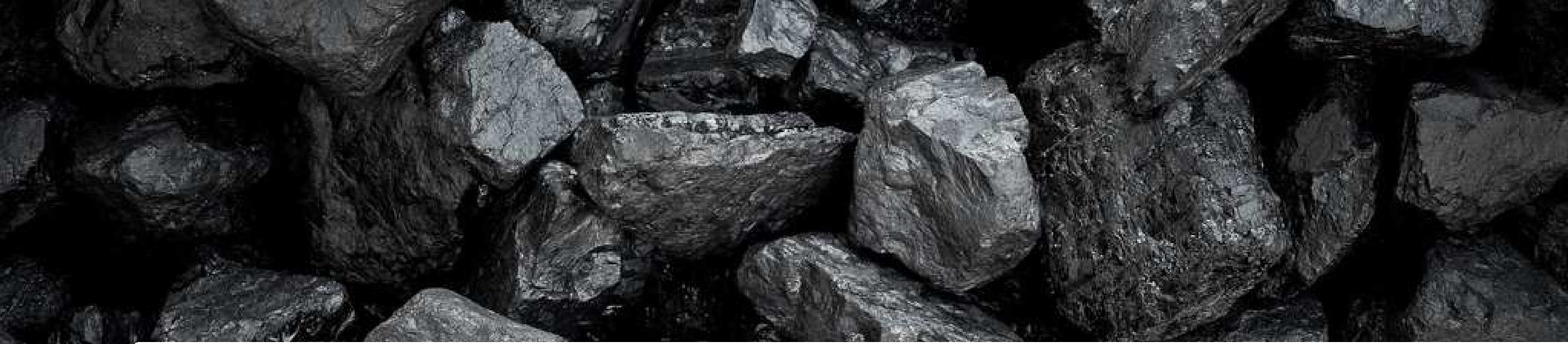
### Challenges to tripling renewables by 2030

According to the IEA, under existing policies and market conditions global renewable capacity is forecast to reach 7,300 GW by 2028 – a growth trajectory that would see global capacity increase to 2.5 times its 2022 level by 2030. The IEA believes the world can close the gap to reach over 11,000 GW by 2030, which would be in line with the agency's Net Zero Emissions by 2050 (NZE) Scenario.

While the challenges in meeting the tripling target vary significantly by region and country, the IEA believes it can be achieved if governments address a number of shortcomings, such as:

- Policy uncertainties, including delayed policy responses to the new macroeconomic environment
- Insufficient investment in grid infrastructure that prevents faster expansion of renewables
- Cumbersome administrative barriers and permitting procedures
- Insufficient financing in emerging and developing economies
- Social acceptance issues

At present, G20 countries account for almost 90% of global renewable power capacity. While growth in these countries is on track to meet the targeted tripling of capacity by 2030, many emerging and developing economies continue to lack renewable targets and/or supportive policies – a key obstacle to the IEA target being met.



## Renewables growth to pass significant milestones

Nonetheless, the IEA expects a number of significant milestones to be achieved in the coming years.

- In 2025, renewables are set to surpass coal to become the largest source of electricity generation.
- Wind and solar PV are projected to surpass nuclear electricity generation in 2025 and 2026, respectively.
- In 2028, renewable energy sources should account for over 42% of global electricity generation, with the share of wind and solar PV doubling to 25%.

China, which the IEA describes as the world's renewables powerhouse, is projected to account for almost 60% of global renewable capacity additions between now and 2028. Deployment of onshore wind and solar PV in China is accelerating, despite the phasing out of national subsidies in 2020 and 2021. The country is expected to reach its national 2030 target for wind and solar PV installations this year, some six years ahead of schedule.

## Policy supportive of renewables growth

Supportive policy environments and the improving economic attractiveness of solar PV and onshore wind are the primary drivers of the renewables acceleration. As residential and commercial consumers seek to reduce their energy bills in jurisdictions such as Europe and Brazil, growth in rooftop solar PV is expected to outpace large-scale plants. In the US, the Inflation Reduction Act includes measures that not only aim to manage inflation but also offer a package of tax incentives and benefits designed to support the country in tackling climate change. Meanwhile, India has pushed through the auction schedule for utility-scale onshore wind and solar PV, which, helped by the improved financial health of distribution companies, is expected to deliver fresh impetus.

The rapid growth in solar energy is propelled by the remarkable decrease in prices for solar PV modules, which fell by almost 50% year-on-year in 2023, coupled with a threefold increase in manufacturing capacity compared to 2021 levels. Yet despite unprecedented policy-driven manufacturing expansion in the US and India, China is expected to maintain its 80-95% share of global supply chains.

**China a significant competitive threat**

The US, the EU, and India face a choice between developing their own domestic PV manufacturing (increasing the security of supply and bringing economic benefits to local communities) and sourcing cheaper imports from China. Intense price competition from China has contributed to a spate of bankruptcies across the European solar power supply chain, according to SolarPower Europe, a trade advocacy group for the industry.

Regardless, the future of renewables seems assured, with an estimated 96% of newly installed, utility-scale solar PV and onshore wind capacity having lower generation costs than new coal and natural gas plants.

**Intuition *Know-How* has a number of tutorials relevant to the content of this article:**

- Sustainability & Sustainable Development
- Net Zero
- Climate Change – Physical Risks
- Climate Change – Transition Risks
- Greenwashing
- Clean Energy (Coming Soon)
- Commodities – Renewables
- Commodities – Electricity
- Sustainable Development Goals (SDGs) – An Introduction
- Sustainable Development Goals (SDGs) – Impact on the Financial Sector