MiFID II and Use of Dealing Commissions

Shining a spotlight on technology costs

By Ian Mawdsley, Head of ETI Trading, EMEA, Thomson Reuters

New MiFID II rules around which services buy-side firms may pay for through commission payments with brokers makes an important distinction between allowing firms to use order flow to pay for FIX connections to brokers (effectively the last mile for placing orders) and using flow to pay for their own order and execution management systems (EMS).

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The last mile of transmitting an order is like a utility, but the systems where the choices are made about what to order or how to execute those orders theoretically could be influenced by who's funding those functions.

What will the inclusion of these rules in MiFID II mean for buy-side firms' trading operations?

While MiFID I did not prevent buy-side firms from receiving an execution management system free of charge, MiFID II's inducement rules are disrupting how execution and related software services are priced and consumed by the industry.

MiFID II prohibits receipt of third-party payment by an investment manager, however, a policy statement (PS 17/14 dated July 2017) from the UK's Financial Conduct Authority (FCA) provides some useful guidance beyond what the European Commission states about its MiFID II rules. FCA guidance states that order management systems should not be considered inextricably linked to an execution service. Therefore, the FCA guidance adds firms subject to enhanced inducement restrictions when they cannot pay for them through execution costs.

The FCA policy statement clarifies that a FIX connection is not considered a distinct benefit and can be considered part of an execution service. The FCA interprets MiFID II Article 12(3) as excluding execution management systems from being an acceptable minor non-monetary benefit, but interprets Article 24(8) of MiFID II as meaning that third-party non-monetary benefits do not create inducement, so FIX connections are exempt from the incoming rules.

However, if the average cost of a FIX connection is above market value, as could be shown in a transactional billing model, that is likely to attract regulatory scrutiny; additionally, this could be considered a backdoor way of subsidizing an EMS.

As a result, the unbundling and increased transparency that the new rules bring will most likely discourage the use of transactional pricing for FIX connections, a change already supported by the FIX network providers.

In this climate, EMS providers can ensure compliance with MiFID II by charging sell-side executing brokers fair value or FIX connectivity. Although MiFID II may not explicitly prohibit covering FIX connectivity, charging fair value is a way for EMS providers to err on the side of caution.

What does all this mean for sell-side firms?

This may turn out to be a double-edged sword. Given that nearly all EMS providers currently charge the vast majority, if not all, of the costs on to brokers, it's highly likely that sell-side firms will vastly reduce their overall spending with technology vendors. This could produce a benefit for buy-side firms, however, with those same sell-side firms being forced to reduce their commission rates since they would be spending less on vendor technology. Ultimately, the incoming rules around use of dealing commissions could achieve at least one overarching intention of MiFID II — true unbundling and cost transparency.

Previously, Thomson Reuters did not charge for its execution management systems, including its REDI trading platform, allowing broker commission flow to be used to cover the costs of those systems. In keeping with these changes, however, Thomson Reuters will now charge buy-side firms for the cost of software used to run EMSs, in order to allow its clients to be compliant with the new MiFID II rules. As both buy- and sell-side firms work to figure out the changes MiFID II brings, Thomson Reuters is here to support their efforts.

About the Author

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Mawdsley has been working in the financial markets for over 25 years, with the first eight years in the front office and the remainder working within the financial technology sector. He joined Thomson Reuters in January 2017 following the acquisition of REDI Holdings LLC. Mawdsley holds a Bsc in Computer Science and has completed postgraduate work around object-based systems design. He is a keen sportsman, spending much of his spare time competing in triathlons alongside coaching a mini-rugby team.