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Industry Perspectives

MiFID II represents a challenge for Canadian dealers

Whether Canadian securities dealers can establish a global model of payment for research will depend on U.S. regulatory accommodation to MiFID II

By Ian Russell | August 16, 2017

The European Securities and Market Authority's (ESMA) development of the large, complex regulatory framework known as the Markets and Financial Instruments Directive II (MiFID II) will have a considerable impact on the trading and securities distributions of Canadian investment dealers in Europe.

MiFID II, which has been in the making for almost four years, is focused on investor protection, market structures and transparency, governance and a harmonized scheme for market access. The two most significant rules impacting Canadian investment dealers' businesses in Europe will be a ban on soft-dollar payments made by asset managers for research, requiring the unbundling of commissions and charging an explicit fee for research, as well as new transparency requirements for fixed-income trading.

This new regulatory framework will offer Canadian investment dealers the opportunity to move to a global model for the payment of research. But the ability to take advantage of that opportunity will depend on amendments to U.S. regulations to accommodate MiFID II and will involve significant changes to systems, business practices and compliance and oversight procedures — all at a substantial cost.

Investment decisions are typically driven and guided by both macro research on the currency and Canadian economy and corporate research on individual firm performance. In most jurisdictions, MiFID II will upend current practices in that firms will be required to unbundle research fees from trading commissions. Firms must also establish a price for individual and packaged research and develop procedures for continued review of research and pricing arrangements, and compliance policies for receipt of funds from the asset managers. These requirements will affect bank-owned and independent integrated dealers as well as many institutional boutiques distributing Canadian dollar equities to European institutions.

Canadian dealers face a conundrum: adopt two distinct payment mechanisms and compliance practices or move to a single global model based on the MiFID II requirements. The latter option is attractive, offering a uniform and efficient compliance system and catering to the Canadian affiliates of global asset managers that may adopt the MiFID II practice of payment for research, a practice likely embraced across the global operations of major U.S.-based asset managers, such as BlackRock Inc., Pacific Investment Management Co. LLC (a.k.a. PIMCO) and Fidelity Investments.

However, there is one complication. The soft-dollar system for payment for research is enshrined in U.S. securities regulations. Under U.S. law, broker-dealers can only accept fees for service (such as

a direct fee for research) if the trader and firm are registered as Registered Investment Advisors (RIA), which subjects them to a fiduciary standard. U.S. dealers are wary to elect this option due to the regulatory risks and the restrictions imposed on proprietary trading.

This puts the U.S. securities industry in an untenable position: either the broker-dealer registers as an RIA, a non-option for most firms; obtains relief from the Securities and Exchange Commission through some form of no-action letter; or ceases distributing research in connection with equities and fixed-income transactions. A single global mechanism for payment for research is thus a non-starter — unless U.S. regulators accommodate the MiFID II rules.

The real-time pre- and post-trade transparency requirements for debt securities under the MiFID II requirements would be the most complex and detailed in the global markets. The regulations require trade date, execution venue, price and notional amount — with all information provided in real time or no later than 15 minutes after the transaction.

Even with relatively small traded volumes in the European markets, the system and oversight/compliance costs will be significant. Ten of the largest Canadian dealers, the market-makers in the over-the-counter debt markets, are caught in the MiFID II transparency requirements, with three of the firms designated as primary dealers in the U.K. gilt markets and roughly 10 firms dealing in Canadian government bonds with European institutions.

ESMA and the European Union have signalled that the year-end deadline for this ambitious and comprehensive rule framework is firm. Firms are struggling to comply, particularly for the pre- and post-trade transparency requirements, and the compliance requirements of unbundling research. Several seemingly intractable problems remain for U.S. financial services institutions. A resolution through some form of regulatory relief is likely early this autumn — and the sooner the better. U.S. regulatory accommodation to MiFID II will determine whether or not Canadian securities dealers can establish a global model of payment for research.

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