CHALLENGES REGARDING THE IMPLEMENTATION OF MiFID II

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Abstract: *Despite the positive effects that MiFID II has had in increasing transparency and the individual investor protection, most recent studies outline the difficulties experienced in practice by the European investment firms when trying to comply with the European regulation. The most recent survey realized by CFA Institute point out to the fact that the European investment services industry has suffered, due to the introduction of the new regulation. The big players might be the only ones for which it seems to be worth remaining on the market, the small investment companies being downsized or eliminated completely. In this paper, we aim at discussing the challenges that the introduction of MiFID has brought for the Romanian investment firms, while comparing this situation with the general situation at the European level.*

Keywords: MiFID II, challenges, investment firm, compliance

1. Introduction

We could say that the regulation of investor protection in financial investment services is pretty recent. The private interests of investors in the relationship with the financial investment service providers have been, for a long time, protected only by the provisions of the commercial law.

The securities regulation was limited to the regulations requiring issuers of securities to disclose a certain level of information to the public and the rules for the organization of securities transactions on stock exchanges. The need to protect investors in their individual relationships with the financial investment service providers has emerged only in the last three decades, largely due to two phenomena:

- technological progress, which created new ways of trading financial instruments;
- changes in the demand for financial instruments, investors' behavior

regarding the market returns, the transition from traditional saving instruments where the risk was covered by the financial institutions in return for a small return provided for investors to other types of financial instruments, involving a much higher individual risk, where the potential market abuse created by the financial investment providers is higher and all investors are affected by systemic risk;

- the financial crisis, when it became obvious that there was a lack of transparency requirements.

Law no. 126/2018 on Financial Instruments transposed Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on financial instrument components - MiFID II. This ensured the alignment of the national legislation with the European standards in what concerns the financial instruments. Some authors refer to the MiFID II as being rather an

evolution of the previous European legislation, rather than a revolution [3].

The main actors of change in the regulatory grid are the investment firms, the traditional intermediaries acting as brokers in the stock market. Similarly, the entities that make important efforts to comply with the new regulations are the credit institutions involved in stock market activities, selling money market products, such as exchange rate and interest rate instruments, government securities and structured assets (whose dynamics depend on another asset variation).

All these intermediaries were advised to do changes in their business and operating conduct in order to mitigate MiFID II risks, by making early investments in order to gain competitive advantage on the financial market [4].

2. New obligations for the investment firms

The main changes that had to be done and implemented by the intermediaries that operated on the financial markets were, in the first place, of an internal or organizational nature, through the implementation of processes and procedures, which firstly involved changes at the level of the used IT systems. Moreover, there were other changes that had to do with the relationship with the customers, increasing substantially the level of information provided and ensuring the right contractual framework. Finally, it is worth mentioning the mandatory reporting of all transactions to the competent authorities.

In order to give just a few examples, the following actions became very important: i) the product's governance obligations, such as the way in which the financial instruments are developed and the potential clients are identified for a particular type of instrument - the target market, (ii) the classification of each client in a certain category (retail, professional or eligible counterparty) based on the information

received from the client, having in consideration its previous experience with financial instruments, according to which the protection granted by the intermediary is established at a lower or a higher level, iii) determination of the matching degree for each client, (iv) implementation of some policies, including the best execution policy for the orders, avoidance of conflict of interest, resolution of complaints through alternative measures as well, and the transparency regarding the incentives that a credit institution or an investment firm might receive from a third party linked with or reflected in the financial instruments of the clients.

Like in the MIFID I case, the investment consultancy is considered a service and a main activity classified in the MIFID II and in the Law no. 126/2018. In addition to the fact that the intermediary needs to have a valid authorization for supplying this service, MiFID II introduces the differentiation between the "independent" and "non-independent" investment advice, the client being informed about the type of consultancy that is being given to him. Unlike the "non-independent" consultancy, which may focus on the valuation and comparison of the financial instruments that the intermediary itself (or an entity closely linked with it) has issued, the "independent" consultancy assumes the analysis of a broader range of financial instruments - without being limited to the ones provided by the intermediary itself, by its employees or other persons with whom the intermediary is economically linked.

The intermediary will have to disclose, "ex-ante", to the client the type of consultancy that will be given, allowing sufficient time prior to the supply of the service. Also, prior to any transaction, the consultants have the obligation of providing to the clients, a statement regarding the adequacy of the services provided, specifying what exactly the consultancy comprised, and the way in which it was compatible with the needs and the characteristics of the retail

client. By way of exception, this statement may be provided ex-post only on certain conditions and after the client expressed his/her consent. Of course, the assessment of the adequacy of the services must also have an ex-ante approach, that will be based

on the characteristics of the products or services, the financial situation of the client, its risk tolerance and capacity of registering financial losses and not at least, its investment objectives.

Table 1 MIFID II coverage

Area of coverage	Governance	Reporting
	<ul style="list-style-type: none"> • New corporate governance requirements • Introducing the concept of management body • Stricter professional criteria for management staff • Stricter control over the pay of staff sales • Increased importance of the role of the compliance officer 	<ul style="list-style-type: none"> • Transparency requirements have been extended to financial instruments other than shares (now covering 100,000+ financial instruments) • Trading reports must be published through Approved Publication Arrangements (APA) specialized companies • Trading reports now comprise much more information (65 fields, versus 23 previously)
	Market structure	Prudential surveillance
	<ul style="list-style-type: none"> • A new market (OTF) for instruments other than shares (such as bonds, derivatives, structured products) • Non-EU companies can establish themselves in the EU through a branch in each state or obtain the European Passport from ESMA 	<ul style="list-style-type: none"> • ESMA and local supervisors have the power to ban certain financial products or practices • Warnings and fines will be made public

Source: CFA Society Romania (2019)

3. Effects of MiFID II on the financial intermediaries

One recent wide survey realized on the European investment industry emphasizes the impact of the enhanced “inducement” rules regarding the payment for investment research on the conduct of the investment firms. The regulation stipulates that providers of research services (like brokers or investment banks) should separately charge research from the other costs (commissions and spreads) and should decide whether to cover these costs internally or pass them to the clients. The results of the survey have shown that the majority of the investment firms have chosen to finance these activities individually, by reducing the research budget, instead of charging clients, which lead to a reduced quality of the research and coverage performed by the investment

funds [1]. Moreover, the evidence has outlined the fact that, in general, the investment firms have not increased their management fees, suggesting that there is an additional budgetary pressure on the investment firms, with a higher impact on the smaller ones, with lower budgets. Moreover, one of the most important observations of the study is the fact that the research provisions are focusing mainly on large-cap companies.

According to CFA Society Romania, given the changes that the MiFID II required at the level of the financial intermediaries, the following business lines have been affected: [3]

a) *retail* - the management of the financial intermediaries experienced difficulties in trying to minimize or cover the losses of revenues coming from giving up incentives, while staying in line with regulation and having competitive prices; at the same time,

they had difficulties in establishing the precise level of transparency for a certain product;

b) *brokerage* - the management of the financial intermediaries expressed concerns regarding the manner in which they can provide investment consultancy over certain products, the way in which they could integrate the brokerage services (consultancy and execution) in the financial services of a credit institution or the distinction between clients when offering a certain type of consultancy;

c) *treasury products*- the way in which the clients of a credit institution can be informed about the costs/fees for treasury products, if a special department should be created in order to offer the consultancy necessary for this type of products or the type of IT solutions that should be implemented.

Some of the most important factors that have lead to a fall in the charged fees practiced by the financial investment firms are the low interest rates on the financial markets, the restrictions regarding receiving/supplying incentives, the generalized decrease of the management fees given the pressure coming from the part of the distributors who do not receive incentives anymore, the less opportunity for transferring incentive costs to clients, respectively the increased competition between brokers as a consequence of the increased disclosure.

As potential solutions, there can be outlined the following:

- Higher distribution fees - unlikely due to the current low interest rates;
- Additional services (market analyses, investment advice, access to data);
- Additional services for institutional clients (custody, treasury, etc.).
- Reducing distribution costs (digitization, use of online platforms)

4. Conclusions

Despite the positive effects that MiFID II

has had in increasing transparency and the individual investor protection, recent studies point to the difficulties experienced in practice by the European investment firms when trying to comply with the European regulation, already disadvantaged in comparison with their U.S. counterparts, which benefit from more pragmatic approaches of their regulators and very developed stock markets.

The majority of the European countries, including Romania, have a bank-oriented financial system, with developing stock markets which strive to become an important part of the financial system. However, the European economy needs the traditional credit-market, as well as a liquid and well-functioning equity and debt market in order to fund its growth.

In comparison with the U.S. investment firms, the European investment firms are lacking in competitive advantages, which trigger negative consequences for the European financial markets. The compliance of the small investment firms with MiFID II seems to be difficult, if not impossible, many studies pointing out to the fact that the European investment services industry has suffered, due to the introduction of the new regulation. The big players might be the only ones for which it seems to be worth remaining on the market. The concentration seems to be the only left solution, the small companies being downsized or eliminated completely. Moreover, it becomes profitable for the remaining investment firms to focus only on large-cap companies, while the others are left out of the attention of the institutional investors, although they are considered the European backbone.

The recent feed-back provided by the investment firms to CFA are confirming the difficulties that the Romanian and the other European investment firms are expressing when trying to comply with MiFID provisions.

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