

## NOVELTIES BROUGHT BY MiFID II AND THEIR IMPACT

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### Abstract

The new legislative package MiFID II aims at increasing transparency and efficacy of markets, at limiting volatility, at enhancing the fair-play of intermediaries, as well as at a more integrated and more competitive market.

To achieve these objectives, MiFID II has brought a set of new rules and requirements in order to strengthen the role of the capital market in the EU economy development, to adapt the financial services regulations to the new technological innovations, as well as to improve the investor protection methods and techniques.

All these novelties brought by MiFID II will have a significant impact on all participants in the capital market, both in terms of internally used processes and IT systems and in terms of how they will define their business lines in the future.

**Keywords: trading venues, investor protection, financial services**

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### Novelties brought by MiFID II

As a novelty, it brings transformations in the capital market by favouring competition between the various trading venues and by subjecting, as much as possible, the financial transactions concluded outside the trading venues (OTC transactions) to a transparency regime similar to that of transactions concluded on the regulated market (RM) or in multilateral trading facilities (MTF).

To achieve this goal, MiFID II contemplates both OTC transactions that are concluded on a multilateral basis, through intermediary networks, and transactions that are concluded by allowing the intermediary to use its own capital.

In this respect, beside the two trading venues regulated by MiFID I, a new trading venue is added, called the organised trading facility (OTF), aiming at bringing to the regulated area the OTC transactions concluded on various broker crossing networks. The creation of OTFs is intended to ensure a fair competitive framework between the OTC transactions and those

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concluded in the trading venues regulated in terms of transparency and trading rules, which will also impact how the best execution is achieved.

Also, in order not to avoid in the future the possibility to form intermediary networks as an alternative to trading through regulated venues, OTF managers will no longer be able to interconnect their trading platforms so as to allow the crossing of orders coming from several organised trading facilities.

As far as independent operators are concerned, MiFID II establishes that acquiring this quality is required only if the relevant financial entity achieved, during the last six months, a certain level of operations on its own, frequently and systematically, using that type of financial instrument, depending on the existence of a liquid market or not, and at the same time if it reached a certain percentage of the total turnover relevant to the transactions concluded using that financial instrument.

As far as how transactions are concluded, intermediaries who are independent operators must not join the sale and purchase interests in a manner allowing the execution of clients' orders on a multilateral basis, since an authorization for acquiring the quality of MTF or OTF is required for this activity.

Also, to ease the access of small and medium enterprises to the financial resources needed, the new legislative package adds a new market segment dedicated to this category of issuers. This sub-category of MTFs will be a growth market for SMEs and will have a suitable flexibility degree in assessing eligible issuers in order to be allowed to this trading venue.

Regarding the way transactions are concluded using financial instruments, MiFID II changes how the best execution principle is applied for the client by charging the intermediaries with the obligation of "taking all sufficient steps" instead of "taking all reasonable steps", as MiFID I used to provide. Also, in the category of execution factors, a new factor is added for non-liquid financial instruments, i.e. "fairness of the price proposed to the client".

Also, to assess how the best execution principle is applied for the client, intermediaries must establish a set of benchmarks depending on the factors and criteria contemplated when executing the order (e.g.: the best price – the lowest purchase price, the highest sale price, minimum trading costs, the shortest execution time).

With the same purpose of improving the application the best execution principle for the client, the "Order execution policy" must be updated from time to time, depending on the market dynamics and on the changes having occurred in the market microstructure. Thus, intermediaries must periodically make an analysis of the transactions concluded for clients by using benchmarks and, depending on the results obtained, they must update the "Order execution policy" or not.

Also, the IT technology evolution has facilitated the occurrence of new trading capacities and models that have responded to the need of increasing the trading speed. Thus, along with the development of algorithmic and high-frequency trading systems and with the need of having direct access to the market, new risks, associated to these types of electronic systems, have been identified.

Therefore, the new rules brought by MiFID II are intended to reduce the following categories of risks associated to electronic systems, namely: i) the risk of trading systems overloading because of the increasing order volume; ii) the risk that algorithmic trading leads to a disorganized market as a result of allowing duplicate or erroneous orders to occur; iii) the

risk that algorithmic trading leads to a higher volatility in the event of an excessive reaction of systems to certain events/situations on the market; iv) the risk that algorithmic and high-frequency trading leads to distortions on the market liquidity.

Also, due to the more and more integrated level of the new trading capacities, intelligent order routers can be included in the category of algorithmic trading systems since some of these, in view of optimizing the order execution processes, determine other parameters of orders as well, besides those regarding the trading venue or venues where the order should be placed.

In the case of a direct electronic access to the market, the new legislation allows this for the clients within the limit of the value established by the intermediary. This limit is established depending on the intermediary's capacity of managing the counterparty's credit risk, as well as the operating risks relevant to the clients' direct access to the market.

With regard to the pre-trading transparency, MiFID II extends the requirements applicable to capital securities and to other financial instruments. To that effect, the rules applicable to shares admitted to trading on a regulated market shall be extended to deposit certificates, to exchange-traded units, to emission certificates, as well as to other similar financial instruments. These new financial instruments are traded the same way and meet an economic purpose similar to that of shares admitted to trading on a regulated market.

Also, a set of changes are brought with regard to post-trading transparency as well, with a view to ensuring the quality of data regarding financial transactions, as well as to consolidate it in order to be able to give investors an overview of the transactions concluded within the EU using a certain instrument, regardless of the venue or of the trading system they were concluded in. Thus, MiFID II charges the entities responsible for publishing, reporting and consolidating the data with the obligation of becoming authorized as: 1) an "Approved Publication Arrangement" (APA), an entity publishing trading reports of intermediaries, 2) an "Approved Reporting Mechanism" (ARM), an entity reporting transactions to authorities, and 3) a "Centralized Reporting System Provider" (CTP), an entity collecting trading reports, consolidating them and providing consolidated information regarding transactions that use financial instruments.

To consolidate the data on financial transactions and ensure post-trading transparency, intermediaries provide information on the transactions concluded by an APA, and APAs forward this information to a CTP. CTPs consolidate the information and place it at the disposal of all the market participants. The managers of trading venues that are directly connected to an APA forward the information to a CTP.

At the same time, in view of providing the investors with the possibility of comparing intermediaries in terms of order execution quality, financial entities will have the obligation of publishing the data regarding the trading activity in the first five trading venues actually used during the past year.

MiFID II also comes with additional requirements in terms of ensuring the highest possible protection degree for investors, requirements that are based on three general principles that intermediaries must adopt in their relationship with investors, namely: i) act honestly, fairly and professionally, in accordance with the client's best interest, ii) provide the client with suitable and comprehensive information, that must be accurate, clear and non-misleading, iii) provide services aimed at ensuring the best adequacy between the features of the financial

instrument/service and the risk profile of the investor or of the target market. These principles are applied both to the financial services concerning the “classic” financial instruments and to the structured products issue and distribution activities.

As far as the client assessment is concerned, the categories mentioned in MiFID I are kept unchanged, but several changes are brought in that municipalities and local public authorities are treated as retail clients, with a capacity of becoming professional clients. Also, depending on the type of financial investment service provided to the client and on the type of requested financial instrument, the client must provide a set of information needed for making certain tests.

To that effect, opportunity tests are made, to find out whether the client is able to understand the financial risks he/she is getting exposed at in the event that such investment is made, as well as adequacy tests, to find out whether the products/services are suitable for the client, depending on its needs and risk profile. When the investment consulting refers to a product package, the “packed” product as a whole must be suitable for the client. The final purpose of the two tests is to identify: “the right product for the right client”.

Depending on the size of information provided by the client and, implicitly, on the possibility of making or not one of the tests, the intermediary can provide investment consulting to the client, followed by the conclusion of certain transactions, an introduction of the financial instruments, followed by the conclusion of certain transactions or just trading services.

As regards the investment consulting activity, there is a new requirement regarding the segregation of the concept of independent and non-independent consulting in view of ensuring increased protection for clients. The information regarding the type of consulting to be provided must be communicated to clients upon starting a contractual relationship, along with the applicable restrictions. Also, the MiFID II legislative package defines a set of parameters that must be met in order to provide independent consulting.

Also, MiFID II imposes to intermediaries a certain transparency regime regarding the rates charged for the investment consulting service and, at the same time, to their employees who provide consulting – to have a certain level of professional training.

As far as the investment research activity is concerned, MiFID II imposes stricter conditions regarding the level of payments made by clients for investment research, the obligation of using a dedicated payments account, and the obligation of making periodic assessments regarding the quality of the research activity.

The level of research payments and their frequency must be based on a research budget determined between the intermediary and its clients, and cannot be linked to the size/value of the transactions concluded by the clients. Intermediaries must regularly assess the quality of the research activity, including their capacity to contributing to better investment decisions, and the extend this is beneficial to the client portfolios.

In terms of structured products governance, MiFID II introduces a set of obligations applicable to the issuers and distributors of such financial instruments, aimed at ensuring the best adequacy of the offered products considering the profile and needs of the clients who are part of the target market. Thus, issuers and distributors must make efforts to maintain this adequacy during the entire life of the issued and distributed products. Also, MiFID II establishes attributions for the national competent authorities to supervise how the

governance rules relevant to the financial products are observed by the financial entities in issuing and distributing the same.

Also, a set of restrictions are introduced regarding the incentive systems, the intrinsic rewards and the sale targets for the staff involved. These conflicts of interest avoidance measures are aimed at obtaining a responsible business behaviour, ensuring a fair treatment for all clients and, at the same time, acting to the clients' best interest.

### **The impact of the new requirements brought by MiFID II**

MiFID II supplements the previous regulations in order to cover the new practices and technological capacities having occurred during the last decade in the financial instruments trading activity, in the financial products issue and distribution activity, and in financial services.

These new rules and requirements were aimed at increasing the level of transparency for financial transactions and services, at favouring competition between the various capacities/trading venues, as well as between various intermediaries, at avoiding conflicts of interest, at increasing protection of retail investors, as well as at opening access to the capital market for issuers who now meet the listing requirements. All these are eventually aimed at improving investor confidence in capital markets and in extending the role of these markets in the economic development of the EU.

Also, the implementation of these new rules and requirements introduced by MiFID II will impact the market participants on all business and compliance levels, and implicitly the internally used electronic systems. Thus, intermediaries must a) redefine their business lines and their financial instruments selling techniques, b) change their internal policies and regulations, c) ensure more skilled human resources as a result of the new professional skills requirements, d) update their internal back-office systems both to ensure the new data and information flows that need to be published or transmitted to other entities, and to update the opportunity tests, adequacy tests, and comparison tests for the offered products, e) adapt their trading capacities to the new market architecture and, implicitly, update the best execution models/parameters a.s.o.

Additionally, due to the new requirements brought by MiFID II in the market architecture, as well as to the financial innovation, in the future we will witness a reorientation of intermediaries to the new business niches, such as financial product issue and distribution, independent operators, or OTF managers.

All these changes needed for implementing the new MiFID II requirements will lead to additional financial efforts for intermediaries, that some of them will not be able to sustain and will withdraw from the financial services provision business.

Finally, due to the high detail in which MiFID II regulates aspects regarding the financial instrument markets, the national authorities will still be able to regulate only a very small number of aspects, which will contribute to the emergence of a unique capital market at the EU level in terms of the applicable legal regime. Also, due to the novelties brought by MiFID

II, the implementation of this legislative package will lead to a remodelling of the financial services market in the EU.

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