MIFID II
IMPACT ASSESSMENT

# Mifid II in Austria: An example of unintended consequences

Markus Fellner and Martin Wallner of Fellner Wratzfeld & Partners review how clients have been responding to the regulatory requirements imposed by Mifid II

Mifid II was passed in response to the global financial crisis a decade ago, with the aim to improve the integrity and transparency of financial markets and strengthen investor protection. Mifid II marked the peak stage of regulatory density of European capital markets law, and its numerous legal requirements framed a constitution for financial markets of sorts, built on the basic principle of 'the greater the transparency, the greater the investor protection'.

Initially, many of the directive's complex legal amendments were a challenge for both the development of appropriate technical systems and the timely implementation of the necessary legal regulations. In Austria, Mifid II was implemented through the Austrian Securities Supervision Act 2018 (*Wertpapieraufsichtsgesetz 2018, SSA 2018*) and the Austrian Stock Exchange Act 2018 (*Börsegesetz 2018, SEA 2018*), which entered into force on January 3 2018. Moreover, the implementation of Mifid II enabled the revision of over 40 acts of legislation.

Mifid II has affected Austria's entire investment services market by prompting changes across four different areas: distribution and advisory, trading and execution, reporting and transparency, and risk management. Mifid II tightened transparency regulations for shares and covered considerably more financial instruments than before. The introduction of Mifid II also led to fundamental changes for markets where equity-like instruments, bonds, structured finance products and over-the-counter (OTC) derivatives are traded. The modifications by Mifid II profoundly affected investment firms (including banks active in the securities business) and the entire structure of the European securities market. As a result, investment firms were forced to reassess their strategic direction, optimise existing processes, develop new ones and make extensive adjustments to their IT systems.

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The impact of the regulation's heightened investor protection has been felt throughout the financial industry. Strict regulation of third party benefits for financial advisors have forced some market participants to review and revise their entire costing structure and product portfolio. The product governance regime covering the defined target market pushed distributors of financial products to make time-consuming and costly additional assessments in respect of certain customers. Compliance with new record-keeping obligations and investor protection rules required market participants to scrutinise their customer communication and to retrain their staff. Some market participants even had to review their agreements with customers and to modify their general terms and conditions to ensure compliance.

In the wake of the implementation of Mifid II, the Austrian Financial Market Authority (*Finanzmarktaufsicht, FMA*) proved to be cooperative on implementation matters, issued clarifications on the draft laws of the SSA 2018 and SEA 2018, and offered guidance on the interpretation of the various legal requirements. Furthermore, the FMA worked with the Austrian Chamber of Commerce to answer questions that the latter had collected from the Austrian financial sector regarding the implementation of Mifid II. Both questions and answers are a valuable resource that are freely accessible online.

## The post-implementation market

In practice, several of Mifid II's requirements went well beyond the legitimate objective of reasonable investor protection.

Mifid II imposed excessive disclosure requirements, without including any option for clients to opt out of receiving certain kinds of recurring information, such as quarterly deposit reports, *ex-ante* cost information, and declarations of suitability for multiple transactions of a similar nature executed within a short period. Similarly, according to Article 63, paragraph 1 of the Delegated Regulation (EU) 2017/565, each quarter, investment firms must provide their clients with physical records of financial instruments held, adding considerable cost with questionable add-on value for clients, who can access their report online or request an extract from their consultant at any time. Even if clients wanted to, Mifid II would not allow them to opt out of this disclosure and information regime.

Furthermore, extensive information obligations regarding *ex-ante* costs has led to considerable problems, with few financial services providers' sales staff and clients willing to accept the information. Mifid II allowed financial services providers to disclose *ex-ante* cost information just once for each product group with an almost identical cost structure, eliminating any incremental benefit for clients from retrieving the same information again. Certainly, *ex-ante* cost disclosure requirements have failed to improve cost transparency and homogeneity of how costs are broken down and presented. Most market actors break down and present their *ex-ante* cost information in a different manner, relying on different terms and definitions, making direct comparison of cost structures between actors confusing and difficult.

The information obligations under Mifid II apply to professional clients and suitable counterparties as well. For the most part, both transact with financial services providers by telephone and under high time pressure, which makes the *ex-ante* cost delivery requirement impractical. As prices fluctuate as *ex-ante* cost information is being transmitted, reliance on such outdated *ex-ante* cost information can have an adverse financial impact on clients. Lastly, each time a bank withdraws an offer, any difference in price would require a new offer to be accompanied by new *ex-ante* cost information.

According to an European Securities and Markets Authority (ESMA) Q&A update, annual *ex-post* cost and charges disclosure requirements under Article 50(9) of the Mifid II Delegated Regulation must be aggregated at least at the portfolio level, unless clients request an itemisation. Per Article 60 of the Delegated Regulation, these *ex-post* disclosures may be sent together with other periodic reports to clients, such as quarterly (or monthly) cost statements. ESMA further clarified that even if clients (opt to) receive more frequent cost information, they nevertheless must receive *ex-post* cost information on an annualised basis to be able to have a clear picture of costs incurred for the whole year. This increases the administrative burden for firms.

The most burdensome and costliest requirement Mifid II has imposed was to keep records of telephone conversations with clients. Substantial compliance costs aside, following implementation into Austrian law phone consultations were reported to have declined considerably. Against this backdrop and from an investor protection perspective, the usefulness of phone records is not quite clear and prompted calls for less arduous alternatives. Incidentally, the COVID-19 pandemic may pave the way for a relaxation of these rules. In March 2020, ESMA issued a statement on the requirement to record telephone conversations during the COVID-19 pandemic, allowing firms to adopt alternative arrangements to ensure compliance with regulatory requirements such as the use of recordable electronic communications or written minutes of

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phone conversations in the event that phone conversations cannot be recorded due to working from home arrangements.

Finally, despite its aim, Mifid II does not relax compliance requirements in the event national competent authorities take different product intervention measures that apply in and from their respective member state. ESMA has clarified in its Q&A that in such cases investment firms active across borders must comply with the measures in both states: those of the member state in which the investment firm is authorised, and those where the client it provides cross-border services to, is located.

## Mifid II/Mifir review process

Given Mifid II's extensive and costly documentation requirements and the unbundling of research services, it became clear that without changes many financial services providers would exit less liquid markets – such as Austria – to avoid compliance costs. In addition, larger players seeking to expand their market share would increasingly price out smaller competitors. The likely result: less market transparency, less market liquidity and a weakened financial system.

During ESMA's Mifid II/Mifir-review process in Q2 of 2020, the Austrian government relayed many of the concerns illustrated above. Building on a joint proposal developed by the Austrian Chamber of Commerce and the FMA, the Austrian government's position for Mifid II reform centred on three pillars:

- The introduction of a dynamic deadline regime for the national application and implementation of level 2 measures;
- A relaxation of information obligations; and
- Exempting small and medium-sized enterprises (SME) issuers from Mifid II's research regime.

The implementation deadline for Mifid II has been criticised as being too short and insufficient, resulting in undue and burdensome pressures for market participants. Under an affixed application and implementation schedule, a delayed European Commission request to ESMA for level 2 technical advice – which takes up to 12 months – ultimately cuts short the period that national legislators and market participants have to ensure timely application and implementation at the national level. To avoid a repetition of past mistakes, the Austrian government advocated instituting a dynamic deadline regime, under which the 12-month application and implementation period is only triggered once all level 1 and level 2 legislation and technical standards have been adopted.

Austria advocated for the relaxation of information obligations, particular *vis-à-vis* eligible and professional counterparties: expanding on the opt-in model for eligible counterparties pursuant to Article 30, the Austrian government proposed an opt-out for eligible counterparties from information obligations pursuant to Article 24, paragraphs 4 and 5; and Article 25, paragraph 6 of Mifid II, respectively.

In addition, any time an investment firm acts on behalf of a professional counterparty or its own account, such a professional counterparty should be able to opt out of any information obligations optional for eligible counterparties. To avoid inundating customers with information, the proposition calls for information obligations to be re-evaluated and dropped. In particular, this refers to recurring orders at similar conditions within a short time frame, provided that customers agree to such opt-out and that the documentation of such orders by investment firms is ensured.

Lastly, financial sector stakeholders proposed an exemption of SME issuers from Mifid II's research unbundling. The directive's research regime resulted in a market failure that the regulation had sought to avoid. The unbundling of research services resulted in the loss of coverage of most SME issuers, as research focuses on blue chip issuers. Furthermore, smaller market participants are priced out of increasingly expensive high quality research products.

As a result, rather than increased transparency and protection, Mifid II's outcome was the exact opposite: less investor clarity particularly on SME issuers, less market transparency and less liquidity of SME issuances. In this respect, the directive proved particularly harmful to less liquid markets such as the Austrian Traded Index (ATX).

## European Commission's proposal for a Mifid II 'quick fix'

The European Commission (EC) was receptive of critical feedback during the consultation process and acknowledged that some of its regulation imposed burdens that had unintended and negative effects, particularly on small and medium sized firms. It agreed that the removal of such obstacles was key to strengthening European financial markets, especially in light of the challenges posed by the COVID-19 pandemic.

In its July 2020 proposal for a Mifid II 'quick fix', the EC offered a more finely balanced system of transparency, investor protection and compliance by moving to eliminate documentation and disclosure requirements, not counterbalanced by corresponding increases in investor protection. Among the things that the EC proposes are phasing out paper-based communications, relaxing *ex-ante* cost and reporting requirements and exempting issuers with a market cap of up to €1 billion from the research regime.

Even though Mifid II has been in effect for a mere three years, its impact is felt throughout the financial industry. In some areas, the directive's impact certainly overshot regulatory intent and resulted not just in unintended consequences, but incidentally those that Mifid II had sought to avoid. Having said this, our view from the previous year holds that the strict regulations regarding investor protections will lead to fewer investor litigation cases. To date, however, many legal questions surrounding implementation and application remain, which the Supreme Court has yet to address.