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IMPACT OF THE MiFID II DIRECTIVE ON ISCs

M&A, Investing and Corporate Finance

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1.INTRODUCTION

The main aim of this report is to analyze and comment how the different regulations of the MiFID II Directive (Markets in Financial Instruments Directive) affect the profitability of the ISCs (Investment Service Companies), as well as how along the years the ROE obtained from the services offered by these companies have been affected in terms of gains or losses.

Moreover, this analysis is focused on two type of ISCs: (1) Securities firms and (2) Securities agencies. Securities firms are those investment services companies that can operate professionally, both for their own account and for the account of others and perform all investment and ancillary services. Securities agencies are those investment services companies that professionally may only operate on behalf of others, with or without representation.

In 2019, the CNMV (Comisión Nacional del Mercado de Valores) confirmed that the MiFID II Directive was affecting all ISCs, especially the small ones. The main conclusion made by the CNMV was that the new regulation was transforming the industry's trading structure in a significant way. Thus, this study is relevant to understand why each of these companies are making a big effort on adapting their business and organization in order to comply with MiFID II Directive. This effort is mainly related to the heavy IT investments necessary for making changes in their processes and systems and implementing new information technologies which implies incurring in additional large costs for the ISCs.

In order to do so, I will first conduct an overview of the financial statements of the ninety-six agencies and brokerage/securities firms registered and operating in Spain. Then I will perform an analysis of the evolution of the sector from 2013 to 2019 in terms of their ROE and will plot it in a graph. And finally, I will examine some dummy variables (time, brokers, fintech's, financial traders), micro (log of total assets, current and cash ratios) and macroeconomic (Euribor 3-month and term spread) variables using the OLS regression analysis to prove that adoption of the MiFID Directive has affected the ROE of ISCs.

To sum up, after considering all this information, I will try to prove why I will accept or reject my hypothesis on how the changes in the regulatory system have affected the different ISCs entering, executing and diversifying their products in the market, how the actions of the CNMV have affected their ROE and have exposed these companies into regulatory risks.

2. CONCEPTUAL FRAMEWORK

2.1 Market Description

Investment services companies (ISCs) are entities authorized in Spain to perform various activities related to the securities markets. These activities are aimed to investors or companies that issue securities. The activities or services directed to investors are the following:

- Receiving, addressing and executing orders for the purchase and sale of bonds, shares and other products in the securities markets on behalf of their clients.
- Manage the assets or portfolios of investors who have given them a mandate to do so.
- Act as intermediaries when companies issue shares, bonds or promissory notes, and when they carry out public offerings of securities, bringing investors' knowledge of these issues and offers, so that they can buy if they wish to do so.
- To be depositories and administrators of securities and financial products of savers.
- To grant credits or loans to investors so that they can carry out the transactions in which the ISC is involved.
- Advise companies and investors.

La Comisión Nacional del Mercado de Valores (CNMV) is the competent supervisory body that authorizes this fund raising, management and investment services for third parties. There are currently four types of ISCs in Spain. There are activities and services that can be provided by all of them, and there are some services that are limited to one type of ISC.

The first type of ISC is the **securities firms (SV)**, which can offer all types of investment services. It should be noted that these companies are authorized to operate both on behalf of clients and for their own account.

Securities brokerage firms (SAs) cannot operate on their own account; they can only process orders for the purchase or sale of securities on behalf of their clients. This prohibition limits activities they can perform and the services they can offer. Thus, for example, they may not grant credit or loans to investors.

One type of investment service is portfolio management. This activity can be conducted by both securities firms and broker-dealers, as well as by a third type of ISC.

The **portfolio management companies (PMCs)**. These entities are only authorized to manage investment portfolios in accordance with the express mandates given to them by investors and to offer advice to both companies and investors.

Financial Advisory Firms are individuals or entities registered in the EAF (Empresas de Asesoramiento Financiero) registry that provide investment advisory service understood as making personal recommendations to clients on financial instruments and advising on ancillary matters as industrial strategy, capital structuring and other services related to mergers and acquisitions. Being this advisory service as the only service they are authorized to provide.

For an ISC to start competing in the market, it must be authorized by the CNMV and then register in the Mercantile registry and in the registry of the CNMV. As dictated in the Chapter II about Authorization, registration, suspension and revocation of Royal Decree 1464/2018. Consequently, the article 149. Authorization states the following.

1. The CNMV will be responsible for authorizing the creation of investment services and activities companies. In all cases, the procedure will be carried out by electronic means.

The authorization will state the type of investment services and activities firm in question, the list of investment services and activities, ancillary services and financial instruments, as well as the ancillary activities referred to in article 142.2, which it is authorized to perform.

2. The administrative decision shall be reasoned and shall be notified within six months of receipt of the application or of the time at which the required documentation is completed. If the application is not resolved within the afore mentioned period, it may be understood to have been rejected.

The authorization granted by the CNMV will be valid for the entire European Union and will allow an investment services and activities firm to provide the services or carry out the activities for which it has been authorized throughout the European Union, either under the right of establishment, including a branch, or under the freedom to provide services.

In order to obtain and retain authorization, investment services and activities firms shall at all times comply with the general and specific requirements for obtaining authorization, as well as the provisions contained in this Chapter and in Chapter IV, V and Sections 1.^a, 2.^a, 3.^a and 4.^a of Chapter VI, in Title VII, as well as in Title II of Royal Decree-Law 21/2017, of 29 December.

1. Investment services and activities firms may not carry out investment services and activities, nor ancillary services on financial instruments that are not expressly stated in the authorization referred to in paragraph 1. Likewise, in no case shall authorization be granted for the provision only of ancillary services.

2. For the provision of the management service of a multilateral trading system or an organized trading system, the governing bodies of regulated markets may also be authorized, as well as the entities constituted for this purpose by one or more governing bodies, which must have as their exclusive corporate purpose the management of the system and which must be wholly owned by one or more governing bodies, provided that they comply, under the terms and with the adaptations established by regulation, with the requirements for investment services and activities companies to obtain the authorization established in this chapter.

3. The procedure for the authorization of investment services and activities companies shall be regulated by regulation.

Once the company is authorized, it must proceed with the registration in accordance with the article 150. Registry of Chapter II about Authorization, registration, suspension and revocation of Royal Decree 1464/2018. The aforesaid article establishes the registration procedure based on the following procedure stated in the article 149 of Chapter II about Authorization, registration, suspension and revocation of Royal Decree 1464/2018.

1. For an investment services company, once authorized, to start its activity, the promoters must incorporate the company, registering it in the Mercantile Register and subsequently in the corresponding Register of the National Securities Market Commission. In the case of financial advisory companies that are natural persons, registration in the registry of the National Securities Market Commission will be enough.

2. The National Securities Market Commission shall notify the European Securities and Markets Authority of any authorization granted.

Lastly, the minimum general requirements stated by the article 152. General authorization requirements. From the Chapter II about Authorization, registration, suspension and revocation of Royal Decree 1464/2018

1. The entities must comply with the requirements of a corporate and financial nature, corporate governance, adhesion to the investment guarantee fund, compliance with the rules of conduct, the procedures related to the prevention of money laundering and internal organization as may be determined by regulation.

2. In the regulatory development of the requirements provided for in this article, account must be taken of the investment and ancillary services and activities which the companies are authorized to provide, especially in relation to the establishment of the minimum share capital and minimum equity.

The financial regulatory framework of the ISCs has changed drastically recently, both quantitatively and qualitatively, and will continue to do so in the following years. In the presence of this constantly evolving regulatory landscape, it is crucial for entities to identify, assimilate and implement changes in a timely manner.

The following are the requirements imposed on the financial activities carried out by ISCs at the national level and applicable to the investment services sector. The publication of Royal Decree 1464/2018, which completes the transposition of MIFID II in Spain, is particularly noteworthy.

"Article 15. Financial requirements for investment services firms. Investment services firms shall have an initial capital of not less than the following amounts: a) Securities firms; 730,000 euros. b) Securities agencies authorized to provide the management services of a Multilateral Trading System or Organized Trading System; 730,000 euros. c) Securities agencies; 125,000 euros. d) Securities agencies not authorized to hold in deposit funds or transferable securities of their clients; 50,000 euros. e) Portfolio management companies and financial advisory firms that are legal entities must have: 1) An initial capital of 50,000 Euros; or 2) Professional liability insurance, a guarantee or other equivalent guarantee that allows them to meet liability for negligence in the exercise of their professional activity throughout the territory of the European Union, with a minimum coverage of 1,000,000 Euros per claim for damages, and a total of 1,500,000 euros per year for all claims. 3) A combination of initial capital and professional indemnity insurance resulting in a level of coverage equivalent to that of paragraphs 1

and 2 above. In the event of transformation of another entity, the shareholders' equity at the time of registration must reach at least the amount indicated in paragraph 1 above. The initial capital may only consist of one or more of the items referred to in Article 26.1. a) to e) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013. Such initial capital must be fully paid up in cash, in the case of new creation. In the case of conversion, the payment of the difference between the minimum share capital and the net assets of the entity requesting the conversion must be in cash. 2. The modifications to the list of activities of the investment services companies that foresee the performance of activities for which a higher share capital is required shall be conditioned to the corresponding increase in capital. 3. The minimum initial capital of the agents of investment services companies that are legal persons shall be that which corresponds to the legal form adopted."

2.2 Regulatory System

2.2.1 What is MiFID II

MiFID acronym stands for "Markets in Financial Instruments Directive" a legislative framework instituted by the European Union to regulate financial markets and seek greater investor protection in the markets as well as a greater transparency when operating in the sector.

In 2014 the European Parliament approved the creation of a new Directive to improve the regulation established by MiFID, the Markets in Financial Instruments Directive that had been in force since 2007. MiFID II comes into effect in 2018, with the ultimate goal of establishing a higher level of protection for investors by tightening regulations.

As Ferrarini (2016) said, MiFID II is going to cause a great impact on the financial industry from now on.

2.2.2 Why MiFID II

The explanatory memorandum of the MiFID II Directive explains the reasons that led the European legislator to revise the financial market regulations, arguments that are similar to those already stated by the G20 in the London Declaration of April 2, 2009. In particular, the recital 4 of the aforementioned directive states that "The financial crisis has exposed a number some weaknesses in the functioning and transparency of financial

markets. The evolution of financial markets has made clear the need to strengthen the regulatory framework for markets in financial instruments, including when trading takes place over-the-counter, in order to increase transparency, improve investor protection, reinforce confidence, address unregulated areas and ensure that supervisors are given the necessary powers to carry out their tasks."

We can take as an example of lack of transparency in the information provided to customers, the case of interest rate SWAPS that allow the exchange of a fixed interest rate for a variable rate and vice versa, and structured products. In the case of the interest rate SWAPs, during the previous years to the outbreak of the financial crisis, when the interest rates were high, these products were sold together with mortgages as "insurance" against potential interest rate variations. However, this product was sold to people with limited knowledge on the sector, providing incomplete information about the product. Once the crisis had started, and the corresponding interest rate cuts, the clients that had guaranteed this product, did not benefit from the interest rate declines, since their variable-rate mortgages were not sensitive to the variation in the interest rates due to the SWAP contracted.

Crabb (2017) stated some reasons that lead the regulator to its implementation, all of them related to the misinformation to the investors, excessive charging fees and commissions and the lack of transparency. Such reasons are the following:

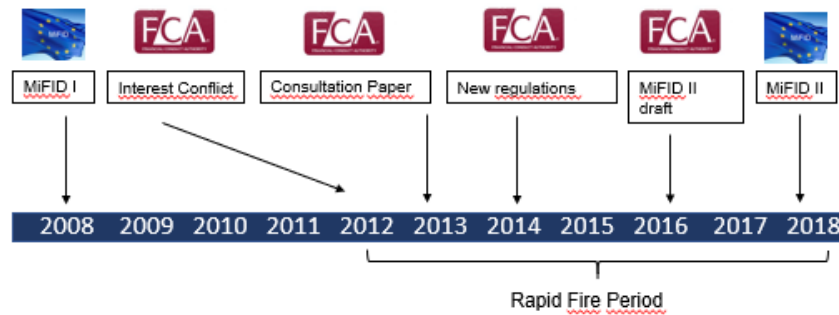
- The high speculation with hundreds of OTC products during the years 2000 to 2007, which triggered, along with other factors, the financial crisis of 2007.
- The excessive charging of fees to investors by funds and asset managers for not meeting benchmark expectations.
- Excessive sales commissions charged by financial intermediaries to fund an asset manager for advice on investment ideas and execution services.
- Exceeding financial leverage limits imposed on large investment banks
- An incorrect supervision of financial market regulators over financial institutions in each country

In addition, Crabb highlights the uncontrolled increase of the leverage level of the largest investment banks before the global financial crisis.

Consequently, all these cases have led to a climate of social distrust with respect to financial institutions and the instruments marketed or advised by them. As a solution,

Directive 2014/65/EU (MiFID II) together with Regulation (EU) no.600/2014 (MifIR) arose. Later modified in 2018.

In the following graph, we can observe the different regulatory packs imposed by other regulatory directives before MiFID II, in a period denominated as “rapid fire” from 2012 to 2017 in order to implement many regulations at the same time.



Graph 1 -Historical evolution of different regulations

Source: modified from the author of the graph Jaime Giacopazzi

2.2.3 MiFID II and MiFIR

The MiFID II framework comprises two key elements: the MiFID II Directive and the MiFIR regulatory framework introduced on January of 2018. This framework, strengthens investor protection by amending existing provisions on authorization, conduct of business and organizational requirements for investment service providers and introducing new obligations and preventive supervision measures.

New requirements on product governance and independent advice are introduced and existing rules are extended to structured deposits. In addition, requirements are enhanced in several areas, such as the responsibility of management bodies, incentives, pre-contractual and periodic customer information, cross-selling, staff remuneration and enhanced execution.

The objectives of this reform, as explained by the CNMV are:

- “To strengthen investor protection.” To this end, advice on the marketing of financial products and their incentives are regulated
- “Adapt to technological and market developments”. Legislates on automatic trading.

- Trading in regulated and organized markets is encouraged as opposed to the so-called over-the counter (OTC) markets, which are not supervised
- “To increase transparency in the markets, not only in relation to the trading of shares and similar instruments but also in relation to bonds or derivatives, to ensure the proper functioning of the markets in price formation”
- “Improve the regulation of some financial products such as derivatives, especially derivatives on commodities”
- “Facilitate access to finance for SMEs”
- “Strengthen and harmonize supervision and sanctions available to competent authorities and avoid regulatory arbitrage”

One of the main pillars of this reform is the MiFID II Directive, strictly speaking Directive 2014/65/EU. A new regulation that appeared after two years of negotiation and after the worst economic crisis that the European Union has suffered. There are three principles that inspire this new directive: security, efficiency and transparency of the markets with the goal of protecting investors.

As the CNMV points out, “it aims to reinforce the current European regulation on securities markets in several ways”. In total, four ways:

- It pursues organized trading to be carried out on regulated platforms.
- It introduces rules on algorithmic and high-frequency trading.
- Improves transparency and oversight of financial markets, including derivatives markets, and addresses certain shortcomings of commodity derivatives markets.
- Strengthens investor protection and conduct of business rules as well as competitive conditions for trading and settlement of financial instruments.

On the other hand, the MiFIR Regulation complements the above-mentioned regulations. MiFIR introduces a specific intervention powers for ESMA (The European Securities and Markets Authority) and national supervisors. These powers will allow them to temporarily prohibit or restrict the advertising, distribution or sale of a financial instrument or a type of financial activity or practice when certain conditions are met.

MiFIR establishes requirements about:

- Dissemination of trading activity data to the public
- Reporting of trading data to regulators and supervisors

- Mandatory trading of derivatives in organized systems
- Removal of barriers between trading systems and settlement service providers to ensure greater competition
- Specific supervisory actions on financial instruments and derivative positions

2.3 Impact on the ISCs Market

“It is clear that transparency will be increased which will impact market liquidity, enhance competition and further accentuate the data management challenge for investment firms”
- Niamh Mulholland (2018), director of the regulatory advisory services at KPMG.

The MiFID tackles structural changes in securities markets’ architecture as well as in parts of the financial system. Two relevant points must be analyzed carefully, the first one: the break of the concentration rule in equities markets and a new approach on client protection when providing investment services.

The MiFID looks forward to creating an integrated and efficient European market that can compete against other developed markets, mainly the American market. In this way, being capable to attract the largest investment flows from a globalized and financial world; and intends to achieve so through the investors protection as an essential axis to gain their confidence in the system. Due to this reason, the way of regulation has changed.

If the Investment Services Directive (ISD) regulated general principles with emphasis on the relationship between supervisors, the MiFID, without departing entirely from the general principles. We have moved from minimum regulation in the ISD to a maximum regulation in which the States do not have the capacity to establish different or additional requirements for investment firms in their countries. In addition, given the existence of identical requirements for the entities, it introduces a hidden element until now, the competition between supervisors who, with the Directive, will be forced to change their supervisory systems and objectives.

In 2019, the vice president of the CNMV, Ana Martinez Pina, ensured that the adaptation of MiFID II was not having a neutral impact and that it was affecting all ISCs, specially the small ones. She said, “The major costs and technological necessities of the application of this regulation are having a great impact on all the ISCs.” In a way in which all of them are having to make an important effort to adapt.

The CNMV has incorporated new obligations in its strategies and objectives, while it has also required a “strong investment” in technology. The new regulation includes, among other requirements, the reporting of huge amount of data, which has increased “exponentially” and requires new tools to reinforce its proper treatment and supervisory analysis.

2.4 Impact on Measures

As mentioned before, the measures that are most impacted are related with the transparency, information, promotion and protection of the investor, compliance and technology.

2.4.1 Transparency

Transparency, perhaps the most emphasized word when talking about MiFID II means that, with the new Directive, the unitholder of an investment fund will have to know in detail all the items for which he pays: management fees, administration fees, custody fees and market analysis.

This transparency obliges ISCs to offer the adequate products for different profiles of investors, by establishing a client risk profile (the result of the new suitability and appropriateness tests); reviewing the contractual management of funds; justifying the execution of their operations for the benefit of their clients; updating the applicable taxation; defining the advisory model that each participant executes (independent or not independent) and associating it with the perception of "incentives and commissions"; and training the advisors who manage the relationship with the client (and, of course, being able to demonstrate such training).

Regarding transparency, the 2017 closing period for Spain was good. Data provided by EFPA (European Financial Planning Association), emphasized that Spain closed with more than 25.000 certified financial advisors, representing an increase of 85% compared to 2016 and 50% compared to the last two years, all due to the entry into force of MiFID II.

2.4.2 Information

The second pillar, regarding **information** to be provided to both the investor and the regulator readjusts again but continuing along the path of MiFID I. It requires the industry to invest in means and measures to ensure that all costs passed on to the client are perfectly delimited and explained in detail, not only before the contract but throughout the whole contractual process.

Professionals in the sector will be obliged to take minutes or record any meeting they hold with the client, especially if they are offering specific products, and they must record the communications made to them, through any channel in which they are advising them. Additionally, this information must be available for the clients in case of request.

2.4.3 Promotion of competition and investor protection

Another indispensable pillar is the **promotion of competition and investor protection**. We can take as an example the different fee collection models operating simultaneously now. Considering the problem that could unchain from the lack of regulation: they could intertwine with each other, making difficult for the investor to know which option is best for him.

A well-regulated market based on vigorous competition could encourage symmetry of information between entities and therefore lower management fees by reducing the intermediation margin. Consequently, the advisor will have to adjust his operations in order to maintain his level of income while remaining competitive, always adapting to the level of risk he is willing to assume.

In this line, according to the perspective of the speculation store industry, MiFID II sets up that the asset advertiser should pick its job while collaborating with the financial backer. The asset advertiser can intercede as an unadulterated backer of orders, as a reliant consultant gathering retrocessions from the asset director and appropriately educating the customer, as a free counselor ensuring that he has assessed various suppliers and suggesting the most reasonable for the customer's profile, or as a portfolio administrator.

From the decision made, it will depend not just on the commitment you have to the financial backer, yet in addition on the sort of expenses you can charge. Undoubtedly, going about as a simple transmitter of orders isn't equivalent to going about as a counselor,

being obliged by MiFID II to report where his pay comes from. This point especially places banking stuck. This is the reason the business is beginning to dispatch items like assets of assets, which permit it to bring outsider items into its contribution.

As a whole, the application of these concepts and requirements not only implies an investment in terms of training, information, technological and operational application, but also has a direct impact on banks. Which according to Inverco data, account for 90% of sales. Also, on taxation (entities that provide independent advice must charge VAT on their advice) and on the income obtained from the commissions received for these services (retrocessions). In many cases accounting for over 60% of the income.

2.4.5 Compliance

Compliance departments with these new regulations, acquire new responsibilities playing a significant role in explaining the changes brought about the regulations related to the financial and reputational risks at which the entity is exposed in the case of not complying with them. Being more precise, we emphasize the constant control, evaluation and follow-up that these areas must exercise over the degree of adequacy and effectiveness of the measures implemented, as well as the actions plans defined to mitigate or eliminate any undesired situation.

2.4.6 Technology

Technological advances appear as a crucial tool to adapt to this new paradigm shift. The new tools in wealth management come together with technology, mainly IT, internet and smart devices. In this sense, MiFID II in terms of advice is a major challenge and some market players may see their position threatened. However, the movement of clients between the different channels as a result of the new segmentation policies, coupled with the expulsion of lower net worth clients. As well as, the generational and economic advance of the so-called Millennials; who are perfectly adapted to the new technologies. Paving the way to a possible profitable business opportunity.

2.5 Challenges

Once seen what is MiFID II, the reasons why it was adapted and the overall impact on specific measures. It's important to emphasize that investment firms are facing numerous challenges on the path to MiFID II compliance. Because of MiFID II's wide reach,

projects are likely to be broader, more complex, and interconnected than other regulatory reform projects.

MiFID II implementation will result in large and complex transformation of projects requiring massive resources, depending on the scale, scope, and activities of an investment firm. Although daily activities must be continued, resources must be allocated.

There are several key risks specific to MiFID II programs that need to be addressed:

- **Inadequate evidence to trace compliance:** regarding the inadequate evidence of completeness and appropriateness of the project design regarding the requirements applicable to the firm. The problem is that the firm may be exposed to the risk of not complying at the end of the project.
- **Insufficient resources can lead to project failure:** Because of the nature and complexity of MiFID II implementation projects, they can take a lot of time and money, and they rely heavily on expert knowledge (not only regulatory experts, but also in areas like logistics, IT, and compliance/risk management). MiFID II implementation programs often run concurrently with other projects, putting a strain on the availability of key staff who remain in charge.
- **Organizational “silos” undermine cross-departmental work streams:** Larger companies are impacted by the limited interaction among departments although processes are similar, and the same systems are used. The requirements of MiFID II often cut across departments which increases the effort to coordinate projects. Furthermore, implementing new criteria often constrain redefining core procedures, revealing existing differences, overlaps, or disputes. Organizational “silos” occurs when employees or departments in an organization do not want or do not have the adequate instruments to share information with one another. This phenomenon is not common in small companies due to the small number of employees, what makes communication between departments smoother.
- **Compliance must be maintained on an ongoing basis:** Once the project is complete, compliance must keep going on. The purpose is to address end-to-end process definitions, data requirement or risk and control frameworks in a day-to-day environment.

2.6 New Landscape

The MiFID II reform will trigger a shift to a new landscape. As explained over the course of the paper and the goals of the MiFID II, the intention of the requirements is to provide a positive impact on the market by promoting competition, transparency, financial stability and the well-functioning of markets. Only variants from the previous regulation of MiFID I have been introduced by MiFID II.

The main aspects that I will be mentioning below about the main changes introduced by the regulation of MiFID II are mainly the answers of stakeholder to the consultation paper of ESMA in which the participants were: investment services companies, consumers associations and the different national authorities as well as the ESMA.

Many aspects have changed with the regulation; hence I will focus on the ones that most affect the variables studied after in the analysis. In particular those affecting the brokerage firms and securities agencies.

To begin with, the first change introduced is about **registries**. The new features introduced by MiFID II with regard to record-keeping can be divided into two main groups, on one hand, the obligations relating to the keeping of certain minimum records. On the other hand, the major novelty of recording all telephone conversations and electronic communications that may lead to the execution of a transaction on behalf of the client even if the transaction does not actually take place.

Another relevant aspect to analyze and that has changed with MiFID II are the **incentives**. Incentives related with independent advisory services and discretionary portfolio management. MiFID II establishes, by virtue of Article 24(7) and (8), that all fees, commissions and monetary or non-monetary benefits paid to or received by the investment firm, commonly known as "inducements", will be prohibited whenever the firm provides the service of independent advice or discretionary portfolio management. In the event that inducements are received from a third party when these services are provided, the institution must reimburse the amounts received to clients, and it is not allowed to compensate such incentives with costs and expenses to be paid by the clients.

On the contrary, the rest of investment services different from the independent advisory and discretionary portfolio management it is still allowed as long as the requirements for this are tighten. MiFID I had already established that, provided that the existence of such

incentives prior to the provision of the service and that the payment of such incentives would increase the quality of the service provided to the client and would not hinder the fulfillment of the client's best interest, the collection of inducements was considered a lawful activity. However, MiFID II tightens both the obligations to inform clients about the existence of permissible inducements and the conditions for considering that they increase the quality of the service.

In the professional environment, employees must be given incentives to motivate them and get a better performance and one way to do this is by giving them a variable compensation that rewards them.

Before MiFID II, firms would receive these inducements without the knowledge of the clients. Once the regulation was adapted, it was compulsory to inform the clients about these inducements. The clients thought they weren't paying this retrocession, but for the company it was an intriguing income, being 1% of the portfolio. Due to the transparency introduced by the regulation, and as explained before, firms have the obligation to provide this type of information in advance, prior to the provision of investment or ancillary services, with the incentives received.

The **advisory services** are the cornerstone of the participation of many retail customers and for small and medium sized companies as well as for professional. We understand as advisory services the provision of personalized recommendations to the client, either at the client's request or on the investment and service firm's own initiative.

We can differentiate two types of advisory services: independent and non-independent. According to the article 24.7 of MiFID II, we consider an independent advisory service as those services where retrocessions are not allowed and on the other hand, it is necessary to offer suitable and diversified range of instruments available in the market. Regarding the enough range of instruments, ESMA has clarified which instruments are those in the Technical Advice to the Commission.

In those cases, in which it is not possible to carry out the selection process due to the business model or the specific scope of the services provided by the entity, qualification will not be possible, and the service may not be qualified as "independent".

Lastly, the advisory service qualified as non-independent, will be the one that is not able to comply with the requirements of the independent advisory services.

The non-independent advice has a consequence due the normative of transparency, the client knows what the entity is receiving and therefore it will pressure these advisory entities to receive a less costly and translucent advice.

MiFID II Directive allows mixed advisory services, although some requirements are established. The first one constitutes that the firm shall, prior to the provision of the advisory service, inform its retail clients whether the type of advice to be provided is independent or not. Followed by, the investment firm is not required to hold itself out as independent for the entirety of its business, although the entity may hold itself out as independent for those services for which independent advice is provided. The last requirement, it should count with organizational measures and adequate controls to ensure that both services are differentiated.

Overall, firms offer a non-independent advice because they usually offer their services through a hybrid system. The client orders the investment, but the financial advisor makes recommendations.

With reference with the previous section, the MiFID II directive also establishes that more information should be provided rather than just the one related to type of advisory service provided to the customer. Information related to financial instruments and costs and expenses. As the customer is the center of the operation, and the aim is to provide transparency. The requirements of information include services (commissions, fees, expenses), products (profitability commission, product transaction costs) and monetary incentives.

Another issue to be addressed in respect to the new landscape, **adequacy and suitability**. The requirements relating to the suitability and appropriateness assessment are set out in Article 25 of the MiFID II Directive. Article 25 of the MiFID II Directive.

On one hand, the suitability assessment required for the provision of advisory or discretionary portfolio management services is strengthened in the text of the new Directive, insofar as it requires, on the one hand, obtaining more information on the client's financial situation, in order to prove the client's ability to bear losses, and on the other hand with respect to investment objectives, to obtain information on the client's risk tolerance. In this sense, the recommendation provided to the client must consider the above-mentioned information in order to determine whether a product is suitable for a client.

While for the other cases rather than advisory or portfolio management, the obligation to evaluate the suitability of the product by analyzing the knowledge and experience is maintained.

The aim of the MiFID II regulation over suitability and adequacy is to guarantee a real value added for the client. Through specific guidelines to enable investment services firms to gather relevant information to carry out such evaluations.

The main obligation regarding **remuneration** is set forth in the following article 24.10 de MiFID II, subsequently developed by the ESMA in its Technical Advice to the Commission, section 2.11.

MiFID II considers the remuneration of staff providing investment services to clients as a very significant aspect in order to avoid potential conflicts of interest between the entity and its clients. In this sense, the remuneration policies must be aligned with the active management of the conflicts of interest that may arise and should not provide incentives to people responsible for providing investment services or marketing financial instruments to favor their own interests.

For these reasons, it should be ensured that there is a balance between fixed and variable remuneration. Additionally, the latter should consider both qualitative and quantitative factors. This obligation acts independently from classification of the entity's customers

Another relevant aspect that MiFID II incorporates is the fact that it subsumes the remuneration in kind; not only considering monetary remunerations.

The importance related to this point is that the administrative organ will oversee the remuneration approval, as well as the practice of this norm with the objective to avoid risks relating the conflict of interests.

Lastly, **knowledge and experience** as set out in the article 25 of the MiFID Directive. The change from MiFID I has derived due to several reasons. Previously, those people involved in investment services were only required to have a general knowledge required to perform such services. As the complexity of investment products and services was increasing, the continuous innovation in their design and the poor distribution practices. The need for certified people with a certain level of knowledge and competence with respect to the products and services they offer has arouse.

Therefore, the legislator has introduced certain requirements that require physical entities who provide advice or information on financial instruments, investment or ancillary services, have specific knowledge and that enable them to adequately fulfill their obligations.

3. EMPIRICAL ANALYSIS

3.1 Sample Description

The sample used for my analysis initially covered 96 brokerage and securities firms operating in the Spanish market from 2013 until the moment. I had to take out 8 companies from the set because they are either in liquidation or in a M&A process, therefore their data did not go along with the rest of the companies and was not adequate to analyze the evolution of the sector. On the other hand, I have classified the sample into four sections depending on their business model

- Asset Managers
- Stockbrokers
- Financial products traders
- FinTechs

The reason for this segmentation is to get homogeneous results being more reasonable and therefore comparable among them.

The analysis will be conducted from 2013 to 2019. I have divided the sample into two groups. The first one from 2013 to 2017 and the second one with the following years. The aim of the distribution into this two groups is to see whether with the adaptation of MiFID II in 2018, profitability has increased or decreased. To see such result, I will mainly focus on analyzing the ROE as the dependent variable.

3.1 Characteristics of the Sample

The total number of observations are 314. Considering that some of the companies did not have information for some years or some financial data, likewise of group 1 there are 215 observations while for group 2, 99 observations. The reason why the number of observations varies is because the second sample covers less years and therefore less companies, although many of them were founded from 2018 onwards. Indeed, all 88 firms

operating in the market now a days are not considered because several of them were founded after 2019. Meaning that those are not part of the sample analyzed.

The information I collected is financial information: total assets, total liabilities, total equity, net income, cash and marketable securities, EBITDA, EBIT, EPS (earnings per share) and price of closing period if publicly traded. I gathered this information mainly from the CNMV website that provides the financial statements of all these ISCs. The missing information I took it from their websites. For the price of closing period, I either got it from the website of the IBEX35 (for the ones publicly traded in Spain) or from the web pages of their corresponding stock exchanges.

Brokerage and securities firms analyzed, provide investment services and activities regarding the following instruments:

- Negotiable securities.
- Money market instruments traded in the money market (treasury bills and commercial papers).
- Stocks and shares.
- Options, futures, swaps, forward rate agreements and other derivative contracts relating to securities, currencies, interest rates or yields, emission allowances or other derivative instruments, financial indexes or financial measures that may be settled by physical delivery or cash, venture capital entities and closed-end collective investment entities.

Some of the firms are publicly traded, such as: Alantra Wealth Management, Merrill Lynch Capital Markets Spain, Mapfre Inversión Sociedad de Valores... On the other hand, the five largest securities agencies and firms have a share capital of more than 9.000.000.

3.2 Analysis

For a clearer answer of how the evolution of the profitability of these ISCs has been, I will consider one dependent variable: Return on Equity (ROE), it is a measure for the profitability of a company in relation to stockholders' equity. Seven **dummy variables** and not including the asset manager's category as a dummy variable because it will act as the base category.

- Time dummy (between 0 and 1), it differentiates the two groups. For the value of 0, data from 2013 to 2017. For the value of 1, 2018 and 2019. This variable is the first and most significant independent variable. It is used to indicate the absence or the presence of the regulation effect that might shift the outcome expected.
- Broker dummy (between 0 and 1), for the value of 0 those companies that are not brokers. For the value of 1, those ISCs that are brokers.
- FinTech dummy (between 0 and 1), for the value of 0 those companies that are not FinTech's and for the value of 1, those two companies that are FinTech's
- Trader dummy (between 0 and 1), for the value of 0 those companies that are not financial trader's companies and for the value of 1, those that are financial trader companies.
- The other 3 dummy variables are interception variables. Broker's, FinTech's and Financial Trader's times the time dummy. As a result, I will get a more precise answer on the impact.

Three independent **microeconomic variables** that are statistically related with the first parameter. The following variables are significant in assessing the profitability in this case, the profitability of ISCs.

- Logarithm of the assets determines the firm's size
- Cash Ratio measures the company's liquidity by showing a company's ability to cover its short-term obligations using only cash and cash equivalents. It is in a certain way an indicator of the firm's value under the worst-case scenario.
- Current ratio, it is a liquidity ratio that measures a company's ability to pay short term obligations. In the contrary of the cash ratio, this ratio compares all its current assets to its current liabilities. A higher current ratio, means better performance

As well as, two **macroeconomic variables**: 3-month Euribor rate is based on the interest rates at which a panel of European banks borrow fund from one another. There are different Euribor rates depending on their maturity. In this case, I have taken the 3-month rate. They are important because they provide the basis for the price or interest rate of all kinds of financial products. Secondly, the term spread (10-year government bond yield – Euribor) being described as the term structure of interest rates. And represents the relationship between the interest rates and the remaining time to maturity of debt securities.

3.2.1 Summary Statistics

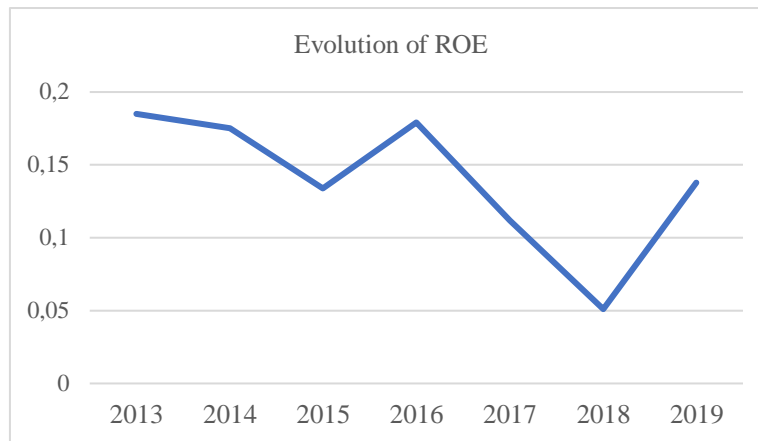
| | <i>ROE</i> | <i>2013-2017</i> | <i>2018-2019</i> |
|-------------------------------------|------------|------------------|------------------|
| Media | | 0,155033322 | 0,094085374 |
| Varianza | | 0,113860237 | 0,087822961 |
| Observaciones | | 215 | 99 |
| Varianza agrupada | | 0,105681862 | |
| Diferencia hipotética de las medias | | 0 | |
| Grados de libertad | | 312 | |
| Estadístico t | | 1,543586132 | |
| P(T<=t) una cola | | 0,061851134 | |
| Valor crítico de t (una cola) | | 1,649752124 | |
| P(T<=t) dos colas | | 0,123702268 | |
| Valor crítico de t (dos colas) | | 1,967596497 | |

Table 1 - Two Sample T-test

Source: own elaboration

As a result of a t-test of means, were we test the dependent variable (ROE) across the two different groups, we can observe that the mean of ROE for group 1 before MiFID II Directive was adapted in 2018, is lower than the mean of group 2 after those regulations came into effect.

In order to reject the null hypothesis that they are not statistically different from 0 (the difference equal to 0 is the null hypothesis), we must look at the statistic t. It is considered as null hypothesis if it is different or equal to 0. The statistic t is not significant, it is a value that allows us to reject the hypothesis. We can reject the null hypothesis values of the t statistics in excess of approximately 1,69. Moreover, in this case we cannot reject the null hypothesis. Although we can see that the mean (0,15) from 2013-2017 is higher than the mean (0,09) from 2018-2019. Meaning that profitability has decreased after the implementation of the MiFID II.



Graph 2 - Evolution of ROE

Source: own elaboration

Looking at the evolution of ROE, we must consider that the number of observations is not the same for all the years. Either because not all ISCs studied were founded or because many of them did not provide data on some years.

Moreover, we see that there was a slight decrease in ROE in 2015 but recovered afterwards in 2016, the results for this year are unusual and it can be due to outliers or data inputting issues. But we must look to the change from 2016 to 2018. In 2018 the MiFID was introduced, and the ROE fell by 6,1% compared to the previous year.

As shown in the graph, the increase of 8,7% from 2018 to 2019 was not as expected in the hypothesis. Since we wanted to see the impact on the year after the regulation was adapted. Although, this is because there was a very notable decrease in 2018.

3.2.2 OLS Regression Analysis

Afterwards, an OLS regression analysis is made, in order to see how the independent variables can explain the variations in the dependent variable. The goal is to see to what extent the independent variables can explain the dependent variable and what is the relationship among the different variables studied. Overall, if this relation is statistically significant or not.

Firstly, I will analyze a multivariate regression with all the dummy variables, afterwards a second multivariate regression with the microeconomic variables (dummy variables, logarithm of total assets, cash ratio and current ratio). Finally, a third multivariate

regression with the dummy variables, microeconomic and macroeconomic (Euribor and term spread) variables.

Multivariate Regression 1

R^2 , tells us that the dummy variables are equal to explain approximately 9,7% percent in the variation of ROE. This gives us a sense of how well to what extent the variation of the dummy variables can explain the variation in ROE. The extent to which the model can explain the variation.

The coefficients tell us what the significance for the dummy variables. For this first multivariate regression, I will take into consideration the base category (asset manager) and the dummy variable 2 (brokers) to see whether ROE has decreased or increased.

The ROE for the former is $0,270$ (coefficient for interception) – $0,163$ (coefficient for time dummy) = $0,107$. The time dummy is used to calculate the ROE so the two time periods (2013-2017 and 2018-2019) are taken into account to measure the impact of MiFID II.

While the ROE for the latter, before 2018: $0,270$ (coefficient for interception) - $0,166$ (coefficient for broker) = **$0,104$** . After 2018: $0,104 + [-0,163$ (coefficient for time dummy) + $0,137$ (broker*time dummy) = **$0,078$** . Comparing both results, ROE has decreased after MiFID II was adapted and, in this case, the hypothesis is approved. For brokers, regulations have affected their profitability decreasing it by a 2,6%.

The coefficient tells us the magnitude of the variable, the direction (increase together or decrease together). The size of the relationship between the dummy variable and the ROE. If positive, higher values for the dummy variable and higher for ROE.

Is this relation statistically significant? Is the coefficient different from 0? We check it by looking to the t statistic. The t-statistic in the case of brokers is negative ($-3,60$) and therefore it is significant and negatively correlated. The reason is the following, we always must look at the reference level ($1,69$) either negatively or positively. In other words, if it is not higher or lower than that value, it will not be significant.

On the contrary, for FinTechs the ROE before 2018: $0,270$ (coefficient for interception) – $0,705$ (coefficient for FinTech) = **$-0,435$** . After 2018: $-0,435 + [-0,163$ (coefficient for time dummy) + $0,015$ (FinTech*time dummy) = **$-0,583$** . The ROE is seen negatively impacted but this is also due to the scarce number of observations for these FinTech's,

keeping in mind that most of them have been founded after 2019 and are not included in the sample studied.

Multivariate Regression 2

In this case, we can see that none of the micro variables are significant. Although, the t-statistics for the brokers, fintech's and financial traders remain significant and negatively correlated. This means that on average, after 2018, the ROE for ISCs has decreased.

One unit increase in ROE, would correspond to a 0,002 increase in logarithm of assets. A positive relation, what means that higher values of ROE are related to higher values of logarithm of assets. Although, higher coefficient of logarithm of total assets, means a larger size and so it is better. This t-statistic for this variable is not in excess of 1,69 therefore is not statistically significant

In the case of the cash ratio a unit increase in ROE, it would suppose a 0,08 increase in the cash ratio. And for the current ratio, it would suppose a 0,001 increase. Both positive, meaning that they will go along with the growth of the dependent variable. Although, they are not statistically significant

Multivariate Regression 3

With the introduction of the macroeconomic variables, this regression is not significant at all. There is no relationship among the macroeconomic variables, moreover results do not seem in line.

| | <i>Multivariate Reg.1</i> | <i>Multivariate 2</i> | <i>Multivariate 3</i> |
|---|---------------------------|-----------------------|-----------------------|
| <i>Indep Var 1 (time dummy)</i> | | | |
| coeff 1 | -0,162914676 | -0,158477454 | -0,136144341 |
| t-stat | -2,688291534 | -2,601526857 | -1,9943907 |
| <i>Indep Var 2 (broker dummy)</i> | | | |
| coeff 1 | -0,166011118 | -0,177294588 | -0,180459753 |
| t-stat | -3,604216114 | -3,478642315 | -3,525415456 |
| <i>Indep Var 3 (fintech dummy)</i> | | | |
| coeff 1 | -0,705457767 | -0,67862729 | -0,654057361 |
| t-stat | -2,261908322 | -2,169084101 | -2,07899915 |
| <i>Indep Var 4 (trader dummy)</i> | | | |
| coeff 1 | -0,165363316 | -0,169284636 | -0,167045856 |
| t-stat | -1,82186899 | -1,852815906 | -1,821687312 |
| <i>Indep Var 5 (broker*time dummy)</i> | | | |

| | | | |
|--|-------------|--------------|--------------|
| coeff 1 | 0,13703197 | 0,134262788 | 0,138760551 |
| t-stat | 1,701125032 | 1,664405525 | 1,713884141 |
| <i>Indep Var 6 (fintech*time dummy)</i> | | | |
| coeff 1 | 0,01585203 | -0,055043878 | -0,081769041 |
| t-stat | 0,043711324 | -0,143563737 | -0,212247404 |
| <i>Indep Var 7 (trader*time dummy)</i> | | | |
| coeff 1 | 0,426833786 | 0,432037879 | 0,430038881 |
| t-stat | 2,845130279 | 2,859565975 | 2,838809944 |
| <i>Indep Var 8 (log.total assets)</i> | | | |
| coeff 1 | | 0,00198184 | 0,001807752 |
| t-stat | | 0,164384934 | 0,149630563 |
| <i>Indep Var 9 (cash ratio)</i> | | | |
| coeff 1 | | 0,008340725 | 0,008749099 |
| t-stat | | 0,469424705 | 0,491178212 |
| <i>Indep Var 10 (current ratio)</i> | | | |
| coeff 1 | | 0,001067837 | 0,001007714 |
| t-stat | | 1,249312271 | 1,172452852 |
| <i>Indep Var 11 (euribor 3-month)</i> | | | |
| coeff 1 | | | 0,09181456 |
| t-stat | | | 0,927837122 |
| <i>Indep Var 12 (term spread)</i> | | | |
| coeff 1 | | | -0,0057912 |
| t-stat | | | -0,258510161 |
| N. OBSERVATIONS | 314 | 314 | 314 |
| R2 STAT | 0,096707526 | 0,095354308 | 0,091959269 |

Table 2 - OLS Regression Analysis

Source: own elaboration

4. RESULTS

I partly find evidence that introduction of new regulation affects ISCs, that it reduces profitability of those financial entities. This is seen in the dummy variables for the four categories of ISCs. As mentioned previously, the segmentation of the ISCs into their business activities has helped determine in a homogenous and precise way that the dependent variable ROE has been affected with the adaptation of MiFID II.

All dummy coefficients are statistically significant exceeding the reference level 1,69 and negative correlated for the three multivariate regressions. On the other hand, computing the ROE for these categories taking into account the time dummy to differentiate the two time periods, we can see that ROE has in all cases decreased. It means that on average after 2018 ROE of ISCs has decreased. Therefore, I can “claim” that it is due to regulatory

changes. ISCs have become the most versatile regulated vehicle with the advent of MIFID II, making them more competitive and therefore diminishing their profitability.

5. CONCLUSION

After a deep analysis of the main characteristics of the market in which these firms operate, how MiFID II works and its impact on the ISCs landscape, I have concluded the following:

We are talking about a strong regulated and competitive sector in which the more regulated is the market, the less profitable are the players operating in it. I expected to see this assumption clearly and especially affecting the medium and small enterprises. We have seen that brokers, fintech's, financial traders and asset manager's ROE have decreased since 2018.

However, the expected effect has been seen only in the variables related to abovementioned categories of the ISCs. This might be because results have been biased on account of three main reasons: firstly, the microeconomic and macroeconomic were not categorized into the business activities of the securities firms and securities agencies, therefore the data is not homogeneous and not comparable. Secondly, the sample I have worked on has turned up to be smaller than expected since many companies were founded recently (2019-2021) and others did not have all the financial information available to make the analysis. Lastly, in relation to the size of sample, economies of scale could hold on a larger sample.

Even though, results have been partially as expected and it can be said that the expected impact will be seen in a longer period. As it is very difficult to see the impact of regulations in such a short period of time as one year. The more perspective on the time of series and the more historical data is available, the conclusions will be more aligned with the initial hypothesis.

What it is known for sure is that as more information is required to the ISCs, clients will be more demanding with the services and the company will incur in greater costs. This new model is more exhaustive due to the **transparency and information** that has been given to consumers. Consequently, investors know what income the entity is receiving. Moreover, they will push for cleaner, cheaper and lower cost funds. Paving the way to a more professional advice. From the point of view of the ISCs, they have lost the income

from the retrocessions (1% of the portfolio) a juicy income that the client was not informed and additionally, the main source income of the industry.

In addition, the **increase of competition and investor's protection rights** will imply new effort on new investments in terms of training, information systems and technological platforms implementation, and operational adjustments. As well as on taxation (charging VAT on their services) and as mentioned before, the prohibition of retrocessions leading to a fall in income. In many cases accounting for over 60% of the income.

Finally, in terms of **compliance and technology** heavy investment effort is required as well. Particularly, the new regulation includes, the reporting of huge amount of data, which has increased "exponentially" and requires new tools to reinforce its proper treatment and supervisory analysis.

All in all, we cannot rely that this is a precise conclusion to answer whether regulations have affected the profitability of these firms with absolutely confidence. I consider that further analysis is needed to fully judge how new regulation can impact ISCs. Maybe a longer time series is needed or that one may need to focus on other aspects of ISCs (i.e. look at other profitability measures, or other measures that might incorporate faster the impact of new regulation).

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