36

FINANCIAL MARKET REGULATION IN THE INTERNAL MARKET

Kern Alexander and Vivienne Madders

I. **Introduction and Background** 36.1
II. **Free Movement and EU Supervisory Centralization** 36.7
III. **Reducing Risk in the Banking Sector: The Capital Requirements Directive IV—A Level 1 Perspective** 36.11
A. Capital Requirements Regulation (CRR) 36.15
B. Capital Requirements Directive (CRD) 36.18
C. CRD IV and maximum harmonization 36.24
D. CRD V Reform Package 36.31
IV. **European Banking Authority: Regulatory and Technical Standards** 36.34
V. **EU Legislation Regulating the Sale of Retail Investment Products** 36.40
A. Rationale and theory 36.42
B. EU financial legislation 36.51
VI. **Markets in Financial Instruments Directive II/Markets in Financial Instruments Regulation (MiFIR)** 36.62
A. Conduct of business rules 36.64
B. Product regulation 36.69
C. Unbundling and firm organization 36.73
D. European Securities and Markets Authority (ESMA) 36.75
E. Selling processes and implementation 36.80
F. Packaged Retail Investment Insurance Products (PRIIPS) 36.88
VII. **Summing Up—EU Financial Services Legislation—Levels 1 and 2** 36.94

Copyright Material. Not for distribution.

I. Introduction and Background

36.1 The chapter considers some of the main post-crisis European Union (EU) financial legislation from the perspective of high-level principles (Level 1) that apply to credit institutions and certain investment firms under the Capital Requirements Directive IV (CRD IV), including prudential requirements to hold minimum capital and liquidity requirements and prudential governance standards. The chapter also analyzes the EU legislation that regulates investment funds and the sale of investment products and the distribution of financial products, particularly the Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR), the Undertakings for Collective Investments in Transferrable Securities (UCITS), the Personal Retail Investment Products Regulation, and the Alternative Investment Funds Managers Directive (AIFMD).

36.2 In the European Union, the two tasks of financial regulation and supervision have, since the 1990s, been in principle distributed between central and national authorities as follows. The general rule was that, with some exceptions, important regulation is in the hands of the EU while supervision is almost completely the responsibility of national competent authorities.

As discussed in Chapter 35, the Banking Union has changed this with respect to banking supervision in the Eurozone with the ECB (European Central Bank) gaining full competence as a bank supervisor.

36.3 Nevertheless, the problems of coordination among decentralized regulators and supervisors across all EU states are acute. The traditional principle governing bank supervisory competences was set forth in the Second Banking Directive of 1989[1] that established a 'single-passport', according to which a bank chartered in one EU country could operate in another based on the home country control principle for supervision, so that the home country supervisor would also oversee the foreign EU/EEA branches. This resulted in inadequate coordination between home and host country supervisors in which the home country authority of an EU/EEA country with large international bank exposures (eg Iceland) had little incentive to consider the externalities that lax domestic supervision would impose on depositors and other bank customers in other EEA countries. Similarly, a host country supervisor would not consider the consequences (systemic or not) for domestic residents of a failure, or restructuring, of a local branch or subsidiary, but only the consequences in terms of systemic stability in the host jurisdiction. Another unfortunate result post-crisis of the home country control principle is that national competent authorities now often limit or even forbid banking subsidiaries operating under their supervisory competence from transferring liquidity to the group parent in another EU state.

Copyright Material. Not for distribution

36.4 For the rest of the EU, however, the suitability of the centralization of regulatory powers at the EU level depended crucially on how decisions were made at the level of EU institutions. Until the early years of the last decade, the legislative process in matters of financial regulation was extremely complicated and therefore also very slow. De facto and to a certain extent also de jure, changes in financial regulation had to be based on a consensus among all major EU Member States. In particular, the UK government used to be opposed to any new regulation that might impose undue restrictions on UK-based financial institutions, and Germany and some other continental European countries were opposed to a far-reaching policy of deregulation that the EU Commission traditionally favoured.

36.5 This situation changed to some extent under the EU Financial Services Action Plan of 1999 (EU FSAP) along with the Lamfalussy Committee Report of 2000 that recognized that to promote further integration of the EU internal market for financial services and capital required a more harmonized legal and regulatory regime to govern securities markets.[2] The European Commission adopted Decisions creating the Lamfalussy four-level process and the three Level 3 Committees to promote the adoption of more harmonized financial regulation across securities, banking and insurance and occupational pension funds.[3] The four levels consisted of: Level 1 legislation containing high level principles adopted through Directives

[1] Article 1(6) Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC [1989] OJ L386/1.

[2] See Alexandre Lamfalussy and others, 'Final Report of the Committee of Wise Men on the Regulation of the European Securities Markets' (Brussels, 15 February 2001).

[3] Commission Decision 2001/527/EC of 6 June 2001 establishing the Committee of European Securities Regulators [2001] OJ L191/43; Commission Decision 2004/5/EC of 5 November 2003 establishing the Committee of European Banking Supervisors [2004] OJ L3/28; and Commission Decision 2004/6/EC of 5 November 2003 establishing the Committee of European Insurance and Occupational Pensions Supervisors [2004] OJ L3/30.

and Regulations. Level 2 involved EU finance ministers proposing legislative measures at the Member State level to implement the high-level principles contained in EU secondary legislation. Level 3 involved Member State regulators making proposals to Level 2 Finance Ministries regarding adoption of implementing measures and then consulting with other Member State regulators about agreeing to harmonized supervisory approaches for implementation. And Level 4 concerned Member State approaches to enforcement and European Commission oversight of Member State implementation, including bringing infringement proceedings.

36.6 Although the Lamfalussy process was a regime for financial rule-making that allowed for faster adoption of legislation by slightly relaxing the consensus requirement, decision-making power was still highly decentralized so that prompt and far-reaching decisions were hard to reach in a short time. These institutional weaknesses in EU financial decision-making and inadequate Member State supervisory coordination raised important questions about the effectiveness of the Lamfalussy framework in performing effective supervision of European financial markets.[4] Nevertheless, prior to the crisis, the political will to support increased centralization of supervisory authority at the EU level did not exist. The drawback of not having any transnational EU-wide supervisory authority with true decision powers was deeply felt when large multi-country banks got into trouble in the financial crisis. Well-intentioned agreements between national supervisors, so called Memoranda of Understanding, and regular meetings of national supervisors in so called colleges of supervisors proved to be insufficient instruments of coordination in the crisis. If this state of affairs—a severely handicapped European regulator and non-existent European supervisory institutions—had remained as it was before, it would have prevented the EU from responding to the crisis in any substantial way.

Copyright Material. Not for distribution.

II. Free Movement and EU Supervisory Centralization

36.7 After the 2007–08 crisis, EU financial regulation changed in substance along with greater consolidation of financial standard setting at EU agency level. Recognizing these institutional weaknesses and legal gaps, the EU High Level Group on Financial Supervision, chaired by former IMF Managing Director and Banque de France President Jacques De Larosière, submitted its Report on 25 February 2009[5] that made recommendations proposing that the EU adopt legislation to create a European System of Financial Supervision (ESFS). Reflecting the views in the De Larosière Report, the Commission proposed legislation that the ESFS consist of a European Banking Authority (EBA), a European Securities and Markets Authority (ESMA), and a European Insurance and Occupational Pension Authority (EIOPA).[6] The three ESAs would, with support from a European Systemic Risk

[4] See IMF, 'Euro Area Policies: 2007 Article IV Consultation' (IMF Country Report No 07/260, 2007) 27.

[5] Commission, 'Report of the High-level Expert Group on financial supervision in the EU' (Chaired by Jacques de Larosière, Brussels, 25 February 2009) paras 194–214 (hereafter de Larosière Report) <http://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf> accessed 10 February 2020.

[6] Articles 1–2, 10, and 14–16 European Parliament and Council Regulation (EU) 1093/2010 of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/78/EC [2010] OJ L331/12; European Parliament and Council Regulation (EU) 1094/2010 of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/79/EC [2010] OJ L331/48; European Parliament and Council Regulation (EU) 1095/2010 of 24

Board (ESRB),[7] promote more effective micro-prudential and macro-prudential regulation and supervision of European financial markets and a more efficient functioning of the EU internal market.[8]

36.8 The ESFS entered into force on 1 January 2011 and applies to all EU Member States requiring their participation in, and coordination with other EU states, the three European Supervisory Authorities in adopting regulatory and technical implementing standards.[9] The ESAs' responsibilities include developing single rulebooks consisting of regulatory and technical implementing standards and guidelines for Member States to apply in their respective financial sectors. The creation of the 'single rulebook' is designed to support a more unified financial regulatory policy on an EU-wide basis, with the aim of enhancing financial stability and protecting depositors and investors. In banking, the single rulebook refers to the EU directives, regulations, technical standards and guidance that apply to the twenty-eight EU states' domestic banking regulatory regimes.[10]

36.9 Of particular significance, the European Banking Authority's specific tasks and responsibilities are set forth in Article 8 EBA Regulation that include contributing to the 'establishment of high quality common regulatory and supervisory standards and practices'.[11] The EBA has competence to contribute to the 'consistent application of legally binding EU acts',[12] as well as to monitor and assess market developments in the areas of its competence, and to coordinate and cooperate with the ESRB and other the ESAs in conducting EU-wide assessments of financial institutions' resilience to adverse market conditions (ie stress tests).[13]

Copyright Material. Not for distribution.

November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84.

[7] European Parliament and Council Regulation (EU) 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board [2010] OJ L331/1. In connection to the functioning of the ESRB, specific tasks were conferred on the ECB concerning macroprudential oversight of the financial system. See Council Regulation (EU) 1096/2010 conferring specific tasks upon the ECB concerning the functioning of the European Systemic Risk Board [2010] OJ L331/162. See also the discussion of Eilís Ferran and Kern Alexander, 'Can Soft Law Bodies be Effective? Soft systemic risk oversight bodies and the special case of the European Systemic Risk Board' (2010) 6 European Law Review 751.

[8] See Jean-Victor Louis, 'The implementation of the Larosière Report: a progress report' in Mario Giovanoli and Diego Devos (eds), *International Monetary and Financial Law: The Global Crisis* (OUP 2010) 154.

[9] Kern Alexander, 'Reforming European Financial Supervision: adapting EU institutions to market structures' (2011) 12 Journal of the Academy of European Law 229, 232–33.

[10] The EU single rulebook in banking includes European Parliament and Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338 (hereafter Capital Requirements Directive IV/CRD IV); European Parliament and Council Regulation (EU) 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012 [2013] OJ L176/1 (hereafter Capital Requirements Regulation/CRR); European Parliament and Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) 1093/2010 and (EU) 648/2012, of the European Parliament and of the Council [2014] OJ L173/190 (hereafter BRRD); European Parliament and Council Directive 2014/49/EU of 16 April 2014 on deposit guarantee schemes [2014] OJ L173/149. The CRD IV and CRR implement the Basel Capital Accord (now Basel III and IV) into EU law, while the BRRD provides a minimum harmonisation framework requiring Member States to adopt recovery and resolution laws for banks and certain investment firms.

[11] Article 8(1) Regulation (EU) 1093/2010 providing an exhaustive list (without prejudice to Article 9) of the tasks conferred upon the EBA. These regulatory and supervisory standards and practices are further specified in Articles 10–16 and 34.

[12] Articles 10–21, 29, and 34 Regulation (EU) 1093/2010.

[13] See Article 8(1) Regulation (EU) 1093/2010, containing an exhaustive list of the tasks conferred upon the EBA, while paragraph 2 features an exhaustive list of all regulatory and other powers conferred on it in order to fulfil its tasks.

36.10 Despite the goal of a more unified banking market based on harmonized prudential supervisory standards, it has been argued that European banking regulation and supervision is far from integrated and harmonized.[14] Some of the barriers to a more integrated and harmonized supervisory framework include cultural differences, such as language and local customs, but also civil and commercial law differences. For instance, the financial industry operates largely on the basis of legal contracts that are essentially governed by Member State law. Financial products such as loans, deposits or mortgage-backed securities are contracts, which terms and conditions depend on local legislation and judicial decisions. Moreover, differences in corporate and personal insolvency laws, and collateral enforcement regimes, are considered a primary barrier to the creation of pan-European bank business models and financial products.[15] In addition, the promotion of more harmonized supervisory practices by the EU Supervisory Authorities has been constrained by the unfinished business of creating an EU-wide Capital Market Union (CMU) (see Chapter 35).

III. Reducing Risk in the Banking Sector: The Capital Requirements Directive IV—A Level 1 Perspective

Copyright Material. Not for distribution.

36.11 The EU took regulatory action in response to the crisis as early as October 2008 by beginning to implement the international regulatory reforms agreed by the G-20. Following the G-20 Heads of State Summit in September 2009, the EU began to adopt a number of directives and regulations to implement the international principles agreed by the G-20. This involved a number of new capital related regulations adopted in the form of an amendment of Capital Requirements Directive that became known as the CRD III.[16] These new rules are a clear reflection of the crisis experience. Among other things, the new rules tighten capital requirements for securitizations and for the trading book risks and impose longer deferral periods for the bonuses that bankers can receive.

36.12 The EU also adopted a Regulation in 2009 regulating credit rating agencies.[17] The regulation subjects EU-based CRAs to a mandatory licence and strict conduct of business rules, whereas, unlike the US, no rules had been in place prior to the crisis. However, unlike the US, which mandated the removal of all references to credit ratings in regulatory acts (under the Dodd-Frank Act),[18] the EU has not done so yet, and ratings continue to be used for determining the risk weights in the standardized approach of the Capital Requirements Directives (CRD, implementing Basel II and III) and in the ECB's open market operations providing short-term credit and liquidity to Eurozone banks.[19]

[14] Vicente Vázquez Bouza, 'Cross-border Bank M&A? Europe Is Not Ready' (*Oliver Wyman Insights,* 8 November 2017) <http://www.oliverwyman.com/our-expertise/insights/2017/nov/cross-border-bank-m-and-a-europe-is-not-ready.html> accessed 10 February 2020.

[15] Ibid.

[16] European Parliament and Council Directive 2010/76/EU of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies Text with EEA relevance [2010] OJ L329/3 (hereafter CRD III).

[17] See European Parliament and Council Regulation (EC) 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1.

[18] See Dodd-Frank Act §939A, 15 U.S.C. §78o-7 (2012).

[19] See Francesco de Pascalis, *Credit ratings and Market Over-Reliance* (Brill Nijhof 2017) 86–88. See also Kern Alexander, 'The Risk of Ratings in Bank Capital Regulation' (2014) 25 European Business Law Review 295, 302–03.

36.13 Probably the most important piece of regulatory change in the EU after the financial crisis was the adoption of the Capital Requirements Directive (CRD IV), which implemented the Basel Capital Accord amendments (known as Basel III) into EU law. The CRD IV consists of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD). Most provisions of the CRD IV took effect in Europe in January 2013 and apply to a wide range of banking activities, including bank capital and liquidity management, corporate governance and risk management. The CRR of the CRD IV containing the capital and liquidity rules and provisions that became applicable in 2013, which addresses the calculation of regulatory capital and liquidity requirements for EU-based credit institutions and certain investment firms. As a Regulation, it is directly applicable to EU Member States' regulatory law and administrative rulebooks. In contrast, the Capital Requirements Directive, as a Directive, is not directly applicable in Member States and must be implemented through the adoption of domestic legislation. As a Directive, the Member State is able to adapt the provisions of the Directive in a way that respects national legal requirements and practices, whereas the Regulation affords much less flexibility and must supersede through direct application existing provisions of Member State laws.

36.14 Regarding the regulation of bank governance, Article 162 CRD requires the transposition into domestic law of the CRD's provisions dealing with 'sound and prudent management' of credit institutions and certain investment firms and administrative sanctions by 31 December 2013.[20] Consequently, as a matter of EU law, the relevant provisions of the CRD IV applying to the 'sound and prudent management' of credit institutions and administrative sanctions were required to have been implemented by Member States by 31 December 2013 and should have been applicable to all regulatory enforcement actions relating to bank governance beginning in 2014. The European Commission considers the implementation of CRD IV to be an essential element in rebuilding the EU financial regulatory regime in the aftermath of the global financial crisis.[21]

Copyright Material. Not for distribution.

A. Capital Requirements Regulation (CRR)

36.15 The use of a Regulation to implement capital and liquidity standards is a significant change from past EU bank legislation practice, which relied exclusively on directives that afforded Member States discretion in implementing the directive into Member State law and regulation. This past practice led to diverse practices in prudential regulation across Member States that allowed states, in some situations, to engage in regulatory arbitrage by imposing less stringent capital standards on banks in certain areas of risk measurement.[22] This allowed some banks to have a competitive advantage over other EEA banks that were supervised more strictly in other jurisdictions.

[20] In contrast, the Capital Requirements Regulation (CRR) requirements concerning capital and liquidity requirements for systemically important financial institutions (Article 131) and returns on initial capital for credit institutions are not required to be implemented until 1 January 2016.

[21] Commission, 'Note Presenting a Stock-Take of Financial Reforms' (Brussels, 29 November 2017) 1–3 <http://www.consilium.europa.eu/media/31936/note-presenting-a-stock-take-of-financial-reforms.pdf> accessed 10 February 2020.

[22] For example, the UK and Italy did not require banks to hold capital against risk-based assets they originated if the bank had shifted the asset off its balance sheet through securitization or some other type of risk transfer.

36.16 The CRR increases the level of core Tier 1 regulatory capital to 7 per cent (including a capital conservation buffer) from 2 per cent under the pre-crisis CRD 2006.[23] Also, core Tier 1 capital has a tighter definition consisting of only ordinary common shares and equivalent loss-absorbent financial instruments, an additional 2.5 per cent countercyclical capital ratio (yet to be determined for implementation) and a higher capital charge for global systemically important financial institutions (SIFIs) of between 1 per cent and 2.5 per cent.[24] Basel III and CRD IV also set forth liquidity requirements in which the main requirements consist of a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR would require the banks to hold a certain ratio of high-quality liquid assets (ie highly-rated government and corporate bonds) that could be sold in a stress scenario to cover a loss of funding for up to one year.[25] The NSF ratio would require banks to maintain a positive ratio of incoming funds to out-going funds over a period of time approved by the relevant supervisor.[26] Another important requirement with respect to liquidity is that Basel III and the CRD IV would require banks to limit their overall leverage to 3 per cent or 33.5 to one (total leverage/total common equity). These requirements are generally expected to limit the ability of banks to have excessive reliance on short-term funding that could be withdrawn quickly in a severe market downturn and excessive debt funding.[27]

36.17 The issue of how to implement the capital and liquidity requirements had created political and diplomat concerns in European capitals, especially in London where the UK Parliament was critical of the maximum harmonization approach for implementing the single rulebook that tightly constrained the discretion of Member States to require stricter capital and liquidity requirements than those set forth in the CRR. Many large cross-border banks generally favour the 'single rulebook' approach for determining capital and liquidity; however, they have criticized the stricter capital requirements under the CRR as limiting their ability to lend to small and medium size businesses in the EU markets. This could potentially put the EU at a competitive disadvantage if other jurisdictions, such as the US, followed a more relaxed approach to Basel III implementation.[28]

B. Capital Requirements Directive (CRD)

Copyright Material. Not for distribution.

36.18 The Capital Requirements Directive addresses mainly the Basel III pillar II standards of corporate governance, counter-cyclical capital requirements, and risk management, while also containing pillar three market discipline disclosure requirements for credit institutions so that investors have more meaningful information about their solvency and liquidity. Most of the CRD IV requirements that relate to bank corporate governance standards and risk

[23] See Article 92(1)(a) CRR and Article 129(1) CRD IV.
[24] See Article 131(4)–(9) CRD IV.
[25] See Article 412 CRR.
[26] See Articles 413 and 510 CRR.
[27] See Article 87 CRD. The detailed rules on leverage calculation and reporting can be found in Articles 429 and 430 CRR.
[28] The European Banking Federation has also expressed its 'concern over the impact of the new requirements' and has raised strong concerns regarding the liquidity requirements. See European Banking Federation, 'European banks vigilant on unintended consequences from the proposals for CRD IV' (Press Release EBF ref D1329A-2011, Brussels, 20 July 2011) <http://www.ebf.eu/wp-content/uploads/2017/01/D1329A-2011-Press-Release-CRD-IV.pdf> accessed 10 February 2020.

management practices are found in the CRD. The use of a Directive affords much more discretion to Member States to devise rules governing bank corporate governance and risk management from within their existing domestic legal and regulatory regimes. In that regard, the CRD requirements regarding bank corporate governance and risk management build on and enhance existing requirements that were established under the previous Capital Requirements Directives I, II, and III.[29]

36.19 Under the CRD, bank supervisors have wide discretion to address the particular risks that individual banks face and pose to the domestic banking system. As such, bank supervisors are not subject to a prescriptive framework of rules (although rules supplement the exercise of supervisory discretion). Supervisors may adopt stricter requirements with some banks, as opposed to others, where they decide that the institution has not devised a risk management model or implemented suitable corporate governance practices and strategies that address the particular risks that the bank faces and poses to the financial system.[30]

36.20 Under CRD IV, Member State supervisory authorities have the authority to take all necessary measures to ensure the prudent and sound management of banks and certain investment firms, and they may subject these institutions to remedial, business and recovery and resolution plans whose content must be approved by the supervisor. Under CRD IV, the bank supervisor may also regulate and approve the risk management practices and strategies of banks under its supervision and may vet and approve the appointment of bank senior managers and board members during normal periods of bank operations as well as when the bank is subject to remedial orders or plans and/or recovery and resolution plans.

36.21 The CRD does not simply replicate Basel III into EU law. The CRD is designed to take into account certain requirements of EU law and the particular institutional and legal frameworks in Member State jurisdictions. For instance, although the Basel Accord was originally intended only to apply to internationally-active banks, EU law has always applied it to all banks and investment firms, because its application to only internationally active banks would have created competitive distortions and the opportunity for arbitrage in the internal market.

36.22 The CRD addresses the level playing field concerns within the EU internal market by making minor adjustments to Basel III in four areas when transposing it into EU law. First, the CRD IV Directive strengthens corporate governance arrangements and processes and introduces new rules that aim to increase the board of director's oversight of risk management, strengthening the risk management function within the bank. Second, Member State supervisors are required to impose administrative sanctions on banks and individuals if the CRD or rules adopted by the European Banking Authority to implement the CRD are breached. Fines and penalties must prove to be effective deterrents to violations of the CRD.

Copyright Material. Not for distribution.

[29] See European Parliament and Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1. See also European Parliament and Council Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L177/201 (hereafter together referred as CRD I); Commission Directive 2009/83/EC of 27 July 2009 amending certain Annexes to Directive 2006/48/EC of the European Parliament and of the Council as regards technical provisions concerning risk management [2009] OJ L196/14 (hereafter CRD II).

[30] Kern Alexander, 'The EU Single Rulebook: Capital Requirements for Banks and the Maximum Harmonisation Principle' in Luis Hinojosa and Jose Beneyto (eds), *European Banking Union: The New Regime* (Wolters Kluwer 2015) 24.

36.23 Third, supervised firms are required to provide supervisors with an annual supervisory review program which must include greater and more systematic use of on-site supervisory examinations and forward-looking risk assessments. Fourth, the CRD aims to reduce reliance by credit institutions on external ratings. This would be achieved in part by requiring all banks' investment decisions to be based not only on ratings but also on their own internal credit opinion. Also, banks with a material number of exposures in a given portfolio must develop their own internal ratings for that portfolio, rather than relying on external ratings of that portfolio to determine its capital requirements.

C. CRD IV and maximum harmonization

36.24 CRD IV poses major implementation challenges for EU/EEA States, especially with respect to maintaining a level playing field for the application of enhanced capital and liquidity standards. The European Banking Authority (EBA) has responsibility for ensuring that Member State supervisors follow a maximum harmonized approach to regulating bank risk management and measurement practices. This 'maximum harmonization' principle has been emphasized by EBA officials as being a linchpin of the new EU/EEA supervisory framework and has attracted criticism from some Member States, notably the United Kingdom.

36.25 Member States can apply stricter requirements in some circumstances if these can be justified by national circumstances. For example, higher capital requirements for real estate lending could be imposed to address the danger of a real estate bubble. Such requirements would also apply to institutions from other Member States that do business in that Member State. In addition, each Member State is responsible for adjusting the level of its countercyclical buffer to its economic situation and to protect the economy/banking sector from any other structural variables and from the exposure of the banking sector to any other risk factors related to financial stability. The countercyclical buffer would allow regulators to require banks to hold additional capital during good times, both to slow the growth of credit and to build reserves to absorb losses during bad times.

36.26 Under the CRD IV's 'Pillar 2' system, Member States can also impose a range of measures, including additional capital requirements, on individual institutions or groups of institutions in order to address higher-than-normal risk. Therefore, theoretically, national supervisors should be able to impose higher requirements if they so wish. However, whether they are able to do so in practice may depend on the threshold for evidence required to justify any deviation from the baseline requirements set in the CRD, and whether it is practical to implement such requirements.

36.27 CRD IV applies to over 8,000 deposit-taking banks and investment banks with their headquarters or subsidiaries in an EU Member State.[31] The impact of CRD IV on the costs of

Copyright Material. Not for distribution.

[31] See House of the Oireachtas, 'EU Scrutiny Report No 1: CRD IV Legislation on Prudential Capital Banking Requirements under Basel III' (31/FPER/006, Irish Joint Committee on Finance, Public Expenditure and Reform, 14 February 2012) 3 <http://www.europarl.europa.eu/RegData/docs_autres_institutions/parlements_nationaux/com/2011/0452/IE_HOUSES-OF-OIREACHTAS_CONT1-COM(2011)0452_EN.pdf> accessed 10 February 2020.

the banks' business has been significant. The Commission has estimated that for EU banks to implement CRD IV fully they will have to raise an additional 544 billion euro of CET1 capital by 2019.[32] These amounts are equivalent to just less than 3 per cent of the industry's risk-based assets.[33]

36.28 The EU's maximum harmonization approach to implementing the single rulebook has created a level playing field for the CRR's capital and liquidity requirements. Assuming consistent implementation across EU countries, regulatory arbitrage for other areas of banking activity, including wholesale and investment banking may be less likely to be a concern. However, it is not clear that Basel III will be consistently implemented outside the EU, where countries are free to follow different implementation approaches. Nevertheless, CRR and CRD constitute a maximum harmonization regime in which capital and liquidity requirements (CRR) and the more general governance and risk management standards (including counter-cyclical capital), along with administrative sanctions, are expected to be applied in a substantially similar way across EU Member States.

36.29 From a financial stability perspective, the CRD IV has a number of weaknesses and gaps that arise from the fact that CRR and CRD only apply to 'credit institutions' and certain investment firms. 'Credit institution' is defined as an 'undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account'. However, it is pointed out that the concept of 'repayable funds from the public' and the concepts of 'credit' and 'deposits' can be interpreted in different ways, meaning that financial institutions performing similar activities in different Member States may be classified as a 'credit institution' in one Member State, but not in another. This means that the CRD IV does not apply to an array of institutions not defined as credit institutions under diverse Member State laws. Similarly, a 'credit institution' subject to the ECB's Single Supervisory Mechanism jurisdiction for carrying on activities governed by EU prudential banking law is not subject to ECB supervision for activities not subject to EU prudential banking law, such as brokering and dealing securities or the marketing and sale of retail financial products.[34]

36.30 Although the CRR and CRD attempt to mitigate systemic risk at the level of individual institutions, it does not cover a wide variety of financial institutions borrowing and lending in the so-called shadow banking markets, as competent authorities only have powers to supervise individual banks or 'credit institutions' as defined under EU law.[35] Member State prudential authorities do not have competence to regulate non-bank financial intermediaries—such as shadow banks—nor do they have competence to regulate the off-balance sheet entities involved in the securitization and structured finance markets that are increasingly playing a greater role in channelling large volumes of credit and leverage to European businesses and consumers.[36] In other words, the Member State authorities (including the ECB) have very

Copyright Material. Not for distribution.

[32] Ibid.

[33] European Banking Authority, 'Basel III Monitoring Exercise—Results based on Data as of 31 December 2017' (4 October 2018) 13 <http://eba.europa.eu/documents/10180/2380948/2018+Basel+III+Monitoring+Exercise+Report.pdf> accessed 10 February 2020. For a complete overview of data related to bank capitalization and CET1 ratios as of Q3 2018, see ECB, 'Supervisory Banking Statistics: Third quarter 2018' (January 2019) <http://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisorybankingstatistics_third_quarter_2018_201901.en.pdf> accessed 10 February 2020.

[34] Article 4(1)(1) CRR.

[35] See Commission, 'Shadow Banking—Addressing New Sources of Risk in the Financial Sector (Communication)' COM (2013) 614 final.

[36] Article 5 SSM Regulation.

limited authority to address the macro-prudential systemic risks that can arise outside the formal banking sector where non-bank financial intermediation is growing.

D. CRD V Reform Package

36.31 The Commission's 2017 proposed Regulation and Directive[37] proposes to make the scope of prudential capital and liquidity regulation more proportionate to the risks that individual credit institutions and investment firms pose to the financial system, but it fails to address the financial stability risks posed by the shadow banking market. Rather, the CRD V package focuses on it reducing capital, liquidity and risk management requirements for investment and securities firms subject to the CRD IV (including investment firm groups without a credit institution) but which are not deemed under the legislation to be systemically significant. Instead, the CRD V would apply less strict requirements in these areas in order to make prudential regulation more proportionate to the risks that smaller and medium-sized investment firms pose to the market. It is also intended to lessen prudential regulatory requirements for non-bank investment firms which trade or invest in company and other securities and thereby support increased investment in firms as part of the European Union Capital Markets Union initiative.[38]

36.32 However, a few systemically important investment firms, defined as such under Article 131 CRD IV, would still be subject to the CRR/CRD IV framework, including the proposed CRD V amendments to the CRR/CRD IV because these firms incur and underwrite risks (both credit and market risks) on a largescale basis in the EU single market. The rationale for subjecting smaller and systemically less important institutions to exemptions from the CRD IV capital and liquidity requirements is based on the lower level of perceived systemic risk they pose to the financial system. This is designed to provide a 'more streamlined regulatory toolkit' to allow these firms to provide services more efficiently across different type of business models.[39]

36.33 CRD V package does not contain any additional regulatory requirements to control risk-taking in the shadow bank market, and it also fails to address the loophole in EU bank capital legislation that does not require EU-based banks to hold regulatory capital against their holdings of EU Member State sovereign bonds. This has distorted the EU and Eurozone sovereign debt market and has resulted in many large and systemically important financial institutions holding disproportionate and excessive exposures against Eurozone sovereign debt.

Copyright Material. Not for distribution.

[37] Commission, 'Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulation (EU) No 575/2013 (EU) No 600/2014 and (EU) No 1093/2010' COM (2017) 790 final, 3–4.

[38] See Chapter 35.

[39] Commission, 'Review of the prudential framework for investment firms' SWD (2017) 481 final, 16–19. See also Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures' COM (2016) 854 final, 4.

IV. European Banking Authority: Regulatory and Technical Standards

36.34 The European System of Financial Supervision consists of the European Banking Authority (EBA), European Securities and Market Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).[40] The three European Supervisory Authorities (ESAs) have responsibility for developing the legally binding regulatory and technical implementing standards, rules and non-binding guidelines and recommendations that, together with the Level 1 EU secondary legislation, constitute the EU single rulebook in financial services regulation. This section will discuss the role of the EBA in adopting regulatory and technical standards and non-binding guidance. The European Banking Authority was established in 2010 to promote enhanced harmonization of supervisory practices in transposing EU banking legislation across the Member States. As discussed in Chapter 35, EU banking regulation and supervision demonstrates the complexity of the EU federal system of laws and jurisdictions that contain layers of administrative rulemaking that overlap. The use of EU state agencies to implement Union law has long been a feature of the EU, but Union authorities and agencies have grown in influence and legal importance.[41] The three European Supervisory Authorities (ESAs) have come to be involved on a day-to-day basis with executing supervision and in the case of the EBA coordinating with the Single Resolution Board make decisions on whether banks should be taken into resolution.

36.35 The EBA is designated under CRD IV to develop regulatory technical standards (RTS) to give more precision to Member State authorities regarding how they define regulatory capital and liquidity and risk governance standards, and to ensure that Member States adopt administrative regulations to implement the CRD IV based on the EU constitutional principles of proportionality, legality and due process.

36.36 The implications of Brexit are important in the context of how the EBA conducts itself after the UK exits the European Union. This is of particular importance regarding voting reforms in the EBA and the other ESAs. The Commission's 2017 consultation on the ESAs and European Systemic Risk Board (ESRB) includes a response that post-Brexit voting shares in the EBA/ESAs should be calculated based on the size of a Member State's financial sector.[42] Also, Banking Union countries suggested the elimination of double-majority

Copyright Material. Not for distribution.

[40] See Commission, 'Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority); Regulation (EU) No 1094/2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority); Regulation (EU) No 1095/2010 establishing a European Supervisory Authority (European Securities and Markets Authority); Regulation (EU) No 345/2013 on European venture capital funds; Regulation (EU) No 346/2013 on European social entrepreneurship funds; Regulation (EU) No 600/2014 on markets in financial instruments; Regulation (EU) 2015/760 on European long-term investment funds; Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds; and Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market' COM (2017) 536 final, 13, 23.

[41] See Miroslava Scholten, *The Political Accountability of EU and US Independent Regulatory Agencies* (Brill Nijhoff 2014); Edoardo Chiti, 'European Agencies' Rulemaking: Powers, Procedures and Assessment' (2013) 19 European Law Journal 93; Madalina Busuioc, 'Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope' (2012) 19 European Law Journal 111; Merijn Chamon, 'EU agencies between *Meroni* and *Romano* or the devil and the deep blue sea' (2011) 48 Common Market Law Review 1055.

[42] Commission, 'Feedback Statement on the public consultation on the operations of the European Supervisory Authorities having taken place from 21 March to 16 May 2017' (Brussels, 20 June 2017) 16; see COM (2017) 536

voting, while Member States outside the Banking Union argue that double-voting should be maintained.[43] The Commission proposed a draft Regulation[44] in 2017 that the voting arrangements in the EBA should be amended to include voting status of the SSM and SRB on the EBA supervisory board in order to help bridge the current institutional divide between regulatory, supervisory and resolution functions. The Commission also proposed to keep the double majority voting system for measures and decisions adopted by the EBA Board of Supervisors,[45] but that voting rules should be modified to ensure that votes would not have to be postponed if a quorum on the BoS is not met. The draft Regulation amendment therefore clarifies that a decision would need to be supported by a simple majority of NCAs from non-participating Member States present at the vote and of national competent authorities from participating Member States present at the vote.[46]

36.37 The EBA is also responsible for administering the EU-wide stress tests and the development of a complete methodology, whereas national competent authorities (including the ECB) are responsible for the quality of the data and operation of the stress test. Coordination between EBA and national supervisors (including the ECB) is required, but often lacking. Although it does not have direct control over the quality assurance process of the stress tests, the EBA is held accountable to EU policy-makers for the EU-wide stress tests. It is recommended therefore that close cooperation between the EBA and ECB is necessary to ensure the quality and accountability of the stress tests.[47]

36.38 Related to the EU-wide stress tests, the EBA is also responsible for designing technical standards and guidelines for the supervisory review and evaluation process (SREP) that assesses bank corporate and risk governance under the Capital Requirements Directive 2013. An important component of the SREP involves the EBA developing and refining forward-looking scenario stress tests that Member State competent authorities (including the ECB) are required to apply. The application of the SREP methodology may result in additional capital requirements, and the adjustment of bank business models and strategy. The Commission's consultation, however, recommends that the EBA could further refine the SREP Guidelines and scenario testing for business models and strategies in order to promote enhanced supervisory convergence across EU states. Also, the EBA encourages

Copyright Material. Not for distribution.

final, 23–24; See Commission, 'Communication from the Commission to the European Parliament, the Council, the European Central Bank, The European Economic and Social Committee and the Committee of the Regions reinforcing integrated supervision to strengthen Capital Markets Union and financial integration in a changing environment' COM (2017) 542 final.

[43] Jakub Gren, 'The Eurosystem and the Single Supervisory Mechanism: institutional continuity under constitutional constraints' (2018) European Central Bank Legal Working Paper Series No 17, 16 <http://www.ecb.europa.eu/pub/pdf/scplps/ecb.lwp17.en.pdf?b39bee753107db68032c7238e711ae91> accessed 10 February 2020. See Commission, 'Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1023/2013' SWD (2017) 336 final, 12 <http://ec.europa.eu/info/sites/info/files/171011-ssm-review-report-staff-working-document_en.pdf> accessed 10 February 2020. For the opposite view, see Paul Weismann, 'The European Central Bank under the Single Supervisory Mechanism: Cooperation, Delegation, and Reverse Majority Voting' (2018) 24 European Journal of Current Legal Issues; Roland Vaubel, 'The Breakdown of the Rule of Law in the Euro-Crisis: Implications for the Reform of the Court of Justice of the European Union' (International Law and the Rule of Law under Extreme Conditions, XIVth Travemünde Symposium on the Economic Analysis of Law, 27–29 March 2014) 8.

[44] COM (2017) 536 final.

[45] Ibid, 23.

[46] Ibid, 24.

[47] SWD (2017) 336 final, 52.

the ECB to coordinate the development of its own SREP methodology to avoid legal uncertainty and divergent supervisory practices across EU states.[48]

36.39 The EBA also seeks to ensure that the exercise of supervisory powers, including the exercise of powers that intervene in the governance of banking and investment firms and the application of sanctions under the CRD IV, is not excessively divergent across EU jurisdictions and that the exercise of supervisory powers, including imposing administrative and punitive sanctions, are based on recognized principles of proportionality, legality and due process.

V. EU Legislation Regulating the Sale of Retail Investment Products

36.40 Investor protection is a central element in the political and legal character of post-crisis EU banking and investment services law. The financial crisis caused cross-market financial turmoil and exposed the interlinkage between macro- and micro-prudential regulation. As financial stability was weakened by systemic risk, market confidence was also shaken by massive mis-selling of investment and financial products by banks and other financial institutions. In turn, weak investor confidence further harmed financial stability. Indeed, financial policy-makers and regulators now acknowledge that a vicious cycle can arise between investor confidence and financial stability.[49]

36.41 The European Union is exemplary for having strong consumer-oriented regulation and case law to fight misleading sales practices and other manipulative and anti-competitive behaviour, which can be seen across competition, data protection and financial and investment services law. In the latter realm, the retail investor is exposed to potential market failures such as information asymmetries and product distributors' conflicts of interest. The EU has aimed to address these concerns by replacing the 2004 Markets in Financial Instruments Directive I (MiFID I)[50] with the stricter and more elaborate MiFID II[51] and Markets in Financial Instruments Regulation (MiFIR).[52] These laws have been viewed as the cornerstone of how EU investment services law, changing the way in which investment service providers act in business and towards their clients.[53] The EU follows a sectoral approach to regulating the marketing and sale of financial products, which results in segmentation and arbitrage risks. This section analyzes the theoretical basis of the regulation of retail markets by asking: who are the retail investors, what risks do they face and how and to what extent

Copyright Material. Not for distribution.

[48] Ibid, 44.
[49] See Chapter 20.
[50] European Parliament and Council Directive 2004/39/EC of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (MiFID I).
[51] European Parliament and Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L173/349 (MiFID II).
[52] European Parliament and Council Regulation (EU) 600/2014 of 15 May 2014 on markets in financial instruments and amending Regulation (EU) 648/2012 [2014] OJ L173/84 (MiFIR).
[53] Matthias Lehmann, 'Security Markets and Services: Introduction to MiFID II and MiFIR' in Matthias Lehmann and Christoph Kumpan (eds), *European Financial Services Law: Article-by-Article Commentary* (CH Beck, Hart Publishing, and Nomos 2019) 1.

should regulation intervene? It then discusses how EU law has intervened on a number of fronts to protect investors and ensure more efficient capital market regulation.

A. Rationale and theory

36.42 Individual economic welfare is enhanced through long-term savings and investment products.[54] The economy also relies on investment services for the provision of liquidity to the market and a more efficient allocation of resources. According to Moloney, '[r]etail markets matter',[55] as well as their regulation, as 'greater responsibility for financial planning and welfare provision is being imposed on individuals and households internationally: welfare is increasingly being privatized and governments are seeking stronger individual financial independence'.[56] There is hence a transfer of risk from the government to the household and with intensified retail engagement, risk exposures are magnified.[57] The retail investment market also has societal impacts since poor investor decisions can erode individual financial circumstances in the short and long term due to lacking product suitability or unanticipated and/or excessive charges and costs.[58] Lack of product access may also prompt exclusion risk.[59]

36.43 Retail investor detriment can be caused by external structural factors in financial markets that are driven by innovation and volatility in the financial system.[60] The macroeconomic environment, globalization, technological advancements, and disruptions in the financial system can penetrate to and harm retail investors.[61] Moreover, detriment to retail investors may arise in connection with investment service providers that are influenced by substandard business models, misleading marketing and sales techniques and weak corporate governance. These can produce supply chain or product risks that can harm retail investors. Further, retail investment decision-making can be affected by behavioural bias, overconfidence, financial background and cultural factors.[62]

36.44 Prior to 2007, EU retail market policy was mainly driven by the information paradigm, a theory emblematic to the law and economics school of thought. Under this theory, investors will take rational decisions if they are provided with all necessary information. According to Beales, information about price, quality and other product attributes enables investors

Copyright Material. Not for distribution.

[54] Niamh Moloney, 'Regulating the Retail Markets: Law, Policy and the Financial Crisis' in Colm O'Cinneide and George Letsas (eds), *Current Legal Problems* (vol 63, OUP 2010) 396 (hereafter Moloney, 'Regulating the Retail Markets: Law, Policy').

[55] Moloney, 'Regulating the Retail Markets: Law, Policy' (n 54) 384.

[56] Ibid, 387.

[57] Ibid, 387. Moloney mentions in footnote 66 that this phenomenon has been recurrently stated in reports, such as Ignazio Visco and others, 'Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies' (Banca d'Italia 2005) and Jacques Delmas-Marsalet, 'Report on the Marketing of Financial Products for the French Government' (November 2005).

[58] Financial Services User Group, 'For Better Supervision and Enforcement in Retail Finance' (October 2016) 8.

[59] Ibid. Exclusion in this context would arise when a consumer has no access to banking services such as a bank account or a line of credit.

[60] Ibid.

[61] Ibid.

[62] Ibid.

to 'make the best use of their budget by finding the product they most prefer'.[63] This in turn creates an incentive for product distributors to compete and provide higher quality products. Superior distributors will aim for enhanced disclosure to distinguish themselves from others.[64]

36.45 The information paradigm theory is based on several presuppositions, including that (i) information enables rational investment decision-making;[65] (ii) investors use and analyse the information available; and (iii) the supplier's information is adequate. According to the Nobel Prize winner Eugene Fama's efficient capital market hypothesis, the information in the market about the financial product would be reflected in the product's market price.[66] In this framework, the regulator's task is to provide a disclosure regime that focuses primarily on requiring the disclosure of relevant information, thus justifying regulatory intervention only where strictly necessary.[67]

36.46 A fundamental assumption of EU policy-makers was that the disclosure of more and relevant information to investors and customers would lead to a more efficient and socially optimal market. Indeed, the Commission in 1999 presented the Financial Services Action Plan (FSAP) consisting of over forty pieces of legislation aimed to make European financial markets more competitive and innovative in order to compete globally, particularly with the US capital markets.[68] The FSAP relied on the notions that disclosure of information ensured by regulation would better protect investors and consumers and that regulatory intervention can only be justified when it is cost-effective and a least restrictive option to protect consumers.

Copyright Material. Not for distribution.

36.47 A paradigm shift, however, occurred with the financial crisis of 2007–08. In addition to weak prudential regulation and inadequate oversight of financial stability, the crisis revealed persistent and systematic mis-selling of financial products by financial institutions and investment firms, partly due to conflicts of interest of product distributors. The crisis exemplified the substantial failure of the pre-crisis regulatory approach based on the disclosure paradigm to protect retail investors and other customers who were mis-sold financial products. As the European Commission observed:

> [t]he financial crisis . . . provided a stark reminder of the importance of transparency in financial products and of the potential costs of irresponsible selling. A collapse in investor confidence has underlined the urgency of ensuring the right regulatory framework is in place, so that the rebuilding of confidence can occur on a sound basis.[69]

36.48 The 2011 European Commission Staff Working Paper Executive Summary of the Impact Assessment identified further weaknesses in regulation and market practice concerning

[63] Howard Beales, Richard Craswell, and Steven C Salop, 'The Efficient Regulation of Consumer Information' (1981) 24(3) Journal of Law and Economics 492 (hereafter Beales, Craswell, and Salop, 'The Efficient Regulation of Consumer Information').

[64] Ibid.

[65] Ibid, 491–92.

[66] Eugene Fama, 'Efficient Capital Markets: A review of Theory and Empirical Work' (1970) 25 The Journal of Finance 383–417.

[67] See Beales, Craswell, and Salop, 'The Efficient Regulation of Consumer Information' (n 63) 532–39, discussing examples of situations deemed deserving of regulatory intervention under the law and economics approach.

[68] Commission, 'Implementing the Framework for Financial Markets: Action Plan' COM (1999) 232 final.

[69] Commission, 'Packaged Retail Investment Products (Communication)' COM (2009) 204 final, 2.

the inadequate quality of product distribution especially due to conflicts of interest that pervaded the distribution of financial products and investments.[70] Accordingly, EU policy-makers planned to overhaul the pre-crisis approach by accentuating the limits of the information paradigm and emphasising the influence of behavioural elements. Through behavioural finance, in which psychology is infused into the traditional realm of law and economics, investment choices are shaped not by reason but rather by behavioural bias and heuristics.[71] These can lead to investors behaving according to economically irrational 'rules of thumb', herd behaviour and other psychological factors such as hindsight bias and risk aversion.[72]

36.49 The Commission, through numerous reports on investment patterns, consumer decision-making and investor confidence, has now reformulated much of EU retail investor protection legislation on the assumption that the retail investor is unsophisticated, unskilled in decision-making and prejudiced by behavioural weaknesses.[73] It finds that the average retail investor struggles to comprehend conflict of interest disclosures and risks and relies heavily on investment advice.[74] Hence, retail investors confront capability barriers and fail to make decisions based on financial literacy which, according to the OECD, entails 'financial awareness, knowledge, skills, attitude and behaviours necessary to make sound financial decisions'.[75]

36.50 EU financial policy by and large has now incorporated a behavioural finance approach devoted to investor protection and the fair treatment of customers.[76] Information remains a key element to resolve asymmetry of information. In the interests of the investor and transparency, EU legislation will be discussed below about how it requires the presentation and form of information to be fair, clear and not misleading to enable optimal decision-making.

Copyright Material. Not for distribution.

B. EU financial legislation

36.51 EU retail market regulation has the purpose to protect and empower investors, build investor confidence and congruently achieve market stability.[77] The protection of investors can be accomplished both through defensive action against unscrupulous market actors and interventionist action in the market to correct market failures arising from information

[70] Commission, 'Commission Staff Working Paper Executive Summary of the Impact Assessment on MiFID' SEC (2011) 1227 final.

[71] Mydhili Virigineni and M Bhaskara Rao, 'Contemporary Developments in Behavioral Finance' (2017) 7(1) International Journal of Economics and Financial Issues 448.

[72] Ibid.

[73] Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, OUP 2014) 776; Optem, 'Pre-contractual Information for Financial Services: Qualitative Study in the 27 Member States' (2008); BME Consulting, 'The EU Market for Consumer Long-Term Retail Savings Vehicle: Comparative Analysis of Products, Market Structure, Costs, Distribution Systems, and Consumer Savings Patterns' (2007); Decision Technology and others, 'Consumer Decision-Making in Retail Investment Services: A Behavioural Economics Perspective' (2010) (hereafter 'Decision Technology').

[74] Decision Technology (n 73) 5–7.

[75] OECD, 'OECD/INFE Toolkit for Measuring Financial Literacy and Financial Inclusion' (May 2018). See also Dimity Kingsford Smith and Olivia Dixon, 'The Consumer Interest & The Financial Markets' in Niamh Moloney, Eilís Ferran, and Jennifer Payne (eds), *Oxford Handbook on Financial Regulation* (OUP 2015) 707.

[76] Ernst & Young, 'MiFID II: Time to Take Action' (29 July 2014) 5.

[77] Moloney, 'Regulating the Retail Markets' (n 54) 739–44.

asymmetries.[78] Arguably, post-crisis, the EU has taken an interventionist approach to achieve investor protection.[79] In the EU, the building blocks for achieving investor protection can generally be considered to be (i) the provision of information for enhancing transparency on the product structure and issuer; (ii) conduct of business rules to mitigate conflicts of interests in distribution; and (iii) product governance regulating the availability of products on the market.[80]

36.52 The regulation of EU retail financial markets consists of a number of legislative measures.

36.53 The Prospectus Directive 2003/71/EC[81] and Regulation (EU) 2017/1129[82] require issuers of securities to the public or trading on a regulated market to produce a prospectus in a standardized and comprehensible format.[83] The prospectus contains information concerning the issuer such as its financial position, assets and liabilities and rights attaching to its securities.[84] Such issuers are required to file a prospectus that includes a summary prospectus with the authority of their home Member State.[85] Failure to comply can lead to the imposition of civil liability on the issuer.[86]

36.54 As discussed below, the Packaged Retail and Insurance-Based Products Regulation (EU) 1286/2014 (PRIIPs)[87] requires PRIIPs[88] producers and distributors to issue a Key Information Document (KID)[89] containing summary information to allow investors to assess the comparability of products across financial sectors.[90]

36.55 The Undertakings for the Collective Investment in Transferrable Securities IV2009/65/EC (UCITS)[91] Directive regulates collective investment schemes and requires UCITS funds to publish a Key Investor Information Document (KIID) containing standardized and

Copyright Material. Not for distribution.

78 Ibid.

79 Moloney, *EU Securities and Financial Markets Regulation* (n 73) 771.

80 See Veerle Colaert, 'Building Blocks of Investor Protection: All-Embracing Regulation Tightens Its Grip' (2017) 6 Journal of European and Consumer Market Law 229.

81 European Parliament and Council Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L345/64. The Prospectus Directive is valid until 20 July 2019, following which only the Prospectus Regulation will apply.

82 European Parliament and Council Regulation (EU) 2017/1129 of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC [2017] OJ L168/12 (Prospectus Directive).

83 See Recital (27) Prospectus Regulation.

84 Ibid. Article 5(1) Prospectus Directive which also requires the information to be presented in a concise and appropriate manner.

85 Article 14(1) Prospectus Directive.

86 Article 6(1) and (2) Prospectus Directive; See also ESMA, 'Comparison of liability regimes in Member States in relation to the Prospectus Directive' (ESMA/2013/619, 30 May 2017).

87 European Parliament and Council Regulation (EU) 1286/2014 of 26 November 2014 on key information documents for packaged retail and insurance-based investment products OJ L352/1 (PRIIPs Regulation).

88 Article 4(1) PRIIPs Regulation defines PRIIPs as: 'an investment . . . where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor'.

89 See Chapter II PRIIPs Regulation. KID information includes the identity of the product manufacturer and a presentation of the risks and rewards, costs, including performance examples. Information must be presented in an easily analyzable and comprehensible format.

90 Joint Committee of the European Supervisory Authorities, 'Discussion Paper: Key Information Document for Packaged Retail and Insurance-based Investment Products (PRIIPs)' (JC/DP/2014/02, 17 November 2014) 5.

91 European Parliament and Council Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32 (hereafter UCITS IV).

comprehensive information about a UCITS product.[92] Civil liability can arise when information in the KIID is misleading, inaccurate or inconsistent with the prospectus.[93]

36.56 The Insurance Mediation Directive 2002/92/EC (IMD),[94] succeeded by the Insurance Distribution Directive 2016/97/EU (IDD)[95] that came into effect in October 2018, requires insurance product distributors to adhere to certain information and conduct of business requirements.[96] The IDD increases the requirements of its predecessor (IMD) by imposing stricter conduct of business rules that are substantially similar to the conduct of business rules of MiFID II.[97]

36.57 The Investor Compensation Scheme Directive 97/9/EC (ICSD)[98] allows retail investors to receive up to 20,000 euro compensation if an investment firm fails to meet its repayment obligations to the investor because of fraud or operational failure.[99] ICSD has been criticized on the grounds that it does not cover losses caused by other types of misconduct, such as violations of conflict of interest rules, negligent advice and misleading advertising. This is particularly concerning from a consumer protection perspective given that there were millions of investor claims for mis-selling against financial institutions across Europe both before and after the 2007–08 crisis.[100]

36.58 MiFID II[101] and MiFIR[102] introduce changes to product distribution, governance and intervention rules that concern a wide range of financial instruments.[103] MiFID II/MiFIR constitute the most comprehensive and strictest body of EU investment services law and regulation. Moloney and Colaert have observed that this legislative regime and regulatory framework is 'silo-based', as different measures impose different requirements to functionally similar products.[104] This approach has been critically analyzed as leading to regulatory arbitrage, thereby undermining investor protection and the operation of the internal market.[105]

36.59 The EU has acknowledged the problems associated with the silo-based legislative-regime. The 2007 Commission Call for Evidence[106] found that stakeholders support having an integrated distribution, disclosure and product governance model, yet the Commission cautioned that such a project would involve massive organizational re-structuring and risks

Copyright Material. Not for distribution.

[92] Chapter IX, Section 3 UCITS IV.
[93] Article 79(2) UCITS IV.
[94] European Parliament and Council Directive 2002/92/EC of 9 December 2002 on insurance mediation [2002] OJ L9/3 (Insurance Mediation Directive).
[95] European Parliament and Council Directive (EU) 2016/97 of 20 January 2016 on insurance distribution (recast) [2016] OJ L26/19 (Insurance Distribution Directive).
[96] Chapter V Insurance Distribution Directive.
[97] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 776.
[98] European Parliament and Council Directive 97/9/EC of 3 March 1997 on investor-compensation schemes [1997] OJ L84/22 (Investor Compensation Scheme Directive).
[99] Article 4 Investor Compensation Scheme Directive.
[100] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 843.
[101] MiFID II (n 51).
[102] MiFIR (n 52).
[103] See Danny Busch, *Product Governance* (OUP 2017).
[104] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 779–780. Such products include UCITS collective investment schemes ('CIS'), non-UCITS CIS, insurance-linked investments and structured securities. Moloney, *EU Securities and Financial Markets Regulation* (n 73) 779–80.
[105] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 780.
[106] Commission, 'Need for a Coherent Approach to Product Transparency and Distribution Requirements for 'Substitute' Retail Investment Products' (Call For Evidence G4, 2007).

for firms.[107] Nevertheless, the EU legislator has addressed segmentation risks in the PRIIPs Regulation by introducing more coherence and harmonization across financial product sectors by adopting a cross-sectoral and horizontal selling regime for PRIIPs investments and products. MiFID II, MiFIR, and the IDD also aim to be more aligned in setting similar stringent standards for different financial products.[108]

36.60 Although retail markets involve many different financial products governed by various EU legislation, the next section will examine the MiFID II/MiFIR regime. MiFID II/MiFIR are deemed to be the biggest and most substantial pieces of EU post-crisis financial and investment services legislation, ushering in a new regulatory landscape for EU capital and investment markets.[109]

36.61 Despite the implementation of MiFID II/MiFIR, the EU has acknowledged the problems associated with the silo-based legal framework. Further, evidence suggests that stakeholders support having an integrated distribution, disclosure and product governance model.[110] As discussed above, the PRIIPs Regulation introduces cross-sectoral requirements and standards for a more coherent and horizontal selling regime across sectors.[111] MiFID II, MiFIR and the IDD also aim to be more aligned in setting similar stringent standards for different financial products.[112] Although retail markets involve many different financial products and areas of legislation and regulation the following section focuses on the MiFID II/MiFIR regime. MiFID II/MiFIR are deemed to be the biggest and most substantial pieces of EU post-crisis legislation in financial and investment services, likely to redesign the face of EU capital and investment markets and the way firms operate.[113]

Copyright Material. Not for distribution.

VI. Markets in Financial Instruments Directive II/Markets in Financial Instruments Regulation (MiFIR)

36.62 MiFID II has the stated objective of making European financial markets safer, fairer and more transparent and to restore investor confidence after the financial crisis. As part of its post-crisis reforms, the Commission attempted to address gaps and weaknesses in MiFID I by replacing it with Directive 2014/65/EU (MiFID II) and adopting Regulation 600/2014 (MiFIR).[114] The Commission has issued a number of implementing and delegated acts further specifying the rules under MiFID II[115] and

[107] Moloney, *EU Securities and Markets Regulation* (n 73) 779–80.

[108] Ibid, 778.

[109] See, for instance, Ernst & Young, 'The World of Financial Instruments is More Complex. Time to Implement Change' (Client Brochure, 2015) 1.

[110] Commission, 'Need for a Coherent Approach to Product Transparency and Distribution Requirements for 'Substitute' Retail Investment Products' (Call For Evidence G4, 2007).

[111] Moloney, *EU Securities and Markets Regulation* (n 74) 780.

[112] Ibid, 778.

[113] See for instance, Ernst & Young, 'The World of Financial Instruments is More Complex. Time to Implement Change' (Client Brochure, 2015) 1.

[114] European Parliament and Council Directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU [2014] OJ L173/349 (hereafter Markets in Financial Instruments Directive/MiFID II) and European Parliament and Council Regulation (EU) 600/2014 of 15 May 2014 on markets in financial instruments and amending Regulation (EU) 648/2012 [2014] OJ L173/84 (hereafter Markets in Financial Instruments Regulation/MiFIR).

[115] For instance, Commission Delegated Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating

MiFIR.[116] MiFID II was required to be transposed into Member State law by July 2017 and, together with MIFIR, became legally enforceable on 3 January 2018.[117] As discussed below, the Commission launched several infringement actions against Member States who failed to transpose the legislation by the deadline.[118]

36.63 MiFID II regulates investment firms, market operators, data reporting services providers and third country investment firms with an EU branch[119] that sell or advise clients on structured deposits,[120] certain services provided by UCITS[121] and Alternative Investment Funds (AIF).[122] MiFID II responds to the MiFID I shortcomings exhibited by the financial crisis in which major scandals of financial product mis-selling occurred. Arguably, this was due to MiFID I's inadequate regulation of product distribution and disclosure, leaving room for investment firms to deviate or not fully acknowledge them.[123] The sectoral application of MiFID I may have also contributed to mis-selling activities as the same investor protection was not afforded to different products, thereby promoting regulatory arbitrage. In fact, Colaert suggests that firms repackaged mutual funds into life insurance products or structured deposits to escape the stricter MiFID regime.[124]

A. Conduct of business rules

Copyright Material. Not for distribution.

36.64 MiFID II adopts stricter conduct of business rules than MiFID I. More rigid restrictions are placed on clients' abilities to reclassify or purchase certain complex structured products

conditions for investment firms and defined terms for the purposes of that Directive [2017] OJ L87/1; Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits [2017] OJ L87/500.

[116] For instance, Commission Delegated Regulation (EU) 2017/567 of 18 May 2016 supplementing Regulation (EU) 600/2014 of the European Parliament and of the Council with regard to definitions, transparency, portfolio compression and supervisory measures on product intervention and positions [2017] OJ L87/90. The Commission has adopted more than 30 implementing and delegated acts for MiFID II and MiFIR.

[117] European Parliament and Council Regulation (EU) 2016/1033 of 23 June 2016 amending Regulation (EU) 600/2014 on markets in financial instruments, Regulation (EU) 596/2014 on market abuse and Regulation (EU) 909/2014 on improving securities settlement in the European Union and on central securities depositories [2016] OJ L175/1; European Parliament and Council Directive (EU) 2016/1034 of 23 June 2016 amending Directive 2014/65/EU on markets in financial instruments [2016] OJ L175/8.

[118] See Commission, 'Wednesday, 4 October 2017: The Commission is planning to adopt its monthly infringements package' (Press Release, Brussels, 5 October 2017) <http://europa.eu/rapid/press-release_AGENDA-17-3428_en.htm> accessed 10 February 2020. As of 20 February 2018, ten Member States did not fully implement MiFID II and Commission Delegated Directive (EU) 2017/593.

[119] Article 1(1) MiFID II. Insurance undertakings and related undertakings are expressly excluded from MiFID II scope (Article 1(1) MiFID II).

[120] Article 1(4) MiFID II. This is wider in scope than MiFID I which only applies to 'investment services' relating to 'financial instruments'.

[121] Collective investment schemes providing certain MiFID services. See Article 6(3)-(4) UCITS IV.

[122] Article 6(4)–(6) of Parliament and Council Directive 2011/61 of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) 1060/2009 and (EU) 1095/2010 OJ L174/1 (Alternative Investment Fund Managers Directive/AIFMD).

[123] Commission, 'Proposal for a Directive of the European Parliament and of the Council on Markets in Financial Instruments (Recast)' COM (2011) 656 final.

[124] Veerle Colaert, 'MiFID II in Relating to Other Investor Protection Regulation: Picking up the Crumbs of a Piecemeal Approach' in Danny Busch and Guido Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR* (OUP 2017) 591 (hereafter Colaert, 'MiFID II in Relating to Other Investor Protection Regulation').

on an execution-only basis. This has resulted in many clients falling under the retail client category.[125] MiFID II introduces provisions on sales targets and remuneration aimed at financial intermediaries and investment firms to promote the client's best interest and avoid conflicts of interest.[126] Product distributors need to inform their clients about the nature of the advice (whether it is independent or tied), the financial product selection advised on, the firm's policy on periodic suitability assessments, risks, charges and costs.[127] Independent investment advice must relate to cross-market instruments and commission payments for such advice are prohibited.[128]

36.65 Know-your-Customer (KYC) rules require investment firms to carry out suitability and appropriateness tests. In assessing suitability, a firm is required to obtain information concerning the client's background including knowledge and experience in finance, financial situation, the ability to bear losses and investment objectives.[129] Based on this, the provider is to recommend financial products suitable for the client. Under the appropriateness tests, which is to be carried out in execution-only relationships, the investment firm is to request information on the client's knowledge and experience in finance, based on which it assesses whether the products are appropriate.[130]

36.66 The investment service provider must adhere to the principle of fair treatment of clients and the duty to act in the client's best interests.[131] This addresses the principal-agency problem as well as asymmetric information. Firms must also communicate all information, including marketing communications and information on costs and fees, to clients in a 'fair, clear and not misleading manner'.[132] Moreover, in ensuring quality of advice, MiFID II obliges investment advisers to have the necessary competence and knowledge about financial instruments.[133]

36.67 The distribution of financial products requires regulation due to the particularities of the retail market. It has been shown that retail customers place strong trust in advice and other intermediary means of distribution.[134] Conflicts of interest between the investment service provider and the client, and between two different clients, may arise, for instance, as a result of commission-based products sold by the service provider.[135]

36.68 MiFID II requires product distributors to adopt certain organizational rules to prevent conflicts of interest. Under the product governance rules, distributors must 'maintain, operate and review a process for the approval of each financial instrument' and ensure that the product fits the target market before being marketed or distributed.[136] Reports of certain

Copyright Material. Not for distribution.

[125] Client classification determines the level of protection afforded. A customer can be an eligible counterparty, a professional client or a retail client. The categorization depends on the client's experience, knowledge and expertise (Article 4(1)(10) MiFID II and Annex II). Each client has per se status but requalification is possible when certain qualitative and quantitative criteria are fulfilled. MiFID II has made these criteria much stricter.
[126] See Article 24 MiFID II.
[127] Article 24(4) MiFID II.
[128] Article 24(7) MiFID II.
[129] Article 25(2) MiFID II.
[130] Article 25(3) MiFID II.
[131] Articles 9(3)(c) and Article 24 MiFID II, respectively.
[132] Article 24(3) MiFID II.
[133] Recital (79) Article 25(1) MiFID II.
[134] See, for instance, Decision Technology (n 73).
[135] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 793–94.
[136] Article 16(3) 2nd para MiFID II.

activities in this regard must be kept, including records of telephone conversations or electronic communications when clients deal on their own account or in execution-only orders.[137]

B. Product regulation

36.69 Product regulation in MiFID II/MiFIR addresses product quality requirements, product design and product bans. MiFIR product intervention measures grant competences to National Competent Authorities (NCAs) and the European Securities and Markets Authority (ESMA).[138] Product intervention can be achieved *ex-ante* through product governance or *ex-post* through product prohibition. *Ex-post* measures are intended for exceptional cases and where MiFID II organizational and conduct rules have been unsuccessful.[139] The rationale for this is that product intervention carries risks such as harm to innovation, reduction in investor choice, regulatory arbitrage and excessive regulation.[140]

36.70 The role of NCAs is to monitor and potentially restrict or prohibit financial instruments marketed, distributed or sold, or a type of activity exercised in a Member State.[141] Intervention may be exercised where there are 'significant investor protection concerns' or dangers to the orderly functioning and integrity of financial markets and the risks warranting intervention are not sufficiently addressed in existing EU regulation or cannot be better addressed by improved supervision or enforcement of existing measures.[142] Before utilizing such measures, Member State authorities are to ensure that intervention is appropriate and proportionate.[143] They must also coordinate with NCAs from other Member States and ESMA.[144] Moreover, the ban must cease to apply when the conditions that gave rise to the intervention are no longer present.[145]

36.71 MiFID II includes rules on NCA enforcement. NCAs must use their supervisory powers, set administrative sanctions and measures for infringement and, where national law so requires, impose criminal sanctions.[146] Additionally, NCAs have a duty to provide, exercise and publish NCA decisions.[147] MiFID II further requires NCAs to report infringements, ensure appeal rights and extra-judicial mechanisms for consumer complaints.[148]

36.72 ESMA has been granted additional powers under the new framework which include market monitoring and temporary product restriction or prohibition.[149] ESMA's interventions will supersede NCA action.[150] The reasons for intervention are identical to those for NCAs, ie

Copyright Material. Not for distribution.

[137] Article 16(7) MiFID II.
[138] Articles 41–42 MiFIR.
[139] Moloney, *EU Securities and Financial Markets Regulation* (n 73) 829 and 833. See also Recital (29) MiFIR.
[140] Moloney, *EU Securities and Financial Markets Regulation* (n 74) 825.
[141] Articles 39(3) and 42 MiFIR.
[142] Recital (46) and Article 42(2)(a)-(b) MiFIR.
[143] Article 42(2) MiFIR.
[144] Article 42(2)(d) and (3) MiFIR.
[145] Article 42(6) MiFIR.
[146] Title VI, Articles 67–88 MiFID II.
[147] Article 42(5) MiFIR.
[148] Reporting infringements (Article 73 MiFID II), Right of appeal (Article 74 MiFID II), extra-judicial mechanism for consumer complaints (Article 75 MiFID II).
[149] Article 40(1) MiFIR.
[150] Article 40(7) MiFIR.

in cases of significant investor protection concerns and danger to the orderly functioning and integrity or stability of financial markets.[151] In addition, ESMA can only take action if existing EU regulatory requirements insufficiently address the threat in question and the NCA has taken no or inadequate action. ESMA's intervention in this context will supersede NCA action.[152] ESMA is also tasked with the coordination of NCA activities.

C. Unbundling and firm organization

36.73 MiFID II applies to all financial institutions and infrastructure including banks, investment firms, fund managers, exchanges and other trading venues, high frequency traders, brokers and pension funds and retail investors. Banks and other financial intermediaries are required to unbundle client payments for analyst research and trading commissions, and provide stricter standards for investment products. The unbundling of client payments for analyst research and trading commissions is likely to affect how financial products are sold and how investment advice is rendered. The unbundling and organizational requirements are expected to have an impact beyond the EU. The EU demands for the personal details of traders are already creating tensions with the privacy rules of other jurisdictions outside the EU, such as Hong Kong, Singapore, and the United States. The MiFID II regime on payments for research also poses a significant challenge for US brokers.[153] The Securities and Exchange Commission (SEC) (the US regulator), however, has waived the US registration requirements until 2020 for brokers under the Investment Advisers Act 1940 that would have otherwise prohibited them from receiving direct payments from their customers for research without registering. Beyond 2020, it is expected that US banks and other institutions which employ these brokers will come under pressure to comply with the MiFID II rules and if they do so they will agree to register with the SEC as investment advisers in order to be able to continue servicing clients with EU operations.[154]

36.74 MiFID II also addresses the selling processes of financial institutions by adopting rules governing the organizational requirements and conduct of business provisions. As to the investment firms' organizational requirements, reference is made to the new provisions on product governance arrangements relating to firms which develop financial products and to those which sell them.[155] The purpose of such provisions is to enhance the firms' understanding of the products they develop or sell and to ensure that they are suitable to the clients to whom they are being sold.[156] To this end, investment firms are required to maintain, operate and review the process for approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.[157] Moreover, specific record-keeping provisions have been laid down in the context

Copyright Material. Not for distribution.

[151] Article 40(2)(a) MiFIR.
[152] Article 40(2)(b)–(c) and Article 40(7) MiFIR. Article 43 MiFIR.
[153] Under US regulations, brokers cannot receive direct payments for research unless they are formally registered as investment advisers under the Investment Advisers Act of 1940.
[154] Siobhan Riding, 'End the clash over EU research rule, SEC urged' *Financial Times* (2 February 2019).
[155] See Danny Busch, 'Product Governance and Product Intervention under MiFID II/MiFIR' in Danny Busch and Guido Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR* (OUP 2017) ch 5, 124 (hereafter Busch, 'Product Governance and Product Intervention under MiFID II/MiFIR').
[156] Article 16 MiFID II.
[157] Article 16(3) MiFID II.

of the organizational requirements. In particular, records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. Investment firms must also notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result, or may result, in transactions will be recorded.[158]

D. European Securities and Markets Authority (ESMA)

36.75 As discussed in section II, it has been suggested that the financial crisis paved the way 'towards a greater Europeanisation and centralisation of financial supervision' as the EU engaged in a major overhaul of the financial system.[159] An illustration of this is that the European System of Financial Supervision (ESFS) aims to ensure coherent and consistent financial across the EU.[160] The ESFS framework attempts to linked-up the ESRB's macropudential oversight with the microprudential standard setting of the three European Supervisory Authorities (ESAs).[161]

36.76 As discussed above with the EBA, the ESAs establish and supervise the implementation of a single rulebook which consists of rules for individual financial institutions.[162] They are also attentive to financial market conditions for timely detection of risks and vulnerabilities.[163] In the field of investment services, ESMA has the task to improve investor protection and ensure the proper functioning of financial markets in the EU.[164] ESMA's powers reach beyond those of its predecessor, the Committee of European Securities Regulations (CESR), which was more a network of national supervisory authorities rather than a centralized EU authority with special mandates and competences. ESMA's tasks and powers include:

(1) To enact (quasi-)rules by adopting regulatory technical standards implementing legislation and issuing guidelines, recommendations and warnings.[165] NCAs and market participants are demanded to 'make every effort to comply'.[166] ESMA may investigate a breach and intervene when an NCA has not complied with its duties. In cases of consistent non-compliance of an NCA with an ESMA guideline defining a

Copyright Material. Not for distribution.

[158] Article 16(6) and (7) MiFID II. It should also be mentioned that to ensure that record keeping occurs properly, the investment firms must even synchronize their clocks with clocks at the exchanges.

[159] Olha O Cherednychenko, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law' (2015) 21 European Law Journal 506 (hereafter Cherednychenko, 'Contract Governance in the EU').

[160] ECB, 'European System of Financial Supervision' <http://www.bankingsupervision.europa.eu/about/esfs/html/index.en.html> accessed 10 February 2020.

[161] Ibid.

[162] See Recital (22) of European Parliament and Council Regulation (EU) 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision 716/2009/EC and repealing Commission Decision 2009/77/EC OJ L331/84 (ESMA Founding Regulation).

[163] Recital (43) and Article 32 ESMA Founding Regulation.

[164] Article 1(5) and 8(1)(h) ESMA Founding Regulation.

[165] Cherednychenko, 'Contract Governance in the EU' (n 159) 506. Article 8(1)(a) ESMA Founding Regulation.

[166] Article 16(3) ESMA Founding Regulation.

breach of EU law, ESMA may investigate and take further action according to Article 17 of the ESMA Founding Regulation.[167]

(2) To monitor financial products that are marketed, distributed or sold in the EU. The Commission's 2017 proposal to strengthen the ESFS includes an extension of ESMA's direct supervisory powers to specific, highly-integrated sectors with significant cross-border activities and which are mostly regulated by directly applicable law.[168]
(3) To gather information from local supervisory authorities on supervisory practices.[169]
(4) To restrict or ban products (temporarily, not in excess of three months although renewal is possible) that either raise significant investor protection concerns; threaten the proper functioning and integrity of financial/commodity markets; or wholly or partly threaten financial stability.[170]

36.77 Although ESMA can intervene when a service involves retail or professional clients, it is not directly competent with respect to complaints against credit or financial institutions. Nonetheless, under Article 17 of ESMA Founding Regulation, ESMA may investigate a breach and intervene where a NCA has not complied with its duties.[171]

36.78 Whilst ESMA can produce binding decisions only in certain circumstances,[172] ESMA's presence can be considered significant in influencing EU conduct of business rules and supervision at national level. For instance, ESMA's 2016 guidelines on MiFID's suitability requirements has arguably played a considerable role in harmonizing conduct of business rules.[173] However, according to the *Meroni* principle, ultimately ESMA's powers are limited as it cannot have discretionary decision-making power that involves or could shape EU policy.[174] This would restrict ESMA's potential contract-shaping abilities, also because it lacks the competence to terminate, suspend or modify contractual obligations.[175] Moreover, Della Negra argues that were such powers conferred, ESA acts may decline in 'effectiveness and credibility', and risks of systemic regulatory errors could increase.[176] Additionally, NCA discretion and flexibility could be undermined.[177]

Copyright Material. Not for distribution.

[167] ESMA Founding Regulation. See also Commission, 'Report to the European Parliament and the Council on the evaluation of the Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps' COM (2013) 885 final.

[168] Article 2(5) ESMA Founding Regulation; Article 39(1) MiFIR; Commission, 'Capital Markets Union: Creating a stronger and more integrated European financial supervisory architecture, including on anti-money laundering' (Fact sheet, 1 April 2019).

[169] Article 45(1) MiFIR in particular. See also Articles 22(3), 25, and 26 MiFIR; Cherednychenko, 'Contract Governance in the EU' (n 159) 506–07.

[170] Article 40 MiFIR.

[171] ESMA Founding Regulation (n 164).

[172] ESMA can take binding decisions when such task has been specifically delegated to it.

[173] ESMA, 'MiFID Suitability Requirements Peer Review Report' (ESMA/2016/584, 2016). Cherednychenko, 'Contract Governance in the EU' (n 159) 506.

[174] Case C-9/56 *Meroni & Co., Industrie Metallurgiche, SpA v High Authority of the European Coal and Steel Community* [1958] ECR 133.

[175] Federico Della Negra, 'The Effects of the ESMA's Powers on Domestic Contract Law' in Mads Andenas and Gudula Deipenbrock, *Regulating and Supervising European Financial Markets* (Springer 2016) 123. Della Negra further argues that if such function were assigned to ESAs and market participants could challenge an ESA decision, the effectiveness and credibility' of ESAs' consumer protection mandate would dissolve.

[176] Ibid.

[177] Ibid. Moloney, 'Regulating the Retail Markets: Law, Policy' (n 54) 1312, 1317. See also Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market—A Tale of Two Competences: Part (1) Rule Making; Part (2) Rules in Action' (2011) 12 European Business Organisation Law Review 184, 190.

36.79 ESMA first agreed to use its Article 40 MiFIR product intervention powers in March 2018, according to which it would place restrictions on the provision of contracts for differences and prohibit the selling of binary options to retails investors.[178] As the products were deemed unduly complex, non-transparent and risky due to a build-up of excessive leverage, ESMA restricted them for raising 'significant investor protection concern'.[179] Indeed, according to ESMA, contracts for differences have caused between 74 and 89 per cent of retail clients to incur losses.[180] The measures were formally adopted in June 2018 and have been in effect since July 2018.

E. Selling processes and implementation

36.80 As discussed above, MiFID II also addresses the selling processes of financial institutions by adopting rules governing the organizational requirements and conduct of business provisions. As to the investment firms' organizational requirements, reference is made to the new provisions on product governance arrangements relating to firms which develop financial products and to those which sell them.[181] The purpose of such provisions is to enhance the firms' understanding of the products they develop or sell and to ensure that they are suitable to the clients to whom they are being sold.[182] To this end, investment firms are required to maintain, operate and review the process for approval of each financial instrument and significant adaptations of existing financial instruments before it is marketed or distributed to clients.[183] Moreover, specific record-keeping provisions have been laid down in the context of the organizational requirements. In particular, records shall include the recording of telephone conversations or electronic communications relating to, at least, transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders. Investment firms must also notify new and existing clients that telephone communications or conversations between the investment firm and its clients that result, or may result, in transactions will be recorded.[184]

Copyright Material. Not for distribution.

36.81 Sales targets and remuneration rules are also applicable to banks and other covered financial intermediaries. These rules are based on the ESMA's[185] Guidelines on Remuneration Policies and Practices and aim at ensuring that staff incentives do not result in conflict of interests or impinge upon the firm's obligation to act in the best interest of the client.[186] Finally, as to conduct of business, Articles 25 and 27 of MiFID II narrow the list of execution-only products and widen the list of information investment firms have to provide with regard to best execution.[187]

[178] Hannah Murphy, 'Europe Regulators Back Tough Rules for Spread-Betters' *Financial Times* (London, 27 March 2018).
[179] ESMA, 'ESMA agrees to prohibit binary options and restrict CFDS to protect retail investors' (ESMA71-98-128, 27 March 2018).
[180] Ibid, 1.
[181] See Busch, 'Product Governance and Product Intervention under MiFID II/MiFIR' (n 155) ch 5, 124.
[182] Article 16 MiFID II.
[183] Article 16(3) MiFID II.
[184] Article 16(6) and (7) MiFID II. It should also be mentioned that to ensure that record keeping occurs properly, the investment firms must even synchronise their clocks with clocks at the exchanges.
[185] See Chapter 20.
[186] Article 24(10) MiFID II.
[187] Articles 25 and 27 MiFID II.

36.82 MiFID II now contains a stronger principle of fair treatment that includes a fiduciary-style obligation on the investment firm to act fairly in the client's best interests (Article 24(1) MiFID II), and a duty to act honestly, fairly, and professionally in accordance with the best interests of firm's clients. This is known more generally as a duty of loyalty that is designed to address the weaknesses with the previous information disclosure regime that did not take account of the disadvantages confronting clients who often suffer from asymmetric information problems and behaviour biases.[188] Also, regarding marketing, Article 24(3) requires that all information addressed by a firm to clients to be '*fair, clear and not misleading*'.[189]

36.83 Compared to MiFID I, MiFID II aims to enhance the level of protection of different categories of clients. However, there will be room for further analysis once the implementation process is completed in accordance with the Commission's ongoing Level 2 rule-making process and the final Level 3 compliance and enforcement stage. Before the Brexit referendum, the UK competent authorities were considering the necessary changes for transposing MiFID II into domestic legislation.[190] In particular, they were assessing the impact that the new EU legislation may have on the ability of UK credit institutions and investment firms to contract out of their duty of care to retail and wholesale customers and to limit their liability to both consumer and commercial customers.[191] As of 2019, the UK has implemented all requirements on the distribution and sale of financial and investment products under MiFIR/MiFID II. In a Brexit 'no-deal' scenario, the UK could potentially qualify as having a regulatory regime for the distribution of financial products that qualifies for an 'equivalence' designation by the European Commission under the MiFID II equivalence provisions.

36.84 The final date for Member State transposition of MiFID II into national law was 3 July 2017 and the rules came into effect for market participants on 3 January 2018.[192] However, as of 25 January 2018, implementation was still incomplete across the EU with merely 12 out of 28 Member States having fully transposed the Directive into their national law, thereby leaving the transposition status at 64 per cent.[193] This may undermine the effectiveness of the general framework as the MiFID rules are only legally binding on market participants once the Directive is transposed into national law.[194]

Copyright Material. Not for distribution.

[188] See Niamh Moloney, *The Age of ESMA* (Hart Publishing 2018) 15–21.

[189] See Luca Enriques and Matteo Gargantini, 'The Overarching Duty to Act in the Best Interest of the Client in MiFID II' in Danny Busch and Guido Ferrarini (eds), *Regulation of the EU Financial Markets: MiFID II and MiFIR* (OUP 2017) ch 4.

[190] The Financial Services and Markets Act 2000 (Qualifying EU Provisions) (Amendment) Order 2016. This Order applies some amendments to the Financial Services and Markets Act 2000 (Qualifying EU Provisions) Order 2013. The purpose of these amendments is twofold: (1) to make MiFIR a qualifying EU provision for various parts of FMSA; and (2) to ensure that the FCA and PRA have the appropriate powers to perform their roles under MiFIR.

[191] HM Treasury, 'A new approach to financial regulation: judgment, focus and stability' (Cm 7874, July 2010) 15–16 <http://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf> accessed 10 February 2020.

[192] Article 93 MiFID II; Commission, 'MiFID II Directive—Transposition Status' <http://ec.europa.eu/info/publications/mifid-ii-directive-transposition-status_en> accessed on 10 February 2020.

[193] Jeroen Jansen, 'Monthly update on the latest EU policy and regulatory developments—issue no 1/2018' (DLA Piper, 14 February 2018) <http://www.dlapiper.com/en/ukraine/insights/publications/2018/02/eu-impact/> accessed 10 February 2020.

[194] See generally the EU principle of direct effect.

36.85 The Commission has launched infringement proceedings against Member States including Slovenia and Spain for not, or only partially, notifying the Commission of national measures transposing MiFID II.[195] This line of events is similar to 2007 when the Commission commenced infringement actions against Member States for failure to transpose of MiFID I.[196] The inadequate implementation may point to the complexity and volume of MiFID I/II measures which would require a longer timeframe to transpose into national law.[197]

36.86 Investment service providers have also encountered complexities and high costs in implementing the MiFID regime.[198] It can be argued that considerable firm misconduct leading to investor harm occurred during and after the crisis because MiFID I rules had not been correctly implemented by firms. This can be supported by the fact that numerous studies suggest that MiFID I implementation by firms was largely unsuccessful. The 2011 Commission/Synovate market study on advice in retail investment services concluded that under MiFID I:[199]

- information collected by investment firms on financial knowledge, experience and situation of their clients was oftentimes insufficient;
- investment firms frequently laid more importance on the amount a client could invest rather than performing due diligence;
- financial advice was based rather on superficial information lacking in detail which undermined an informed decision by the investor. Accordingly, in only 57 per cent of mystery shopping cases could investors make informed investment decisions.

36.87 A similar pattern may exist in the MiFID II era: in February 2018, a study by SCM Direct was conducted on investment firms' compliance with MiFID II duties of full transparency of fees and charges through aggregate presentation.[200] The findings include that 40 per cent of traditional investment funds use the European MiFID II Template (EMT), a non-compulsory industry-created template, to disclose MiFID II cost disclosures on their websites.[201] Zero per cent of Robo-Advisers/Online Wealth Managers disclosed any aggregate costs and charges on their websites.[202] Accordingly, it could be argued that, in its MiFID I review, the EU missed the opportunity to introduce a standardized cost and fees information document for MiFID II products as the KID exists for UCITS products. This could for instance have been possible by making the use of the EMT compulsory.

Copyright Material. Not for distribution.

[195] Commission, 'Securities markets: Commission refers Slovenia and Spain to the Court of Justice for failing to fully enact EU rules on markets in financial instruments' (Press Release IP/18/4530, 19 July 2018).

[196] Commission, 'Commissioner McCreevy urges Member States to ensure rapid implementation of Markets in Financial Instruments Directive ("MiFID")' (IP/07/547, April 2007).

[197] Silla Brush, 'More than half of the EU Is Still Racing to Comply with MiFID Rules' *Bloomberg News* (18 October 2017).

[198] Joel Lewin, 'MiFID II preparation could cost firms $2.1bn—report' *Financial Times* (29 September 2016).

[199] Commission/Synovate, 'Consumer Market Study on Advice within the Area of Retail Investment Services' (Final Report 2011).

[200] SCM Direct, 'SCM Direct Research into Cost and Fees Reporting in the UK Post MiFID II Legislation' (12 February 2018).

[201] Ibid, 9.

[202] Ibid, 10.

F. Packaged Retail Investment Insurance Products (PRIIPS)

36.88 Another gap in the MiFID II regime is that it does not apply to insurance-based investment products. Insurance-based investment products (IBIPs) are also known as endowment insurance products. The Packaged Retail Investment Insurance Products (PRIIPs)[203] Regulation applies to such products and introduced this technical term to insurance law. PRIIPs requires that the sale of such products be accompanied by a Key Information Document (KID) that describes the risks and is not misleading.[204] IBIPs expose retail investors to the risk of capital loss (directly or indirectly) subject to market fluctuations. However, they are also often linked to capital life insurance, unit-linked life insurance and hybrid products. This type of investment product acknowledges that life insurance contracts cover biometric risks and frequently contain an investment component (with risks and opportunities) intended to offer value to policyholders both in the event of death and survival.

36.89 The PRIIPs Regulation defines IBIPs as insurance products which offer 'a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations'. IBIPs generally are not subject to MiFID II regulatory controls on product regulation, conflicts of interests and remuneration. Instead, IBIPs have been subject to lighter touch regulation under the Insurance Mediation Directive (IMD), which contains only minimum restrictions on the design and distribution of products and minimal restrictions on remuneration. The IMD has since been replaced by the Insurance Distribution Directive (IDD) in October 2018.[205]

36.90 Under both PRIIPs and the IDD, there is an obligation for the issuer of IBIPs to produce a KID and additional requirements for distribution stipulated in the IDD Implementing Act that covers advice and sales. MiFID II and the IDD have similar principles for the regulation of product design and distribution, such as the general duty to act honestly, fairly, and professionally in accordance with the customer's best interests (Article 17(1) IDD reflecting Article 24(1) MiFID II). Although they contain similar principles, there are significant differences between MiFID II and IDD. There are higher protections under MiFID II. For instance, IDD has no separate conduct of business rule on product governance (equivalent to

Copyright Material. Not for distribution.

[203] European Parliament and Council Regulation (EU) 1286/2014 of 26 November 2014 on key information documents for packaged retail and insurance-based investment products [2014] OJ L352/1 (hereafter PRIIPs).

[204] See Commission Delegated Regulation (EU) 2017/653 of 8 March 2017 supplementing Regulation (EU) 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products (PRIIPs) by laying down regulatory technical standards with regard to the presentation, content, review and revision of key information documents and the conditions for fulfilling the requirement to provide such documents [2017] OJ L100/1. The Commission's Delegated Regulation for PRIIPS requires that the KID is limited to three pages and must contain a description of (1) purpose; (2) the product; (3) what are the risks and expected returns?; (4) what if the underlying PRIIPS issue is unable to pay out to the investor?; (5) what are the costs?; (6) how long must the investor hold the product before selling it?; and (7) complaints procedure.

[205] See Publications Office of the European Union, 'National Transposition measures communicated by the Member States concerning: Directive (EU) 2016/97 of the European Parliament and of the Council of 20 January 2016 on insurance distribution' (2019) <http://eur-lex.europa.eu/legal-content/EN/NIM/?uri=CELEX:32016L0097> accessed 10 February 2020. See Proposal of the Commission to postpone the implementation of the IDD to October 2018 <http://www.fca.org.uk/news/news-stories/update-proposed-delay-insurance-distribution-directive-idd> accessed 10 February 2020.

Article 24(2) MiFID II). Also, MiFID II and IDD have different conduct of business rules for inducements, independent advice, and investor protection.

36.91 Regarding inducements,[206] MiFID II prohibits all inducements with limited exceptions, whereas the IDD permits insurance intermediaries/undertakings to receive inducements so long as it is part of '*fulfilling their obligations*' to their customers and if not detrimental to the quality of service and duties to act honestly, fairly, and professionally in the customer's best interests. The IDD provides minimum harmonization in this area while Member States are allowed to have stricter '*super-equivalent*' provisions along the lines of the UK Retail Distribution Review.

36.92 Regarding '*independent advice*' MiFID II has strict rules regarding disclosure to the customer about whether the adviser is providing independent advice. Moreover, the provision of independent advice must involve advice on a wide variety of products, and also comply with the inducements regime (Article 24(7) MiFID II). In contrast, the IDD has minimum harmonization rules on the provision of independent advice and Member States are not required to restrict inducements (ie bonuses) for the provision of independent advice.

36.93 Moreover, for investor protection, MiFID II has a much stricter distinction between retail and professional investors and limits the ability of the firm to upgrade a retail investor to professional investor status unless certain assessments are completed regarding investor's suitability to be treated as a professional investor. In contrast, the IDD has no such distinction between retail and professional investor. This is a significant difference in treatment regarding the sale and distribution of MiFID II products and IBIP products governed under the IDD.

Copyright Material. Not for distribution.

VII. Summing Up—EU Financial Services Legislation—Levels 1 and 2

36.94 The EU legislative framework follows a sectoral approach to financial regulation involving the sectoral authorities—the EBA, ESMA, and EIOPA[207]—adopting regulatory and implementing standards that reflect the sectoral focus of Level 1 and Level 2 legislation. Where financial firms and their investment products serve and have similar functions and characteristics, this sectoral approach may overlook gaps and overlaps that can result in more unnecessary fragmentation and segmentation in the markets. Another regulatory risk arises where the prudential supervision objectives of the CRD IV, for example, are often at odds with the investor and consumer protection objections of other EU legislation, such as MiFID II, because lower and more transparent costs in financial products might limit bank profitability and in some cases undermine their solvency and stability.

36.95 An important development going forward is that the CRD V Regulation and Directive[208] (CRD V Package) have the aim of making prudential regulation more proportionate. One

[206] Colaert, 'MiFID II in Relating to Other Investor Protection Regulation' (n 124) 596.
[207] See Chapter 20.
[208] Commission, 'Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulation (EU) 575/2013 (EU) No 600/2014 and (EU) No 1093/2010' COM (2017) 790 final, 3–4.

way the CRD V does this is by making the regulation of securities and investment firms that are deemed to be systemically insignificant less stringent as part of the Capital Markets Union initiative that is designed to increase the flow of capital to European companies and entrepreneurs from non-bank finance sources.[209] Specifically, the CRD V reforms propose to reduce capital, liquidity and risk management requirements for certain investment and securities firms (including investment firm groups without a credit institution) that are currently subject to the CRD IV. CRD V would create a category of securities and investment firms that would be deemed to be non-systemic and thus subject to much less stringent prudential requirements. CRD V aims to make prudential regulation for securities and investment firms more proportionate to the risks that they pose to the financial system and economy. It is also designed to support the objective of loosening regulatory requirements for securities and investment firms and companies seeking to raise capital in the EU markets.

36.96 However, a few systemically important investment firms, defined as such under Article 131 CRD IV, would still be subject to the CRR/CRD IV capital, liquidity and risk governance requirements because these firms incur and underwrite risks (both credit and market risks) on a largescale basis in the EU single market. The rationale for subjecting smaller and systemically less important institutions to exemptions from the CRD IV prudential requirements is based on the lower level of perceived systemic risk they pose to the financial system.[210] This is meant to provide a 'more streamlined regulatory toolkit' to allow these firms to provide services more efficiently across different type of business models and to adjust prudential requirements accordingly to reflect the diminished systemic risk they pose to the financial system.[211] An important omission in the CRD V package, however, remains that it does not address the financial stability risks that appear to be emerging the EU shadow banking market.[212]

36.97 The CRD V package is likely to make a great deal of further regulatory adjustment necessary including renewed reform of capital and liquidity requirements under the Basel Accord 2017 reforms that allow banks to rely less on internal ratings-based models by limiting the reduction in risk-based assets to not less than 70 per cent of the standardized approach and stricter counter-party margining requirements. These proposals, among others, are contained in the draft CRR III and will apply the proportionality principle further to take into account the specificities of Member State markets as well as the European market.

36.98 Other weaknesses in the EU framework include that it is piecemeal and lacks common concepts and terminology. For instance, MiFID II should perhaps have covered also insurance-based investment products (IBIPs) which are generally considered to be substitutes for certain financial instruments and structured deposits which are subject to MiFID II's conduct of business rules. These differences lead to segmentation risk and to regulatory arbitrage.[213] As mentioned, EU supervision is sectorally divided (MiFID: ESMA/IDD: EIOPA)

Copyright Material. Not for distribution.

[209] See Chapter 35.
[210] COM (2016) 854 final.
[211] COM (2017) 791 final, 2.
[212] COM (2016) 854 final.
[213] Colaert, 'MiFID II in Relating to Other Investor Protection Regulation' (n 124) 988–89; Kern Alexander, 'Marketing, Sale and Distribution. Mis-selling of Financial Product' (2018) ECON Committee <http://www.europarl.europa.eu/RegData/etudes/STUD/2018/618996/IPOL_STU(2018)618996_EN.pdf> accessed 10 February 2020.

between the ESMA and EIOPA. This hampers creation of a true regulatory level playing field for all investment products within the EU internal market. The EU sectoral approach to regulating differently investment products that have similar economic characteristics should be reconsidered, as different regulatory approaches for these products lead to segmentation risk and regulatory arbitrage.

36.99 The chapter also discusses how the MiFID II and MiFIR regime has become core to EU financial product and investment services law. Nevertheless, the MiFID II/MiFIR rules contain some gaps in coverage leading to segmentation in the types of investment products covered, while Member State transposition has not been uniformed or timely. Further, evidence suggests that the industry is not disclosing the full costs of investment products in a clear and unambiguous way. These issues could be addressed through concrete EU guidance, aimed at assuring Member State competent authorities' have adequate capacities to achieve stronger supervisory convergence, which may occur in the future through the implementation of the Capital Markets Union.

Copyright Material. Not for distribution.