How Current Financial Legislation Wrestles with Individual Liberty: The MiFID II / MiFIR Case

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Abstract

The entry into force of the 'Package' made by Directive 2014/65/EU (MiFID II) and Regulation (EU) No. 600/2014 (MiFIR) strengthens the call for advocating the principle of financial freedom, even in a world profoundly reshaped by the 2007-2009 crisis. The legislation *de quo* sets forth new constraints upon the industry – in particular, investment banking and asset management – by establishing a greater degree of investor protection, in a way which significantly limits the ability of non-professional parties to engage in financial operations. In theory, this aims to reduce information asymmetries and smooth the functioning of markets; actually, it wrestles the view of a self-determining individual, able to bargain with credit institutions and investment firms in a context where both parties can take responsibility for their actions. This is the dismal result of a diminishing concern not only for *individual liberty* – as if the crisis had exposed retail investors to be unable to engage in operations involving even a minimal understanding of risk-return mechanisms – but also for *market freedom*, because the distortions stemming from heavier compliance requirements end up threatening the 'level playing field' that they are intended to promote. The paper highlights the contrast between MiFID II / MiFIR provisions and the approach historically followed by many European legislators, based on classical economic rights, which shaped 'contract law' without making any discernment between financial contracts and different ones. Finally, some policy implications – envisaging a liberty-oriented revision of the Package – are laid down.

1. Introduction

Economic liberalism has always regarded market players – producers or consumers, regardless of their size – as endowed with an inalienable right to act freely for their own sake. By the powerful effects of *human action* (Mises, 1949), a spontaneous order going toward the equilibrium gets created, as Smith (1776) had already expressed in his most famous *oeuvre*.

From that point in history up to present day, the economic system has experienced an outstanding evolution, mainly thanks to that technological progress which would have not sprung so widely had centralised government constrained and directed the development of ideas (Friedman, 1962). At the same time, liberalism has progressively unbound itself from that proto-industrial world which inspired Smith and would have been the background of

many "classical" thinkers (including Marx). Yet, the intrinsic value of the individual as a free agent – able to determine his/her own economic fate whichever the "rules of engagement" and the institutional environment – has survived throughout these twenty-four decades. We have no reason to deny that this applies to the financial universe as well as the so-called 'real economy'. In particular, as we shall see, the birth of financialization cannot be disentangled from the advancement of 'real' markets.

Still nowadays, in a capitalist framework, every economic interaction appears as a conjunction of legitimate interests. This makes the underlying economic relationships based not on exploitation and undue appropriation, as advocated by Marxists, but on the counterparties' free will (Nozick, 1974). That famous statement by Smith (1776) keeps an intact validity: *It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest*. Notwithstanding the astonishing changes in both economic science and moral philosophy, the former continues being an axiom from which we cannot prescind to judge the relationship between financial intermediaries and their clients.

Over the last years, there has been an increasing amount of studies inquiring on the link between psychological dynamics and investment decisions, signalled by some Nobel Prizes being awarded to eminent behavioural economists. At the same time, a growing number of scholars have focussed on the roots of periods of financial distress, which both the Marxist and the Keynesian schools of thought deem to be quintessential to capitalism, so that they would occur somehow "cyclically". Combined, these two academic trends have stirred the regulator's concern for a deeper and wider intervention: the objective was to amend those alleged deficiencies that might be harmful not only to the weakest parties in financial transactions (at a *micro*- level) but, also, to systemic stability (at a *macro*- one).

Coming back to the philosophical background of the theories commonly used to investigate the functioning of financial markets, we should acknowledge that none of the 20th-century systems has managed to disentangle that very basic idea popularised by the Austrian 'marginalist revolution': namely, that economic interaction is possible thanks to – and inherently made of – the unintended consequences of intentional actions (Wundt, 1886). If we just thought of the word *speculation*, we would find not only that its meaning in the financial realm is substantially neutral (without that negative characterisation often attached to it in common language) but, also, that speculators' and promoters' action is essential to *direct production into those channels in which it satisfies the most urgent wants of the consumers in the best possible way* (Mises, 1949), thus representing a pillar of that complex

mechanism that we generally label 'market'. Therefore, the EU legislator's suspicion towards investors whose action is merely 'speculative' may have its historical reasons, but is theoretically misplaced.

We are now going to review how such idea was borne, evolved, and has been addressed during recent years.

2. The idea of investor protection over time

The concept of 'investor protection' is probably the first that comes to mind when thinking of MiFID, either the first or the second Directive. Before it, the idea that the weakest party in financial relationships should have been adequately protected was present but not very well developed. In civil and commercial law – which can however be surpassed by sectoral legislation, pursuant to the *lex specialis derogat generali* principle –, contracts have often been intended in the way in which Nozick (1974), drawing up on the 'economic analysis of law' (EAL) strand, would have used as the fundament of this philosophical system: namely, as the legitimate encounter of free wills.

In the Napoleonic Code, as well as in all the civil-law legislation derived from it in many European countries subjected to the French rule, contracts were seen in that way: classical economic rights were upheld with no relevant exceptions. Of course, abuses would have been punished: this occurred when a counterparty, aware of another's objective weakness, exploited that situation to shape the contract in its favour and, thus, get some undue advantage. In other words, the French revolutionary tradition – based on the same pillars as classical liberalism applied to the juridical matter – intended to preserve the parties' freedom to agree on specific terms, even if detrimental to one or more of the participants, provided mutual "good will" had presided over the agreement. Besides, no discernment was made depending on the realm to which a contract belonged, albeit some regulatory interventions have actually succeeded over time in various countries (*e.g.*, in respect of housing and real-estate rents).

Unlike the very investor-friendly United Kingdom, where finance had played a large role since the 19th century, US financial markets faced increasing regulation over time. In a very young nation, where individuals were struggling against the twofold frontier of nature and human possibilities to build a free society, there was huge room for investments. The vast

majority of the first inhabitants of America – especially in those territories west of the thirteen founding colonies – were financially in *deficit*. Therefore, financial services started being provided under a framework whereby the interests of clients were taken in much greater consideration than those of capital owners.[1] The 2010 Dodd-Frank Act represented a renewed legislative commitment towards constraining banking activities onto less risky ones, unlike what had been pursued in the past (so-called *Volcker Rule*)[2]. Throughout years, deregulation has been a reality, but what cannot be established without ideological prejudices is the link between liberalised financial services, on the one hand, and the propagation of GFC effects, on the other.

Supervision had its faults, thoroughly addressed by the 2009 De Larosière Report; EU legislation had its own guilts, as MiFID I was far from ensuring a perfectly levelled playing field and an improved efficiency of financial markets. Yet, much of the criticism moved onto the Directive started from the ideological assumption that an insufficient degree of regulation had prompted supervisors to exert insufficient control upon overseen entities. In turn, these latter had been able to disregard transparency requirements, widen information asymmetries in their exclusive interest and detrimentally to clients, originate and distribute products encompassing a significant component of systemic risk. Under a macroeconomic point of view, they should not be intended as the financial version of that statist view which deems the general interest to be prominent *vis-à-vis* individual rights. These last, in fact, should reasonably be conceived as the only ones to exist and, thus, deserving protection from a superior entity, though of a minimal extent (Rand, 1964). Conversely, it should be thought as a tool to preserve individual investors from the damage potentially caused by wrong decisions taken by others in light of the 'freedom to choose' that every market participant, in every market, is endowed with.

Since globalisation has made the world smaller,[3] individual interactions have become increasingly closer ad, thus, the effect of a single financial decision – especially if involving relatively high amounts of money – may well either influence other people's choices or have

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([1]) It should also be noted that the antitrust *vogue* started at the end of the 19th century did not spare finance, as a strict banking legislation prohibited credit institutions from geographically expanding their activities: *de facto*, banks were forcedly circumscribed to a single State or a few bordering ones. With the passage of time, this principle will have been mitigated, but not fully rejected.

([2]) Named after the former Fed chairman Paul Volcker, it prohibited banks from engaging in proprietary trading *tout court*, without any discernment between different kinds of products or instruments.

([3]) The idea of a 'small world' – academically given by the notion of 'global village' by McLuhan (1968) – was explicitly mentioned by then Italian Prime Minister, Giovanni Goria, in a popular TV appearance in 1988 where he was asked of the effect of dollar fluctuations onto the Italian pound.

an impact on their financial results. If transparency – labelled as *the best of disinfectants* by US Supreme Court justice Louis Brandeis (1913) – were not a value *per se* (it enhances the efficiency of price formation), a "neutral", non-ideological legislator could not state that information improves performance in an economic environment. Throughout these last years, we have seen that many episodes of "panic" have been driven by the uncontrolled spread of information, not always consistent with the underlying reality, with self-fulfilling effects.[4]

Markets convey signals and transmit incentives; they do not offer universal solutions for financial problems that differ from individual to individual. Besides, financial chronicles have worried the EU legislator with the idea that HFT is intrinsically a source of systemic risk. This belief may be true, but only if we qualify such risk as a 'tail' one: that is, very unlikely to occur, but very pernicious upon its occurrence. This correctly means that, for one time in which it triggers or magnifies turbulences, there are much many others in which HFT supports market efficiency, as well as liquidity, hence turning out being extremely beneficial not only for traders which employ it, but even from a market-wide standpoint. The EU legislator has actually failed in acknowledging this; hence, such huge innovation is still seen under great suspicion.

It is unfortunately true that *regulation often comes after disasters* (Gordon, 2000), and this is exactly the reason why it struggles to deliver on its purposes: rules are designed to address "pathological" conditions rather than "physiological" ones. MiFID I partially succeeded in avoiding such negative feature, as it was the response to a more limited crisis[5] and – most importantly – came when long-term trends were undoubtedly pointing to growth and development. At that time, although approaching to an end, the so-called 'Great Moderation' (GM) still promised a shining future.[6] Counterfactual history is always a difficult exercise, yet we have all the rights to theoretically claim that, had the GFC not occurred, we would not have come to discuss whether and how current legislation wrestles with individual

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([4]) This repeatedly occurred during the sovereign debt crisis of various European countries (mainly the so-called 'PIIGS') between 2011 and 2012: at that time, irresponsible *deficit*-oriented fiscal policies scared investors much more deeply than the actual macroeconomic conditions. In fact, with the possible exception of Greece (and perhaps of Ireland, where a severe banking crisis was taking place), they showed deteriorating yet still viable fundamentals. The waterfall effects stemming from the sudden rise in the cost of sovereign bond issuances, triggered by panic sell-offs of those securities, eventually impaired those fragile economies.

([5]) Basically, the intertwining between the short recession following 9/11 attacks and the *dot-com* bubble.

([6]) It was a period, started in the second half of the Eighties, characterised by low interest rates, low inflation, rising output, and – most importantly – relative stability, meaning low volatility, in respect of many market fundamentals. It had been the glorious era of deregulation, especially in the realm of international trade, but also that in which many pieces of soft legislation regarding financial industry – *e.g.*, the first two rounds of the Basel Accords – had been passed.

liberty. The logical obstacle, however, is given by the fact that many of the commonly-accepted causes of the GFC – 'easy credit' policies (Jagannathan *et al.*, 2013), excess liquidity created by means of illiquid assets (Ackermann *et al.*, 2008), loose monetary policy suddenly reversed by a tightening which crowded investors' expectations out (Cabral, 2013), and so on – did contribute to determine the GM. Hence, they can hardly be disentangled from it.

Between 2007 and 2008, the *alchemy* (King, 2016) built over previous years, along with the idea of promoting investors' freedom to choose, started being blamed as the source of turmoil. As many episodes of government intervention (*e.g.*, the American TARP) have actually shown, the rescue of global economy was often pursued with disregard of market players' individual liberty, regardless of their size. We are now going to detail and prove our statement in respect of the MiFID II / MiFIR package.

3. The Package discipline and its weaknesses

The *rationale* of investor protection has always been found in the information asymmetries which separate the providers of investment services, or the performers of investment activities,[7] *vis-à-vis* the recipients of such services/activities.[8]

Before the Package, the *Prospectus Directive* (No. 2003/71/EC) had not represented any tilt towards the "modern" idea of investor protection, albeit it was centred around corporate stocks being admitted to trading and, thus, potentially harming the overall stability in case of too weak financials. In Europe, there had been many situations in which investors suffered damage from an unfaithful representation by the companies wherein they had

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(7) The two phrases are often intended as synonyms, in the Package itself as well as in many implementing legislations at a domestic level. Yet, some national legislations – *e.g.*, the Dutch one – have actually discerned between them.

(8) However, there are significant differences across industries: in banking and insurance, counterparties might be the least viable ones (*adverse selection*) or might behave in a way inconsistent with their obligations (*moral hazard*). As of the underwriting of units of a collective investment scheme (CIS), as well as the purchase of a security, the uncertainty yielding the asymmetry is much more on the seller's side, as this latter is often represented by an 'institutional' subject, endowed with far more awareness of that product's risk than the vast majority of clients.

invested.[9] The EU legislator viewed this in the most simple and unquestionable manner: a breach of contractual bonds.[10]

MiFID I had amended but not rejected the approach upholding classical economic rights in an undifferentiated manner, without making any discernment between financial and non-financial contracts. Starting from the abovementioned piece of EU legislation, the regulator had thought 'client categorisation' (CC) as the major tool to enable investor protection without directly disrupting markets. However, the effect of some CC-based rules could be particularly pervasive: in fact, the performance of certain activities, or the provision of certain services related to certain instruments or products may be prohibited to certain groups of investors, with a clear limitation of their private autonomy.

The EU legislator envisages three main categories, reflective of investors' knowledge, skills, and experience. If a subject meets the characteristics laid down in *Annex II* of the Directive, it is deemed to be a *professional client*; otherwise, it is residually a *retail client*. A third category – actually, a subset of the former – is that of *eligible counterparties*, made of subjects which in some specific cases may ask to be classified in that way (hence, *via* an opt-in mechanism). This is consistent with a more general *elevator principle* – which allows a subject to be classified differently from its default categorisation – is extended to the passage between retail and professional clients: if seeking for less protection (and, thus, more investment opportunities), the former may ask to be treated like the latter, the reverse occurring if the investor desires tighter protection. This is a surprisingly liberal provision which helps mitigating the overall *rationale* of investor protection in MiFID II: thanks to it, a financial

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([9]) As for Italy, the Cirio and Parmalat cases (exposed between 2001 and 2003) are the most noteworthy ones.

([10]) There is a whole literature on the "liberal" inspiration of contractual laws, especially those based on EAL. Under such framework, the EU legislator seems particularly concerned of abiding by – at least – the *Hobbes' normative theorem*, claiming that law should minimise the harm brought by the failure of private agreements: thus, it should avoid 'coercive threats' and prevent disagreements from being disruptive. The *rationale* is that, if an agreement fails, the mutual benefits that it would have generated get lost. Outside financial markets, this is the case in which a company becomes non-viable and, thus, remaining invested in it – hence, continuing the contract – becomes a suboptimal choice: the investor would want his/her money back but, once obtained this, s/he would have lost an investment opportunity, whereas the company would rely upon a narrower capital base. Conversely, if the company gets admitted to trading, the investor would be able to sell his/her shares (before their value gets furtherly impaired) to another which tendentially values them the most. Since this keeps capital allocation efficient, the company would not be harmed, unlike the investor. Therefore, seeing the problem with the lenses of contract law, the call for investor protection gets increased, for it is viewed as the 'necessary evil' to defend private autonomy (or, more specifically, *libertas contrahendi*) in its broader sense: namely, the individual's ability to take a decision – even a microeconomically irrational one – without external interferences, and by relying on a complete set of information.

player is still allowed to self-assess its profile and, thus, make its own choice regarding the trade-off between opportunities and protection.[11]

The 'elevator mechanism' works under strict provisions set forth by the Directive. More specifically (Annex II, section II), *in order to waive some of the protections afforded by the conduct-of-business rules*, the EU legislator requires *an adequate assessment of the expertise, experience and knowledge of the client*, for the purpose of giving *reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making investment decisions and understanding the risks involved*. This prompts us taking a little step backwards to discuss the pillars on which the whole of the investor-protective architecture is based. We can find three of these pillars:[12] *(a)* product governance; *(b)* product intervention; *(c)* rules governing the relationship between intermediaries and their clients. The difference between product 'governance' and 'intervention' appeals to the semantic difference between the two words, which in turn reflect two major approaches used by regulators throughout history: either *prudential* (nowadays the most common), based on the idea that overseers should not distort the 'structure' of the market by directly ruling the business, or *structural*, advocating the latter supervisory style instead.

The third pillar, however, is the one which has faced the largest overhaul during recent years, for it has been increasingly intended in a way which we could define as a 'cradle-to-grave' approach.[13] As if the former were a baby, incapable of taking care of himself/herself, the Package advocates a thorough commitment, by the provider of financial services (in

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([11]) A perfect allocation within those categories would probably occur only in a perfect world, which – as we have seen – the EU legislator sometimes seems to unrealistically assume. As a matter of fact, however, the elevator works frequently downwards and rarely upwards, for in troubled times every potentially experienced investor – *e.g.*, high-net-worth individuals – prefer adopting a more prudent approach, accepting the regulatory constraints not to engage in certain operations. It is a curious case whereby the recipients of supervision, instead of attempting escaping it, wants the oversight to be stricter. Of course, had the elevator mechanism being in charge during GM years and not only GFC ones, we would have witnessed the reverse trend, as low (high) volatility plainly makes riskier investments relatively more (less) financially convenient.

([12]) See Prof. Carmine Di Noia's hearing at the Italian House of Deputies on 15 June 2017: *http://www.consob.it/documents/46180/46181/Audizione_DiNoia_20170615.pdf/ae0afeb1-ca1a-4b83-a5b8-246e9e6c398a*

([13]) The parallel with Lord Beveridge's (1942) idea of welfare state might be surprising, if we consider all the differences between the two historical periods: when that *Report* was published, Britain was suffering from both war and the Thirties' recession; today, notwithstanding the GFC, the situation is completely reversed: all over the world, globalisation – inherently connected to free markets – has steadily contributed to reducing poverty and expanding personal incomes in those countries where capitalism can unleash its potential. This has been possible because capital can flow much more freely than before, and peace is supremely ensured all over the capitalist world. Hence, there would have been no reason to revive that pernicious fashion of the years from the Forties to the Seventies, yet this is what has been happening since the GFC outbreak. Nowadays, the retail investor may be seen as the equivalent of a working-class person in wartime Britain.

particular, portfolio management), toward *the best interest of the client* (Article 24^{D}, par. 8). Another surprising element is the absence of any substantial mitigation of such principle, as we are going to see. If the 'manufacturer' and the 'distributor' of a financial product do not coincide – something which is increasingly common, given the complexity of modern financial markets –, the Package mandates specific attention to be paid, the *rationale* being that the double layer of financial intermediation represents *per se* a threat to clients' interests. In fact, reality – though after the Package being approved – has rather proven the reverse. For instance, several misconduct cases have actually occurred whenever credit institutions have placed to their depositors the products they had manufactured: *e.g.*, subordinate debt instruments whose inherent risk had not been fully understood by such retail clients.

In addition to CC, the other relevant issue concerning investor protection addressed by the Package – but, still, resembling MiFID I provisions – is about the 'suitability' and the 'appropriateness' principles, along with the 'best execution' of client orders. First of all, we should remark that the Directive does not show the noun *suitability* or the adjective *suitable* only in the technical meaning that we are going to clarify: actually, the legislator invokes them in different context and for different purposes.[14]

Both principles are currently enforced by means of *ad hoc* questionnaires ('tests') aimed at assessing various clients' characteristics. *Suitability* takes into account the investor's general features for "profiling" purposes;[15] *appropriateness*, instead, has a more refined purpose: once detected the investor's general profile, the regulator wants to ensure that the intermediary provide a valuable service to *that* single, specific investor, for *that* specific instrument, in *that* specific moment in time.[16]

In particular, the EU legislator seems to have somehow revived its commitment toward preserving private autonomy by envisaging that the appropriateness test may be waived if all the following conditions are met (Article 25^{D}, par. 4): *(a)* the instrument to which the service

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([14]) For instance, competent authorities are charged with the duty of ensuring that direct electronic access (DEA) of trading venues gets provided to market participant in a 'suitable' manner (Article 17 MiFID II, par. 5), such that risks potentially contributing to a disorderly market may be prevented from arising.

([15]) In the test aimed at assessing it (imagine dealing with a retail client who is a natural person), we may find questions about the client's household's composition, monthly revenues and expenses, financial obligations toward third parties (both in terms of periodic outflows and outstanding debt), security and real-estate holdings, his/her investment profile (risk-averse *vs.* risk-loving attitude), along with the preferred time horizon and the reason underlying investment choices (saving for retirement, income smoothing, *etc.*).

([16]) In order to deliver on this, questionnaires must necessarily investigate more personal and contingent information: they include education, job, frequency of update on financial markets, knowledge of basic economic dynamics (e.g., risk-return association, the meaning of certain types of risk, *etc.*), the client's financial behaviour in terms of operations recently undertaken, their monetary amount, the products invested in, *etc.*).

is related fulfils specific criteria which allow it for being considered as non-complex; *(b) the service is provided at the initiative of the client or potential client*; *(c)* this last has been *clearly informed*, even by means of a warning *provided in a standardised format*, about the lacking appropriateness test; *(d)* the investment firm complies with its obligations regarding conflicts of interest, pursuant to Article 23^{D}. As we may see, the legislator ends up devising a heavy set of conditions. In particular, we should consider that 'non-complex' is a quite narrow label; moreover, condition *(b)* is not as burdensome as conducting an appropriateness test, but nonetheless accrues the ponderous number of supervisory requirements charged by the Package upon intermediaries. In a world which moves at increasing speed, opportunity costs associated with compliance should not be underestimated. Furthermore, we shall see how the 'conflicts of interest' issue has been very inefficiently addressed by the EU legislator.

As of the *best interest of the client* objective, we should not think that this be pursued by means of the suitability and appropriateness tests. Instead, it is something different: in Recital 71^{D} – reprised by Article 24^{D}, par. 2 – is mandated that the Member States not only ensure that investment firms act in accordance with the best interests of their clients and comply with what is provided for by the Directive, but also that those entities *establish and review effective policies and arrangements to identify the category of clients to whom products and services are to be provided*. More in detail, the reference is to both the 'manufacturers' and the 'distributors' of the products, in a way which allows to *meet the needs of an identified target market of end clients within the relevant category of clients.* This – labelled *know your merchandise rule* by the doctrine – is the most radical version of the appropriateness principle: even before administering any test to the single investor, the intermediary is required to circumscribe its counterparties and, thus, fine-tune the provision (performance) of its service (activity) to what is most financially advantageous to the group of clients identified in such way.[17]

In addition to suitability and appropriateness, another principle set forth by MiFID II – as well as its predecessor – is the so-called 'best execution'. It envisages that, when a firm executes orders, *it must take all reasonable steps to obtain the best possible results for its clients*

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(17) Once that data will have become more widely available – that is, once a good number of MiFID2-compliant questionnaires, different from those based on MiFID I, will have been administered over a sufficiently large time horizon –, behavioural economists would tell us whether such treatment actually yields different choices by similar investors depending on whether they 'received the treatment' (namely, they answered the questionnaire). While waiting for such research be materially possible, we might discuss whether the method is a valuable one from an individual liberty standpoint.

taking into account the execution factors.[18] These are all of the most common characteristics of a transaction in financial instruments: price, costs, speed, execution and settlement, size, nature, and so on. The MiFID legislation stresses the need for 'appropriate information' as an essential requisite for 'best executing' client orders. This encompasses provisions that are not directly referred to investor protection but are nonetheless deemed to be relevant for the orderly functioning of exchanges: on the one hand, we have the requirements charged on market operators (in particular, on their management bodies); on the other, the discipline of inducements related to the provision of investment advice.

This prompts us considering, more in detail, how 'information' is dealt with by the Package. It is easily understandable that, while too few information is a problem, the same should be told in case it be overwhelming. Although with reference to the online-available knowledge, some even posit that an information overload equals the absence of it, and may eventually lead to manipulating decision-making (Persson, 2013). In respect of this issue, the parallel between the Package and consumer-oriented legislation is particularly striking: in Article 24[D], par. 3, we may read that *all information … shall be fair, clear and not misleading* with the obligation to explicitly label any marketing communications. In par. 4, the term 'appropriateness' is referred to the set of information provided to clients or potential ones *in good time* (that is, by allowing the recipients to carefully read and analyse them), regarding not only *the investment firm and its services* but also *proposed investment strategies, execution venues and all costs and related charges*. This provision is followed by a list showing the content of such information: first of all, it must be stated whether the advice *is provided on an independent basis* or, alternatively, is given by a 'tied agent' acting on behalf of a specific firm; then, the 'scope' of the investment must be clarified; finally, such disclosure has to declare whether a *periodic assessment of the suitability of the financial instruments recommended* is scheduled.

Moreover, the second category of information to be necessarily released is the one dealing with *appropriate guidance and warnings on the risks*, also including the declaration on whether that specific instrument *is intended for professional or retail clients*, still in light of the principle of identifying a 'target' for any product and addressing all the advice to potential clients referable to that target. Finally, "direct" costs to be disclosed are related to *both investment and ancillary services*: hence, they encompass amount to be paid by the client, the disbursements to be faced by third parties (if any), and the cost of advisory itself.

([18]) See Q2 of the CESR Q&A on MiFID I, published in 2007 (*www.esma.europa.eu/sites/default/files/li-brary/2015/11/07_320.pdf*)

The wording above plainly shows that investor protection – declined in terms of suitability and appropriateness – is not intended under a "static" point of view, but rather a "dynamic" one: the outcome of those tests has to be compulsorily reviewed over time, as previous conditions might rapidly change in an evolving economic environment. In this way, the whole of the *alea* incorporated in any financial contract turns out being significantly reduced, and the contract itself converges towards non-financial types, at the cost of a remarkable compliance burden to be borne by intermediaries. Moreover, such MiFID II provisions seem not to consider the importance of legal certainty, for the review of suitability and appropriateness may well end up terminating the contract well in advance of what could have been rationally expected. Even more harmfully, this might happen because of changes not in market conditions – which occur physiologically, as no one would assume to rely upon exactly the same inputs over time (Hayek, 1941) – but in the investor's personal situation. Again, the legislator's good intensions are very likely to backfire.

Article 24^{D}, par. 4, also encompasses one of the most important principles followed by the legislation: that is, clients' right to fully and effectively understand the more technically financial aspects of what is offered to them: not only in terms of return, but – most importantly – in relation to *all costs and associated charges* linked to it, without anything hidden. This encompasses the expenses or losses – or, with more neutral wording, *the effect on cumulative return* – yielded by something other than *the occurrence of underlying market risk*. Moreover, such information must be disclosed *on a regular basis*, meaning *at least annually*, and the Member States are even charged with the mandate of ensuring that such communication occur in a proper and efficient way (that is, mainly in standardised formats). The GFC has clearly shown how the detection of risks different from "plain" market ones – in other words, what is often labelled as a 'black swan' (Taleb, 2007) – is often an "oracular" exercise.

Did someone think that Lehman Brother was on the brink of default when it actually went bankrupt? Not at all. Investors are sometimes driven by panic reactions, yet the vast majority of times they rely upon rational expectations, whose primary source is represented by authoritative institutions' analyses and opinions, like those of credit rating agencies (CRAs). Since the GFC has exposed that CRAs – as well as many other analysts – are subject to dramatic failures in their judgement, it will not be one line in a EU piece of legislation to change the way in which expectations get formed. This would require a complete "paradigm shift", which takes years to occur. The EU legislator seems to assume the omniscience of

market players, but this does nothing to refute the basic notion of human fallibility, which in finance is more evident than in any other field (and today like never before).

From an individual liberty standpoint, another debated issue is the one of investment advice being provided *on an independent basis*. The criteria to be match for that definition to apply are laid down in Article 24[D], par. 7: first of all, a wide and 'diverse' range of financial instruments – instead of a narrow or too little diversified one – must be presented to the client, with the prescription not to be limited to what is offered by a single investment firm or its related entities. Moreover, in abidance by the "popular" meaning of independence, the investment firm must not accept *fees, commissions or other monetary or non-monetary benefits* from third parties. Actually, inducements are limited to *minor non-monetary benefits*, provided that they do not bring prejudice to the investment firm acting in the client's interest but rather enhance the *quality of the service*.[19]

These rules are not criticisable *per se*, as they correctly circumscribe the meaning of 'independence', something that should theoretically prompt investors to better decide when advised on a given investment. However, in light of the pre-existing structure of the investment industry, they are often regarded as disproportionately burdensome. Moreover, the Directive does not waive 'tied agents' from abiding by the supreme rule of acting in the client's best interest. The outcome is a clear paradox: on the one hand, the advisor's independence is valorised by means of an express definition; on the other, it is not significantly separated from different situations, with a definite increase in the overall regulatory charge.

4. Conclusions and policy implications

As we have seen, the legislator of the Package is much more concerned with ensuring market stability than preserving the players' freedom to choose. However, looking at those provisions merely from a system-wide, *macro*-oriented standpoint would not allow us to

([19]) Further provisions are laid down in respect of portfolio management, the disclosure to clients of the minor benefits allowed, the prevention of conflicts of interest and market abuse, the consistency between compensation practices and the investor-protective inspiration of the Directive, the compulsory disenfranchisement of the costs and charges in case of bundled products, and the duty to inform clients about the possibility to have them sold separately (Article 24[D], paragraphs 8-11). Other MiFID II articles deal with the records that intermediaries are bound to collect, store and disclose when providing investment services.

understand the interactions between investors' *individual liberty*, on the one hand, and the broader concept of *market freedom*, on the other. While the latter undoubtedly stems from the former, financial legislation – at least since the GFC outbreak – has often attempted to constrain the single investor in taking decisions that could have impaired his/her own wealth and, thus, potentially transmitting negative effects onto so-called 'real' markets.

There are many examples that legitimate us being worried by the current 'big government' (*rectius*, 'big regulator') approach: we have mentioned the restrictive attitude shown toward OTC exchanges[20] and AT/HFT techniques[21]. For the sake of investors – endowed with the right to access various data regarding the execution of orders –, the EU legislator has openly restrained market freedom. In terms of the efficiency in capital allocation, the benefits associated with enhanced transparency might be offset by the coercive transfer of significant amounts of money from OTC platforms to trading venues (mostly OTFs), as well as by the substantive increase in compliance costs when entering AT or HFT.

Investor protection is one of the pillars of the Package, and it does show the same weaknesses. In particular, the EU legislator seems to have achieved – by means of the overlap between different rules, even of different rank – what has been defined as a "legislative flooding". The overall effect is a deplorable one: since the financial industry is "crowded out" by the frequency and the content of the multiple layers of regulation to which it is subjected, investors end up being "paralysed" in their activity and, thus, either renounce to undertake certain operations or have to recur to suboptimal choices. The equivalence between too much information and its absence is, unfortunately, a matter of fact. Since retail clients do not form a monolithic category, many of the least experienced, least informed investors tend to restrain themselves from entering any financial contracts, especially in the wake of the alleged

([20]) The 2009 G-20 summit held in Pittsburgh had addressed the issue of OTC derivatives as one of the main roots of the GFC, thus urging worldwide legislator to take a step against the accrual of systemically dangerous risks. Brussels responded by means of the *European Market Infrastructure Regulation* (EMIR, No. 648/2012), but the Package has introduced a new type of trading venue – namely, the 'organised trading facilities' (OTFs) – based on bilateral matching as well as OTC platforms, and allowing the investment firm operating them to discretionarily decide which trades to execute (though subject to a non-discrimination principle). Transparency was the main source of concern: since many transactions had moved from trading venues – namely, 'regulated markets' (RMs) and 'multilateral trading facilities' (MTFs) – to OTC markets, the EU legislator tried to "re-regulate" many trades by creating a *tertium genus* between traditional, multilateral exchanges – subject to heavy transparency requirements – on the one hand, and those alternative, bilateral platforms – whose operators are charged with almost no regulatory obligations – on the other.

([21]) MiFID II pursues, also, a definite tightening over certain kinds of unregulated platforms, such as 'dark pools' and 'broker-crossing networks', where transparency is at its lowest levels. By doing this, although formally enlarging the possibility to settle transactions, the EU legislator has strongly narrowed the extent of any market player's right to decide where executing a trade in which it is involved. We can appreciate that this has been achieved by means of incentives more than by explicit obligations (either 'positive' or 'negative'), but substance remains.

scandals reported in the financial realm. Coupled with the intermediary's policy of recommending quite hazardous instruments – *e.g.*, subordinated debt – to clients with a very prudent risk/return profile, this has yielded a substantive, alarming capital misallocation in the industry as a whole.[22]

Such perspective prompts us facing that old, unescapable question: are investors really different from the 'consumers' of goods and non-financial services? Or, conversely, consumer laws could be reasonably applied – *mutatis mutandis* – to the provision (performance) of investment services (activities)? Given the reasoning that we have developed, the answer should be clear. At least theoretically, there is no reason to opt for a differentiated treatment, as this is likely to have several contraindications and might eventually turn out yielding results opposite to the legislator's intent. What seems to have been forgotten in the Package is that financial contracts do involve an *alea* which is often absent in other kinds of agreement, but – in general – belongs to both parties. Which actually bears a higher share of risk is hard to determine: in fact, the difference between types of risk is much wider than the reasons why one might fail to fulfil its contractual obligations in other industries. The party holding the higher bargaining power – *i.e.*, usually but not necessarily, the intermediary – will be able to shift most of the *alea* onto the other. Yet, this occurs in financial markets as well as in different ones. Moreover, one of such common reasons is actually the same in the two worlds: namely, the unaffordability of some payment duty, in a way which had not been known *ex ante*. Therefore, a person which enters a plain-vanilla contract with a large financial conglomerate would not deserve any reinforced protection *vis-à-vis* that afforded to clients of a great supermarket chain: lest, the regulator would make an arbitrary value judgement.

In addition to this, we should consider how artificial is the separation between the so-called 'real' economy, on the one hand, and finance, on the other. The GFC – as well as the recession of the Thirties – has shown how interconnected are the two worlds. If this were not self-evident, history would remind us that the largest stock exchanges in the world were all established as places to trade securities written on commodities – either of agricultural or mining origin –, mainly for hedging purposes. We need not stopping at the dawn of merchant

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([22]) It is undoubtedly too early to openly judge the financial consequences of the Package, yet one thing is clear: uncertainty – *rectius*, volatility – is surging. The new "moderation" of interest rates, achieved by means of the ECB's direct market intervention – which we are not going to discuss, for it would clearly deserve a separate analysis – has slightly receded starting from 2016. No one could foresee what the future will look like: we can only reasonably argue that, once the 'quantitative easing' (QE) programme will be definitely terminated in December 2018, interest rates will come back to their remarkably fluctuating path. This will occur not only due to the ECB's retreat but – at least in the medium-to-long term – because of the structural change in financial markets that will likely be triggered by the evolution of investors' behaviour, in turn adjusting to the new regulatory framework.

capitalism, between the 16th and the 17th centuries: instead, even the ancient civilities – in particular, Greeks – were somehow used to the idea of such "modern" contracts (Goetzmann, 2017). Moreover, finance has never been deemed to be segregated from the rest of the economy until very recent years: such a conceptual shift probably came with the 1929 crisis, which was not sparked by agricultural overproduction, unlike its 1873 predecessor.[23]

Nevertheless, financial distress also has system-wide consequences, because of the significant net of interconnections between players and markets, undoubtedly expanding with the passage of time. Yet, this additional source of concern has always been faced *via* a much tighter oversight *vis-à-vis* markets for goods or financial services, the vast majority of which is not supervised at all. Anyway, direct regulatory intervention – inherently distortive of decision-making – is something further than public authorities exerting legitimate control upon intermediaries.[24] Unfortunately, the Package – and, even more, secondary legislation derived from it – follows the latter approach instead of the former, and much more vigorously than MiFID I.

Nowadays, in light of the GFC, investors are called to show much greater responsibility – *i.e.* self-discipline – than in the past. As for banking crises, the novel EU rules[25] follow the emerging principle of *burden sharing*, stating that a bank's shareholders should not be the only ones – among the wider set of claimholders – to suffer losses for the purpose of providing capital to a distressed credit institution. Of course, we are not going into detail on this, for it

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(23) Of course, before the *roaring Twenties*, financial markets – and, in the people's imagery, stock exchanges – were not particularly developed. Hence, they were not intended as a standalone component of the economic system, but rather a commercial sector like many others based on the provision of services.

(24) This idea had spread during GM years. In particular, it is epitomised by Directive 1989/626/EEC, which laid down the *mutual recognition* and the *home-country control* principles: banks could be allowed to provide their services in foreign EEC Member States, still being overseen – in the first instance – by their domestic competent authority.

(25) We refer to the *Banking Recovery and Resolution Directive*, No. 2014/65/EU, and Regulation No. 600/2014 – have dropped the old principle of bailing out distressed credit institutions in favour of either gone-concern, market-based solutions or a going-concern 'internal recapitalisation', termed *bail-in* to signal the rejection of any government intervention pursued by spending taxpayers' money. Yet, governments have not dropped their interventionist policies in the banking system, and not merely to rescue troubled intermediaries: in Italy, subordinated bondholders of six credit institutions – with a medium to large size, with respect to the domestic banking system – have been refunded for their claims being cancelled over the recapitalisation process.

would require a thorough discussion of the European Banking Union's architecture;[26] yet, we note that such an appreciable attitude by the EU legislator has been unfortunately offset by the Package's "paternalistic" intent and obtrusive content. The financial system would have needed an additional incentive for investors to become more aware of the risks incurred, more closely monitor their counterparties, and more carefully evaluate their profile and current conditions before taking any financial choice. As a matter of fact, legislators all over the world are endeavouring to constrain financial activities to preserve systemic stability; however, they do not seem exerting an adequate push on the other side of the coin: namely, spreading an investment culture which is essential to the functioning of a capitalist system. This would entail promoting economic literacy, designing a framework where saving is commended rather than blamed as in the Keynesian view, and defending the idea that there is no inherent difference between investing in financial instruments – even without any direct link to firms' funding – and directly establishing a business. Unfortunately, most of the rulers – either governments or regulatory authorities – do not regard this as a priority nowadays.

Hence, after some "experimental" period, MiFID II and MiFIR should be quite extensively revised from a liberty-oriented standpoint. First, as far as markets are concerned, the legislator should drop its hostility toward OTC platforms: transparency is not the only thing to be looked at when discussing their functioning, as they have managed to satisfy the needs of players in search of wider opportunities than those constrained by heavier regulatory requirements. Moreover, their role in the uncontrolled spread of positions in derivatives, often with poor-quality underlying assets – which is, of course, the reason behind such *Kulturkampf* against them –, has been directly faced by another piece of EU legislation: namely, EMIR, which has (*inter alia*) mandated those transactions to be centrally cleared. Still regarding markets, AT and HFT should be seen no more as potential threats to systemic stability, as they had been hitherto. Carefully reporting the use of such new techniques is a good principle, yet it cannot become an obsession. This does not descend from any assumption on market freedom but is rather grounded in the 'state of the art' of financial transactions: by steadily gaining ground over time, technology is making exchanges

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([26]) We can just note that the latter – in addition to concentrating the supervision of systemically significant banks and designing a common framework for managing the crisis of credit institutions – envisages an element which actually deters responsibility, rather than supporting it, as long as it waives from burden sharing – and, explicitly, from the application of the bail-in – depositors holding up to € 100,000 at the *failing or likely to fail* institution. As widely acknowledged by the literature, deposit insurance gives rise to morally hazardous behaviours by the bank's management (*inter alia*, Merton, 1977). However, we should consider that depositors cannot be plainly regarded as investors, for the main *rationale* behind opening a bank account is storing and preserving money, rather than making it yield any interest or giving the right to get some other payoff.

increasingly automated and, thus, of a widening extent. Current ties to AT and HFT may seem legitimate, now, but will easily turn out being anachronistic – thus, inadequate – over the next few years, when computer science will have provided us with even speedier and efficient systems. Although the pace of such advancement may be unknown, there is little doubt that a progress will anyway occur notwithstanding the regulatory constraints, for its many positive spillovers are too significant for market forces to neglect them.

As for investor protection, the EU legislator – in its attempt to defend the weakest economic agents from undue damage caused by both negative market conditions and the intermediaries' misconduct, including the *mala gestio* of financial firms – has significantly impaired the degree of individual liberty that each agent, regardless of its identity, should be endowed with. What we have called 'market freedom' is a consequence: it entails a level playing field between firms, the removal of barriers to the latter ones' operations, and the acknowledgement of financial markets – open to foreign subjects – as the elective "place" for decisions attaining to capital allocation, such that they can develop in accordance with the agents' actual needs. Yet, it could not exist without the investors being individually free to make their choices, in absence of external constraints.

Therefore, rethinking how asset categorisation is applied, repealing the ideological statement – made several times throughout the Package – that intermediaries must act in the client's best interest (for instance, by stepping back on those burdensome rules on inducements), ensuring that product governance and intervention do not make markets shrink (in terms of thickness, width, and elasticity),[27] as well as avoiding any counter-productive information overload spurred by the suitability and appropriateness tests, are the steps that the EU legislator should take before good intentions end up backfiring.

It is not too late to come back on the right track.

([27]) *Thickness* refers to the presence of orders diverging from current price; *width*, to the difference between "extreme" orders; and *elasticity* to the speed at which price, once altered, tend to come back at its equilibrium level.

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