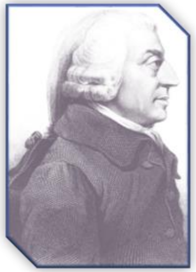
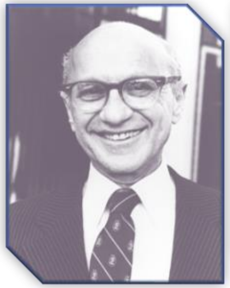
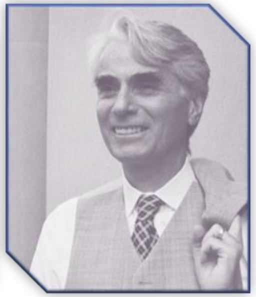
HOW CURRENT FINANCIAL LEGISLATION WRESTLES WITH INDIVIDUAL LIBERTY: **THE MIFID II / MIFIR CASE**

LUCA BELLARDINI
UNIVERSITY OF ROME "TOR VERGATA"

ISTITUTO BRUNO LEONI
XII MISES SEMINAR
SESTRI LEVANTE, 13-14 OCTOBER 2018

FREE TO EXCHANGE: THEORETICAL FOUNDATIONS



- The effects of *human action* (Mises, 1949): a spontaneous order going toward the equilibrium.
- Ideas freely arising and spreading in absence of a centralised government (Friedman, 1962).
- The value of individuals as free agents: the Enlightenment,
  the Industrial Revolution, and the rise of stock exchanges.
- From economic transactions as the free encounter of self-interests (Smith, 1776)…
  … to the legitimacy of contracts given the counterparties' free will (Nozick, 1974)
- Recent trends: alleged cyclicality of crises in capitalism
  and the success of behavioural economics.
  As a result: call for tighter regulatory intervention.
- The Marginalist truth: *unintended consequences of intentional actions* (Wundt, 1886).
- Financial markets: even mere speculators' action is critical to ensure market efficiency.

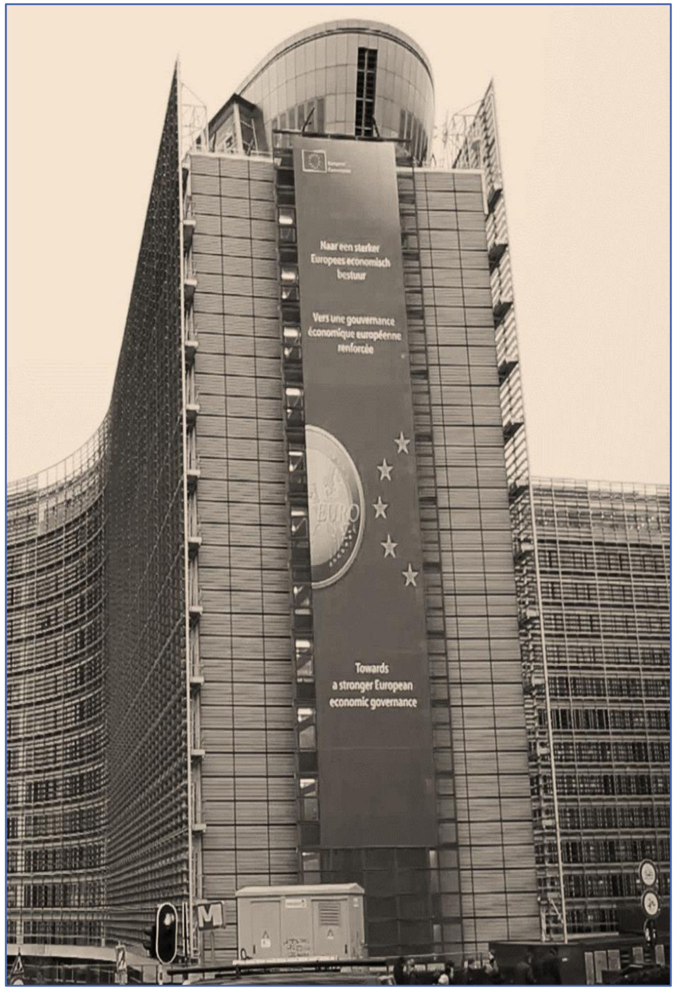
[BLACK?] SWAN LAKE: FINANCIAL LEGISLATION OVER TIME

- Before MiFID I (Dir. 2004/39/EC), investor protection was discussed but not effectively upheld. Possible regulatory loopholes?
- The baseline principle (→ economic analysis of law) was the defence of contractual autonomy, regardless of the counterparties' economic strength or bargaining power.
- In Europe, this dated back to *post* French Rev. laws (e.g., Napoleonic Code). Asymmetries were punished not *per se*, but only if unduly exploited. No substantial difference between financial contracts and other ones.
- In the USA, settlers were financially in *deficit* → borrower-friendly legislation. Antitrust *vogue* (late 1800 – early 1900) → geographically constrained banks. Banking: Glass-Steagall Act (1933; reformed 1999) as a response to 1929 crash.
- The GFC: has 1980s-1990s deregulation backfired, leading to the crisis? → Dodd-Frank Act (2010; reformed 2018), including the so-called Volcker Rule.

THE END OF ALCHEMY: WHAT THE CRISIS EXPOSED

- In fact, MiFID I had failed to level the playing field. At the GFC outbreak, the EU financial system was well-functioning but showed little resilience against turmoil.
- Especially at a systemic level, the EU supervisory architecture was inadequate. Report by De Larosière (2009) → establishment of the ESFS, made of 3 *micro*-prudential ESAs (EBA, ESMA, EIOPA) and the *macro*- ESRB.
- Transparency had been lacking → *mala gestio* cases in financial institutions; uncontrolled spread of information with self-fulfilling effects.
- *Regulation often comes after disasters* (Gordon, 2000). However, the roots of the GFC substantially coincide with those of the GM:
  - easy credit policies (Jagannathan *et al.*, 2013);
  - liquidity created by means of actually illiquid assets (Ackermann, 2008);
  - loose monetary policy, suddenly reverted with a crowding-out effect (Cabral, 2013).

THE FAULT, DEAR BRUSSELS, IS [NOT?] IN MIFID I…



- In early 2000s, concerns raised by the unfaithful representation of certain companies' results, eventually impairing investors' wealth.
- Before MiFID I, misconduct would have seen just as a breach of contractual bonds between the counterparties of a transaction in financial instruments.
- That Directive mitigated but not rejected the "holistic" view of markets.
- Client categorisation as the main investor protection tool.
  The *elevator principle*. Suitability and appropriateness tests.

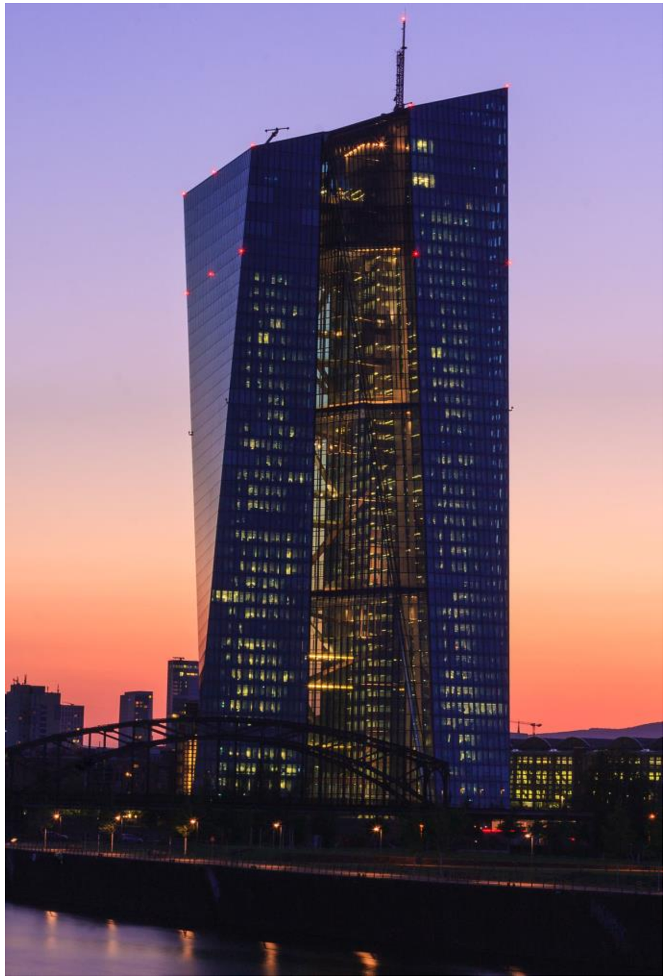
Professional clients

Eligible counterparties

Retail clients

ELEVATOR PRINCIPLE

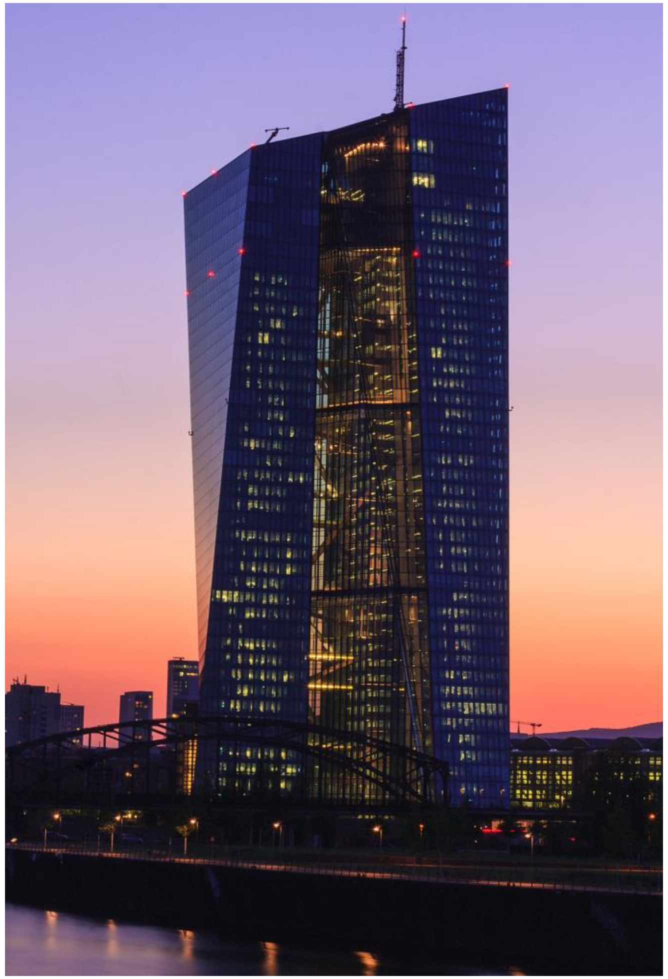
BRAVE NEW WORLD: THE MIFID II / MIFIR PACKAGE **(I)**



THE THREE PILLARS OF THE PACKAGE (Di Noia, 2017)		
Product governance	Product intervention	Intermediary-client relationships

- Product governance *vs.* product intervention (prudential *vs.* structural regulation)
- Intermediary-client relationships shaped by a *cradle-to-grave* approach.
- An unreasonable *dogma*: each player must pursue *the best interest of the client* (Article 24[D], par. 8), including tied agents when advising clients.
  → Investment advice provided on an independent basis not duly valorised.
- Even greater care of this principle if the *distributor* differs from the *manufacturer*.
- Investment firms must identify a *target market of end clients* (Recital 71[D]; Article 24[D], par. 2), other than administering tests and complying with other provisions.

BRAVE NEW WORLD: THE MIFID II / MIFIR PACKAGE **(II)**



- The appropriateness t. may be waived, but required conditions are hard to meet.
- Enhanced best execution: an IF must take into account all relevant factors in order to *obtain the best possible results for its clients*.
- Information overload for both IFs, burdened by heavy transparency provisions, and clients, overwhelmed by disclosures. This alters decision-making (Persson, 2013).
- Distortion of established economic rights in the discipline of inducements. Independent advisors banned from receiving anything different from *minor non-monetary* ones (Article 24[D], par. 7).
- Overhauled business models: research costs unbundled from service-related ones.
- Advisors charged with heavy disclosure requirements to clients (*all costs and related charges*) with strict periodicity. Possible review of suitability.
  → dynamic approach to investor protection.
  What happens to outstanding contracts? → certainty of law

A RISING LEVIATHAN? THE INDUSTRY'S WORRIES

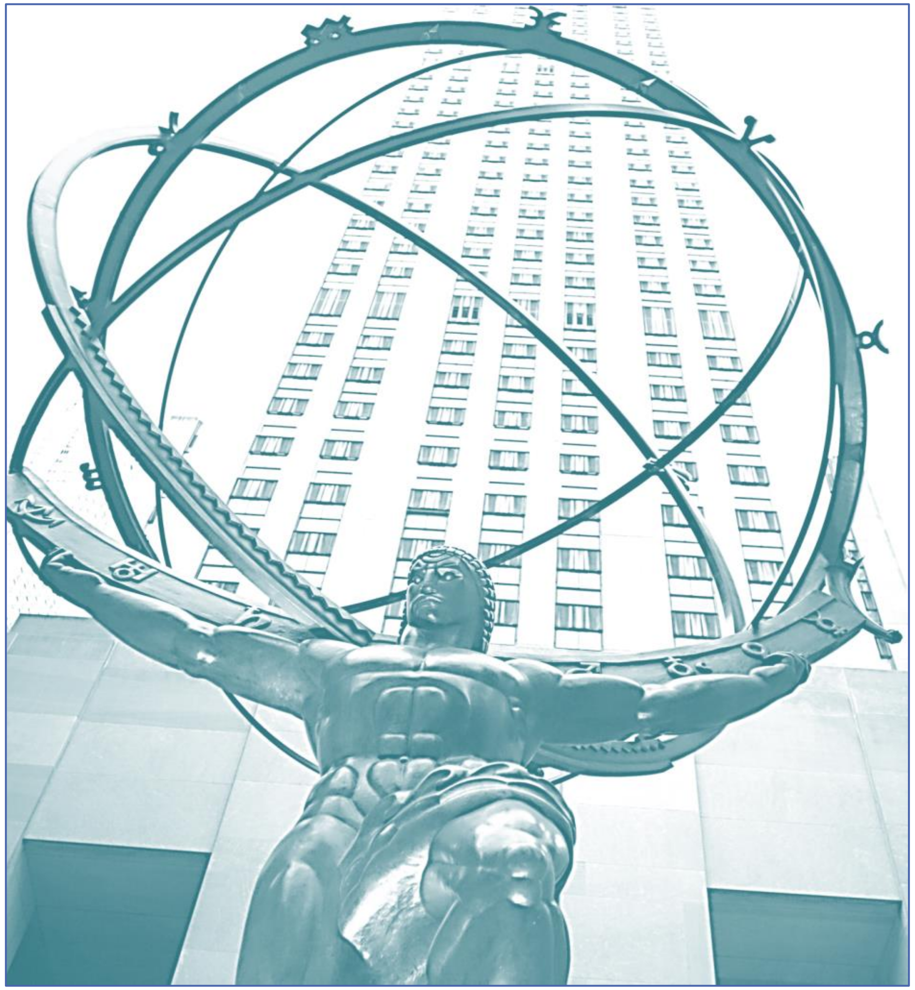
- A twofold concern: individual liberty and market freedom.
- *Big regulator* approach : *e.g.*, constraints to AT/HFT
  → possible drawbacks on capital allocation
- Legislative flooding, continuously crowding out expectations.
- Retail clients are not as monolithic as thought by the EU legislator.
  Certain complex products may be less risky than non-complex ones.
- "Holistic view" abandoned; real *vs.* financial markets distinction upheld.
  → Do they really differ? Is outcome uncertainty so crucial?
- In any financial contracts, all parties bear some risk.
  Like in "real" markets, risk distribution depends on bargaining power.
  → The same reason underlying defaults: unaffordable payments.

ALL HAS CHANGED UTTERLY… A TERRIBLE BEAUTY IS BORN?

- The Package's "protective" *esprit* sharply contrasts with the "liberal" approach followed as for the resolution of banks.
- Too much concerned with systemic stability?
  What about the following…?
  - investors' actual awareness of risks;
  - careful self-assessment before undertaking any investments.
  - close monitoring of counterparty's behaviour.
- What about spreading an investment culture centred around the relevance of savings to a free capitalist economy?
- What about overcoming the popular prejudice against "rent-seeking" financial investments as opposed to "real" (industrial) ones?

TO STRIVE, TO SEEK, TO FIND… AND TO YIELD SOME RETURNS

- Future developments in financial markets: the role of technology.
- Does the transparency burden represent a threat to progress?
  → disproportionate regulatory reaction against HFT and OTC failures (EMIR provisions; introduction of OTFs; *etc.*)
- Investors more protected yet less free than in the past.
  → from *micro*- imbalances to new *macro*- blows to stability?
- *If you destroy a free market, you create a black market. […]*
  If you make 10,000 regulations, you destroy all respect for the law.
  (Winston Churchill, 1949)
- How to amend the Package in a liberty-oriented way?
  - Repeal the 'best interest of the client' *dogma*
  - Set limits to product gov./int. to avoid that markets shrink
  - Prevent information overload from arising (curb informative obligations)



END OF PRESENTATION

My warmest thanks
for your kind attention.