

STUDY

Requested by the ECON committee



Subordinated Debt and Self-placement

Mis-selling of Financial Products



Policy Department for Economic, Scientific and Quality of Life Policies

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Mis-selling of Financial Products: Subordinated Debt and Self-placement

STUDY

Abstract

This paper forms part of a series of five studies on mis-selling of financial products in the EU. The focus of this document is mis-selling of subordinated debt and other junior liabilities and weaknesses of MiFID. This report concludes that the mis-selling, essentially through self-placement, was due to violations of MiFID rules rather than weaknesses of the legislative scheme. The report includes proposals to strengthen the legislation and to provide compensation for retail investors. This document was provided by Policy Department A at the request of the ECON Committee.

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AMF	<i>Autorité des marchés financiers</i> (France)
AT 1	Additional Tier 1
Basel III	Regulatory standards on bank capital adequacy and liquidity agreed by the Basel Committee on Banking Supervision in 2010
BRRD	Banking Resolution and Recovery Directive
BES	Banco Espírito Santo
CCyB	Countercyclical capital buffer
CCB	Capital conservation buffer
CESR	Committee of European Securities Regulators
CET 1	Common Equity Tier 1
CNMV	<i>Comisión Nacional del Mercado de Valores</i> (Spain)
CMU	Capital Markets Union
CMVM	<i>Comissão do Mercado de Valores Mobiliários</i> (Portugal)
CoCos	Contingent Convertibles
Commission	European Commission
CONSOB	<i>Commissione Nazionale per le Società e la Borsa</i> (Italy)
CRD IV	Capital Requirements Directive (2013/36/EU)
Creval	Credito Valtellinese
CRR	Capital Requirements Regulation (575/2013)
DGS	Deposit Guarantee Scheme
ECB	European Central Bank
ECON	European Parliament's Economic and Monetary Affairs Committee
EBA	European Banking Authority
ELTIF	European long-term investment funds
EFSF	European Financial Stability Facility
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board

EU	European Union
FCA	Financial Conduct Authority
FSAPs	(IMF) Financial Sector Assessment Programs
GDP	Gross Domestic Product
IMF	International Monetary Fund
MAR	Market Abuse Regulation
MiFID I	Markets in Financial Instruments Directive of 2004 (2004/39)
MiFID II	Markets in Financial Instruments Directive of 2014 (2014/65)
MiFIR	Markets in Financial Instruments Regulation of 2014 (600/2014)
MPS	Banca Monte dei Paschi di Siena
MOU	Memorandum of Understanding
MTF	Multilateral trading facility
NCA s	National Competent Authorities
NIRP	Negative Interest Rate Policy
NPL	Non-performing loan
SEC	Securities and Exchange Commission
SMSG	Securities and Markets Stakeholder Group
SRB	Single Resolution Board
SRB	Single Rule Book
SRF	Single Resolution Fund
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
STS	Simple, transparent and standardised securitisation Regulation of 2017 (2017/2402)
TLAC	Total Loss Absorbing Capacity
UK	United Kingdom
ZIRP	Zero Interest Rate Policy

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EXECUTIVE SUMMARY

The past years have been marked by high number of serious cases in several Member States due to mis-selling of subordinated debt and junior liabilities by financial institutions to retail investors. **Retail investors in the some Member States have invested massively into subordinated debt and other junior liabilities, as well as shares, of financial institutions of which they were clients.** Those sales took place through a process called '**self-placement**', a term coined in 2012 by the author of this report, by which a financial institution sells its own securities to its clients. Many of these retail investors did not realise that the financial instrument they were buying was dangerous and could be subject to significant dilution or complete loss of value in case of restructuring. The risk of bail-in increased considerably after the 2008 financial crisis as a political choice was made to protect taxpayers from bail-out.

Some Member States have tried to protect retail investors from the full consequences of the bail-in. Although it is justified from the perspective of the Markets in Financial Instruments Directive (MiFID), this could also be an **obstacle to the application of the bail-in tool** itself because of the political reluctance to apply losses on retail investors. Therefore, **the issue of mis-selling of subordinated debt and other junior liabilities is not just an issue of investor protection but also now of financial stability as it could stand in the way of applying the Banking Recovery and Resolution Directive (BRRD).**

Based on the severity of the damages, the most concerned Member States are Spain, Portugal and Italy. Many Spanish financial institutions, especially savings and loan banks (*Cajas*) sold to their retail clients **participaciones preferentes** and other hybrid instruments in 2008 and 2009 in order to improve their capital ratios, as required under Basel II. Retail investors suffered huge losses starting in 2012 in Spain, but also in Portugal, Italy and Slovenia. Shares issued by mutual banks to their clients were also subject to mis-selling, especially in Italy.

Weak enforcement of MiFID rules rather than weak regulation was responsible for mis-selling. MiFID I rules did present some weaknesses as they did not regulate specifically self-placement despite the high risk of conflict of interest. The concept of '*personal recommendation*' which triggers the application of the suitability test was probably not precise enough in order to apply automatically in case of self-placement. Very often, financial institutions did not apply the suitability test and the **client was only protected by the appropriateness test if the financial instrument was complex.** The **appropriateness test does not provide a high level of protection.** If the **financial instrument was not complex** (e.g. listed shares), retail investors benefited from the requirement to provide clear and fair information and on conflicts of interest under MiFID I.

The fact that MiFID rules have been violated and the severity of those violations have led to actions in the Member States affected in order to compensate investors. Retail investors have succeeded in court (Spain), benefited from public arbitration schemes (Spain and Italy), private arbitration organised by the financial institution which was accused of mis-selling (Spain), partial or total reimbursement by the acquiring bank (Spain and Italy) or partial or total reimbursement by private or public funds (Spain, Italy and Portugal).

The Securities and Markets Stakeholder Group (SMSG) of the European Securities and Markets Authority (ESMA) took notice of this issue and **alerted ESMA as soon as December 2012** on the risks associated with self-placement in view of the Spanish experience. Specifically, it requested that the proposed draft for the MiFID II Level 2 text be changed to: '*procedures **must** include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects*

on clients' instead of '**may**'. ESMA agreed with the request of the SMSG and '**must**' was included in the advice to the Commission¹ and finally in **Article 41 Additional requirements in relation to advice, distribution and self-placement** of Delegated Regulation 2017/565. This is a **major step forward to protect retail investors** since, **in case the bank is in difficulty, the provision is close to a de facto ban**.

ESMA took several further steps. On 2 June **2016**, ESMA issued a statement regarding MiFID practices for firms selling financial instruments subject to the BRRD resolution regime. ESMA stated that it was '*of the **opinion** that, under **self-placement** situations, it is **extremely likely** that in substance the interaction between the investor and the credit institution involve **personal recommendations** (i.e. investment advice) being provided to clients. Firms are reminded that a thorough assessment of the **suitability** of the financial instrument for the client should be conducted*'². This provision is **close to a de facto ban** since, if the suitability test is applied, it should prevent retail investors from investing.

MiFID II and MiFIR have strengthened the legislative regime designed to prevent mis-selling to retail investors and will make enforcement easier for supervisors. Product intervention powers by national supervisors and ESMA should be particularly useful. Also, supervisors have now the power to issue a permanent ban against any member of the investment firm's management body or any other natural person, who is held responsible, to exercise management functions in investment firms. However, some targeted changes in the EU securities and banking legislative regime should be made to limit the risk of a recurrence of mis-selling, especially in the case of self-placement. Essentially, **Article 41** of the Level 2 Delegated Regulation 2017/565 should be amended to provide that the **suitability test is made compulsory in case of self-placement**. This reform could follow a parallel structure as the 2015 Regulation on European long-term investment funds (**ELTIF**) which requires the manager of the ELTIF to perform a suitability test in case of distribution to retail investors. A similar requirement is included in Article 3 of the in the new Securitisation Regulation (**STS Regulation**) of 12 December 2017.

Also, the EU legislator should **reduce the negative effects of the 'silo approach'** by which directives and regulations are disconnected from one another. In particular, **securities supervisors should have access to more information from banking supervisors** as to the true state of specific banks. If they had this information, they could focus their enforcement efforts on a risk-based approach when such banks engage in self-placement. Cooperation is being required by the Council Regulation n°1024/2013 of 2013 establishing the Single Supervisory Mechanism (SSM) but seems insufficient in practice.

Judicial proceedings are long, unpredictable, costly and not always decided by experts, unless there is centralisation in one single court. In addition, **because the damage was collective, the compensation should be collective**, but class actions are not allowed in many Member States. Therefore, as to the past, the **European Parliament should encourage Member States to develop out-of-court independent arbitration procedures, free of charge**, for retail investors in order to allow a faster compensation of their claims and to **establish compensation funds**³. Retail investors who went to court have usually won their case so

¹ ESMA, *Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, 19 December 2014 ESMA/2014/1569, point 7, p. 86.

² ESMA, Statement, MiFID practices for firms selling financial instruments subject to the BRRD resolution regime, 2 June 2016 ESMA/2016/902, Point 25, p. 8.

³ NB the Directive 97/7EC on Investor Compensation is not discussed in this context as it covers only the repayment 'of money owed to or belonging to investors and held on their behalf in connection with investment business' or the return of instruments belonging to investors 'and held, administered or managed on their behalf in connection with investment business' (Article 2) up to a maximum threshold of EUR 20.000. It does not cover cases of devaluation of shares.

either of these options will simply make the process faster. If arbitration is chosen, **the national securities supervisor is the natural authority to act as the arbitrator.**

When the bank responsible for the mis-selling has entered into resolution, Member States should be encouraged to establish funds to reimburse retail investors. These funds could be **financed by a fee on the banking sector or through the deposit protection fund**, like it occurred in Italy, **or the resolution fund**, like it occurred in Portugal. There **could be a cap on reimbursement**, to be decided by each Member State. Retail investors could benefit from a rebuttable presumption that those securities were mis-sold to them, especially when they invested a disproportionate amount of their assets in those securities. Institutional investors should be excluded from the benefit of this presumption unless they can prove that they were subject to mis-selling. Financing could come from the **Single Resolution Fund (SRF)** or national resolution funds which could cover cases of mis-selling up to a certain amount. Finally, the EU legislator could consider whether the BRRD should be amended to exclude retail investors who bought financial instruments through self-placement, at least up to a limited amount, from the effect of a bail-in.

1. INTRODUCTION

1.1. Historical developments

The past years have been marked by serious cases in several Member States due to mis-selling of subordinated debt and junior liabilities by financial institutions to retail investors.

These retail investors lost suddenly all or a significant portion of their savings when some of these financial institutions were subject to **capital increases**, diluting the participation of investors and the value of their investment, or **entered into resolution (*bail-in*)** reducing the value of their investments to zero or **converting bonds into equity** with massive loss of value. These scandals have taken place despite retail investors being protected by rules established by the Markets in Financial Instruments Directive of 2004 (MiFID I)⁴, especially, but not exclusively, the appropriateness and the suitability tests. Those investors thought that they were buying non-risky assets and the subsequent losses came as a surprise.

The Committee on Economic and Monetary Affairs (ECON) of the European Parliament received a number of petitions from retail investors from several Member States⁵. To follow up on these complaints, the ECON Committee has commissioned i.a. this paper to study mis-selling of subordinated debt and junior liabilities by financial institutions. The two main questions asked by the ECON Committee are: Has the appropriateness test been an adequate tool to prevent mis-selling to retail investors? Which type of remediation options would be appropriate for retail investors affected by such practices? The ECON Committee already commissioned three studies in advance of the public hearing with the Chair of the Single Supervisory Mechanism in 2016 on a more precise policy aspect of this issue⁶.

Subordinated debt and other junior liabilities are not legally defined. A subordinated (junior) debt is a liability that, in case of default, will be repaid only after other debt (senior debt) has been settled in full. Although not technically debt, shares in financial institutions are also subordinated because in case of liquidation or default, they will be repaid after other subordinated debt has been repaid. Therefore, they are also a type of debt from the accounting perspective. Consequently, the issue of mis-selling by financial institutions concerns also shares in some Member States.

Regulation designed to avoid mis-selling of financial instruments by banks to retail investors already exists in MiFID I which entered into force in 2007. However, the issue of mis-selling of subordinated debt and junior liabilities by financial institutions to retail investors presents unique risks because it takes place in the context of '**self-placement**'.

1.2. The concept of 'self-placement'

Self-placement, a term first coined in 2012 by the author of this report as a member of the Securities and Markets Stakeholder Group (SMSG) of the European Securities and Markets

⁴ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

⁵ For instance, petitions mainly from Spain between 2012 and 2013: <http://www.europarl.europa.eu/sides/getDoc.do?type=COMPARTL&reference=PE-502.154&format=PDF&language=EN&secondRef=03>.

⁶ Carletti, E. & Masciandaro, D., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016; Resti, A., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016; Götz, M., & Tröger, T., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

Authority (ESMA)⁷, is the practice of financial institutions selling proprietary financial instruments, such as common shares, preference equity shares, hybrid securities and debt (in either the firm itself or in another entity within the same group), to their own clients. Self-placement entails a major and unique conflict of interest between the financial institution and the client. However, self-placement was not specifically regulated by MiFID I. This was not surprising because until the 2008 great financial crisis, banks did not seem to be risky investments. This all changed after 2008 and the adoption of a policy to allow the bail-in of banks.

Self-placement is widespread. In many Member States, financial institutions have intensively used their branch networks to sell to their depositors shares and subordinated debt issued by them. This was done sometimes for general purposes such as financing expansions or acquisitions and has been going on even recently. For instance, in 2015, Banco de Sabadell raised EUR 1.1 billion from its branch network, out of nearly EUR 2 billion, to fund the takeover of the TSB Banking Group in the United Kingdom (UK)⁸.

However, a significant portion of these self-placements has been done for regulatory purposes or to anticipate regulatory requirements to strengthen capital ratios. In order to implement the **Basel III standards** (2010-2011)⁹, the Capital Requirements Directive (**CRD IV**) of 2013¹⁰ and the Capital Requirement Regulation (**CRR**) of 2013¹¹ required credit institutions to enhance capital buffers and increase the total capital ratio, including the capital conservation buffer (CCB) to at least **10,5 % of risk-weighted assets by 2019**.

There is also the **discretionary countercyclical capital buffer** (CCyB) which aims to ensure that capital requirements take account of the macro-financial environment since periods of excess credit growth have often been associated with the build-up of system-wide risk. Capital is increased when cyclical systemic risk is increasing, creating buffers that increase the resilience of the banking sector during periods of stress when losses materialise. It is implemented as an extension of the CCB and consists of Common Equity Tier 1 capital. The level of CCyB is left to be decided by the Member States. If the minimum CCyB requirements are breached, capital distribution constraints are imposed on the bank. The European Systemic Risk Board (ESRB) has issued guidelines for their setting¹². Only three Member States (Czech Republic, Slovakia and Sweden) have applied a CCyB¹³.

1.3. Shareholder's equity and subordination of debt instruments

A bank's capital consists of Tier 1 and Tier 2 capital. Tier 1 capital includes **Common Equity Tier 1** (CET1), which consists of common shares (including non-listed shares of mutual and saving and loan banks) and retained earnings, and **Additional Tier 1 capital** (AT1) which includes preferred shares and some contingent capital. CET1 should be at least 4.5 % of risk-

⁷ 'In particular, the SMSG would like to highlight the enhanced risks which arise with respect to self-placement by firms of their proprietary financial instruments (shares, preferred shares, hybrid securities and/or debt)'. SMSG, Advice to ESMA, *Advice on Guidelines on remuneration policies and practices (MiFID)*, 16 November 2012 ESMA/2012/SMSG/69, p. 5. The author of this report also drafted the SMSG advice.

⁸ Neumann, J., & Legorano, G. & Kowsmann, P., *In Southern Europe, Bank Share Sales Can Hit Depositors Hard*, Wall Street Journal, 9 August 2015.

⁹ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010.

¹⁰ Directive 2013/36/EU of the European Union and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

¹¹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

¹² Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1).

¹³ https://www.esrb.europa.eu/national_policy/ccb/applicable/html/index.en.html.

weighted assets and AT1 at least 1.5 % by 2019. The **capital conservation buffer** of 2.5 % is also composed exclusively of CET1.

Tier 2 capital includes some contingent capital, which cannot qualify as AT1 for various reasons, and subordinated debt. Tier 2 Capital should be 2 %.

Contingent capital are debt securities with mandatory conversion to equity or mandatory write-down in the event that certain regulatory capital ratios (accounting value trigger), usually CET 1 capital ratio to risk-weighted assets, or the market price fall below pre-defined trigger points, usually a ratio of the bank's stock market capitalisation to its assets, or at the discretion of the supervisor (point of non-viability trigger). This is the case of **contingent convertibles** (CoCos)¹⁴. CoCos are included in AT 1 or Tier 2 capital depending on whether they have a maturity date or not and on the level of the trigger. Under Basel III, a breach of 5,125 % of the CET 1 ratio allows the CoCos to be considered AT 1, and therefore Tier 1 capital. Also, under Basel III, all CoCos need to be subject to a point of non-viability trigger decided by the supervisor in order to be considered AT 1 or Tier 2 capital¹⁵. CoCos are loss absorbing in two possible technical ways: conversion into shares or write-down. The first one is a conversion-to-equity which increases CET 1 capital by converting at a pre-defined conversion rate. The second approach is a principal write-down which raises equity by having the CoCo incurring a full or partial, permanent or temporary, write-down.

The amendment of the Banking Recovery and Resolution Directive (BRRD)¹⁶ will require also that banks build up **total loss-absorbing capacities** (TLAC) to enable a failing bank to be stabilised without the need for a bail-out using public funds.

In addition, banks have been subject to **stress tests** by the European Banking Authority (EBA) and in 2014 to an **Asset Quality Review** (AQR) by the European Central Bank (ECB). These comprehensive assessments have been done by the ECB since on selected banks. CRD IV and Basel III regulations led banks to issue great amounts of new equity or equity-like instruments, including to the retail clients of those banks. In 2016, *'Empirical data are presented, showing that Tier 2 capital accounts for 16.2 % of total regulatory capital (or 2.7 percentage points in terms of risk-weighted assets)'*¹⁷.

One of the problems with these issuances for investor protection is that the weaker the bank, the more likely it would turn to retail investors since the institutional market would be closed for them. In addition, a 2016 study *'shows a negative correlation between bank equity and subordinated debt financing, indicating that more fragile banks finance themselves to a larger degree with subordinated debt'*¹⁸.

At the same time, retail investors, that is, banks' depositors, have been interested in purchasing such financial instruments because of a search for yield.

1.4. Widespread distribution of subordinated debt and other junior liabilities to retail investors through 'self-placement'

Since the financial crisis of 2008, retail investors willing to invest into risk-free assets have been starved for yield. In order to fight deflation, and to stabilise the euro after 2011, the

¹⁴ Avdjiev, S. & Kartasheva, A. & Bogdanova, B., 'CoCos: a primer', *BIS Quarterly Review*, September 2013, p. 43.

¹⁵ <https://www.bis.org/press/p110113.pdf>.

¹⁶ Proposal for a Directive of the European Parliament and of the Council amending Directive 2014/59/EU on loss-absorbing and recapitalisation capacity of credit institutions and investment firms and amending Directive 98/26/EC, Directive 2002/47/EC, Directive 2012/30/EU, Directive 2011/35/EU, Directive 2005/56/EC, Directive 2004/25/EC and Directive 2007/36/EC, Brussels, 23.11.2016.

¹⁷ Resti, A., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

¹⁸ Götz, M. & Tröger T., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

European Central Bank (ECB) as well as other central banks (Bank of England, Swiss National Bank) whose currencies are linked to the euro, have engaged into **financial repression** of savers. They have reduced short term interest rates, sometimes below zero, and bought sovereign and corporate debt at a massive scale through so called '*quantitative easing*' programs, under various names. The policy has been called **Zero Interest Rate Policy** (ZIRP) and **Negative Interest Rate Policy** (NIRP) and inflicts negative real interest rates, at least in some Member States such as Germany for instance¹⁹.

Because of this lack of yield, retail investors, especially retirees who could not increase their regular income, have been more susceptible than in other circumstances to invest into riskier products sold by financial institutions.

1.5. Potential conflict between protection of retail investors under MiFID and bail-in and the 2013 Banking Communication

Retail investors in the EU have massively invested into subordinated debt and other junior liabilities of financial institutions of which they were clients. It appears that many of these retail investors did not realise that the financial instrument they were buying was dangerous and could be subject to significant dilution or complete loss of value in case of restructuring. The risk of bail-in increased considerably after the 2008 financial crisis as a political choice was made to protect taxpayers from bail-out. In the first more general financial assistance programs for Ireland, Greece and Portugal, no bail-in of creditors was required. Then, the Commission and the European legislator became supportive of bail-in of subordinated debt and even of senior debt.

First, Spain was asked in 2012, in order to receive funding (EUR 55.9 billion) from the European Financial Stability Facility (EFSF), to restructure and recapitalise its banking sector, i.e. to perform bail-in²⁰. Prior to the recapitalisation of the most vulnerable institutions, shareholders and holders of *participaciones preferentes* and subordinated debt had to assume massive losses. Shareholders of the four most affected banks (Bankia, Catalunya Banc, Nova Caixa Galicia and Banco de Valencia) were fully bailed-in, except in the case of listed banks (Bankia and Banco de Valencia) where investments were greatly diluted.

Then, the **2013 Banking Communication of the European Commission on State Aid** in the banking sector required that shareholders and junior bondholders be bailed-in before public support could be used so as to reduce costs to taxpayers and mitigate moral hazard²¹. Second, the Banking Recovery and Resolution Directive (BRRD) of 2014 requested that the '*bail-in tool*' applies as of 1 January 2016²². Whereas the 2013 Banking Communication limits the applicability of the bail-in to shares and junior debt (subordinated debt and hybrid instruments), the BRRD enlarges the eligibility to more liabilities including senior debt and deposits.

Between 2008 and 2016, the entry into force of the bail-in provisions of the BRRD, there have been **many cases where bail-in of shareholders and junior creditors occurred**

¹⁹ In May 2018, the German 10 year bond yields nominally around 0,6 % and German inflation is around 1,6 %. The German 10 years nominal bond yield was slightly negative from June to September 2016.

²⁰ Point 17, Spain, Memorandum of Understanding on Financial Sector Policy Conditionality, 20 July 2012.

²¹ Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') OJ C 216, 30.7.2013, p. 1–15.

²² Directive 2014/59/EU of the European Parliament and of the Council 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) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

under national legislation or legislation implemented in anticipation the entry into force of the bail-in instrument of the BRRD.

This is the case, for instance, in **Ireland** (Anglo-Irish Bank, Allied Irish Bank, 2010), Greece (13 banks, 2011), **Netherlands** (SNS Reaal, 2013), **Spain** (Bankia, 2013), **Slovenia** (Ljubljanska Banka, Nova Kreditna Banka Maribor, Abanka, Banka Celje, Probanka and Factor Banka, 2013-2014), **Portugal** (Banco Espírito Santo, 2014) and **Italy** (Banca Romagna Cooperativa, 2015; Banca Marche, Cassa di Risparmio di Ferrara, Banca Popolare Etruria e Lazio, and CariChieti, 2015). In some cases, **senior creditors**, including depositors, were also bailed in or subject to liability management exercises. This was the case, outside the EU in **Iceland** (three large Icelandic banks, 2008), and in the EU in **Denmark** (Amagerbanken, 2011; Fjordbank Mors, 2011), **Ireland** (AIB, 2012), **Cyprus** (Bank of Cyprus and Laiki, 2013), **Greece** (four main banks, 2015) and **Austria** (Hypo Group Alpe Adria and HET Asset Resolution, 2015).

Table 1: Bail-in in the EU between 2013 and December 2015

Bank	Country	State aid granted	shares	
SNS Reaal	Netherlands	Feb. 2013	wiped out	wiped out, but Jul. 2013 retail investors repaid 100%
Bank of Cyprus	Cyprus	Mar. 2013	diluted > 90%	Converted into shares
Bankia	Spain	Mar. 2013	diluted > 90%	repaid 64% (hybrid bonds)/ 87% (bonds w. maturity)
Banco Gallego	Spain	Mar. 2013	diluted > 90%	repaid 61% (hybrid bonds)/ 89% (bonds w. maturity)
Catalunya Banc	Spain	Mar. 2013	diluted > 90%	repaid 60% (hybrid bonds)/ 85% (bonds w. maturity)
NCG Banco	Spain	Mar. 2013	diluted > 90%	repaid 60% (hybrid bonds)/ 87% (bonds w. maturity)
Aug. 2013 : EC Banking Communication published				
Hypo Alpe Adria Grp	Austria	Sept. 2013	nationalised 2009	left intact
Monte Paschi Siena	Italy	Nov. 2013	diluted > 90%	left intact
NLB	Slovenia	Dec. 2013	wiped out	wiped out
NKBM	Slovenia	Dec. 2013	wiped out	wiped out
Abanka	Slovenia	Dec. 2013	wiped out	wiped out
Probanka	Slovenia	Dec. 2013	wiped out	wiped out
Factor banka	Slovenia	Dec. 2013	wiped out	wiped out
Jun. 2014 : EU Banking Recovery and Resolution Directive enacted				
Banca Tercas	Italy	Jun. 2014	wiped out	left intact
Parex / Reverta	Latvia	Jul. 2014	nationalised 2008	left intact, but to be repaid upon state aid repayment
Hypo Alpe Adria Grp	Austria	Aug. 2014	nationalised 2009	wiped out, but Sept. 2016 offered 45% repayment
Banco Espírito Santo	Portugal	Aug. 2014	became shares and bonds of the bad part of the bank	
Banka Calje	Slovenia	Dec. 2014	wiped out	wiped out
Permanent TSB	Ireland	Apr. 2015	diluted > 90%	left intact
Banca Romagna Coop	Italy	Jul. 2015	wiped out	repaid 100% by the coop-interbank fund (FGD)
Banca Etruria	Italy	Nov. 2015	wiped out	wiped out, but April 2016 offered 80% repayment (expropriated holders with annual income <35000€ or movable property <100000€)
Banca Marche	Italy	Nov. 2015	wiped out	
CaRiChieti	Italy	Nov. 2015	wiped out	
CaRiFerrara	Italy	Nov. 2015	wiped out	

				or arbitration with up to 100% repayment (all expropriated holders)
Nat'l Bank of Greece	Greece	Dec. 2015	diluted > 90%	Partial write-down (70% hybrid bonds, 22% bonds w. maturity), then conversion into shares at recap rate
Piraeus Bank	Greece	Dec. 2015	diluted > 90%	

Source: Guillaume Prache, Managing Director – Better Finance, 'Bail-in: How far does it have to go? The case of the expropriation of share- and bondholders in Slovenia'.

When dilutions and bail-in occurred, retail investors claimed that it took them by surprise. It is true that after the 2008 financial crisis, most banks subject to a restructuring saw the equity wiped out or diluted whereas, as a discretionary decision in order to avoid tensions on the bond markets, junior bondholders were usually spared. Therefore, as long as retail investors did not hold equity shares but subordinated debt, provided they were not mis-sold, they could feel safe in buying such financial instruments. After the entry into force of the bail-in provision of the BRRD in 2016, the risk became obvious and at least more transparent to clients. However, most mis-selling occurred before 2016.

Unfortunately, there is a **large stock of bail-inable securities which is held by retail investors** and which has been already bailed in or can be subject to a bail-in. *'Based on national statistics and anecdotal evidence, it can be inferred that a significant share of Tier 2 issues is held by retail investors.'*²³

The impact of bail-in on retail investors has been huge and disproportionate. Often, retail investors lost a large amount, if not all, of their life savings. The consequence has been, as reported by the Financial Times in 2016, a **'social disaster'** with serious political consequences, especially a rise in populism²⁴.

Because those disproportionate losses inflicted on the most fragile investors are socially unacceptable, legally challengeable under the applicable (at the time) MiFID I rules, and politically dangerous, **some Member States have tried to protect retail investors from the full consequences of the bail-in by using various strategies.**

Although this is justified from a MiFID perspective since investors should be compensated in case of mis-selling, this could also be an **obstacle to the application of the bail-in tool** because of the political reluctance to apply losses on retail investors among accusation of widespread mis-selling. This obstacle seems particularly serious in **Italy**, since *'As of October 2015, the Bank of Italy estimates that 46 % of the total subordinated securities (EUR 67.2 billion) issued by Italian banks is held by individuals and families'*²⁵.

Therefore, **the issue of mis-selling of subordinated debt and other junior liabilities is not just an issue of investor protection but also now of financial stability as it could stand in the way of applying the BRRD.** This leads to the question of which of the two goals should be given priority.

The issue of mis-selling of shares and subordinated debt by financial institutions to retail investors is, without a doubt, the **most serious regulatory and enforcement failure in the area of investor protection in the EU since the 2008 crisis.** There has been

²³ Resti, A., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.
²⁴ Sanderson, R., *Once-thriving Veneto becomes heart of Italy's bank crisis. Retail investors lost €5bn in two local banks amid questions over mismanagement*, Financial Times, 24 November 2016.
²⁵ Resti, A., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

widespread mis-selling to retail investors in some Member States and this has led to various remedies taken. The reason for this situation are violations of MiFID rules by financial institutions and a weakness in public enforcement, as pointed out by Better Finance in its April 2017 briefing paper²⁶, rather than loopholes in MiFID I. However, the blame should not be put too easily on national securities supervisors as they were not well equipped to detect such widespread violations. The entry into force of MiFID II²⁷ and MiFIR²⁸ should considerably reduce the risk of mis-selling but this is not enough and there is a need for additional targeted legislative changes.

²⁶ Better Finance, *A major enforcement issue: the mis-selling of financial products*, Briefing Paper, Brussels, April 2017.

²⁷ Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

²⁸ Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

2. WIDESPREAD MIS-SELLING TO RETAIL INVESTORS IN SOME MEMBER STATES AND REMEDIES TAKEN

Weak enforcement rather than weak regulation was responsible for mis-selling. The fact that MiFID rules have been violated and the severity of those violations have led to actions in the Member States affected in order to compensate investors.

2.1. Sample of Member States where mis-selling to retail investors occurred

Mis-selling through self-placement to retail investors occurred in several Member States but happened more often in Southern Europe because this is where most banking restructurings took place. For these reasons, the report focuses on these Member States, especially Spain, Italy and Portugal. The reasons for mis-selling are linked mostly to enforcement weaknesses.

The amount of self-placement varies depending on Member States.

Key characteristics have been the fragmentation of the banking market, as smaller and weaker banks are more likely to use self-placement, and investors' preferences for low risk assets.

Although several Member States have been affected by issues of mis-selling, the severity of the damages concerns mostly, in the order of their revelation, Spain, Slovenia, Portugal and Italy.

2.1.1. Spain

The banking sector in **Spain** was fragmented with systemic banks but also many small banks and **Cajas** (savings and loan) with very weak governance. Weak governance manifested itself with directors and/or chairmen lacking sufficient qualifications, such as a university degree or experience in the banking sector. As noted by the Bank of Spain in a 2017 Report, *'the singularities of the legal status of savings banks were determined, first by their complex and rigid governance structure, which was less flexible than that of listed companies and less conducive to implementing best international practice in terms of corporate governance and to ensuring that the members of their governing bodies had the necessary professional experience.'*²⁹ Also, some financial institutions were politically controlled which implied that decisions were often taken for political reasons. Weak governance had a direct impact on the performance of these financial institutions³⁰.

The *Cajas* were **not listed** and could not be listed due to their legal status. *'Savings banks were subject to structural restrictions preventing them from obtaining high-quality capital other than by capitalising profit. Unlike commercial banks, they were unable to issue shares and raise capital on the financial markets, since equity units (cuotas participativas) were the only similar instrument available to them and, as these do not include voting rights, over time they proved to be unattractive to investors.'*³¹ *Cuotas participativas* are considered Tier 1 capital. This created an incentive to increase regulatory capital through self-placement. Logically, as noted in the Wall Street Journal, *'In southern Europe, which has a tradition of mutually owned or unlisted savings banks, it is a legal and long-standing practice for branch employees to sell stocks and bonds issued by the bank to people who have deposits and loans with the bank.'*³² As part of the reforms which took place post 2012 crisis, the Spanish

²⁹ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 54.

³⁰ For Spain, Cuñat, V. & Garicano, L., *Did Good Cajas Extend Bad Loans? Governance, Human Capital and Loan Portfolios*, 2009, <http://www.vicentecunat.com/cajas.pdf>.

³¹ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 47.

³² Neumann, J., & Legorano, G. & Kowsmann, P., *In Southern Europe, Bank Share Sales Can Hit Depositors Hard*, Wall Street Journal, 9 August 2015.

Law 26/2013 of 27 December 2013 obliged large *Cajas* to transform themselves into banks or banking foundations³³ and also strengthened the fit and proper rules for the governing bodies of *Cajas*.

As a reaction to the bankruptcy of Lehman Brothers in 2008, many Spanish financial institutions sold financial instruments such as ***participaciones preferentes*** and other hybrid instruments to their retail clients. *Participaciones preferentes* are a perpetual debt which provides a fixed yield and then later a variable yield, both subject to the fact that the bank would make profits. They were considered Tier 1 capital provided certain conditions were met. *Participaciones preferentes* could not account for more than 30% of Tier 1 capital³⁴. The name was misleading for retail investors since *participaciones preferentes* means preferred shares. The term 'preferred' relates to the fact that in case of insolvency the owners take priority over owners of common shares and liquidating assets. Also, the owners have priority when it comes to paying dividends. However, the term 'preferred' does not mean protection against dilution or loss of the investment. *Participaciones preferentes* could yield more than 7 %, with quarterly payments making them especially attractive for retail investors.

These financial instruments, first created in 1998 and mostly issued at the time for tax reasons by subsidiaries in the Cayman Islands, were legislated in Spain in 2003³⁵. In 2004, the new chair of the Spanish National Securities Market Commission CNMV (Manuel Conthe), with the full support of the vice-chair (Carlos Arenillas) set limits on the issuance and sale of *participaciones preferentes* to retail investors, because the CNMV was concerned that retail investors could not understand what they were buying, which caused a massive drop in issuance. This led to protest by the banking sector and the CNMV, with a new chair and vice-chair, gave in because the limitation was deemed to be illegal. Information efforts were made at the same time by the CNMV towards retail investors and reminders to financial institutions of their duties under MiFID I. In order to avoid misleading investors, the CNMV requested issuers to include the following warnings: 1) Preferred shares are complex products and in some cases do not have a maturity; 2) Preferred shares are not bank deposits and they were not hedged by the Spanish Deposit Guarantee Scheme; 3) Despite the fact that the product includes the word '*preferente*', they do not have any privileges in the event of bankruptcy. The CNMV also prohibited advertisements in media, on the internet and in branches, of *participaciones preferentes*.

The wave of issuance of *participaciones preferentes* took place mostly when Spain implemented the 2004 Basel II Agreement which required higher capital ratios³⁶. Between October 2008 and September 2009, EUR 14 billion of *participaciones preferentes* and EUR 28 billion of subordinated debt were issued. At the same time, institutional investors stopped purchasing those type of investments leaving retail investors as the only buyer³⁷.

Issuance resumed in 2011 until it came to an abrupt end in 2012³⁸. According to the 2013 Report to the Spanish Lower House (*Congreso de los Diputados*) of the Commission on Hybrid

³³ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 175.

³⁴ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 50.

³⁵ *Ley 19/2003, de 4 de julio, sobre régimen jurídico de los movimientos de capitales y de las transacciones económicas con el exterior*.

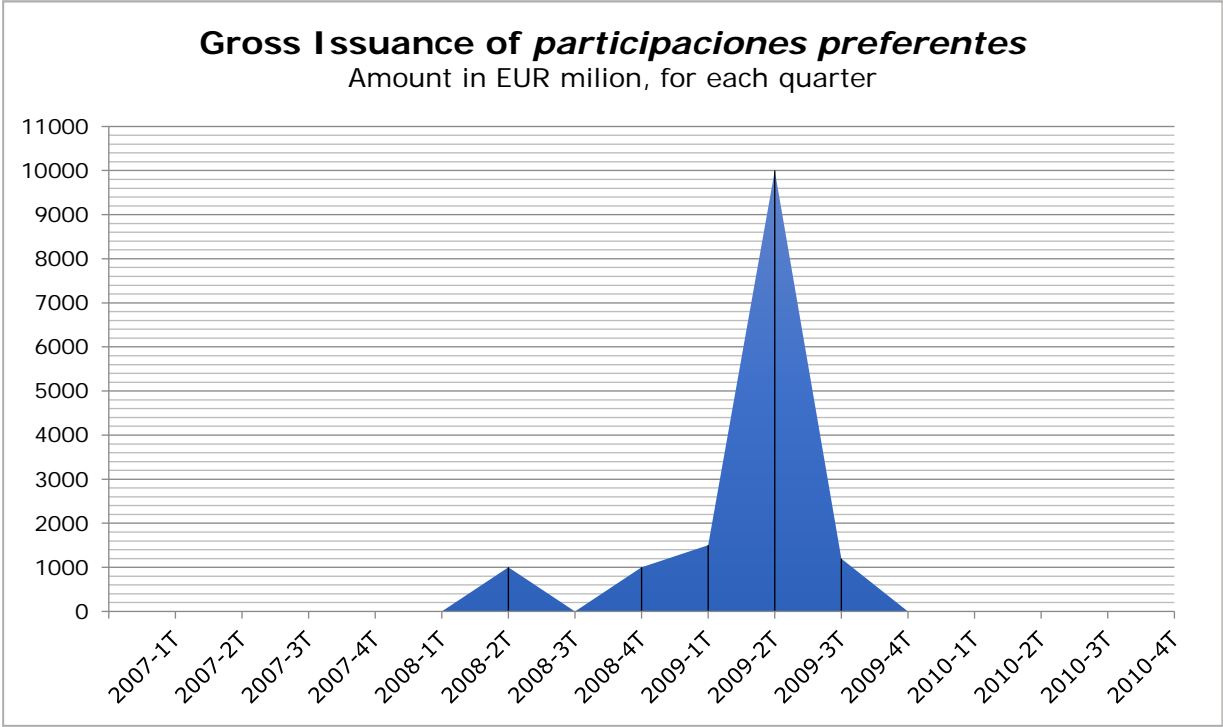
³⁶ *Real Decreto 216/2008, de 15 de febrero 2008, de recursos propios de las entidades financieras and Circular del Banco de España 3/2008, de 22 de mayo 2008*.

³⁷ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 101.

³⁸ Zunzunegui, F., 'Mis-selling of Preferred Shares to Spanish Retail Clients', *Journal of International Banking Law and Regulation*, Thomson Reuters, 2014, Issue 3, p. 174.

Subordinated Debt-Capital Instruments³⁹, established with the Ministry of the Economy, **between 1998 and 2012 EUR 115.3 billion of hybrid subordinated debt-capital instruments were issued, mainly preferred shares, subscribed by 3.1 million of retail clients.**

Figure 1: Issuance of *participaciones preferentes* between 1998 and 2012



Source: Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 100.

³⁹ *Comisión de Seguimiento sobre Comercialización de los Instrumentos Híbridos de Capital y Deuda Subordinada*, 2013. The Commission was established in 2013 and included the following members: the chair of the CNMV, as president, the Sub-governor of the Bank of Spain, as vice president, the General Secretary for Health and Consumers (Ministry of Health), the General Secretary of the Treasury (Ministry of Finance) and the chair of the Council of consumers and users of public services.

Table 2: Issuance of *participaciones preferentes* between 1998 and 2012

Type of financial instrument	Number of issues		Amounts raised (EUR million)			Number of subscribers		
	Public offer	Admission to trading	Public offer	Admission to trading	Total	Retail investors	Qualified investors	Total
PPRS	94	21	40 244	2 378	42 622	1 107 940	50 939	1 158 879
OBS	267	73	59 662	12 154	71 817	1 944 008	97 544	2 041 552
AFS	6		845		845	47 588	925	48 513
Total	367	94	100 711	14 532	115 284	3 099 536	149 408	3 248 944

PPRS: *Participaciones Preferentes*

OBS: Subordinated bonds (*Obligaciones subordinadas*), including Convertible Subordinated bonds (*Bonos Subordinados Convertibles*)

AFS: Equivalent to *Participaciones Preferentes* but issued by cooperative banks (*Aportaciones financieras subordinadas*)

Source: *Comisión de Seguimiento de Instrumentos Híbridos de Capital y Deuda Subordinada. Informe sobre la comercialización de instrumentos híbridos de capital y deuda subordinada*, May 2013, p. 6.

Table 3: Issuance of *participaciones preferentes*, junior bonds between 1 January 1998 and 31 December 2012

Year	Amount (EUR million)
1998	2 250
1999	7 450
2000	4 438
2001	8 358
2002	5 757
2003	7 695
2004	10 066
2005	4 649
2006	7 476
2007	9 884
2008	4 051
2009	21 643
2010	5 490
2011	12 649
2012	3 425

Source: *Comisión de Seguimiento de Instrumentos Híbridos de Capital y Deuda Subordinada. Informe sobre la comercialización de instrumentos híbridos de capital y deuda subordinada*, May 2013, p. 6.

In some cases, the issuance of *participaciones preferentes* was a matter of life or death for the *Cajas*, as they were the only way to increase capital⁴⁰. There was often very strong pressure on employees such as in the cases of *Caja de Ahorros del Mediterráneo* (for *cuotas participativas*) in 2008⁴¹, Caixa Catalunya in 2008⁴², Bankia in 2010, to achieve sale results⁴³.

⁴⁰ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 112.

⁴¹ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 190.

⁴² Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 190.

⁴³ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 346.

Aggressive selling tactics were used. **Retail investors held 83 % of bail-inable instruments before 2012**⁴⁴. A 2017 report by the Bank of Spain noted that '*the application of this burden-sharing mechanism requiring the holders of preference shares and subordinated debt to bear losses (...) revealed, moreover, a problem of inappropriate marketing of a portion of these instruments to retail customers, who were unaware of the risk they were assuming by purchasing these products*'⁴⁵. Actually, *participaciones preferentes* were sold to retail investors, including minors, retirees, widows, analphabets, and also to people suffering from Alzheimer⁴⁶.

Most of the *participaciones preferentes* were listed on the fixed yield market (*Asociación de Intermediarios de Activos Financieros AIAF Mercado de Renta Fija*) but did not have real liquidity although the CNMV requested in December 2009 that there should be a liquidity provided. Before December 2008, the *Cajas* and banks would usually repurchase them, but they stopped doing this in order not to reduce their capital ratios⁴⁷. There were very few transactions and the market was opaque.

Retail investors also bought common shares through self-placements. For instance, Banco Popular made two capital increases through rights issues in 2012 and 2016. The 2016 increase, presented as a '*glowing opportunity*'⁴⁸ was massively subscribed by employees.

Retail investors suffered huge losses on the *participaciones preferentes* and ordinary shares. First, in 2011, the EBA announced that preferred shares would no longer be considered as Tier 1 capital⁴⁹. Therefore, banks decided to repurchase or exchange them for shares and CoCos. Discounts between 10 % and 30 % were applied. Second, retail investors lost a significant amount of money when *Cajas* started to default and undergo restructuring. The first failure took place in March 2009 (*Caja de Castilla-La Mancha*) but the holders of *participaciones preferentes* were bailed-out through funds injected by the Spanish government⁵⁰. The second failure took place in May 2010 (*Cajasur*) but again holders of *participaciones preferentes* were bailed-out by the buyer of the *Caja*, the Bilbao Bizkaia Kutxa bank⁵¹. After 2012 and the signature of the Memorandum of Understanding (MoU) on Financial Sector Policy Conditionality of 20 July 2012, bail-in was applied⁵². In the case of Bankia, which was created in December 2010 as the consolidation of seven *Cajas*⁵³, the most important one being *Caja Madrid*, the restructuring took place in May 2012 after Bankia had been listed and had issued new shares in July 2011.

These large losses were due to the fact that Spain was hit in 2011 by souring real-estate loans, financial market tensions in the euro area and a double-dip recession⁵⁴. It also appears that the Spanish sector was probably undercapitalised compared to the situation in 2001,

⁴⁴ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 172.

⁴⁵ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 172.

⁴⁶ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 211.

⁴⁷ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 127-128.

⁴⁸ <http://www.expansion.com/empresas/banca/2016/06/01/574ddfe5ca47417b0c8b45f7.html>.

⁴⁹ EBA BS 2011 173, EBA Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1).

⁵⁰ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 125.

⁵¹ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 126.

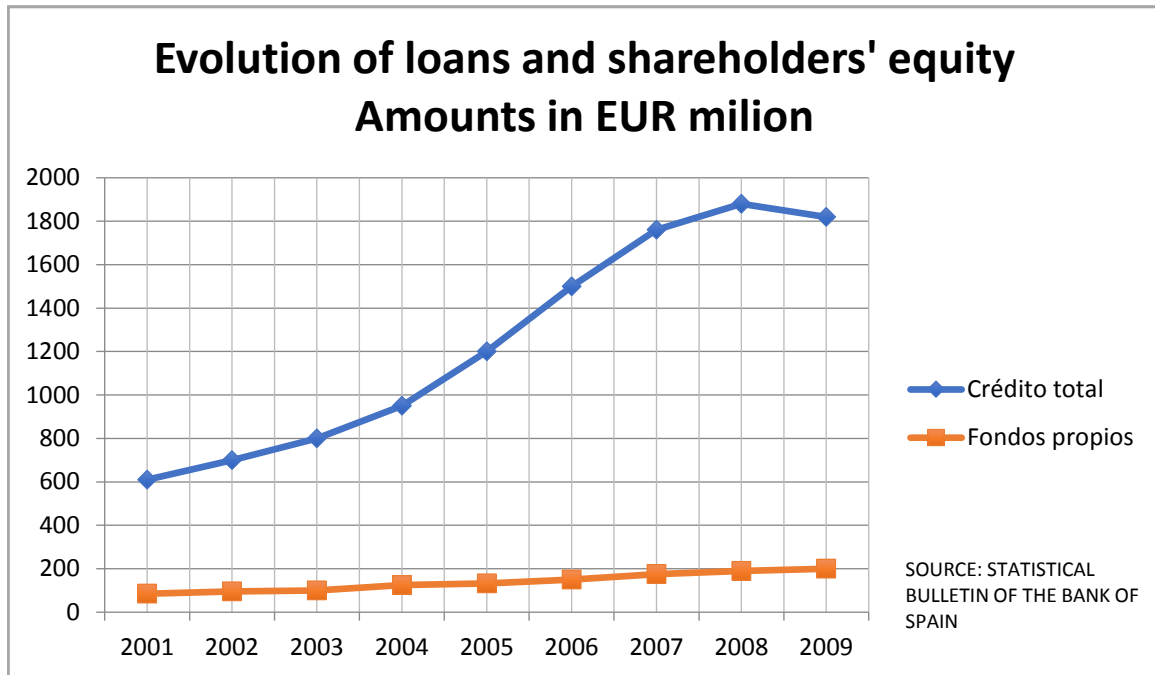
⁵² Spain, *Memorandum Of Understanding On Financial-Sector Policy Conditionality*, 20 July 2012

⁵³ The *Cajas* forming Bankia were *Caja de Ahorros y Monte de Piedad de Madrid*, *Caja de Ahorros de Valencia*, *Castellón y Alicante* (Bancaja), *Caja Insular de Ahorros de Canarias*, *Caja de Ahorros y Monte de Piedad de Avila*, *Caixa d'Estalvis Laietana*, *Caja de Ahorros y Monte de Piedad de Segovia* and *Caja de Ahorros de la Rioja*.

⁵⁴ Bank of Spain, *Report on the Financial and Banking Crisis in Spain, 2008-2014*, Madrid, 2017, p. 80.

with a ratio of shareholders' equity to loans at 11.1 % in 2009 (see Figure 2)⁵⁵, although the growth of capital was in line to risk-weighted assets (see Figure 3).

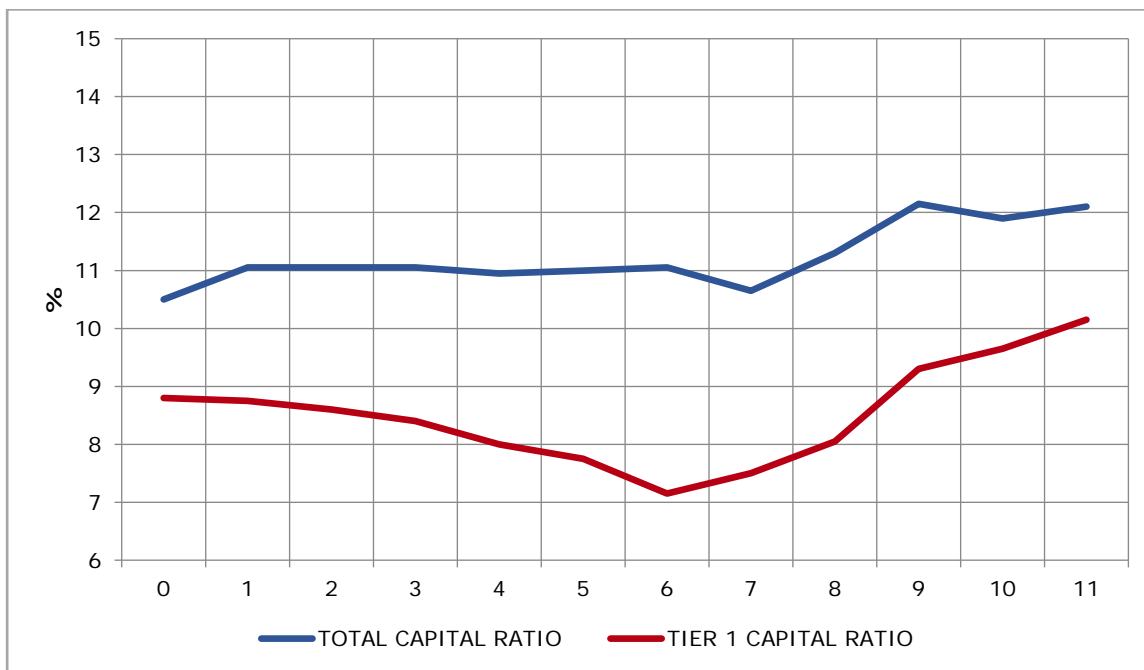
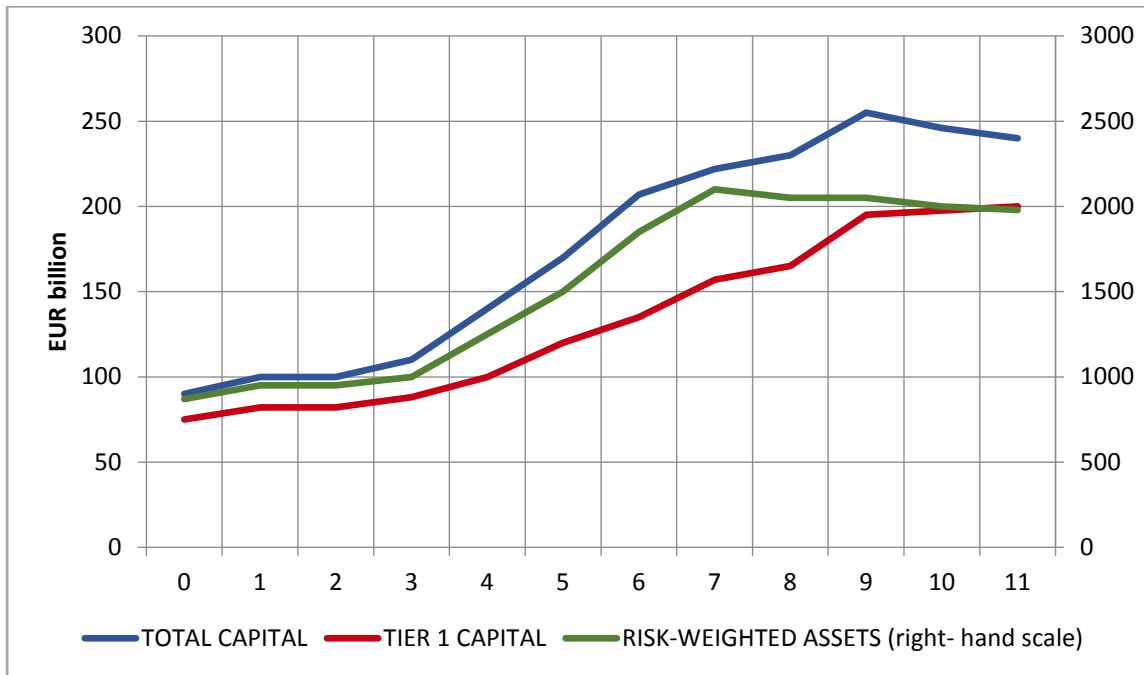
Figure 2: Total capital and loans of Spanish banks (2001-2009)



Source: Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 94.

⁵⁵ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 94.

Figure 3: Total capital, Tier 1 capital and risk-weighted assets of Spanish banks (2000-2011)



Source: Banco de España, Report on the Financial and Banking Crisis in Spain, 2008-2014, 2017, p. 92.

2.1.2. Slovenia

Slovenia has also suffered a major banking crisis with its banking sector being nationalised under national resolution legislation adopted in 2013 and the Commission's 2013 Banking Communication. Equity of EUR 381 million and subordinated debt of EUR 582 million were written off. If the BRRD had been in place, the process would have been unambiguous and the amount concerned by bail-in considerably bigger at around EUR 1.9 billion⁵⁶. Many retail investors were affected. The process has been challenged in the Court of Justice of the European Union and successfully in the Slovenian Constitutional Court in 2016. Claims of mis-selling have been made but the principal and successful legal ground has been an infringement of Slovenian constitutional rules on expropriation because of a lack of legal remedy. The proceedings are ongoing.

2.1.3. Portugal

The situation in **Portugal** has been similar to Spain, although perhaps not as severe. As reported again by the Wall Street Journal, *'Portugal's Caixa Economica Montepio Geral; Facing a capital crunch in 2013, the small private savings bank sold EUR 200 million of participation units—shares issued by a mutual association. Retail clients bought most of the units through branches, a person familiar with the sale said. The units, sold for EUR 1 each, are now worth EUR 0.79 apiece. When the bank tried in June to sell another EUR 200 million of units, regulators dissuaded it from turning to retail clients, according to the person'*⁵⁷.

However, the most important case of self-placement and bail-in is the failure of **Banco Espírito Santo** (BES) in August 2014. Many retail investors had bought commercial papers with 3 % interest rate, with maturities ranging from nine months to a year. This issuance became large since *'A BES-owned fund called Espírito Santo Liquidez marketed to its retail clients had grown to become the largest fund in Portugal, holding EUR 1.7 billion of debt – consisting almost entirely of short-term commercial paper issued by Rioforte and other ESI'*⁵⁸ companies⁵⁹. Aggressive sales tactics were also used here. *'Bank employees visited their customers, sometimes toting bottles of Champagne, to try to sell them the debt, according to a group representing the investors'*⁶⁰. *'In August 2013 the Portuguese stock market regulator, alarmed by the growing amount of ESI (Espírito Santo International) debt BES had marketed to its clients, passed rules to ban groups from putting more than a fifth of their own securities in a fund.'*⁶¹ In addition, in the case of BES, there were accounting irregularities and the Central Bank of Portugal discovered secret dealings between BES and a Swiss finance company (Eurofin) which led to bigger losses.

2.1.4. Italy

The situation in **Italy** is rather similar to Spain with a very fragmented banking sector with some systemic banks but also many medium-sized **Banche Popolari** and smaller cooperative banks (*Banche di credito cooperativo*). *Banche Popolari*, while on average larger than *Banche di credito cooperativo*, are also mutuals (cooperative). Therefore, each client has to have at least one share of the company – but minimum amounts of shares were often required to enjoy the mutual benefits, such as cheaper credit – and consequently holds one

⁵⁶ World Bank Group, Bank Resolution and "Bail-in" in the EU: selected case studies pre and post BRRD, 2016, p. 61.

⁵⁷ Neumann, J., & Legorano, G. & Kowsmann, P., *In Southern Europe, Bank Share Sales Can Hit Depositors Hard*, Wall Street Journal, 9 August 2015.

⁵⁸ Espírito Santo International, a company incorporated in Luxembourg which was the ultimate parent company of BES.

⁵⁹ Johnson, M. & Wise., P., *Banco Espírito Santo: Family fortunes*, Financial Times, September 11, 2014.

⁶⁰ Kowsmann, P., *Buyers of Espírito Santo Debt Face Financial Uncertainty*, Wall Street Journal, March 5, 2015.

⁶¹ Johnson, M. & Wise, P., *Banco Espírito Santo: Family fortunes*, Financial Times, September 11, 2014.

vote in the general meeting. The link between the *Banca Popolare* and its shareholders is very close, with shares being passed from one generation to the other, and self-placement is coherent with this structure. Many *Banche Popolari* and other Italian banks were held at least partially by charitable foundations and had weak corporate governance. Small banks had no or limited access to the bond market and relied more on self-placement. However, larger banks also relied on self-placement.

There have also been issues of self-placement of shares in the *Banche Popolari*. Those shares were often not listed (*Banca Popolare Etruria e Lazio* was listed and was an exception) but would be subject to an annual evaluation by the management of the bank with the assistance of auditors and submitted to the shareholders meeting for approval. The shares could be sold on the internal stock exchange managed by each bank. Apparently, at least in some cases, selling orders of parties related to the management were favoured.

Some of these banks engaged in **active campaigns to recruit new clients**. There are reports about cases of banks offering a loan to new clients, who would probably not have otherwise received a loan from another bank because of their bad credit profile or history, in exchange for purchasing shares. For instance, Veneto Banca offered in 2010 a loan to a company on the basis that 20 % of it would be used to buy bank shares⁶². It appears that misleading statements were made by staff, perhaps in good faith or perhaps knowing that they were false. For instance, *'In 2013, Sergio Picinotti, a 63-year-old unemployed man living with his elderly mother, invested much of their nest egg of EUR 40 000 in a bond issued by Banca Etruria, their local bank based in the medieval Tuscan city of Arezzo. They (bank staff) said "what are you doing keeping that in your checking account? Put it here, you'll earn 4 % flat", Mr Picinotti recalls. "A friend at the bank told me: Trust me, it will take the third world war to shut down Banca Etruria".'*⁶³ Banca Etruria was subject to a bail-in, under the BRRD, in November 2015 which affected shareholders and bondholders. Two Italian authors noted that *'retail investors have suffered from egregious cases of mis-selling of bonds issued by the banks acting as their investment services providers'*⁶⁴.

Although the Italian banking sector withstood well the 2008 crisis, Italy's sovereign debt crisis began to affect the economy in 2012 and led to massive bank restructurings in 2015.

Restructuring and bail-in started in Italy in July 2015 with Banca Romagna Cooperativa. Then, **in November 2015, four small Italian regional banks** (Banca Marche, Cassa di Risparmio di Ferrara, Banca Popolare Etruria e Lazio and CariChieti) **entered resolution**. In August 2016, Atlante, a private fund financed by banks and sponsored by the Italian government, took control of **Banca Popolare di Vicenza** and **Veneto Banca**. In June 2017, those banks were declared *'failing or likely to fail'* by the ECB due to breaches of regulatory requirements and shareholders and junior bondholders were subject to a bail-in.

In July 2017, **Monte dei Paschi di Siena**, the fifth largest Italian bank, was subject to a precautionary recapitalisation amounting to EUR 8.3 billion. The Italian State subscribed for EUR 3.8 billion in new shares, diluting existing shareholders and owning more than 68 % of the bank. In addition, EUR 4.3 billion of junior bondholders were converted into shares. 150 000 small shareholders who owned more than 55 % of the bank were affected. As part of the restructuring, Monte dei Paschi di Siena will divest EUR 26.1 billion of NPLs to a private securitisation vehicle refinanced at 95 % by the Italian Recovery Fund (formerly known as Atlante II), owned by Italian financial institutions. Retail investors were particularly hit

⁶² Sanderson, R., *Once-thriving Veneto becomes heart of Italy's bank crisis. Retail investors lost €5bn in two local banks amid questions over mismanagement*, Financial Times, 24 November 2016.

⁶³ Politi, J., *Italy bank rescues spark bail-in debate as anger at Renzi grows*, Financial Times, December 22, 2015.

⁶⁴ Enriques, L. & Gargantini, M., *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case*, The Italian Law Journal, Vol. 3, n°2, 2017, p. 486.

because of the amount of shares and bank bonds held by the household sector and have complained about mis-selling.

2.2. Reasons for the mis-selling

The reasons for the mis-selling are related somewhat to regulatory weaknesses in MiFID I and in Member States securities legislation, but essentially to violations of MiFID rules and weaknesses in public enforcement.

2.2.1. Regulatory scope of MiFID I

As to the **regulatory scope of MiFID I**, there are three issues to consider. The first issue is whether some securities sold to retail investors were outside the scope of MiFID I. In Spain, *participaciones preferentes* are financial instruments under the MiFID I definition. Therefore, there was no regulatory loophole. In Portugal, **commercial papers** sold by BES did not fall fully within the supervision of the Portuguese Securities Markets Commission, the *Comissão do Mercado de Valores Mobiliários* (CMVM), because commercial papers, which are a type of money market instrument, are outside the scope of the Prospectus Directive of 2003⁶⁵ if their maturity is less than two months⁶⁶. However, money market instruments are within the scope of MiFID I⁶⁷. In Italy, shares of *Banche Popolari* are also financial instruments according to MiFID I even if they are not listed.

A second issue was whether self-placement was within the scope of MiFID I. In Italy, *'Under the MiFID I regime, the treatment of direct placement of proprietary financial instruments (self-placement) by investment firms was uncertain. In Italy, the traditional view was that direct placement by issuers – whether corporate or financial institutions – did not fall within the scope of MiFID-regulated activities, because the ability to raise capital that is inherent to the very essence of every company inevitably requires direct contacts with multiple potential investors, and no indication exists that such day-to-day contacts qualify as reserved activities. The law was thus amended in 2005 to make MiFID I conduct of business rules applicable to self-placement by banks and insurance companies. Art 25-II Consolidated Law on Finance.'*⁶⁸ This precaution was not necessary. MiFID I did not include an exception for self-placements and ESMA has always correctly considered it to be within the scope of MiFID.

The third issue is whether retail investors were protected by MiFID I rules on information, as well as the appropriateness and suitability tests. In addition to disclosure, which must be fair, clear and not misleading, there are three possible regulatory situations for a financial institution selling securities to retail investors.

2.2.2. Suitability test

The highest level of protection comes with the application of the **suitability test in case the financial institution provides 'investment advice' or 'portfolio management services'**. Most violations seem to have been with investment advice as retail investors do not usually have large portfolios.

⁶⁵ Directive 2003/71/EC of the European Parliament and of the Council 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.

⁶⁶ Art. 2(1)(a) of the Prospectus Directive states that '*securities*' means transferable securities as defined by Article 1(4) of Directive 93/22/EEC with the exception of money market instruments as defined by Article 1(5) of Directive 93/22/EEC, having a maturity of less than 12 months.

⁶⁷ CESR, Q&A, MiFID complex and non-complex financial instruments for the purposes of the Directives appropriateness requirements, CESR/09-559, 3 November 2009.

⁶⁸ Enriques, L. & Gargantini, M., *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case*, *The Italian Law Journal*, Vol. 3, n°2, 2017, p. 501.

According to Article 19(4) of MiFID I, '*When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in the investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him*'. The suitability test requires an assessment of the client's ability to understand the risks of the securities, and of the alignment between the client's investment needs and the securities being recommended⁶⁹. Article 4(4) of MiFID I holds that '*investment advice means the provision of personal recommendations to a client, either upon his request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments*'. Article 52 of Implementing Directive 2006/73 specified that a '*recommendation must be presented as suitable for that person, or must be based on a consideration of the circumstances of that person, and must constitute a recommendation to take one of the following sets of steps: (a) to buy, sell, subscribe for, exchange, redeem, hold or underwrite a particular financial instrument; (b) to exercise or not to exercise any right conferred by a particular financial instrument to buy, sell, subscribe for, exchange, or redeem a financial instrument. A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public*'.⁷⁰ In 2010, ESMA's predecessor, the Committee of European Securities Regulators (CESR), held that a service amounted to investment advice if it fulfilled all five of the following conditions: it constitutes a recommendation; the recommendation in relation to one or more transactions in financial instruments; the recommendation at least one of the following is presented as suitable or is based on a consideration of the person's circumstances; the recommendation issued otherwise than exclusively through distribution channels or to the public, and the recommendation is made to a person in his capacity as an investor or potential investor or as an agent for an investor or potential investor⁷¹.

In addition, illiquid financial instruments such as shares unlisted on a regulated market could be subject to enhanced suitability test. This was the case, for instance, in Italy for the shares of unlisted *Banche Popolari* which the Italian Companies and Exchange Commission (CONSOB) subjected to stronger scrutiny in 2009⁷².

The **suitability test is, if correctly applied, a very powerful tool to protect investors**, retail as well as professional, since Article 19(4) of MiFID I makes no distinction between retail and professional clients. If applied, in most cases of self-placement of shares and subordinated debt and other junior liabilities, it would have led the bank to provide a negative opinion on this investment, and, depending on the individual circumstances of each investor, at least to advise a limited exposure to these investments. Under the suitability test, there should always be an appropriate degree of risk diversification so that the concentration of risk into a single financial instrument should not be suitable. The contrary occurred as bank representatives strongly advised these products and sometimes told retail investors to put all their assets in those securities. Actually, a portfolio with a high concentration of bonds issued by the client's bank can reasonably be viewed as indirect evidence that such bonds had been recommended to clients. Unfortunately, retail clients who did not sign a contract on the provision of '*investment advice*', that is the majority, if not all, retail clients, did not

⁶⁹ Moloney, N., *EU Securities and Financial Markets Regulation*, Oxford University Press, 3rd edition, 2014, p. 805. Moloney, N. *How to protect investors. Lessons from the EC and the UK*, Cambridge University Press, 3rd edition, 2010, p. 237.

⁷⁰ Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive.

⁷¹ CESR, Question & Answers, Understanding the definition of advice under MiFID, 19 April 2010, CESR/10-293. CESR, Feedback Statement, Understanding the definition of advice under MiFID, 19 April 2010, CESR/10-294.

⁷² <http://www.CONSOB.it/documents/46180/46181/c9019104.pdf/64f86e70-2bb0-460a-8f60-3dd079b6341d>.

benefit from the suitability test. This was a violation of MiFID I because the presentation of a financial instrument as suitable for the investor, in a self-placement, either in an explicit or in an implicit form, constitutes investment advice in accordance. Even if there is a disclaimer to the client that no recommendation is being given, a financial institution could still be viewed as providing investment advice⁷³.

Because of weak enforcement of the rules by financial institutions, the provision of investment advice to retail clients relating to these securities was done without applying the suitability test.

2.2.3. Appropriateness test

If there is no 'investment advice', the financial institution has to apply the 'appropriateness test'. In this situation, investment firms simply have to assess the client's ability to understand the risk involved and to provide information concerning the relevant investment service and financial instruments. According to Article 19(5) of MiFID I *'Member States shall ensure that investment firms, when providing investment services other than those referred to in paragraph 4, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client. In case the investment firm considers, on the basis of the information received under the previous subparagraph, that the product or service is not appropriate to the client or potential client, the investment firm shall warn the client or potential client. This warning may be provided in a standardised format. In cases where the client or potential client elects not to provide the information referred to under the first subparagraph, or where he provides insufficient information regarding his knowledge and experience, the investment firm shall warn the client or potential client that such a decision will not allow the firm to determine whether the service or product envisaged is appropriate for him. This warning may be provided in a standardised format.'*

There is a third situation where there is no appropriateness test if the transaction is at the request of the client and involves **non-complex instruments**. In such case, the financial institution is simply under an obligation to act in the client's best interest under Article 19(1) of MiFID I and to **provide fair, clear and not misleading information**.

According to Article 19(6) of MiFID I, *'Member States shall allow investment firms when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services to provide those investment services to their clients without the need to obtain the information or make the determination provided for in paragraph 5 where all the following conditions are met:*

- *the above services relate to shares admitted to trading on a regulated market or in an equivalent third country market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments. A third country market shall be considered as equivalent to a regulated market if it complies with equivalent requirements to those established under Title III. The Commission shall publish a list of those markets that are to be considered as equivalent. This list shall be updated periodically,*
- *the service is provided at the initiative of the client or potential client,*

⁷³ Placement of financial instruments with depositors, retail investors and policy holders ('Self-placement'), Reminder to credit institutions and insurance undertakings about applicable regulatory requirements, JC 2014 62, 31 July 2014, Point 36, p. 7.

- *the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules; this warning may be provided in a standardised format,*
- *the investment firm complies with its obligations under Article 18. (conflicts of interest)'.*

CESR held as non-complex instruments '*shares admitted to trading on a regulated market or in an equivalent third country market; money market instruments; bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative); UCITS and other non-complex financial instruments*'⁷⁴.

Self-placement concerned both complex and non-complex financial instruments. Therefore, at the time self-placements took place, *Participaciones preferentes* and shares listed on a regulated market were considered as complex financial instruments.

On the contrary, commercial papers and shares not listed on a regulated market or on Multilateral Trading Facilities (MTF) were considered as non-complex financial instruments.

In addition, according to Article 19(2) of MiFID I, '*All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading*'. Article 27(2) of Implementing Directive 2006/73 sets out requirements for marketing communications and requires notably that the information '*shall be accurate and in particular shall not emphasise any potential benefits of an investment service or financial instrument without also giving a fair and prominent indication of any relevant risks*'.

The regulatory regime had probably one weakness. However, the real issue is that the MiFID rules on appropriateness and suitability were not applied as intended.

2.2.4. Regulatory weaknesses

The regulatory weakness is that, **despite the strong conflict of interest for banks, self-placement was not regulated as such in MiFID I**, because at the time of adoption (2004) and negotiation of the directive, there had not been cases of bank restructurings. However, the conflict of interest is so evident in case of self-placement, that the suitability test should have been required by legislation for all financial instruments.

However, the real cause of the mis-selling in self-placement is that **financial institutions did not apply the suitability test when they should have done so**. It was clear that the conditions established by MiFID I, the Implementing Directive 2006/73/EC and the CESR 2010 interpretation of what constitutes '*investment advice*' and a '*personal recommendation*' should have led to the systematic application of the suitability test in many cases⁷⁵. Recommendations given, as part of self-placement, should have been considered a '*personal recommendation*' since the financial institution would place an emphasis on one financial instrument, in a face to face meeting, and taking into consideration the retail investor's personal circumstances since he/she was already a client. For instance, when a retail client would invest a large majority or all his assets in *participaciones preferentes*, junior debts or shares, it is difficult to think that he/she did not receive a '*personal recommendation*' from the financial institution to invest this way. The use of aggressive selling techniques, including meeting the retail investor at his own home, to induce them to purchase bail-inable securities

⁷⁴ CESR, Q&A, MiFID complex and non-complex financial instruments for the purposes of the Directive's appropriateness requirements, 3 November 2009, CESR/09-559.

⁷⁵ CESR, Question & Answers, Understanding the definition of advice under MiFID, 19 April 2010, CESR/10-293. CESR, Feedback Statement, Understanding the definition of advice under MiFID, 19 April 2010, CESR/10-294.

in self-placement seems also fully incompatible with the statement that a '*personal recommendation*' has not been provided.

In Italy, in 2009⁷⁶, CONSOB took a protective approach and '*coped with these issues by establishing a presumption that an investment firm provides investment advice unless it sticks to pre-defined standardised models when interacting with its clients. To the contrary, any free interaction between firms and customers in such critical circumstances may easily result in investment advice and could therefore expose firms not performing suitability tests to a high risk of noncompliance.*'⁷⁷ In Spain, very few financial institutions recognised that they made personal recommendations to their clients to buy *participaciones preferentes*⁷⁸. However, retail clients thought they were receiving advice. As noted by two authors, '*Statements typically made in the sale activity do not expressly qualify a specific financial instrument as suitable to the investor's specific needs, but the investor may perceive them as (implied) recommendations because of the context in which they are made, or because she relies on the investment firm as someone acting as a fiduciary*'⁷⁹. Therefore, retail investors thought that they were receiving a '*personal recommendation*' whereas financial institutions considered, wrongly in most cases, that this was not the case.

Therefore, when **the suitability test did not apply**, or was not applied in situations where it should have been applied, **the client was protected only by the appropriateness test in case the financial instrument was complex**. The appropriateness test **does not provide a high level of protection**. It appears that in many cases the retail clients did not understand what they were buying and the associated risks. They often believed they were buying non-risky assets. Actually, employees of the banks at the time of the sale might have also thought that the assets were not risky and, therefore, in good faith, underestimated the risks. In addition, in the case of the *participaciones preferentes*, a majority of clients bought them despite being warned that they were not appropriate for them⁸⁰. This is not so surprising since clients followed the advice from the representative of the financial institution. The contractual documentation signed by retail clients, indicating that they understood that the financial instrument was not appropriate for them, creates a difficulty for supervisors. The CNMV 2012 Annual report notes that '*... in situations in which the clients claim that they bought the product following a recommendation from the entity, or with the conviction that it was a fixed-term deposit, but in which the entity provides contractual documentation which goes against these declarations, the CNMV lacks supporting evidence which makes it possible to verify what in fact happened*'⁸¹.

This makes more difficult for retail investors and for securities supervisors to come up against the burden of proof and to show a violation of MiFID requirements. However, depending on the Member State's law, it should not bar civil or administrative complaints since the retail investors can argue that they did not understand what they were signing, that they acted following a recommendation from the entity, or that the suitability test should have been applied.

⁷⁶ CONSOB, 'Prime linee di indirizzo in tema di consulenza in materia di investimenti' (Preliminary guidelines on financial advice), 4 (2007); CONSOB, Communication no 9019104 (2 March 2009), 8-9.

⁷⁷ Enriques, L. & Gargantini, M., *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case*, The Italian Law Journal, Vol. 3, n°2, 2017, p. 495.

⁷⁸ CNMV, Annual Report 2012, p. 149.

⁷⁹ Enriques, L. & Gargantini, M., *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case*, The Italian Law Journal, Vol. 3, n°2, 2017, p. 493.

⁸⁰ CNMV, Annual Report 2012, p. 149.

⁸¹ CNMV, Annual Report 2012, p. 149.

If the **financial instrument was not complex** (e.g. listed shares), the retail investor benefited from the requirement to provide clear and fair information⁸² and on **conflicts of interest**⁸³. In case of self-placement, the risk of conflict of interest is heightened.

2.2.5. Conclusion: Weak enforcement rather than weak regulation responsible for mis-selling

In conclusion, there have been **systematic violations of MiFID I requirements**.

The impact on retail clients could have been limited if there had been a strong public enforcement of the suitability test in case of self-placement. However, securities supervisors were not well equipped to deal with such violations of MiFID requirements which took place on a wide scale on the entire territory of their Member State.

Securities supervisors realised very soon the risks linked to self-placement by financial institutions of shares, subordinated debt and other junior liabilities. For instance, the CNMV became aware as soon as 2007 that preferred shares were not very attractive for investors and difficult to value⁸⁴. However, there are two reasons why it is very **difficult for securities supervisors to enforce MiFID I requirements on a real-time basis**.

The first reason is that **securities supervisors do not have enough human resources**. With the exception of the UK, the number of employees in the three largest EU countries is between 400 and 700. This is not enough to be able to oversee something what might happen in any branch in any location of their Member State. It would not be reasonable to increase their human resources with hundreds of new employees. Supervisory authorities can also disclose warnings to retail investors on their official website but they are usually not read by them. Therefore, securities supervisors have to base their enforcement action, through desk-based and routine visits, on a **risk-based approach**. The 2016 ESMA MiFID Suitability Requirements Peer Review Report showed that *'risk models are frequently used (...) to allocate supervisory resource'*⁸⁵. Probably also because of lack of resources, *'It appears that generally (Competent Authorities) CAs have not sought to determine in practice whether and to what extent investment advice is being provided in their respective national markets'*⁸⁶. The Peer Review also showed that *'only some CAs appear to explicitly single out "suitability" as an area deserving specific and tailored supervision and as such could point to their use of thematic reviews, mystery shopping, specific desk-based research and intensive routine or non-routine on-site visits to proactively identify issues in this area of the MiFID conduct requirements'*⁸⁷.

The second reason is that there is **no possibility for the securities supervisor to know the true state of the bank doing self-placement**. There is no transparency from banking supervisors as to the true state of the bank. Although, published asset quality reviews and stress tests provide some indication, it is difficult for a conduct of business supervisor to assess the risk of failing of the bank in order to allocate human resources on enforcement in case this bank operates a self-placement.

Once the issue of mis-selling of shares, subordinated debt and junior liabilities, especially in the context of self-placement, was revealed, remedies were taken to address the issue.

⁸² Art. 19 of MiFID I.

⁸³ Arts. 13(3) and 18 of MiFID I.

⁸⁴ Blanco Marcilla, E., *Participaciones preferentes: Rentabilidad de las emisiones* Monografía No.24, CNMV, Madrid, 2007, p.5.

⁸⁵ ESMA, MiFID Suitability Requirements Peer Review Report, 7 April 2016, ESMA/2016/584, Point 40, p. 13.

⁸⁶ ESMA, MiFID Suitability Requirements Peer Review Report, 7 April 2016, ESMA/2016/584, Point 30, p. 10.

⁸⁷ ESMA, MiFID Suitability Requirements Peer Review Report, 7 April 2016, ESMA/2016/584, Point 40, p. 13.

2.3. Remedies taken to address mis-selling

Several remedies were taken to address mis-selling were taken at the level of the Member States but also at the level of the EU.

2.3.1. Administrative sanctions

Traditionally, enforcement of EU securities legislation at the EU level is based on deterrence through administrative sanctions. Therefore, national securities supervisors took **administrative sanctions** against financial institutions when mis-selling was revealed. For instance, this is the case in Italy with sanctions by CONSOB⁸⁸. In one case, a bank did not change the level of risk connected with its own securities after the Bank of Italy raised concerns about the bank's stability. As a consequence, the suitability test was not avoided, but it was applied with a wrong assessment of the risk and in the following, too many securities were considered suitable for the retail customers⁸⁹. In another case, the sanction was given because a bank claimed its securities were sold upon the customers' initiative and for this reason it did not apply the suitability test. According to the supervisor's assessment prior to the sanction, the bank was recommending its own products⁹⁰. Administrative sanctions were also issued in Spain by the CNMV for violation of MiFID requirements for an amount of EUR 45 million between 2011 and 2015⁹¹. The grounds for the sanctions were violation of information requirements, deficiencies in the application of the appropriateness test and violation of rules relating to conflicts of interests.

Administrative sanctions are helpful for investors since they have a certain deterrent effect to financial institutions and the supervisor's assessment provides information which can be used in courts to claim for damages. However, under MiFID I, the issue of whether retail clients can be compensated or the sale nullified in civil courts in case of mis-selling depends on national rules in each Member State. In addition, the deterrent effect is limited as the level of pecuniary sanctions is small compared to the amount raised by infringing behaviour.

As to compensation, retail investors sometimes applied public pressure on the banks through demonstrations. These yielded sometimes positive results such as in the case of the Spanish *La Caixa* which, after negotiations, agreed to reimburse around 150 000 clients who purchased *participaciones preferentes*.

Retail investors also started judicial actions for civil liability in many Member States. In addition, the reaction in some Member States was to facilitate compensation for retail investors, or even to protect them from the effects of a bail-in, as well as to introduce legislation and regulation to prevent mis-selling in the future.

2.3.2. Judicial sanctions

The first remedy is that **retail investors took judicial actions for violation of MiFID I**. In Spain, most investors victims of mis-selling have won their case in court. In Italy, the cases are pending. One important question for retail investors in these proceedings is whether, in case the bail-in has led to the transfer of the assets to a '*good bank*', investors can sue the '*good bank*' instead of the '*bad bank*' which has no assets.

Some judicial actions have not been based on a violation of MiFID I but on **false information**, given that often the bank restructuring occurred without warning and after the financial institutions released positive financial statements. Under Article 6 of the 2003

⁸⁸ CONSOB Sanction n°19935, 30 March 2017 (Banca Popolare di Vicenza Spa); Sanction n°20067, 12 July 2017 (Banca Popolare dell'Etruria e del Lazio sc).

⁸⁹ CONSOB Sanction n°19935, 30 March 2017 (Banca Popolare di Vicenza Spa).

⁹⁰ CONSOB Sanction n°20067, 12 July 2017 (Banca Popolare dell'Etruria e del Lazio sc).

⁹¹ CNMV, *La crisis financiera en España: marco normativo y actuación supervisora (2007-2015)*, 2018.

Prospectus Directive, a civil liability scheme has to exist but it is left to Member States to decide the legal regime (statutory or case law) that applies to such claims. Some Member States introduced a statutory regime while others relied on general tort law.

In Spain, in two cases filed by retail investors, the **Spanish Supreme Court** (*Sala de lo Civil del Tribunal Supremo*) declared in 2016 the 2011 **prospectus for the listing of Bankia false and misleading**⁹². Therefore, the purchases were declared null and void for fraud as the mistake of investors was excusable since they were not professional investors. The Spanish Supreme Court considered that there had been no '*personal recommendation*' and therefore no violation of MiFID I. As a consequence, **Bankia returned the money to all retail investors who subscribed through a private mechanism**. As of 31 December 2016, EUR 1 564 million, out of the EUR 1 847 million of the retail tranche of the Initial Public Offering (IPO) had been refunded to 219 876 investors, who represented 86 % of the total. Other investors sold before the collapse of the bank, or are suing in court, or did not ask for reimbursement.

However, such actions, based on violation of MiFID or disclosure requirements are long, difficult and the retail client is facing the burden of proof of showing the violation, unless the Member State legislation shifts the burden of proof. The author is not aware of such shifting of the burden of proof in any Member State. Because the **judicial process is slow** and there are usually no class action systems, some Member States took legislative actions to **compensate investors out of court** or to protect them from the effect of the bail-in.

2.3.3. Free arbitration process

In **Spain**, a **special Commission** (Hybrid capital and subordinated debt instrument monitoring committee) was **established in 2013** for Bankia and all banks which received public support, **chaired by the chair of the CNMV**, to provide compensation for retail investors through a **free arbitration process**. An expert (KPMG) estimated if there had been a violation and, if so, the claim would be allowed to move to arbitration. Criteria were established such as the age, income, percentage of assets invested and amount. This Commission ruled in favour of investors in 80 % of the cases and dealt with 60 % of claims. The compensation was paid by the banks themselves.

In **Italy**, an **arbitration system within the CONSOB was established in 2016** (*Arbitro per le Controversie Finanziarie* or ACF). After 12 months of activities, the ACF dealt with almost 1 900 complaints and held in favour of investors in 63 % of the cases.

In some cases, retail investors were not subject to the full effect of the bail-in but were fully or partially bailed-out by governments or by financial institutions themselves.

In Spain, **Nova Galicia Banco and Catalunya Banc resorted to consumer's arbitration to some clients chosen by the entity through an external advisor**⁹³. In the case of **Banco Popular** whose assets were sold for one euro to Banco Santander in June 2017, as part of the first application of the BRRD, Banco Santander offered some retail shareholders and subordinated **bondholders compensation in the form 'loyalty bonds'**⁹⁴. The reason for the offer is to keep the depositors in the bank. The plan excludes institutional investors and is directed to retail clients (individuals and companies) who acquired shares between 26 May (the latest capital increase) and 21 June 2016, and/or purchased subordinated obligations counted as Tier 2 capital in the 29 July 2011 and 14 October 2011 issues of Banco

⁹² *Tribunla Supremo, Sala de lo Civil PLENO, Sentencia n° 23/2016.*

⁹³ Zunzunegui, F., 'Mis-selling of Preferred Shares to Spanish Retail Clients', *Journal of International Banking Law and Regulation*, Thomson Reuters, 2014, Issue 3, p. 174.

⁹⁴ Santander announces a commercial action for retail customers affected by the resolution of Banco Popular, 13 July 2017.

Popular. In both cases, the plan applies only to customers who had their investments deposited in Banco Popular or Banco Santander at the time of the resolution. In order to benefit from these loyalty bonds, customers are required to waive the right to pursue legal actions against Santander, its directors, managers and employees. They must maintain the same commercial relationship with Santander as at the time the investment was made.

2.3.4. Compensation

In Italy, in the case of **Banca Romagna Cooperativa**, which was subject to a liquidation in July 2015, equity and junior debt were bailed in. However, *'no loss was suffered by retail bondholders as the Italian mutual sector's Institutional Guarantee Fund decided to reimburse them in full and became the only senior creditor of the entity in liquidation'*⁹⁵. **In the case of the December 2015 bail-in** of Banca Marche, Cassa di Risparmio di Ferrara, Banca Etruria, Banca Popolare Etruria e Lazio and CariChieti, the **Italian government established a fund to indemnify, at least to a certain extent, some of the 10 500 retail bondholders.**

In June 2017, **Veneto Banca** and **Banca Popolare di Vicenza** were declared *'failing or likely to fail'* by the ECB and **sold to Intesa**. Shareholders and junior bondholders were subject to a bail-in. However, the **subordinated bondholders** who purchased since 12 June 2014 as part of a self-placement will be **compensated 80 %**. This compensation will be paid by the *Fondo di Solidarietà* managed by the **Italian Interbank Deposit Protection Fund** and financed by the banking sector. Also, Intesa has established a **EUR 100 million fund to compensate retail holders of shares**⁹⁶.

In the case of **Monte dei Paschi di Siena (MPS)**, it was subject in July 2017 to a precautionary recapitalisation. The bank's shareholders and junior bondholders contributed through debt-to-equity conversions and dilution of existing shares. However, retail junior bondholders who were subject to mis-selling would be entitled to a compensation through an **exchange of their converted shares into senior MPS bonds**. MPS plans to spend up to **EUR 1.5 billion to compensate those retail junior bondholders**. The European Commission confirmed that *'such compensation is an entirely separate consideration to burden-sharing under the State aid rules'*⁹⁷.

This plan **does not benefit the shareholders**. A shareholders' association (*Associazione dei Piccoli Azionisti della Banca Monte dei Paschi di Siena*) has requested that they receive a free warrant for the future acquisition of the state's share, as well as the assignment of junior notes of the securitised NPLs, or at least receive shares of the *'bad bank'* which took over the NPLs.

In **Portugal**, in the case of the **Banco Espírito Santo (BES)**, under a plan sponsored in 2016 by the Portuguese government, **retail customers will receive EUR 286 million over the next three years out of the EUR 485 million they invested in the commercial paper of BES**. Retail clients who invested up to EUR 500 000 will recover up to 75 % of their investments and those who invested more will get up to 50 %. The money will come from the **Portuguese bank resolution fund**⁹⁸.

⁹⁵ World Bank Group, Bank Resolution and 'Bail-in' in the EU: selected case studies pre and post BRRD, 2016, p. 40.

⁹⁶ http://www.ilsole24ore.com/art/finanza-e-mercati/2017-10-11/intesa-stanzia-cento-milioni--azionisti-venete-104236.shtml?uuid=AFBi0ajC&refresh_ce=1.

⁹⁷ European Commission, Press release, State aid: Commission authorises precautionary recapitalisation of Italian bank Monte dei Paschi di Siena, Brussels, 4 July 2017.

⁹⁸ <https://uk.reuters.com/article/portugal-banks-bes/banco-espirito-santo-retail-customers-to-get-60-pct-of-money-back-idUKL5N1EE4SY>.

Retail investors have benefited from public arbitration schemes (Spain and Italy), private arbitration organised by the financial institution who was accused of mis-selling (Spain), partial or total reimbursement by the acquiring bank (Spain and Italy) or partial or total reimbursement by private or public funds (Spain, Italy and Portugal).

As to out of court arbitration, although it proved much more effective and quicker than court proceedings, the results are not entirely satisfactory. In the case of Spain, only 1/3 of the amount sold to investors was reimbursed. This is due to the fact that not all investors filed for arbitration and, above that, many were not accepted for arbitration. In the case of Nova Galicia Banco, only 27% of the amount raised was reimbursed⁹⁹, while in the cases of Bankia¹⁰⁰ and Caixa Catalunya¹⁰¹ this amounted to only 35 % and 27 %, respectively. This means that many retail investors did not benefit from any reimbursement and lost everything. Some could recover the losses through court proceedings but others, for example, some older investors, could not because they already passed away. Therefore, it is important for this process to be independent and run exclusively by the securities supervisor.

Table 4: Arbitration relating to hybrid capital instruments and subordinated debt in Spain

		Bankia	Catalunya Banc	NCG	TOTAL
Retail investors	Amount (EUR million)	6 231	1 709	1 832	9 772
	Customers	294 905	122 585	116 660	534 150
Requests received	Amount (EUR million)	4 043	1 125	1 453	6 621
	As % of total amount claimable	65	66	79	68
	Customers	229 931	97 460	93 899	421 290
	As % of potential claimants	78	80	80	79
With a favourable award	Amount (EUR million)	2 166	463	496	3 125
	As % of requests received	54	41	34	47
	Customers	171 854	68 353	58 016	298 223
	As % of claimants	75	70	62	71

Note (1): Breakdown of arbitration and its results for customers who could potentially request arbitration because they were retail investors.

Note (2): The data for Bankia and Catalunya Banc are included in the latest quarterly report (the eighth) of the monitoring committee dated March 2015. The data for NCG are included in the July 2014 report (the fifth), since this institution was sold by the FROB to Banco Etchevarria SA/Banesto group on 25 June 2014.

Source: FROB and Banco de España as quoted in *Banco de España, Report on the Financial and Banking Crisis in Spain, 2008-2014, 2017, p. 186.*

⁹⁹ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 296.

¹⁰⁰ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 340.

¹⁰¹ Missé, A., *La gran estafa de las preferentes. Abusos e impunidad de la banca durante la crisis financiera en España*, Alternativas Económicas, Barcelona, 2016, p. 359.

2.3.5. Prevention strategies

Member States also took actions to **prevent mis-selling in the future**. Spain, being significantly affected by this issue, has been very active to protect retail investors. In Spain, under the Memorandum of Understanding (MoU) on Financial Sector Policy Conditionality signed on 20 July 2012, the Spanish authorities were requested to propose specific legislation to avoid mis-selling of subordinated debt instruments to non-qualified retail clients and to substantially improve the process for the sale of any instruments not covered by the deposit guarantee fund to retail clients¹⁰². The securities legislation reform which entered into force in Spain in 2013 provides that, in case of self-placement of *participaciones preferentes*, subordinated liabilities and other junior debts, 50 % of the issue should be sold to at least 50 different institutional investors¹⁰³. Also, the same provision sets out that, when the issuer is not listed, investors are only allowed to buy at least a EUR 25 000 nominal value and professional investors at least EUR 100 000 nominal value. These high minimum thresholds are designed to make sure that only retail and professional investors with significant assets can purchase those financial instruments.

As to the **appropriateness test**, the Spanish law now requires that retail investors have to sign in **handwriting a statement** that they are aware that the financial instruments were not appropriate or that it was not possible to evaluate their appropriateness¹⁰⁴. The requirement is designed to draw the attention of the retail investor and to make sure that he really understood the financial instrument. ESMA, as part of its 2016 MiFID Suitability Requirements Peer Review, criticised this requirement¹⁰⁵. The CNMV has challenged this negative assessment and considered that *'This type of clause was usually signed by clients without being aware of its consequences. Requiring a handwritten note highlights this situation to the client and makes them aware of the fact that the firm considers that it has not provided advice in respect of that operation, so if the client perceives that the firm has made a recommendation regarding the operation (which is usually a common perception of retail clients) they will appear reluctant to write the note and will ask the firm about it. The handwritten note also has a deterrent effect as it discourages firms from including those types of generic clauses in the documents. In fact, our supervisory experience is quite positive and the use of such clauses has diminished.'*¹⁰⁶

2.4. Remedies taken by the European Securities and Markets Authority (ESMA)

Next to the Member States, ESMA has also been active in order to stop mis-selling of shares, subordinated debt and other junior liabilities and to strengthen the MiFID II regime which came into force on 3 January 2018. The Securities and Markets Stakeholder Group (SMSG) has been especially focused on this issue and has seized any chance to alert ESMA and strengthen regulation.

¹⁰² Point 25, Spain, Memorandum of Understanding on Financial-Sector Policy Conditionality, 20 July 2012

¹⁰³ *Ley del Mercado de Valores, Article 214 Evaluación de la conveniencia. Disposición adicional cuarta. Comercialización a minoristas de participaciones preferentes, instrumentos de deuda convertibles y financiamientos subordinados computables como recursos propios.*

¹⁰⁴ *Ley del Mercado de Valores, Article 214 Evaluación de la conveniencia. 5. En caso de que el servicio de inversión se preste en relación con un instrumento complejo según lo establecido en el artículo 217, se exigirá que el documento contractual incluya, junto a la firma del cliente, una expresión manuscrita, en los términos que determine la Comisión Nacional del Mercado de Valores, por la que el inversor manifieste que ha sido advertido de que el producto no le resulta conveniente o de que no ha sido posible evaluarle en los términos de este artículo.*

¹⁰⁵ ESMA, MiFID Suitability Requirements Peer Review Report, 7 April 2016, ESMA/2016/584, Point 133 ff, p. 37.

¹⁰⁶ ESMA, MiFID Suitability Requirements Peer Review Report, 7 April 2016, ESMA/2016/584, Point 136 ff, p. 38.

2.4.1. Action by the Securities and Markets Stakeholder Group (SMSG)

On its own initiative, the SMSG took notice of this issue and **alerted ESMA in December 2012** on the risks associated with self-placement in view of the Spanish experience¹⁰⁷. The lead was taken by the author of this report and Carlos Arenillas (former vice-chair of the CNMV, 2004-2008) until his resignation in 2013. The term '**self-placement**', coined by the author of this report, **was first used in the SMSG**. The author was also the main reporter for the SMSG on all MiFID advice on investor protection from 2012 to 2015 and, with the support of the SMSG, made also several presentations and requests to ESMA on the topic.

In 2012, the SMSG was asked to provide an advice on ESMA's proposed guidelines on remuneration policies and practices¹⁰⁸. In its advice to ESMA, the SMSG highlighted '*the enhanced risks which arise with respect to self-placement by firms of their proprietary financial instruments (shares, preferred shares, hybrid securities and/or debt). Strong conflict of interest risk arises in this context even if there is no specific remuneration attached to the selling of the instruments*'. The SMSG noted that '*Self-placement is not wrong per se. However, already the situation of a self-placement creates a strong conflict of interest. Close monitoring of these sales is necessary. In certain circumstances, however, particularly where financial stability risks arise, there may be political and other circumstance which mean that national action may not be as effective as it should be. Therefore, ESMA should consider whether specific provisions should be developed in this area.*'¹⁰⁹ In its **final guidelines of June 2013**, ESMA followed the SMSG request and provided that '*Remuneration policies and practices should be designed in such a way so as **not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests (for example in the case of self-placement or where a firm promotes the sale of products that are more lucrative for it), to the potential detriment of clients***'¹¹⁰.

As part of the preparation of its advice on proposed draft Level 2 measures to the Commission, ESMA issued in 2014 a consultation paper which included the issue of self-placement. ESMA stressed that self-placement inevitably entails conflicts of interest for banks, and that procedures adopted for their identification and management '*may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*'.¹¹¹

In its advice to ESMA, the SMSG indicated that instead of '*Such procedures may include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*', it would support the following text: '*Such procedures must include consideration of refraining from engaging in the activity, where conflicts of interest cannot be appropriately managed so as to prevent any adverse effects on clients*'¹¹².

ESMA agreed with the request of the SMSG and '*must*' was included in the advice to the Commission¹¹³ and finally in **Article 41 Additional requirements in relation to advice**,

¹⁰⁷ Securities and Markets Stakeholder Group, Summary of Conclusions, 20 December 2012, ESMA/2012/SMSG/72.

¹⁰⁸ Consultation paper, Guidelines on remuneration policies and practices (MiFID), 17 September 2012 ESMA/2012/570.

¹⁰⁹ SMSG, Advice to ESMA, on Guidelines on remuneration policies and practices (MiFID), 16 November 2012 ESMA/2012/SMSG/69, p. 5.

¹¹⁰ ESMA, Final report, Guidelines on remuneration policies and practices (MiFID), 11 June 2013 ESMA/2013/606, point 14, p. 6.

¹¹¹ ESMA, Consultation Paper. MiFID II/MiFIR (ESMA/2014/549), pp. 82-83 and 86 (22 May 2014).

¹¹² SMSG, Advice to ESMA. Investor Protection Aspects of the Consultation Paper on MiFID II and MiFIR, 8 August 2014, ESMA/2014/SMSG/035.

¹¹³ ESMA, *Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, 19 December 2014 ESMA/2014/1569, point 7, p. 86.

distribution and self-placement of **Delegated Regulation 2017/565**¹¹⁴. This article is the **first one in EU legislation which deals specifically with self-placement**.

This is a **major step forward to protect retail investors**. As it was very accurately noted by Professor Luca Enriques and Matteo Gargantini '*the clear-cut nature of the Art 41(2) prohibition may make this new rule more easily enforceable than other protective measures such as the appropriateness test, the inherently nuanced nature of which makes violations more difficult to demonstrate*'¹¹⁵. This was exactly the goal of the SMSG: to **make enforcement easier for the securities supervisor and to facilitate compensation for retail investors in case of violation**. The idea was that should a financial institution be in financial difficulties, a judge or a supervisor could easily consider that it should not have engaged in self-placement. This would be much easier than to assess in each case whether the appropriateness or suitability tests had been correctly applied and it would protect retail investors collectively. **In case the bank is in difficulty, the provision is close to a *de facto* ban**.

ESMA also followed the advice of the SMSG on other proposals. In its response to the draft technical advice covering underwriting and placing, '*the SMSG also suggested that when investment firms undertake self-placement, they should, inter alia, be required to maintain records where an appropriateness assessment has found that the product is not appropriate or that appropriateness cannot be assessed due to a lack of data. ESMA agrees with this proposal and considers that it should be extended to any assessment of appropriateness*'.¹¹⁶ This requirement is now included in Article 56 (*Assessment of appropriateness and related record-keeping obligations*) of MiFID II Delegated Regulation 2017/565.

The SMSG also requested that '*in the case of financial instruments other than shares, issued by credit institutions, the information provided to investors shall include additional information on the differences between the financial product offered and bank deposits in terms of yield, risk and liquidity*'. ESMA also agreed and this requirement is now included in Article 41(4) of MiFID II Delegated Regulation 2017/565: '*Investment firms which offer financial instruments issued that are by themselves or other group entities to their clients and that are included in the calculation of prudential requirements specified in Regulation (EU) No 575/2013 of the European Parliament and of the Council, Directive 2013/36/EU (...) or Directive 2014/59/EU (...), shall provide those clients with **additional information explaining the differences between the financial instrument and bank deposits** in terms of yield, risk, liquidity and any protection provided in accordance with Directive 2014/49/EU (...)*'.

The SMSG also proposed that ESMA should set up a working group to consider the establishment of Level 3 work in this area¹¹⁷. This request was reiterated in 2015 at a joint meeting with the Board of Supervisors of ESMA after the BES bail-in in Portugal.

ESMA has also been tackling the issue of mis-selling of subordinated debt and other junior liabilities and especially self-placement, as part of other work streams.

As to mis-selling, in July 2012, ESMA published '*Guidelines on certain aspects of the suitability requirements*'. In respect of '*complex or risky*' products, these guidelines stated that

¹¹⁴ 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 conditions for investment firms and defined terms for the purposes of that Directive.

¹¹⁵ Enriques, L. & Gargantini, M., *The Expanding Boundaries of MiFID's Duty to Act in the Client's Best Interest: The Italian Case*, *The Italian Law Journal*, Vol. 3, n°2, 2017, p. 503.

¹¹⁶ ESMA, *Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, 19 December 2014 ESMA/2014/1569, point 7, p. 160.

¹¹⁷ ESMA, *Final Report, ESMA's Technical Advice to the Commission on MiFID II and MiFIR*, 19 December 2014 ESMA/2014/1569, point 7, p. 87.

'investment firms should carefully consider whether they need to collect more in-depth information about the client than they would collect when less complex or risky instruments are at stake. This is so firms can assess the client's capacity to understand, and financially bear, the risks associated with such instruments'. In 2016, ESMA also published *'Guidelines on complex debt instruments and structured deposits'*. It included a non-exhaustive list of examples of debt instruments that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved¹¹⁸. The list included subordinated debt instruments.

2.4.2. Action by the European Securities and Markets Authority (ESMA)

As to self-placement, ESMA also took strong measures designed to limit the risk of mis-selling to retail investors.

In **2014**, ESMA published an **opinion on MiFID practices for firms selling complex products**. In its opinion, ESMA classified the following products as complex: exchangeable bonds, callable bonds, puttable bonds, convertible bonds, perpetual bonds and subordinated bonds¹¹⁹. ESMA noted that *'Conflicts of interest arise in the sale of complex products especially when the selling entity is the issuer or is acting as the counterparty of the transaction. The compliance function should consider if incentives relating to the product create conflicts of interest ... NCAs should monitor that firms make sure that any such conflicts are identified and managed'*.

In 2014, shortly before the resolution of Banco Espírito Santo in Portugal, the **Joint Committee of the ESAs** released a *'reminder'* to credit institutions and insurance undertakings about applicable regulatory requirements on placement of financial instruments with depositors, retail investors and policy holders¹²⁰. The joint statement noted that there had been bad practices in the case of self-placement¹²¹. It **recalled the applicable rules under MiFID and ESMA opinions and guidelines** on conflict of interest, remuneration, information to clients, the provision of investment advice and the suitability and appropriateness tests. In addition, on the same day ESMA issued a statement on potential risks associated with contingent convertible instruments (CoCos). ESMA noted that it was unclear as to whether retail investors could fully understand the potential risks, as it required a sophisticated level of financial literacy, and were capable of correctly factor these into their decisions. On the same day also, the UK Financial Conduct Authority (FCA), under its product intervention powers, restricted banks and investment firms from distributing CoCos to retail investors, although this did not apply to Tier 2 subordinated bonds¹²². The prohibition was subsequently made permanent.

Finally, a major development on self-placement occurred in 2016, shortly after the bail-in of the four Italian regional banks in November 2015 (Banca Marche, Cassa di Risparmio di Ferrara, Banca Popolare Etruria e Lazio and CariChieti). On 2 June **2016**, ESMA issued a statement regarding MiFID practices for firms selling financial instruments subject to the BRRD resolution regime. ESMA stated that it was *'of the **opinion** that, under **self-placement** situations, it is **extremely** likely that in substance the interaction between the investor and*

¹¹⁸ ESMA, Guidelines on complex debt instruments and structured deposits, 4 February 2016, ESMA/2015/1787.

¹¹⁹ ESMA, Opinion, MiFID practices for firms selling complex products, 07 February 2014, ESMA/2014/146.

¹²⁰ Joint Committee of the ESAs, Placement of financial instruments with depositors, retail investors and policy holders ('Self-placement'), Reminder to credit institutions and insurance undertakings about applicable regulatory requirements, JC 2014 62, 31 July 2014.

¹²¹ Joint Committee of the ESAs, Placement of financial instruments with depositors, retail investors and policy holders ('Self-placement'), Reminder to credit institutions and insurance undertakings about applicable regulatory requirements, JC 2014 62, 31 July 2014, p. 4.

¹²² FCA, *Temporary product intervention rules. Restrictions in relation to the retail distribution of contingent convertible instruments*, August 2014.

*the credit institution involve **personal recommendations** (i.e. investment advice) being provided to clients. Firms are reminded that a thorough assessment of the **suitability** of the financial instrument for the client should be conducted.*¹²³ This provision is **close to a de facto ban** since, if the suitability test is applied, it should prevent retail investors from investing altogether or at least investing a large amount.

All ESMA's actions, which consisted of opinions, statements or guidelines, became applicable before the implementation of MiFID II since they were interpretations of the existing MiFID I regime. Therefore, they strengthened the existing regulatory regime in anticipation of the implementation of MiFID II in January 2018.

The awareness among securities supervisors of the issue of mis-selling of subordinated debt and other junior liabilities has led to legislative reforms and interventions at the national and at the EU level. However, these actions could and should be strengthened.

¹²³ ESMA, Statement, MiFID practices for firms selling financial instruments subject to the BRRD resolution regime, 2 June 2016 ESMA/2016/902, Point 25, p. 8.

3. REMEDIATION OPTIONS TO DEAL WITH MIS-SELLING

The entry into force of MiFID II and MiFIR has improved the conditions for retail investors. However, some changes in the legislative and enforcement regime are necessary.

3.1. Changes introduced by MiFID II and MiFIR

MiFID II and MiFIR have strengthened the legislative regime designed to prevent mis-selling to retail investors and will make enforcement easier for supervisors.

3.1.1. The strengthening of the legislative regime

First, MiFID II makes clear that self-placement of financial instruments is covered since Article 4(1)(5) holds that order executions include *'the conclusion of agreements to sell financial instruments issued by an investment firm or a credit institution at the moment of their issuance'*. However, this was already the case under MiFID I, although it was not clearly stated. Article 9 of Delegated Regulation 2017/565 defines investment advice exactly as Article 52 of the MiFID I Implementing Directive 2006/73¹²⁴.

MiFID II has kept the approach of MiFID I to require investment firms to act in accordance with the best interests of their clients¹²⁵ and to provide an assessment of suitability and appropriateness¹²⁶. However, under MiFID II, the appropriateness test is compulsory for subordinated bonds since they are now considered to be a *'complex'* financial instrument.

Compared to MiFID I, Article 57 of the MiFID II Delegated Regulation 2017/565 includes in the scope of non-complex instruments those that do not incorporate a clause, condition or trigger that could fundamentally alter the nature or risk of the investment or pay-out profile. This means that bail-inable securities are also complex financial instruments.

Moreover, Article 48 of the MiFID II Delegated Regulation 2017/565 requires a **more extensive disclosure of information about financial instruments**. The description of risks *'shall include, where relevant to the specific type of instrument concerned and the status and level of knowledge of the client, the following elements: (a) the risks associated with that type of financial instrument including an explanation of leverage and its effects and the risk of losing the entire investment including the risks associated with insolvency of the issuer or related events, such as bail in'*. However, money market instruments, such as commercial papers sold to retail investors by BES in Portugal, remain non-complex instruments.

The most important development is the introduction of the concept of product governance¹²⁷ and **product intervention**¹²⁸. The product governance requirements are laid down mainly in Article 16(3) and Article 24(2) of MiFID II and are designed to make sure that financial products are targeted at the appropriate investors. This should reduce significantly the risk for retail investors to become victims of mis-selling of shares, subordinated debt and junior liabilities. In 2017, ESMA published *'Guidelines on MiFID II product governance requirement'*¹²⁹. Point 72 of the Guidelines states that *'(...) Firms should also take into consideration the nature of the products included in the range of those they intend to offer to clients (for example, in terms of complexity/risk) and the existence of any*

¹²⁴ 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 conditions for investment firms and defined terms for the purposes of that Directive.

¹²⁵ Art. 24(1) of MiFID II.

¹²⁶ Art. 25 of MiFID II.

¹²⁷ Conac, P.H., *La nouvelle réglementation des produits financiers dans l'Union européenne : une révolution dangereuse*, in Mélanges en l'honneur Jean-Jacques Daigre, Paris, LGDJ, 2017.

¹²⁸ Art. 42 of MiFIR.

¹²⁹ ESMA, Guidelines on MiFID II product governance requirements, 2 June 2017, ESMA 35-43-620.

conflicts of interest with clients (such as in the case of self-placement), as well as their business model. Some firms could, for example, consider the possibility of not allowing clients to operate if they fall within the negative target market, while letting other clients transact on a financial product that is in the "grey" area, i.e. between the positive and negative target markets'.

As to product intervention, a securities supervisor may, if certain conditions are satisfied including significant investor protection concerns, prohibit or restrict in or from that Member State the marketing, distribution or sale of certain financial instruments or structured deposits with certain specified features or a type of financial activity or practice. Self-placement of bail-inable securities is subject to this power. ESMA has a temporary intervention power in similar circumstances and if a competent authority or competent authorities have not taken action to address the threat or if the actions that have been taken do not adequately address the threat¹³⁰.

Finally, as to self-placement, all previous guidelines, opinions and statements, adopted by ESMA under MiFID I, should continue to apply.

3.1.2. The strengthening of enforcement

With MiFID II, public enforcement should become easier for national securities supervisors. The main reason is that Article 73 requires Member States to ensure that competent authorities establish effective mechanisms to enable reporting of potential or actual infringements of the provisions of MiFIR and of the national provisions adopted in the implementation of MiFID to competent authorities. This **whistle-blowing** should constitute an additional line of defence to inform securities supervisors in case of violation of the appropriateness and suitability tests, especially in case of self-placement, since employees of financial institutions might be reluctant to take part in such violations.

In addition, the deterrent effect of sanctions should be much stronger. As to pecuniary sanctions, violation of the appropriateness or suitability tests will be sanctioned in the case of a legal person by maximum administrative fines of at least EUR 5 000 000, or of up to 10 % of the total annual turnover of the legal person¹³¹. In addition, in case of a temporary or, repeated serious infringement, the securities supervisor could issue a permanent ban against any member of the investment firm's management body or any other natural person, who is held responsible, to exercise management functions in investment firms¹³².

Finally, **protection of retail investors through private enforcement** should also become easier since Article 69 of MiFID II requires that '*Member States shall ensure that mechanisms are in place to ensure that compensation may be paid or other remedial action be taken in accordance with national law for any financial loss or damage suffered as a result of an infringement of this Directive*' or of MiFIR. However, many Member States allowed investors to file a civil complaint in case of violation of MiFID I provisions.

Despite all these significant improvements, some changes are still necessary to better protect retail investors and to ensure compensation for past violations, especially in Italy.

¹³⁰ Art. 40 of MiFIR.

¹³¹ Art. 70(3)(a)(xi) and 70(6)(f) of MiFID II.

¹³² Art. 70(3)(a)(xi) and 70(6)(d) of MiFID II.

3.2. Changes in the legislative and enforcement regime

Some targeted changes in the EU securities and banking legislative regime should be made to limit the risk of a recurrence of mis-selling, especially in the case of self-placement. The public enforcement regime could also easily be strengthened.

3.2.1. Changes in the legislative regime

Some academics have called for a ban on the sale of subordinated debt and other junior liabilities to retail investors completely in order to avoid altogether the risk of mis-selling. Notably, Martin Götz & Tobias Tröger, in their 2016 in-depth analysis prepared for the European Parliament argue *'that debt holders of bail-in able debt shall be (a) sophisticated investors, which are (b) active outside the banking sector and are (c) not subject to an asset-liability mismatch due to their investment strategy'*¹³³. The authors also note that *'Households, however, are not sophisticated investors, as described above, and, as such, are unlikely to charge an adequate risk premium for bail-in able debt, limiting the market disciplining effect of this regulatory tool'*. The risk of bail-in is a powerful check on banks willing to take excessive risk. Therefore, it is key that institutional investors hold bail-inable securities in order to apply market discipline. The two other documents prepared for the European Parliament at the same time did not advise a full ban¹³⁴, although one argued that the reason was that *'from the perspective of financial stability, subordinated debt should be in the hands of retail investors.'* because they are less likely than institutional investors to sell and panic, therefore making the bank fail, since they have less tools to assess the true state of the bank¹³⁵. This argument puts under the light what seems to be a vision among some economists and central banks which are more concerned with financial stability than investor protection. Therefore, **the issue of mis-selling of subordinated debt and other junior liabilities is not just an issue of investor protection but also of financial stability. There is a policy choice to make as to which goal should have priority.**

This analysis could be correct in the short term but seems wrong from a financial stability perspective since, on the contrary, retail investors will be reluctant to fund banks in the long term, even the good ones, once they start to see bail-ins. The reluctance of Italy to apply bail-in is certainly due in large part also to these fears as well as considerations that many elderly people would lose the funds for their retirement.

A general ban on all self-placements to retail investors would be excessive. First, prohibitions are the rare exception in financial market regulation so they should be carefully considered before being introduced. Second, prohibitions are inflexible and are likely not to be removed once adopted, whereas financial institutions could become good investments again. Third, in a democratic and liberal society, investors should not be barred from doing something but clearly warned in case of risk. Also, sometimes prohibitions are just circumvented in a clever way. Finally, such prohibition would lead to a re-intermediation of the financial system in some Member States that will increase the costs for retail investors. The prohibition in Article 41(2) of Delegated Regulation 2017/565 is close to a *de facto* ban but only if the bank is in such conflict of interest that it cannot be appropriately managed. This leaves a lot of flexibility for a judge. However, the provision could be made more effective by stating explicitly when the conflict of interest cannot be managed, such as when the bank has failed a comprehensive assessment by the ECB.

¹³³ Götz, M., & Tröger, T., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

¹³⁴ Resti, A., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

¹³⁵ Carletti, E. & Masciandaro, D., *In Depth Analysis, Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?*, March 2016.

In addition, a key regulatory improvement would be to **include in Level 1 or Level 2 the ESMA opinion of 2016** a statement *'that, under self-placement situations, it is extremely likely that in substance the interaction between the investor and the credit institution involves personal recommendations (i.e. investment advice) being provided to clients. Firms are reminded that a thorough assessment of the suitability of the financial instrument for the client should be conducted'*. This would force the suitability test in all situations of self-placement. The **suitability test should be compulsory in case of self-placement**.

This reform could be put in parallel with the 2015 Regulation on **European long-term investment funds (ELTIF)**¹³⁶. Under Article 28, the manager of the ELTIF is required to perform a suitability test in case of distribution to retail investors. Under Article 30, investment firms distributing those units to retail investors, whose financial instrument portfolio does not exceed EUR 500 000, are also **required to perform a suitability requirement**. In addition, Article 30 holds that the potential retail investor should not invest an amount exceeding 10 % of his financial instrument portfolio in ELTIFs and the initial minimum amount invested in one or more ELTIFs should be at least EUR 10 000.

A similar requirement is included in Article 3 of the new **Securitisation Regulation (STS Regulation)** of 12 December 2017¹³⁷. Under article 3 of the STS Regulation, the seller of a securitisation position is **required to perform a suitability test** in case of sale to retail investors. The sale is not possible if the securitisation position is not suitable for the client.

The ELTIF and STS Regulations could serve as a model for a reform of MiFID II, in addition to the other changes proposed. These reforms could be included in Level 1 or 2 provisions.

The market seems to be moving in this direction. Credito Valtellinese (Creval) launched a capital increase in February 2018 in the first post-MiFID II case of self-placement in Italy¹³⁸. In the case the investor is a depositor at the bank, or, more precisely, does not own shares with pre-emptive rights, the bank will apply a suitability test and, in case the investment is deemed unsuitable, the investor will not be able to subscribe the shares. In case the shareholder owns shares with pre-emptive rights, the suitability test will also be applied but, in case the test is not passed and the customer confirms that he wants to invest, an appropriateness test will be applied and the investor may invest on the basis of a written declaration. There is no prohibition of investment as this would be a violation of the right of a shareholder not to be diluted under the second company law directive¹³⁹.

As to the past occurrence of mis-selling, Spain and Italy have established out-of-court arbitration proceedings. Most of the time, retail investors have won those cases. In addition, some governments, for instance Italy and Portugal, have found ways to indemnify retail investors through funds financed by the financial industry, or the government itself. Sometimes, the acquiring bank has compensated the affected retail investors. These developments show that, **in practice, retail investors who were mis-sold subordinated debt and other junior liabilities, and sometimes shares, have been bailed-out, at least partially**. This raises the question of whether the BRRD should be amended to exclude

¹³⁶ Regulation (EU) 2015/760 of the European Parliament and of the Council of 29 April 2015 on European long-term investment funds.

¹³⁷ Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

¹³⁸ <http://www.gruppocreval.com/Pagine/investor-relations/creval-aumento-capitale-2018.aspx#content>.

¹³⁹ Art. 33, Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.

retail investors, at least when there is a presumption (subject to conditions) that there was a mis-selling, and possibly only up to a limited amount from the effect of a bail-in. On the one hand, the efficiency of the bail-in tool should not be compromised as this is a necessary instrument. On the other hand, financial stability should not be achieved at the cost of mis-selling. Retail investors can still file a complaint in court for mis-selling but it will be time consuming, costly and lengthy. Therefore, some degree of *ex-ante* protection within the BRRD might be justified. This would not defeat the effectiveness of the bail-in tool since other bondholders, and in extreme cases even depositors, will be subject to the bail-in. Also, it would be possible to enforce as the failing bank could easily identify its retail clients among the owners of its bonds or junior securities.

Moreover, it appears that administrative arbitration has been used instead of court proceedings. Judicial proceedings are long, unpredictable, costly and not always decided by experts, unless there is a centralisation in one single court. In addition, **because the damage was collective, the compensation should be collective**, but class actions are not allowed in many Member States. Some Member States allow securities class actions against issuers such as the Netherlands and Portugal, but not Spain or Italy. However, securities class actions are different from complaints for violation of MiFID and might not be applicable. If a large number of complaints was brought individually, court proceedings would clog the judicial system for years. For instance, in Spain, courts spent a lot of time processing complaints related to *participaciones preferentes* and would simply copy a decision and apply it to each plaintiff. Therefore, **administrative proceedings are an effective, fast and cheaper solution**. Administrative proceedings are transparent when they are run by the securities supervisor. For instance, information and decisions are available on the website of the Italian CONSOB¹⁴⁰.

When the compensation was not done by the acquiring bank (because it only acquired the assets of the failing bank) or the bank responsible for the mis-selling (because it has been resolved), Member States should be encouraged to establish funds to reimburse retail investors. These funds could be **financed by a fee on the banking sector**. Alternatively, the money could be paid by **the deposit protection funds**, like it occurred in Italy, **or the resolution fund**, like it occurred in Portugal. In the euro area, the **Single Resolution Fund (SRF)** could also be used when the bank is subject to bail-in and within the competence of the Single Resolution Board. The use of resolution funds is not unjustified since they are intended to deal with the consequences of the application of the BRRD. Especially, the SRF has to pay compensation to shareholders or creditors who incurred greater losses than under normal insolvency proceedings. It could be argued that retail investors suffered greater losses since, under normal insolvency proceedings, they would appear as ordinary creditors (reimbursement of their investment) rather than bondholders. As to the use of deposit guarantee schemes, it could be justified on the grounds that they are designed to protect depositors in order to guarantee financial stability of banks and the protection of retail bondholders who were victims of mis-selling should contribute to financial stability. The lack of protection of retail bondholders could lead to a halt of the financing of other financial institutions, potentially hurting financial stability as other banks would struggle to finance themselves by issuing subordinated debt with retail investors.

There **could be a cap on reimbursement**, to be decided by each Member State and/or to be decided at the EU level. Retail investors would benefit from a rebuttable presumption that they were mis-sold those securities under certain conditions. Those conditions could be the amount subscribed as a disproportionate amount is likely to reflect a lack of suitability, the age of the subscriber, as elderly investors should benefit from a higher protection given the dangers of such financial instruments, and the lack of participation of institutional investors,

¹⁴⁰ See for the *l'Arbitro per le Controversie Finanziarie* at CONSOB: <https://www.acf.consob.it>.

as this will make it likely that hard selling tactics were used on retail investors. Institutional investors should be excluded unless they can prove that mis-selling took place.

Finally, the enforcement regime could be strengthened.

3.2.2. Strengthening the public enforcement regime

The public enforcement regime should also be strengthened at the level of the Member States and at the level of ESMA.

The first way to strengthen the public enforcement regime at the level of the Member States would be to **allow securities supervisors to have access to more information from banking supervisors** as to the true state of specific banks. Securities supervisors, with some exceptions in the EU (e.g. Germany, Finland, Luxembourg) are usually separated from prudential supervisors.

Under the Market Abuse Regulation of 2014, banks whose securities are listed on a regulated market or an MTF are subject to the duty to disclose inside information, unless there is a legitimate reason to postpone it. Such information could consist, as the case may be, in the results of the Supervisory Review and Evaluation Process (SREP) to be conducted in accordance with Article 97 of CRD IV. Under ESMA Q&A, this disclosure is not automatic which is problematic from a disclosure perspective¹⁴¹.

In addition, prudential supervisors have a tendency to publicly downplay the risks in order to avoid a panic effect and protect financial stability. Therefore, securities supervisors are not necessarily aware of the real prudential situation of specific banks. If they had this information, they could focus their enforcement efforts on a risk-based approach.

Prudential supervisors have a duty to cooperate with securities supervisors. Article 56 of the Capital Requirements Directive (CRD IV) of 2013 on *'Exchange of information between authorities'* holds that: *'Article 53(1) (professional secrecy) and Article 54 (use of confidential information) shall not preclude the exchange of information between competent authorities within a Member State, between competent authorities in different Member States or between competent authorities and the following, in the discharge of their supervisory functions: (a) authorities entrusted with the public duty of supervising other financial sector entities and the authorities responsible for the supervision of financial markets'*. Article 68 of MiFID II holds that *'Each Member State shall require that such cooperation also take place between the competent authorities for the purposes of this Directive or of Regulation (EU) No 600/2014 and the competent authorities responsible in that Member State for the supervision of credit and other financial institutions, pension funds, UCITS, insurance and reinsurance intermediaries and insurance undertakings. Member States shall require that competent authorities exchange any information which is essential or relevant to the exercise of their functions and duties'*.

In the euro area, Article 3(1) of Regulation 1024/2013 establishing the Single Supervisory Mechanism (SSM) holds that *'The ECB shall cooperate closely with EBA, ESMA, EIOPA and the European Systemic Risk Board (ESRB), and the other authorities which form part of the ESFS, which ensure an adequate level of regulation and supervision in the Union. Where necessary the ECB shall enter into memoranda of understanding with competent authorities of Member States responsible for markets in financial instruments. Such memoranda shall be made available to the European Parliament, to the Council and to competent authorities*

¹⁴¹ Question 5.1. Are credit institutions required under MAR to publish systematically the results of the Pillar II assessment? ESMA, Questions and Answers on the Market Abuse Regulation (MAR), ESMA 70-145-111, Version 10, Last updated on 14 December 2017.

of all Member States'¹⁴². Therefore, the SSM has a duty to cooperate with ESMA. The SSM regulation does not indicate whether this duty related to disclosure of data on specific banks or a more abstract information. However, since the SSM Regulation does not distinguish and mentions 'closely', the duty to cooperate should be interpreted in the widest sense.

In February 2016, ESMA and the ECB concluded a Memorandum of Understanding (MoU) that will allow the exchange of information and cooperation to help both authorities in fulfilling their respective mandates¹⁴³. The framework proposed by the MoU covers cooperation in the field of statistics, risk management, supervision, market infrastructures and regulation, and includes a '*cooperative arrangement*' which covers specifically central securities depositories participating in TARGET2-Securities. In addition, '*ESMA and the ECB have agreed upon a template MoU to be used between national authorities responsible for markets in financial instruments and the ECB. This template MoU provides for a common framework for cooperation and may be agreed and complemented bilaterally, on a voluntary basis for the performance, respectively, of the tasks under the SSM Regulation and those under MIFID*'. This is positive. However, there is no easily available information on whether such MoUs have been signed and whether the SSM provides precise information on banks. Anecdotal evidence from some securities supervisors seems to show an insufficient level of cooperation.

This information barrier in the EU has to fall since it prejudices the effectiveness of securities supervision. Since securities supervisors are subject to professional secrecy, there is absolutely no reason why such information could not be shared among public entities. Article 68 of MiFID II could be amended to specify that requests in case of self-placement should have to be automatically satisfied by the prudential authority. This would also have a prophylactic effect since the bank which would want to engage in self-placement to retail investors would know in advance that the national securities supervisor would be aware of its situation and would focus its enforcement effort on this specific bank.

A possible additional reform would be to **allow securities supervisors to use the results of 'mystery shopping' exercises to issue sanctions**. Mystery shopping is a quality assurance technique by which persons sent by an external firm hired by a securities supervisor pretend to be clients and visit financial institutions, or websites, to request the provision of financial services. Employees of the securities supervisor might also use mystery shopping themselves, depending on the Member State. The securities supervisor assesses if the financial institutions have applied correctly the relevant legislation and regulation. The French *Autorité des marchés financiers* (AMF) and the Spanish CNMV have been doing this since 2010¹⁴⁴ and 2016¹⁴⁵ respectively. This would increase the deterrent effect of the '*mystery shopping*' exercise, especially in case of self-placement.

Finally, the EU legislator could introduce the 'Fair Funds' concept. 'Fair Funds' were created in the United States the Sarbanes-Oxley Act of 2002 and allow the amount of a pecuniary sanction imposed by the Securities and Exchange Commission (SEC) or a federal judge to be

¹⁴² Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institution.

¹⁴³ <https://www.esma.europa.eu/press-news/esma-news/esma-national-securities-regulators-and-ecb-exchange-information/en>.

¹⁴⁴ For instance, AMF mystery shopping in 2013 '*Following two initial mystery shopping campaigns in 2010 and 2012, the AMF has repeated the exercise in 2013 using the same scenarios ("risk-loving" and risk-averse) plus one new scenario (an employed young person wishing to invest directly in equities). Through this mystery shopping, the AMF is seeking to assess, over time, the extent to which prospects are asked appropriate questions and offered relevant commercial proposals.*'

¹⁴⁵ CNMV 2016 Annual report, p. 187. '*In 2016, the CNMV carried out a pilot test of the use of this tool, commonly known as mystery shopping. To this end, it used an external firm which, following the CNMV's instructions, simulated visits of customers or potential customers to various institutions with the aim of verifying how they market a series of financial products.*'

used to compensate investors¹⁴⁶. The pecuniary sanctions imposed by the national securities supervisor would be used to compensate investors. The process would be much faster than going to court and, even if the investors would only share a percentage of the pecuniary sanction, it would be better than receiving nothing if they do not file a civil suit.

3.2.3. Strengthening the role of ESMA

ESMA could also play a larger role in strengthening public enforcement of the MiFID II appropriateness and suitability requirements. The reform of ESMA, as part of the ESA review, proposed by the Commission in September 2017, should significantly contribute to this¹⁴⁷. First, the **reform of ESMA's governance structure**, which will bring five full-time independent members with voting rights and specific tasks to the Board of ESMA will make it easier to put a securities supervisor who would not enforce vigorously enough MiFID II requirements on notice that it should act more forcefully. Also, the ESA reform provides that the **Committee on Financial Innovation**, established in Article 9 of the ESMA Regulation, will include *'all relevant competent authorities and authorities responsible for consumer protection with a view to achieving a coordinated approach to the regulatory and supervisory treatment of new or innovative financial activities'*.

These reforms are positive. However, a centralisation of supervision of self-placement at the level of ESMA is not necessary and would even be counter-productive since enforcement of MiFID rules has to be done as close as possible to the relevant market.

¹⁴⁶ Velikonja, U., *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distribution*, 67 STAN. L. REV 2015, p. 331.

¹⁴⁷ 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, Brussels, 20.9.2017 COM(2017) 536 final.

4. CONCLUSION

The MiFID I rules had weaknesses but the main reason for the mis-selling of subordinated debt and other junior liabilities to retail investor were **systematic violations of their duties by financial institutions doing self-placement** as well as difficulties, for various explainable reasons, for securities supervisors to stop these violations despite their widespread character. MiFID II rules are significantly improving the situation but should be amended on key points to take into account the work of ESMA. Also, the EU legislator should **reduce the negative effects of the 'silo approach'** by which directives and regulations are disconnected from one another. An all-inclusive approach is necessary.

This issue of mis-selling has been so severe that it has created an obstacle in Italy to the application of the bail-in tool because of a strong political reluctance to apply losses on retail investors. Bail-in should not be blocked by this consideration since it is necessary in order to restructure the European banking sector. In addition, any reluctance to apply the bail-in tool weakens the Banking Union as it gives the impression that the rules are not applied the same way in all Member States. However, **bail-in and the protection of retail investors who were victims of mis-selling are not incompatible**. Retail investors should be compensated for MiFID violations they suffered. The money should come from the financial institution responsible, and if it has been subjected to a resolution, from the resolution fund or the deposit guarantee schemes.

For the future, **consolidation of the banking sector** in the Member States most affected by mis-selling, which has so far mostly taken place in Spain and is now occurring to a certain extent in Italy, **will reduce the problem** since banks will be bigger and better capitalised.

Concerning past cases, the **European Parliament should encourage Member States to develop out-of-court independent arbitration procedures, free of charge**, for retail investors in order to allow a faster compensation of their claims and to **establish compensation funds or use existing deposit guarantee schemes or resolution funds**. Retail investors who went to court have usually won their case so either of these options will simply make the process faster. If arbitration is chosen, **the securities supervisor is the natural authority to act as the arbitrator**.

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